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Modifying Bilateral Income Tax Treaties to Accommodate Pillar Two UTPR Rules

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INTRODUCTION

In January 2019, the Organisation for Economic Cooperation and Development (OECD) published a policy note describing two major "pillars" of work in its ongoing efforts to limit what it has long described as base erosion and profit shifting (BEPS).[1] Pillar One is meant to revise taxable nexus rules to allocate a greater share of income from certain businesses to the jurisdictions in which the relevant customers are located. Pillar Two takes a broader approach, generally seeking to impose an internationally coordinated 15% minimum tax on multinational enterprises' (MNEs') worldwide income. In October 2020, the OECD released a blueprint describing the proposed Pillar Two regime.[2] In December 2021, the OECD published model rules (the Global Anti-Base Erosion, or GloBE rules) laying out how countries could implement Pillar Two.[3] In March 2022, the OECD published commentary and examples illustrating the operation of the GloBE rules.[4]

Since then, in addition to technical concerns regarding how this unprecedentedly ambitious international tax regime will operate, the project has encountered significant political and practical obstacles, including failed attempts in both the United States and the European Union to enact the necessary implementing legislation for Pillar Two.[5] While these obstacles may eventually be cleared, they do force policy makers, taxpayers, and tax advisors to contemplate a scenario in which the rollout of Pillar Two is both delayed and incomplete in terms of the participation of key economies. These obstacles also, however, provide some time to make further adjustments to the design and implementation of the proposed rules.

This article addresses one important aspect of Pillar Two implementation, specifically the coordination of Pillar Two's undertaxed payment rule (UTPR) with the existing network of bilateral income tax treaties based on the OECD and U.S. models.[6] Policy makers would be wise to provide for explicit coordination of the UTPR with bilateral income tax treaties, in order to protect the intended operation of both the UTPR and tax treaties, and to avoid the protracted controversies that undoubtedly will arise without better coordination of the UTPR with the existing treaty frame-

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[1] OECD, *Addressing the Tax Challenges of the Digitalisation of the Economy* — Policy Note (Jan. 2019).

[2] OECD, *Tax Challenges Arising From Digitalisation — Report on Pillar Two Blueprint: Inclusive Framework on BEPS* (Oct. 2020) ("OECD Blueprint").

[3] OECD, *Tax Challenges Arising From the Digitalisation of the Economy — Global Anti-Base Erosion Model Rules: Inclusive Framework on BEPS (Pillar Two)* (Dec. 2021) ("Pillar Two Model Rules").

[4] OECD, *Tax Challenges Arising From the Digitalisation of the Economy — Commentary to the Global Anti-Base Erosion Model Rules (Pillar Two)* (Mar. 2022) ("Pillar Two Model Commentary").

[5] Pillar One seems to be on an even slower implementation track.

[6] OECD, *Model Tax Convention on Income and on Capital* (2017) ("OECD Model Treaty"); U.S. Treasury Department, *United States Model Income Tax Convention* (2016) ("U.S. Model Treaty"). As discussed below, the latest iteration of the model UTPR can no longer accurately be described as an "undertaxed payments" rule, but the acronym remains, perhaps with "profits" substituting for "payment."

work, especially in a world with only mixed uptake of Pillar Two by key jurisdictions.

PURPOSE AND DESIGN OF UTPRs

Overview

At a high level, Pillar Two aims to tax the worldwide income of the largest MNEs at a rate of at least 15%, to be imposed by the MNE parent company jurisdiction, various source-country jurisdictions, or some combination thereof. The main mechanism of Pillar Two is the income inclusion rule (IIR), under which the MNE parent company jurisdiction would impose a top-up tax (TUT) with respect to each low-taxed constituent entity in the group (i.e., an entity in a country in which the group's effective tax rate (ETR) is determined to be less than 15%).[7] The IIR tax with respect to a constituent entity is reduced to the extent of any qualified domestic minimum top-up tax (QDMTT) imposed by the entity's residence jurisdiction. The QDMTT mechanism effectively allows a low-tax jurisdiction to increase its tax rate to 15% and thereby collect the additional TUT revenue that otherwise would be collected by the MNE parent company jurisdiction under the IIR, while allowing the jurisdiction to provide a substance-based income exclusion based on local property and payroll.

The UTPR would operate as a backstop to the IIR in situations in which no MNE group parent or intermediate entity applies a qualifying IIR. In these situations, the UTPR would apply to impose a UTPR TUT amount equal to the amount of IIR tax that would have applied had the MNE parent company jurisdiction imposed a qualifying IIR. If multiple jurisdictions apply a UTPR to a group, the resulting tax liability would be divided among the jurisdictions on a formulary basis (number of employees and value of tangible assets in the jurisdiction, weighted 50-50).[8]

Example

Suppose a country (let's call it HQ) has not enacted the GloBE rules and thus does not have a qualifying IIR. Thus, any low-taxed income of an HQ-based MNE group will give rise to TUT, and this TUT will need to be allocated among GloBE-participating countries on the basis of the group's employees and tangible business assets in those countries. Suppose further that, in the hypothetical taxable year under analysis, only five countries thus far have enacted GloBE rules. A large HQ-based group has some presence in each of these five countries, but the group derives the vast majority of its income in jurisdictions that have not yet adopted GloBE rules. The TUT will be allocated to the five GloBE countries based solely on the group's employees and tangible assets in each of the five countries, and those countries may impose their UTPRs on group subsidiaries in those countries, even if the group's operations in those countries had absolutely nothing to do with earning the low-taxed income, and even in the absence of any payments whatsoever from those group subsidiaries to lower-taxed group entities in other countries.

If HQ or any of the other countries where the group has subsidiaries have standard bilateral income tax treaties in force with any of the five GloBE countries in the example, those countries' attempts to apply their UTPRs will present numerous tax treaty questions under the existing bilateral income tax treaty framework.

ATTEMPTING TO SQUARE UTPRs WITH BILATERAL INCOME TAX TREATIES

In General

Bilateral income tax treaties based on the OECD Model Treaty and the U.S. Model Treaty, in relevant part, establish a framework for allocating taxing rights with respect to MNE income among residence and source jurisdictions based on separate-entity accounting, employee/agent business presence, and arm's-length pricing of related-party transactions. Under this framework, residence countries generally are entitled to tax the business profits of their resident entities, and source countries generally cannot tax the business profits of entities resident in the other treaty country, except to the extent attributable to a permanent establishment in the source country.[9] This mitigates juridical double taxation (taxation of the same income in

[7] The IIR is conceptually similar to, and inspired by, the U.S. global intangible low-taxed income (GILTI) regime, although key countries have taken the view that present-law GILTI does not constitute a qualifying IIR unless it is modified to be imposed at a higher ETR and on a country-by-country basis.

[8] This formulary approach to the UTPR was a new development in the December 2021 Pillar Two Model Rules. Earlier OECD releases had envisioned the UTPR as a deduction disallowance rule applied to related-party payments, as opposed to an additional tax imposed by a jurisdiction simply on the basis of that jurisdiction's proportion of the group's employees and tangible asset value. The tax may be imposed via deduction disallowance or some other mechanism, in all cases targeting an amount of tax consistent with the formulary result. As discussed further below, the elimination of the requirement that there be a relevant intragroup payment represents a significant broadening of the UTPR, taking it well beyond available analogies under existing law, such as interest deduction limitations or the U.S. base erosion and anti-abuse tax (BEAT).

[9] OECD Model Treaty, arts. 5 (Permanent Establishment) and 7 (Business Profits); U.S. Model Treaty, arts. 5 (Permanent Establishment) and 7 (Business Profits).

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the hands of the same entity by two different jurisdictions). Tax treaties generally (but far from universally) include a ''saving clause'' providing that the treaty does not impose limits on a residence country's ability to tax its own residents, subject to several exceptions.[10] Transactions between related entities are priced under the arm's-length standard, to be applied on a coordinated basis and with correlative adjustments by the taxing jurisdictions concerned.[11] This mitigates economic double taxation of the same income in the hands of two different entities by their respective residence countries.

Tax treaties also include non-discrimination provisions, under which the contracting states generally agree in relevant part not to impose deduction limits or other taxation requirements on resident subsidiaries of parent companies resident in the other treaty country that are more burdensome than the limits or requirements that would apply to other similarly situated resident companies.[12] The saving clause noted above does not apply to a treaty's non-discrimination provisions (nor to certain aspects of the arm's-length pricing provisions).

As many commentators have noted, Pillar Two's UTPR sits uneasily at best alongside existing bilateral income tax treaties.[13] The UTPR effectively allows a source country to tax the business profits of an entity resident in a different country, on a formulary basis, due to a conclusion that the residence country (and other source countries) have imposed an insufficient level of taxation on those profits. This result may be subject to challenge under the business profits, associated enterprises, and non-discrimination articles of standard tax treaties. The OECD to date has taken the position that the UTPR does not violate any of these common treaty provisions, primarily based on an argument that a jurisdiction imposing a UTPR is simply taxing its own resident entity as is permitted under the saving clause, and is not discriminating because the UTPR applies on the basis of a group ETR profile in a jurisdiction as opposed to the residence of the recipient of a related-party payment.[14]

Business Profits and Associated Enterprises

These arguments by the OECD can and presumably will be challenged in various national courts around the world by affected taxpayers.[15] With respect to the business profits provisions of tax treaties, a country imposing a UTPR is effectively taxing the business profits of other group entities, even if such profits are not attributable to any permanent establishments of such entities in the UTPR-imposing country. Imposing the UTPR in these situations would seem to violate both the letter and the spirit of the standard business profits article of tax treaties,[16] and it is far from clear that the saving clause can ''save'' the UTPR, given how far beyond prior precedent the UTPR has gone in terms of asserting extraterritorial rights to impose tax on a formulary basis despite longstanding nexus and separate entity accounting principles.[17]

In addition, the UTPR can be imposed on the income of entities that sit above or alongside the UTPR

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[10] OECD Model Treaty, art. 1(3) (Persons Covered); U.S. Model Treaty, art. 1(4) and (5) (General Scope).

[11] OECD Model Treaty, arts. 9 (Associated Enterprises) and 25 (Mutual Agreement Procedure); U.S. Model Treaty, arts. 9 (Associated Enterprises) and 25 (Mutual Agreement Procedure).

[12] OECD Model Treaty, art. 24 (Non-Discrimination); U.S. Model Treaty, art. 24 (Non-Discrimination).

[13] *See, e.g*., Mary C. Bennett, *Contemplating a Multilateral Convention to Implement OECD Pillars 1 and 2*, 102 Tax Notes Int'l 1453 (June 14, 2021); Michael Lebovitz, Gary B. Wilcox, Warren S. Payne, Lucas Giardelli, Juan F. Lopez Valek, and Megan K. Hall, *If Pillar 1 Needs an MLI, Why Doesn't Pillar 2?* 107 Tax Notes Int'l 1009 (Aug. 29, 2022); Jinyan Li, *The Pillar 2 Undertaxed Payments Rule Departs From International Consensus and Tax Treaties*, Tax Notes Federal, Vol. 174 (Mar. 21, 2022); Jefferson VanderWolk, *The UTPR is Inconsistent with the Nexus Requirement of Tax Treaties*, Kluwer Int'l Tax Blog (Oct. 26, 2022); Maarten de Wilde, *Why Pillar Two Top-Up Taxation Requires Tax Treaty Modification*, Kluwer Int'l Tax Blog (Jan. 12, 2022); *see also* Noren, above.

[14] *See* OECD Blueprint, §10.4. Note that the OECD Blueprint was issued in 2020, prior to the redesign of the UTPR in the December 2021 Pillar Two Model Rules. As modified, the UTPR now would be allocated on a formulary basis and is not necessarily keyed in any way to limiting deductions on a related-party payment.

[15] These arguments also will be evaluated by various national governments, in an effort to assess their treaty partners' adherence to the letter and spirit of their bargains, and to determine whether any retaliatory measures under tax and/or trade law may be appropriate.

[16] Note that, prior to the incorporation of the saving clause into the OECD Model Treaty in 2017, some key countries still did not even agree that CFC regimes were permissible under standard business profits articles and thus presumably would (or should) *a fortiori* object to a UTPR under these articles, subject to the potential operation of the saving clause. *See* OECD, *Commentaries on the Articles of the Model Tax Convention* (2010), art. 1, ¶¶ 27.4, 27.5, 27.6, 27.7, and 27.9 (noting observations of Belgium, Ireland, Luxembourg, the Netherlands, and Switzerland taking varying degrees of positions to the effect that CFC regimes may violate the letter and/or the spirit of the business profits article). Indeed, one court held that the business profits article of the income tax treaty between France and Switzerland did not permit France to impose tax on a French parent company with respect to the income of its Swiss subsidiary. *See* French Conseil d'Etat, *Re Societe Schneider Electric*, CE No. 232276 (2002) (discussed in Bennett, above n. 13).

[17] As one group of commentators noted, the UTPR causes profits to be reallocated to jurisdictions where the taxpayer does not have a PE, which ''is exactly what is happening in pillar 1 where there is universal agreement that a treaty violation is occurring'' and thus explicit treaty coordination is required. *See* Lebowitz et

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entity in the ownership chain, and thus, unlike in the case of controlled foreign corporation (CFC) regimes or Pillar Two's IIR, the UTPR cannot be defended as a tax imposed on a resident shareholder's participation in the ownership of a subsidiary. Thus, the logic that protects the ability of countries to apply CFC regimes under typical saving clauses simply does not extend to UTPRs. CFC regimes can plausibly be defended as merely accelerating the taxation of the parent company's own income as a CFC shareholder, whereas UTPRs would impose tax on income that has absolutely no connection to the entity upon which the tax would be levied, and to which the entity has absolutely no legal or economic rights. If this were actually permitted, one wonders what the remaining purpose of the business profits article would be — countries could dream up any sort of notional group income tax base, determined based on factors having no connection to the tax-imposing country, and as long as they have the fig leaf of imposing legal liability for the tax only on a locally resident entity, they can tax any MNE group on an extraterritorial, formulary basis.[18]

In addition to these objections under the business profits article, viewing the UTPR from the perspective of the UTPR-bearing entity, the UTPR can have the effect of taxing the entity on more than its arm's-length profits, potentially implicating the associated enterprises provisions of tax treaties and creating transfer pricing problems to be worked out between the relevant competent authorities under mutual agreement proceedings. For example, if the UTPR-bearing entity is a limited-risk distributor entitled to only a routine return under the governing intercompany agreements and well-established arm's-length transfer pricing principles, and the UTPR-imposing country has a standard tax treaty with the country in which an IP-owning principal company in the group resides, the latter country may have some concern that the income of its resident taxpayers is being subjected to economic double taxation notwithstanding the existence of a tax treaty designed to prevent exactly that.

The OECD has stated that the UTPR does not violate the business profits or the associated enterprises articles of tax treaties, because the UTPR-imposing country is doing nothing more than taxing its own resident entities in the manner it wishes, as it is permitted to do under the saving clause.[19]

Leaving aside the fact that many bilateral income tax treaties lack a saving clause, thus rendering this defense entirely inoperable in many situations, affected taxpayers in jurisdictions with standard tax treaties with saving clauses undoubtedly will put the OECD's arguments to the test in litigation around the world. While it is true on a technical level that a UTPR tax liability would be imposed on an entity resident in the UTPR-imposing country, this again is a mere fig leaf, as the UTPR in substance would violate both the business profits and the associated enterprises articles of tax treaties, leaving various courts to determine whether a contracting state to a tax treaty can be bound to the substance of its contract or instead only to its form.[20]

Non-Discrimination

Similarly, with respect to non-discrimination, affected taxpayers will test the OECD's argument that the UTPR does not depend on the residence of higher-tier entities in the ownership structure but instead depends only on group per-country ETRs, as an attribute ungoverned by non-discrimination provisions, and could theoretically apply to an entirely domestic payment.[21] Here the saving clause is not available to defend the UTPR, leaving various national courts (and administrations) to determine for themselves what it means for a tax provision to operate based on the residence of a higher-tier entity, and what it means for foreign and domestic entities to be similarly situated within the meaning of non-discrimination principles. In addition, the fact that the GloBE's ETR determinations are carried out on a blended basis for group en-

al., above n. 13. The two situations in essence differ only with respect to which entity is liable for the tax, which is a flimsy distinction to rely on in an effort meant to coordinate the taxation of MNE groups based on a set of agreed principles.

[18] By the way, concerns about taxes of this nature are exactly what prompted Treasury and the IRS to add a controversial new "attribution" (i.e., nexus) requirement to the foreign tax credit regulations at the end of 2021. *See* Reg. §1.901-2(b)(5). The IRS presumably will take the position that no tax credits are available for UTPR taxes paid by CFCs under the regulations, even in situations in which a tax treaty applies, although the possibility of a treaty-based indirect credit would depend on the specifics of a country's UTPR implementation and the specific provisions of the relevant treaty. This in turn highlights the oddity of the U.S. Treasury's support for the GloBE while simultaneously promulgating regulations that declare extraterritorial taxes like UTPRs beyond the pale of what can be treated as a creditable income tax.

[19] *See* OECD Blueprint, §10.4.

[20] Indeed, countries contemplating the introduction of a UTPR should be mindful of the requirements of the Vienna Convention (the so-called "treaty on treaties"), which requires parties to apply the provisions of their treaties in good faith. *See Vienna Convention on the Law of Treaties* (1969), art. 26 ("Every treaty in force is binding upon the parties to it and must be performed by them in good faith.") and art. 31(1) ("A treaty shall be interpreted in good faith in accordance with the ordinary meaning to be given to the terms of the treaty in their context and in the light of its object and purpose."). The Vienna Convention has been ratified by over 100 countries. The United States has not ratified it, but generally views it as a useful restatement of international law.

[21] *See* OECD Blueprint, at §10.4, ¶ 691.

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tities within each jurisdiction means that a payment from a high-taxed entity in Country A to a low-taxed entity in Country A would be taxed more heavily than a payment from that same high-taxed entity in Country A to a similarly low-taxed entity in Country B.[22]

Moreover, now that the UTPR does not hinge on the existence of intercompany payments, there are no good analogies to the UTPR in pre-GloBE tax treaty history. For example, the current formulation of the UTPR cannot credibly be analogized to typical interest deduction limitations, nor even to the U.S. BEAT rules, which apply only based on intercompany payments.[23] As with the business profits position discussed above, the implications of blessing the UTPR under a standard non-discrimination provision would be fairly astonishing, insofar as the argument would conclude that it is non-discriminatory to tax a local subsidiary less favorably than similarly situated local companies, entirely based on the tax treatment of group entities that may not even have any transactional or functional connection to the local subsidiary.

PRACTICAL AND POLITICAL CONSIDERATIONS

So, where does all of this lead us?

A key goal of the OECD's BEPS project in general, and of Pillar Two and the GloBE in particular, has been for countries to come together and agree on a framework, in order to avoid the chaos and controversy that a multitude of unilateral measures would inevitably entail. That goal was always a lofty one, and recent events demonstrate how difficult this level of coordination will be to achieve. At this point, it seems likely that some countries will proceed with Pillar Two implementation, including UTPRs, while others will not, or will do so with varying degrees of delay. Taxpayers affected by UTPRs can be expected to look to bilateral tax treaties for relief, and national courts can be expected to reach a range of different conclusions on these issues. This is a recipe for the kind of chaos and controversy that the OECD work was meant to prevent.

Far better would be for policy makers to take the time to integrate Pillar Two properly with the existing bilateral income tax treaty framework, rather than simply contending that they have engineered a way to render that framework a vestigial organ and hoping for the best. Even the OECD has acknowledged that explicit treaty accommodation of Pillar Two would be, if not mandatory, at a minimum desirable as a way to achieve optimal coordination and certainty.[24] The prospect of an extended period of Pillar Two implementation, with significant diversity among key economies in terms of implementation timing and mechanics, makes it even more desirable to tackle the tax treaty aspects of Pillar Two head on.

Modifying treaties to accommodate Pillar Two, presumably through a multilateral instrument, will of course be a large and difficult undertaking of its own, but again the world is already partway down this path under Pillar One, and simply ignoring the Pillar Two treaty issues and hoping for the best is not a wise strategy. While U.S. ratification of tax treaties has proven very difficult in recent years due to the ability of individual senators to effectively block or at least draw out the process, that should not excuse inaction. Considerable progress could be made if other countries were to adopt a multilateral instrument accommodating Pillar Two, and even the United States can manage to ratify treaties that are considered sufficiently important, as it has in a few instances notwithstanding the prevailing procedural difficulties in clearing tax treaties through the Senate.[25] Indeed, if the need for U.S. Senate action is cited as a reason not to modify treaties to accommodate Pillar Two, what does that say about the prospects for the Pillar One effort, which everyone agrees requires treaty updates?

In addition, if the U.S. ability to ratify a tax treaty were viewed as a major issue, the OECD and other key countries could agree provisionally to treat the U.S. GILTI regime as a qualifying IIR pending U.S. accession to the relevant multilateral instrument and thereby address these treaty concerns at least as applied to U.S.-based multinationals (while still permitting local subsidiary-country jurisdictions to impose QDMTTs, just not UTPRs). While that may seem an

[22] *See* Bennett, above n. 13.

[23] And the BEAT rules themselves are difficult to square with the non-discrimination (and the double taxation) provisions of tax treaties, a fact that the U.S. Senate Foreign Relations Committee now has officially recognized in the form of a proposed reservation to the pending U.S.-Chile income tax treaty. *See* David G. Noren, *Broader Implications of Senate Actionon U.S.-Chile Tax Treaty*, 51 Tax Mgmt. Int'l J. No. 7 (July 1, 2022); *see also* H. David Rosenbloom and Fadi Shaheen, *The BEAT and the Treaties*, 92 Tax Notes Int'l 53 (Oct. 1, 2018).

[24] *See* OECD Blueprint, §10.5.3 ¶¶ 705–08 (''Although it is not a prerequisite, a multilateral convention would be the only means to enshrine rule coordination in a legally binding form. Inclusive Framework on BEPS members will therefore develop provisions that could be included in a new multilateral convention and that would be designed to ensure consistency, certainty and coordination in the application and operation of the IIR and UTPR. . . . A multilateral convention could also confirm the compatibility of the GloBE rules with existing double tax treaties providing further certainty for the operation of the GloBE rules. Furthermore it could contain exchange of information and dispute resolution mechanisms. . . .'').

[25] Specifically, in July 2019 the Senate ratified protocols to the U.S. tax treaties with Spain, Switzerland, Luxembourg, and Japan.

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unrealistic request in light of the most recent discussions of the issue, the fact should not be lost that the United States has taken the lead in enacting GILTI, the world's first IIR, as well as the BEAT, which was similar to at least the earlier incarnation of the UTPR.[26] In other words, for all of the difficulty of enacting legislation and ratifying tax treaties under the U.S. non-parliamentary system of government, the United States already has led the way in enacting a tax framework that goes a considerable distance toward Pillar Two and the resulting limits on tax competition. Countries concerned about tax competition should savor that victory and take the time to fully vet and properly implement coordinated improvements to the global tax framework.

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[26] Indeed, the possibility that present-law GILTI might conform with Pillar Two principles was widely entertained, until the Biden administration perhaps improvidently cited Pillar Two compliance as a goal of the administration's ultimately unsuccessful efforts to enact further changes to the GILTI regime. *See, e.g.*, Business at OECD (BIAC), *Written Response to the OECD Public Consultation on the OECD/G20 Inclusive Framework on BEPS Reports on the Pillar One and Pillar Two Blueprints*, ¶¶ 181–86 (Dec. 14, 2020).

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