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The UTPR and International Law: Analysis From Three Angles

by Sjoerd Douma, Alexia Kardachaki, Georg Kofler, Peter Bräumann, and Michael Tumpel

Sjoerd Douma

Alexia Kardachaki

Georg Kofler

Peter Bräumann

Michael Tumpel

Sjoerd Douma is a professor of tax law at the University of Amsterdam and is with Lubbers, Boer & Douma in the Netherlands. Alexia Kardachaki is with Lubbers, Boer & Douma in the Netherlands. Georg Kofler is a professor of tax law at the Vienna University of Business and Economics; Peter Bräumann is an assistant professor and Michael Tumpel is a professor of tax law at Johannes Kepler University Linz; and they are all with Bräumann Kofler Tumpel Tax Research GmbH in Austria. The authors thank Rupal Maheshwari for her research assistance.

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In this article, the authors provide a comprehensive overview of the rule commonly referred to as the UTPR, formerly the undertaxed payments rule, examining the compatibility of the rule with international law from three different legal angles: customary international law, tax treaties, and EU primary law.

On December 14, 2022, the Council of the European Union adopted Directive (EU) 2022/2523 "on ensuring a global minimum level of taxation for multinational enterprise groups and large-scale domestic groups in the Union."[1] This directive marks a monumental step forward for the OECD/G-20 inclusive framework on base erosion and profit shifting's concept of a global minimum tax of 15 percent on the profits of multinational enterprise groups,[2] better known as pillar 2 or the global anti-base-erosion (GLOBE) rules. Strikingly, these rules were not designed as part of an international agreement, but as a set of OECD model rules that can be implemented by individual jurisdictions without requiring reciprocity. The pillar 2 directive puts this concept into binding law and forces each of the 27 EU member states to implement these rules into its

[1]We note that an action for annulment of the directive is launched in the European General Court under *VF v. Council*, T-143/23. However, this action concerns the scope of the exception for shipping income and is not likely to address the issues raised by the authors in the present article.

[2]In essence, an MNE group is in scope of article 1 of the OECD pillar 2 rules if its consolidated financial statements report an annual revenue of €750 million or more and at least one subsidiary or permanent establishment is located in a different jurisdiction than the ultimate parent entity (UPE).

domestic legislation, even while legal implementation in other jurisdictions is still outstanding.[3]

U.S. Treasury Secretary Janet Yellen welcomed the EU's move forward.[4] Congress, however, has not yet paved the way for the pillar 2 rules. In July 2022 the Build Back Better Act (H.R. 5376) failed to secure the support of a majority in the Senate; the bill would have aligned the global intangible low-taxed income regime with pillar 2. Instead, negotiations led to a scaled-down bill, the Inflation Reduction Act (P.L. 117-169), which introduced a corporate alternative minimum tax of 15 percent that is not, however, in line with pillar 2 in a number of ways.[5] On December 14, 2022, 15 members of the Senate Finance and Foreign Relations committees and 17 members of the House Ways and Means Committee wrote a letter to the Treasury secretary that expressed serious concerns about the pillar 2 UTPR (which is now known as the undertaxed profits rule) in its current form.[6] Ways and Means Committee Chair Jason Smith, R-Mo., wrote a similar letter on February 10 to the secretary-general of the OECD, calling the UTPR "fundamentally flawed."[7]

Indeed, the advances in implementation have increasingly raised questions about the compatibility of domestic pillar 2 rules with standing principles of international tax law, whether customary or treaty based. As it does in the aforementioned letters from U.S. lawmakers, the UTPR — the second of the two central pillar 2 rules — in particular seems to spark debates. This hardly comes as a surprise. The first and primarily applicable rule, the income inclusion rule, places an additional tax burden on parent entities that indirectly control low-taxed constituent entities (LTCEs) in an MNE group covered by the pillar 2 rules. This approach is reminiscent of established controlled foreign corporation rules. However, the UTPR, which serves as a backstop to the IIR, does not take the hierarchy of a group into consideration. When applicable, it allows a jurisdiction to collect an additional top-up tax from the local entities of an MNE group (including local permanent establishments) resulting from undertaxed profits of any other group entity (including higher-level or "sister" entities) if the latter does not already face a pillar 2 qualified domestic minimum top-up tax (QDMTT) in its home jurisdiction and is not indirectly controlled by a parent entity that is already subject to the IIR itself. These taxing rights that under some conditions reach across the totality of an MNE group have been considered a novelty in international taxation. While the policy reasons behind the UTPR's function as a backstop are quite understandable, several legal concerns have been raised, and its operation has even been likened to "an invalid expropriation or illegal confiscation."[8]

Against this background, this article scrutinizes the compatibility of the UTPR with international law from three different legal angles. After a summary of the UTPR itself, it will be tested against (1) principles of customary international law; (2) provisions commonly found in tax treaties, especially those based on the OECD and U.N. model conventions; and (3) EU primary law, such as the fundamental freedoms, which is hierarchically superior even to the pillar 2 directive. However, possible frictions among the UTPR, bilateral investment treaties, and friendship agreements will not be explored.[9] Likewise, the obvious concerns regarding the right to property (for example, in the European

[3] As of December 16, 2022, 138 members of the inclusive framework had joined the October 2021 policy statement (see *infra* note 16).

[4] U.S. Department of the Treasury, "Statement From Secretary of the Treasury Janet L. Yellen on the European Union Directive Implementing a Global Minimum Tax" (Dec. 16, 2022).

[5] The corporate alternative minimum tax "is different from the 15 percent Pillar 2 global [anti-base-erosion] (GLoBE) tax proposed by the Organisation for Economic Co-operation and Development and G20 (OECD/G20) and endorsed by 130 countries. The [corporate AMT] imposes a minimum tax on worldwide income, whereas GLoBE would impose a minimum tax in each country. The tax base is different in numerous ways as well. Other minimum taxes currently in force — the tax on global intangible low taxed income [and base erosion and antiabuse tax] — also are not imposed on a per country basis. It is unclear how these taxes would interact with GLoBE, which, if adopted, would allow foreign countries to tax income of U.S. multinationals if effective tax rates are below 15 percent." Jane G. Gravelle, Congressional Research Service, "The 15 Percent Corporate Alternative Minimum Tax," R47328 (Dec. 7, 2022).

[6] Letter from Republican members of Congress to Treasury Secretary Janet Yellen (Dec. 14, 2022).

[7] Letter from Jason Smith, R-Mo., chair, House Ways and Means Committee, to OECD Secretary-General Mathias Cormann (Feb. 10, 2023).

[8] *See* Nathan Boidman, "Christians and Shay Almost See UTPR's Fatal Flaw," *Tax Notes Int'l*, Jan. 30, 2023, p. 577.

[9] For an initial analysis, see Peter Hongler, "Five Possible Violations of International Law by the UTPR," LinkedIn (Mar. 2023).

Convention on Human Rights or the EU Charter of Fundamental Rights), which are triggered by the fact that the UTPR taxpayer might face a tax liability that vastly exceeds its own profits, revenues, or equity, will not be addressed.

The UTPR

Background and Development

On January 23, 2019, the members of the inclusive framework approved the publication of the policy note "Addressing the Tax Challenges of the Digitalisation of the Economy."[10] This policy note announced the two-pillar concept that has ever since shaped the remaining work on the BEPS project. The second pillar therein should go beyond the scope of the digital economy and address "the larger landscape relating to remaining BEPS challenges" — that is, profit shifting and tax competition. The outcome is envisioned as "rights that would strengthen the ability of jurisdictions to tax profits where the other jurisdiction with taxing rights applies a low effective rate of tax to those profits," without, however, interfering with jurisdictions' right to set their own corporate income tax rates. The IIR is already referred to by name in this policy note, whereas the second interrelated rule (what will later be called simply the UTPR) is described as "a tax on base eroding payments."

In February 2019 a public consultation document was released that describes this tax as a denial of "deduction or treaty relief for certain payments unless that payment was subject to an effective tax rate at or above a minimum rate."[11] In May 2019 the inclusive framework approved a program of work that included a potential set of two sub-rules for implementing this tax that accompanies the IIR:

- an undertaxed payments rule that would deny a deduction or impose source-based taxation (including withholding tax) for a payment to a related party if that payment was not subject to tax at a minimum rate; and
- a subject to tax rule in tax treaties that would only grant certain treaty benefits if the item of income was subject to tax at a minimum rate.[12]

The program of work recognizes that these rules can raise issues that might require the amendment of tax treaties.[13]

These concerns appear to have been largely dropped by October 2020, when the inclusive framework approved the "Report on Pillar Two Blueprint."[14] Paragraph 21 of the blueprint states that between the two sub-rules, only the subject-to-tax rule would require changes to existing tax treaties, presumably because it would lead to taxation of income that is subject to taxation by another jurisdiction. According to the blueprint, the UTPR (and the IIR) does not require these changes and could be implemented through domestic law only, because presumably it merely denies the deductibility of payments without taxing income allocated to another jurisdiction. Indeed, paragraphs 689 et seq. of the blueprint explain that the UTPR does not infringe on profit attribution rules in articles 9(1) and 7(2) of the OECD model convention because it would only affect how a jurisdiction taxes its own residents akin to domestic rules on nondeductible expenses:

> It is generally recognised, however, that once the profits have been allocated in accordance with the arm's length principle, how they are taxed is a matter determined by the domestic law of each country.

Furthermore, the UTPR is described as not violating the nondiscrimination rules in articles 24(4) and 24(3) of the OECD model convention. First, the application of the UTPR would not be triggered by the residence of the recipient of the payment, but by the jurisdiction's classification as "low tax" based on the MNE group's local ETR profile in the relevant period. Second, a deniability of deduction in accordance with the

[10] OECD, "Addressing the Tax Challenges of the Digitalisation of the Economy — Policy Note" (Jan. 23, 2019).

[11] OECD, "Public Consultation Document — Addressing the Tax Challenges of the Digitalisation of the Economy," para. 92 (Feb. 13, 2019).

[12] OECD, "Programme of Work to Develop a Consensus Solution to the Tax Challenges Arising From the Digitalisation of the Economy," para. 73 (2019).

[13] *Id.* at para. 49.

[14] OECD, "Tax Challenges Arising From Digitalisation — Report on Pillar Two Blueprint" (Oct. 14, 2020).

pillar 2 rules as laid out in the blueprint would apply not only to payments directly made to low-taxed group entities but eventually to all net related-party expenditures of an entity, whether made to domestic or nonresident entities.

In this context, it must be emphasized that the blueprint described the UTPR as an undertaxed *payments* rule — that is, a tax that is essentially based and dependent on deductible intragroup payments. On this, the blueprint (paragraph 687), *inter alia,* clearly states:

> The top-up tax imposed on each UTPR taxpayer is capped by reference to the gross amount of deductible intra-group payments that are taken into account for the purpose of the allocation keys.

Accordingly, the policy rationale for the UTPR is explained as a hybrid in the blueprint (paragraph 457): On the one hand, it should serve as a backstop to the IIR. Where the home jurisdictions of parent companies in a group covered by the pillar 2 rules do not implement an IIR and pick up a top-up tax that compensates for taxation of the companies' subsidiaries below the intended minimum level, the UTPR should allow for adjustments on this top-up tax, thus reducing incentives for circumventing the application of an IIR. On the other hand, the UTPR is aimed at addressing profit shifting through deductible intragroup payments.

As a result of these considerations, the blueprint (paragraphs 21 and 705 et seq.) and the accompanying cover statement[15] consider an international treaty unnecessary for implementation of the UTPR, while acknowledging that a multilateral convention could facilitate application and coordination. A convention would not change existing tax treaties, but it "could also confirm the compatibility of the GloBE rules with existing double tax treaties," according to the blueprint.

Instead of a formal international agreement, the cover statement speaks of a "common approach." In a statement released a year later, the inclusive framework explained that this means that the group's members:

- are not required to adopt the GloBE rules, but, if they choose to do so, they will implement and administer the rules in a way that is consistent with the outcomes provided for under Pillar Two, including in light of model rules and guidance agreed to by the [inclusive framework; and]
- accept the application of the GloBE rules applied by other [inclusive framework] members including agreement as to rule order and the application of any agreed safe harbours.[16]

This October 2021 statement still calls the UTPR a payment rule and defines it as a rule that "denies deductions or requires an equivalent adjustment." It does not elaborate, however, on the question of what an "equivalent adjustment" is or could be.

On February 2 the inclusive framework released administrative guidance on pillar 2. In the executive summary of this document it is stated that the GLOBE rules, including the IIR and the UTPR, "are designed so that the imposition of top-up tax in accordance with those rules will be compatible with the provisions of the United Nations Model Double Taxation Convention between Developed and Developing Countries . . . and the Model Tax Convention on Income and on Capital: Condensed Version 2017."[17] No further reasoning or analysis on this statement has been provided.

OECD Model Rules and the Pillar 2 Directive

On December 20, 2021, the OECD released the pillar 2 GLOBE model rules (OECD model rules)[18] that guide the "common approach" for domestic implementation. In these model rules, the application of the UTPR (which is no longer referred to as a "payments rule," but is instead

[15] OECD, "Cover Statement by the Inclusive Framework on the Reports on the Blueprints of Pillar One and Pillar Two," para. 7 (Oct. 2020).

[16] OECD, "Statement on a Two-Pillar Solution to Address the Tax Challenges Arising From the Digitalisation of the Economy" (Oct. 8, 2021).

[17] OECD, "Tax Challenges Arising From the Digitalisation of the Economy — Administrative Guidance on the Global Anti-Base Erosion Model Rules (Pillar Two)," executive summary, para. 2 (Feb. 2023).

[18] OECD, "Tax Challenges Arising From the Digitalisation of the Economy — Global Anti-Base Erosion Model Rules (Pillar Two)" (2021).

just used as an acronym) is revised in an important point: Article 2.4.1 still regards the application of the UTPR as a denial of a deduction or an equivalent adjustment. However, the UTPR is no longer connected or limited to payments or other intragroup transactions in any form. The deduction or equivalent adjustment instead only needs to be of an amount that creates "an additional cash tax expense equal to the UTPR Top-up Tax Amount for the Fiscal Year allocated to that jurisdiction." An item of commentary on the OECD model rules, published in March 2022,[19] emphasizes this in its paragraph 45:

> Denial of a deduction under Article 2.4.1 means the denial of a deduction for local tax purposes in respect of expenditure or similar items that are taken into account in calculating ordinary net income for tax purposes in that jurisdiction. The denied deduction need not be attributable to a transaction with another Constituent Entity.

On equivalent adjustments, paragraph 47 of the commentary states:

> The adjustment under the UTPR will depend on the existing design of the domestic tax system and should be coordinated with other domestic law provisions and a jurisdiction's international obligations, including those under Tax Treaties. For example, the adjustment under the UTPR could take the form of an additional Tax levied directly on a resident taxpayer in an amount equal to the allocated UTPR Top-up Tax Amount. Alternatively, a jurisdiction could include an additional amount of deemed income representing a reversal of deductible expenses incurred in [the] current or prior period or a jurisdiction could choose to reduce an allowance or deemed deduction to reflect an allocation of Top-up Tax.

This approach clearly differs from the pillar 2 blueprint discussed above that considered the UTPR *inter alia* as a measure against profit shifting through deductible intragroup transactions. In its final version, the UTPR rather serves as a mere distribution rule that does not take intragroup relationships or hierarchies into consideration but should guarantee that any top-up tax arising for the MNE group under the pillar 2 rules is levied by some jurisdiction. As such, it operates like a reverse IIR, and it is hence not surprising that the pillar 2 directive explicitly refers to it as the "Undertaxed Profit Rule."[20]

These top-up taxes arise in every jurisdiction where the entities, including the ultimate parent entity (UPE), of an MNE group covered by the pillar 2 rules are taxed below the minimum rate established by these rules, consequently referred to as LTCEs. The top-up tax under article 5.2 of the OECD model rules therefore is the difference between this minimum rate and the actual rate of tax as recognized under the OECD model rules. It becomes a UTPR top-up tax under article 2.5 of the OECD model rules if neither the (insofar deemed low-tax) jurisdiction itself fully collects this tax via a QDMTT nor all group interest in the entity is (indirectly) subject to the IIR at the level of higher-level parent entities. In this sense, the UTPR top-up tax is a residuum that can then be claimed by all jurisdictions that have implemented the pillar 2 rules and are home to at least one MNE group entity. The UTPR top-up tax is split up between all these UTPR jurisdictions under a formula that takes the number of employees and value of tangible assets in each of these jurisdictions into account.[21]

As cited above, the OECD model rules do not determine the exact way a UTPR jurisdiction collects the top-up tax attributed to it by the formula from the local MNE group entities (UTPR taxpayers). Article 2.4.2 of the OECD model rules, however, stipulates that the domestic rules must be applied to the extent possible, and that any remaining UTPR top-up tax amount is carried forward. For the period of the carryforward, the jurisdiction is excluded from any further

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

[20] *See* recital 5 of the preamble and article 1(1)(b) of the pillar 2 directive.

[21] *See* article 2.6.1 of the OECD model rules.

participation in the allocation of UTPR top-up tax.[22] From a fiscal standpoint, jurisdictions thus face pressure to exhaust all legal possibilities for collecting the UTPR top-up tax or risk losing their share to other jurisdictions in later years. While paragraph 47 of the commentary mentions that the domestic rules for collecting the UTPR top-up tax should be coordinated with tax treaty obligations, it does not provide further guidance on this.

Finally, it should be mentioned that application of the UTPR, instead of the IIR, is less favorable for an MNE group in situations where the group interest in an LTCE is below 100 percent. The UTPR generally applies to 100 percent of the top-up tax arising from an LTCE, while the IIR only applies to the ownership percentage (however, the pillar 2 rules contain a special provision for partially owned parent entities that are more than 20 percent owned by nongroup shareholders).

The rules laid out in the pillar 2 directive closely follow the OECD model rules. The UTPR operative rules are set out in articles 12-14 of the pillar 2 directive. All EU member states must implement an IIR and a UTPR and can optionally implement a QDMTT to pick up any pillar 2 top-up tax that arises on entities under their jurisdiction. Notably, the EU member states apply an IIR even to "large-scale domestic groups" that only operate within the borders of a single EU member state. Further, the UTPR will not apply to MNE groups located exclusively in the EU or with a UPE in the EU, because of the mandatory implementation of the IIR. UTPR adjustments can take the form of either a direct top-up tax on MNE group entities or a denial of deduction against the taxable income of those constituent entities.

Customary International Law

Principle of Sovereignty

Sovereignty is generally accepted to be a principle of international law superior to all other sources of international law.[23] It is a precondition of the current legal order. Sovereignty has been defined as the bundle of rights and competences that make up the nation state; it can be equated with statehood.[24] As part of sovereignty, jurisdiction denotes the power of a state to declare what the law within its border is and to decide on the means of its enforcement.[25]

A second principle, inherently interlinked with sovereignty, is equality of nations. The sovereignty of one state can never be absolute; it is limited by the sovereignty of others.[26] The extent of a state's sovereignty can thus be determined only if it is confronted with the sovereignty of other states or other principles or rules of international law.[27] According to Ian Brownlie,[28] the principal corollaries of the principles of sovereignty and equality of states are: (1) jurisdiction, prima facie exclusive, over a territory and the permanent population living there; (2) duty of non-intervention in the area of exclusive jurisdiction of other states; and (3) dependence of obligations arising from customary law and treaties.

Fiscal sovereignty can then be defined as the part of a state's sovereignty that refers to its right to legislate, enforce, and adjudicate on fiscal matters. As part of general international law, it underlies tax jurisdiction.[29] Extending Brownlie's view to fiscal sovereignty means that under the principle of territoriality, a state has the authority to tax subjects and objects that have a genuine link or nexus with its territory.[30] At the same time, each

[22] *See* article 2.6.3 of the OECD model rules.

[23] *See also* Hongler, *supra* note 9.

[24] Sjoerd Douma, "Chapter 5: The Principle of Direct Tax Sovereignty" in *Optimization of Tax Sovereignty and Free Movement*, para. 5.1 (2011); Hongler, *Justice in International Tax Law: A Normative Review of the International Tax Regime*, para. 4.1.2.2 (2019).

[25] Stjepan Gadžo, "The Principle of 'Nexus' or 'Genuine Link' as a Keystone of International Income Tax Law: A Reappraisal," 46(3) *Intertax* 194 (2018).

[26] Douma, *supra* note 24.

[27] *Id.*; Hongler, *supra* note 24, at para. 4.1.1.3.2; Filip Debelva, *International Double Taxation and the Right to Property: A Comparative, International and European Law Analysis*, para. 3.2.2 (2019).

[28] Ian Brownlie, *Principles of Public International Law* 287 (2003).

[29] This represents the prevailing view in the tax literature. For an overview of the arguments in favor of the "no limitation" view — that is, that a state's exercise of tax jurisdiction is unlimited, subject to practical considerations — see Debelva, *supra* note 27, at ch. 3; and Tarcísio Diniz Magalhães, "Give Us the Law: Responses and Challenges to UTPR Resisters," *Tax Notes Int'l*, Dec. 5, 2022, p. 1257. *See also* Sol Picciotto, "Formulary Approach: The Last Best Hope for MNEs," *Tax Notes Int'l*, Oct. 24, 2022, p. 437.

[30] *See also* Philip Baker, "Chapter 11: Some Thoughts on Jurisdiction and Nexus" in *Current Tax Treaty Issues: 50th Anniversary of the International Tax Group* 446 (2020).

state has an obligation to respect the fiscal sovereignty of other states under the principle of noninterference. These two principles can be seen as two sides of the same coin. On the one hand, taxation by a state of a person or object that does not have any link in territorial (spatial) terms to that state is prohibited.[31] This also encompasses the idea that nontaxation by a state certainly does not in itself satisfy the nexus principle in respect of another state if there is not already a genuine link with that latter state.[32] On the other hand, any interference in the sovereignty of a state caused by the exercise of tax jurisdiction by another state is only possible if accepted by that other state. Finally, limits also can be set by customary international law (unwritten binding rules) and international agreements, such as tax treaties (written binding rules).

Customary International Law

This raises the issue of the importance of customary international law for the purposes of fiscal sovereignty. Principles of customary international law can establish, but also limit, the exercise of tax jurisdiction. This exercise can also be permitted if there is adequate evidence that a new state practice has emerged as a principle of customary international law.

"International custom as evidence of a general practice accepted as law" is *inter alia* accepted as a source of international law by article 38(1) of the Statute of the International Court of Justice. Customary international law refers to international obligations of states arising from established international practices. It is created when two requirements are met: (i) widespread, uniform, and consistent state practice; and (ii) *opinio juris* — that is, the awareness of a legal and binding obligation to follow that practice. Changing customary international law requires new state practice and evidence that *opinio juris* supports this practice.

According to tax literature, some links to a state[33] and their specific consequences for tax jurisdiction[34] have already become customary international law.[35] These links can be of a personal or territorial nature; they include nationality, citizenship, residence, or different forms of investment and business activities undertaken within that state's territory. Different links justify different intensities of taxation. Worldwide income taxation of residents (often referred to as residence taxation) is justified on the assumption that nationality, citizenship, or residence correlates with a higher level of a person's participation in the economic and political dimensions of a state's community. The same cannot be assumed for nonresident aliens who only derive income from commercial or investment activities in a state's territory; hence the imposition of limited (or source) taxation on income derived from sources within the territory of that state.[36]

In light of economic, technological, and political developments, other links may also apply[37] or emerge. An example worth noting was

[31] Hongler, *supra* note 24, at para. 4.1.2.2.3; and Douma, *supra* note 24, at para. 5.3.

[32] Juliane Kokott, "Chapter 1: Public International Law and Taxation: Nexus and Territoriality" in *Tax Nexus and Jurisdiction in International and EU Law*, para. 1.3.2 (2022); and Baker, *supra* note 30, at 464-465.

[33] Gadžo, *supra* note 25; Céline Braumann, "Taxes and Custom: Tax Treaties as Evidence for Customary International Law," 23(3) *J. Int'l Econ. L.* 747 (2020); Wolfgang Schön, "International Tax Coordination for a Second-Best World (Part I)," 1(1) *World Tax J.* 67, para. 3.3.1 (2009); Joachim Englisch, John Vella, and Anzhela Yevgenyeva, "The Financial Transaction Tax Proposal Under the Enhanced Cooperation Procedure: Legal and Practical Considerations," 2 *Brit. Tax Rev.* 223, para. 2(b) (2013). This view is also supported by Angelo Nikolakakis and Jinyan Li, "UTPR: Unprecedented (and Unprincipled?) Tax Policy Response," *Tax Notes Int'l*, Feb. 6, 2023, p. 743.

[34] Debelva, *supra* note 27, at para. 3.4.1; Debelva and Luc De Broe, "Pillar 2: An Analysis of the IIR and UTPR From an International Customary Law, Tax Treaty Law and European Union Law Perspective," 50(12) *Intertax* 898 (2022); Douma, *supra* note 24, at para. 5.2.1; Gadžo, *supra* note 25; Braumann, *supra* note 33; Niek P. Schipper, "De invloed van de woonplaats op de fiscale behandeling van grensoverschrijdende werknemers," Fiscale Monografieën no. 158, para. 2.2 (2019). This view has also been opposed. *See, e.g.*, Hongler, *supra* note 24, at paras. 4.1.2.2.3 and 4.1.2.3.4. Hongler takes the view that the genuine link requirement and the prohibition of extraterritorial taxation does not directly stem from customary international law but is based on a peremptory rule derived from state sovereignty and the principle of equality of nations.

[35] For a different view, see Magalhães and Allison Christians, "Why Data Giants Don't Pay Enough Tax," *Harvard L. & Pol'y Rev.* (forthcoming) (revised Mar. 23, 2023). Michael Lennard takes the view that if there was customary international tax law, it would seem to be on the most basic issues, not the large areas of difference and dispute under pillar 1 and pillar 2. *See* Lennard, "Customary International Law and Tax — The Fog of Law," *Tax Notes Int'l*, Jan. 30, 2023, p. 601.

[36] Gadžo, *supra* note 25; Douma, *supra* note 24, at para. 5.2.1; Debelva, *supra* note 27, at para. 3.4.

[37] *See, e.g.*, Debelva, *supra* note 27, at para. 3.3.2.1; Hongler, "Is the Pillar 2 Agreement Infringing International Law Obligations?" GLOBTAXGOV, Dec. 11, 2021, at para. 2.3; Kokott, *supra* note 32, at para. 1.3.2.

provided by Advocate General Juliane Kokott in her opinion in *Google Ireland* before the Court of Justice of the European Union. Her opinion was that linking a tax to the language in which the service is provided can also be regarded as a genuine link.[38] Provided that the two requirements of customary international law are met, this or other links could also rise to the level of customary international law.

At the same time, there is general agreement among scholars that customary international law does not go as far as prescribing a common content to supplementary notions such as residence or source.[39] This is left up to states to define within the limitations prescribed by general international law, as set out in the preceding section of this article. Some scholars argue that other common tax treaty rules, such as the arm's-length principle and the PE limitation, also form part of customary international law.[40] However, the latter represents a minority view.[41]

Application to the UTPR

The current design of the UTPR has given rise to a vivid debate on its compatibility with customary international law. So far, three views have emerged:

(1) The link between the UTPR jurisdiction and the UTPR taxpayer itself sufficiently justifies the collection of the UTPR top-up tax.[42] Customary international law does not limit the tax jurisdiction of a state over its own residents.[43]

(2) The MNE group is a single economic unit, and therefore — as evidenced by the inclusive framework's October 2021 statement — there is a consensus that any jurisdiction hosting a constituent entity that is part of the MNE group has a link with the MNE group's income and is therefore entitled to levy top-up tax.[44] It has also been argued that the aforementioned consensus is on the way to becoming customary international law.[45] In a comparable vein, it has been argued that a genuine link or nexus can be found in the existence of common ownership among MNE group entities[46] and by the clear pervasiveness of centrally managed groups.[47]

(3) Other than the fact that the UTPR taxpayer and the LTCE belong to the same MNE group, there is no link between the UTPR jurisdiction and the LTCE or the

[38]Opinion of Advocate General Kokott in *Google Ireland Ltd. v. Hungary*, C-482/18 (Sept. 12, 2019), paras. 48-55.

[39]Magalhães, *supra* note 29.

[40]Reuven S. Avi-Yonah, "International Tax as International Law," 57 *Tax L. Rev.* 483 (2004); Avi-Yonah, "Does Customary International Tax Law Exist?" Univ. of Mich. L. & Econ. Research Paper No. 19-005 (2019).

[41]Avi-Yonah, "UTPR's Dynamic Connection to Customary International Tax Law," *Tax Notes Int'l*, Nov. 21, 2022, p. 951; Joanna C. Wheeler, "Chapter 5: Do Taxpayers Have a Right to DTR?" in *Single Taxation?* para. 5.3.1 (2018); Braumann, *supra* note 33; Guglielmo Maisto, "Chapter 2: On the Difficulties Regarding the Formation of Customary Law in the Field of Taxation" in *EU Law and the Building of Global Supranational Tax Law: EU BEPS and State Aid* (2017). Regarding the PE limitation, see Jérôme Monsenego, "Chapter 2: International Law and Tax Jurisdiction Over Foreign Business Income" in *Taxation of Foreign Business Income Within the European Internal Market: An Analysis of the Conflict Between the Objective of Achievement of the European Internal Market and the Principles of Territoriality and Worldwide Taxation*, para. 2.3.2 (2012).

[42]Magalhães and Christians, "UTPR, Normative Principles, and the Law: A Rejoinder to Nikolakakis and Li," *Tax Notes Int'l*, Feb. 27, 2023, p. 1137. A comparable line of argument is that the UTPR follows the same rationale as CFC rules or other corporate attribute-shifting regimes under tax law, which have not been found incompatible with customary international law. For an analysis, see Rita Szudoczky, "Does the Implementation of Pillar Two Require Changes to Tax Treaties?" 2 *SWI* 144 (2023).

[43]Heydon Wardell-Burrus, "Four Questions for UTPR Skeptics," *Tax Notes Int'l*, Nov. 7, 2022, p. 699; Avi-Yonah, "The UTPR and the Treaties," *Tax Notes Int'l*, Jan. 2, 2023, p. 45. For a discussion, see Debelva and De Broe, *supra* note 34. Regarding the operation of the earlier version of the UTPR, see Fabrizio Pascucci, "Chapter 6: The (Re)allocation of Taxing Rights Following the 2021 Consensus on Pillar Two Blueprint: An Examination of Its Causes and Effects" in *Tax Nexus and Jurisdiction in International and EU Law*, para. 6.4.2 (2022).

[44]Christians and Magalhães, "Undertaxed Profits and the Use-It-or-Lose-It Principle," *Tax Notes Int'l*, Nov. 7, 2022, p. 705. *See also* Picciotto and Jeffery M. Kadet, "The Transition to Unitary Taxation," *Tax Notes Int'l*, Oct. 24, 2022, p. 453; Picciotto, "UTPR Critics Miss the Point of Tax Treaty Principles," *Tax Notes Int'l*, Oct. 10, 2022, p. 153.

[45]Avi-Yonah, *supra* note 41.

[46]Szudoczky, "The New Meaning of 'Always-Somewhere' Under Pillar Two" in *Rara Avis: Liber Amicorum Peter J. Wattel* 165-170 (2022). Michael L. Schler makes a comparable argument in "UTPR: The CFC Precedent," *Tax Notes Int'l*, Jan. 2, 2023, p. 27.

[47]Kadet, "Defending the UTPR: Creative Corporate Structuring Can't Hide Real Connections," *Tax Notes Int'l*, Nov. 28, 2022, p. 1071.

low-taxed income that gives rise to the UTPR top-up tax.[48]

The question underlying the debate is a legitimate one: Is the UTPR in line with customary international law as described in the preceding paragraphs, and in particular with the principles of territoriality and noninterference? Considering the principle of territoriality, the personal or territorial links that, according to the literature, have emerged to become customary international law and would underpin residence or source taxation appear to be absent. From a personal perspective, the low-taxed income is de facto not income of the UTPR taxpayer, not even deferred income or indirect income. Even if that income was artificially diverted to another jurisdiction with an abusive motive, the operation of the UTPR (that is, aggregation of the top-up taxes of the LTCEs and allocation among UTPR jurisdictions based on a formulaic key) makes it very difficult to identify and show the existence of abuse at the level of the LTCEs, and even more so on the level of the UTPR taxpayer. Furthermore, in the absence of a direct or indirect ownership interest or control between the UTPR taxpayer and the LTCEs, it is difficult to argue and show that the UTPR taxpayer has in any way contributed to the generation of that income. From a territorial perspective, the low-taxed income arises in a jurisdiction other than the UTPR jurisdiction. Also, the factors in the formulaic key (that is, employees and tangible assets)[49] only establish a territorial connection of the UTPR jurisdiction with the UTPR taxpayer, not with the foreign activities of any other LTCEs within the MNE group. These factors are not per se indicative of any territorial link between the UTPR top-up tax — and the income that gave rise to it — and the UTPR jurisdiction that collects it.[50] Indeed, the UTPR formulaic apportionment is solely about shifting the taxing right, not about the scope of a taxing right.

This does not mean that tax jurisdiction cannot be established by virtue of another link. Indeed, as per view (2) above, common ownership or control between the UTPR taxpayer and the LTCEs is arguably a plausible justification for the UTPR jurisdiction's exercise of tax jurisdiction. However, even if this is accepted as a link that complies with the principle of territoriality — which at a minimum is an unsettled issue[51] — it should also satisfy the principle of noninterference. Considering the principle of noninterference, in order for the UTPR to apply, the jurisdiction in which the LTCE is located and the jurisdictions in which the parent entities are located will have decided to abstain from introducing, and therefore subjecting their own nationals or residents to, rules similar to the OECD model rules. These jurisdictions may regard the application of the UTPR by the UTPR jurisdiction as an impermissible interference in their sovereignty because the UTPR effectively leads to taxation of income generated by one of their own nationals or residents, even if these taxpayers are not nationals or residents of the UTPR jurisdiction and the taxed income is not being generated from sources in the UTPR jurisdiction. Therefore, the legitimacy of the UTPR would depend on the extent to which the jurisdictions in which the LTCEs are located would be prepared to accept the UTPR jurisdiction's extended exercise of tax jurisdiction in a way that goes beyond the current status quo.

This potential interference could be resolved if pillar 2, and the UTPR in particular, were to gain the status of customary international law and were considered an accepted interference in the tax sovereignty of other states. That development could be indicated by the October 2021 statement that explicitly referred to "an Undertaxed Payment Rule (UTPR), which denies deductions or requires an equivalent adjustment to the extent the low tax income of a constituent entity is not subject to tax under an IIR." The statement also elaborates on the pillar 2 implementation as

[48] Jefferson VanderWolk, "The UTPR Is Inconsistent With the Nexus Requirement of Tax Treaties," Kluwer International Tax Blog, Oct. 26, 2022; VanderWolk, "The UTPR Disregards the Need for Nexus," *Tax Notes Int'l*, Oct. 31, 2022, p. 545; Robert Goulder, "Confessions of a UTPR Skeptic," *Tax Notes Int'l*, Nov. 14, 2022, p. 907; VanderWolk, "The UTPR: Taxing Rights Gone Wild," *Tax Notes Int'l*, Dec. 12, 2022, p. 1369; VanderWolk, "The UTPR, Treaties, and CFC Rules: A Reply to Avi-Yonah and Schler," *Tax Notes Int'l*, Jan. 9, 2023, p. 187; Nikolakakis and Li, *supra* note 33.

[49] *See* article 2.6 of the OECD model rules and article 14 of the pillar 2 directive.

[50] *Contra* Picciotto, "The Long and Winding Road Leads to the Unitary Approach," *Tax Notes Int'l*, Nov. 28, 2022, p. 1065.

[51] Szudoczky, *supra* note 46; Hongler, *supra* note 37, at para. 2.3; Debelva and De Broe, *supra* note 34.

"common approach" and says that inclusive framework members *inter alia* "accept the application of the GloBE rules applied by other [inclusive framework] members."

The view that this statement reflects a development in customary international law has been supported,[52] but has also been clearly opposed, in the scholarly literature.[53] The main counterarguments are as follows:

- The UTPR does not meet the customary law requirement of state practice because it has not yet been implemented by a sufficient number of jurisdictions.[54] However, Filip Debelva and Luc De Broe argue that the October 2021 statement could already demonstrate extensive state practice by the relevant jurisdictions.[55]
- The UTPR does not meet the customary law requirement of *opinio juris* — yet. The October 2021 statement is a soft law instrument, and the common approach described therein is not binding on the inclusive framework members.[56] Also, the statement had focused on undertaxed payments and hence did not reflect the current design of the UTPR, whose application and objective are no longer dependent on the existence of intragroup deductible payments.[57] It is unclear, though, if the latter objection is mitigated by the fact that the subsequent OECD model rules (December 2021) and commentary (March 2022) have been agreed upon by the inclusive framework.

These counterarguments find support in guidance on customary international law adopted in 2018 by the U.N. International Law Commission.[58] According to this guidance, in order for *opinio juris* to be demonstrated, state practice must be undertaken with a sense of legal obligation — it must be accompanied by a conviction that it is permitted, required, or prohibited by customary international law. In other words, it needs to be established that states have acted in a specific way because they felt or believed themselves legally compelled or entitled to do so by reason of customary international law. Accordingly, broad and representative acceptance, together with no or little objection, is required. Practice that states consider themselves legally free either to follow or disregard does not in itself contribute to or reflect customary international law. Finally, even an act adopted by an international organization cannot, of itself, create a rule of customary international law. It may, however, provide evidence of the existence and content of customary international law, or contribute to its development.[59]

In light of this guidance, it seems doubtful that the October 2021 statement or the later developments — at least for now — meet the high standard of the customary international law requirement of *opinio juris*.[60] The statement itself does not create a rule of customary international law. Moreover, it does not provide conclusive evidence that the inclusive framework members will implement or accept the consequences of other jurisdictions' implementation of pillar 2 out of a conviction that they are legally entitled or obliged to do so. There is no adequate indication that pillar 2 and its consequences are sufficiently accepted as law for the purposes of identifying customary international law.

This finding, however, could change for the EU member states after the adoption of the pillar 2 directive. The fact that they were not legally bound by the October 2021 statement, but nonetheless have obliged themselves to introduce the pillar 2 rules, could be seen as evidence that they accept the extension of foreign tax

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[52] Avi-Yonah, *supra* notes 41 and 43. Notably, Magalhães argues that the October 2021 statement establishes a "politically agreed upon order for states to make tax claims regarding the global income of large multinational enterprises." However, although not entirely clear from his articles, it seems that he does not share Avi-Yonah's view as regards pillar 2 having obtained the status of customary international law. *See* Magalhães, *supra* note 29; Christians and Magalhães, *supra* note 44.

[53] Debelva and De Broe, *supra* note 34; VanderWolk, "The UTPR Is Far From Becoming Part of Customary International Tax Law," *Tax Notes Int'l*, Nov. 28, 2022, p. 1069; Lennard, *supra* note 35.

[54] VanderWolk, *supra* note 53. Lennard seems to concur with this view. Lennard, *supra* note 35.

[55] Debelva and De Broe, *supra* note 34.

[56] *Id.*; Lennard, *supra* note 35.

[57] VanderWolk, *supra* note 53; VanderWolk, "Gone Wild," *supra* note 48.

[58] U.N. International Law Commission, "Draft Conclusions on Identification of Customary International Law, With Commentaries," A/73/10 (2018).

[59] *See generally* Lennard, *supra* note 35.

[60] *See generally* Szudoczky, *supra* note 42.

jurisdiction beyond the currently required personal or territorial link as a new (or new development in) customary international law, at least in their intra-EU relationships. However, the same cannot be said to apply in their relations with third-country jurisdictions, which is relevant because the UTPR under articles 12-14 of the pillar 2 directive, in principle, only applies to groups with UPEs in non-EU jurisdictions (because UPEs within the EU are subject to the IIR, unless covered by the exceptions in articles 49 and 50 of the pillar 2 directive). *Opinio juris* is to be sought not only regarding all jurisdictions engaging in the relevant practice (the EU member states), but also regarding those in a position to react to it (the jurisdictions that could be affected by the UTPR application under the pillar 2 directive). Characteristic of this uncertainty is the United States' position. On the one hand, Congress did not adopt the Build Back Better bill, which aimed to align U.S. rules with pillar 2. Further, in two letters, lawmakers highlighted their disagreement with the UTPR. On the other hand, the U.S. Treasury has welcomed the developments on pillar 2. Moreover, the UTPR will apply in EU member states no sooner than January 1, 2025. It is too early to say that customary international law has changed, because that change is dependent on the actual behavior of jurisdictions. These developments also demonstrate that state practice has a number of potential actors. Even within one state the different branches of government — the administration, which is represented in the OECD inclusive framework, and the legislature — might have different perspectives, which might make it even harder to identify a change in customary international law.

Potential Incompatibility

Customary international law and its potential incompatibility with the UTPR is an important parameter that should not be overlooked.

At a national level, a jurisdiction's constitution would be of leading relevance if a challenge to the UTPR were brought to court. Because customary international law is not published, a potential tension with the domestic legislation implementing the pillar 2 directive — and in particular the UTPR provisions contained therein — likely cannot render the latter inapplicable.[61]

At the EU level, as far as the relationship among the EU member states is concerned, the primacy of EU law has the consequence that EU member states cannot invoke customary international law to circumvent or escape obligations arising from the pillar 2 directive.[62] That is different from their relationship with third-country jurisdictions. Based on articles 3(5) and 19(1) of the Treaty on European Union and established case law of the CJEU, the powers of the EU and its institutions should be exercised in line with international law, including customary international law and international agreements, insofar as they codify customary rules of general international law. A measure adopted by virtue of those powers must be interpreted, and its scope limited, in light of the relevant rules of international law.[63] In particular, in its judgment in *ATAA*,[64] which concerned the compatibility of an EU directive with principles of customary international law relating to aviation, the CJEU ruled that there are two conditions that need to be met for an individual to rely on a principle of customary international law to challenge the validity of an act of an EU institution (such as the pillar 2 directive). First, the principle must be capable of calling into question the competence of the EU to adopt that act. Second, the act in question must be liable to affect rights that the individual derives from EU law or to create obligations under EU law in this regard. Even if both conditions are met, because a principle of customary international law does not have the same degree of precision as a provision of an international agreement, judicial review must be limited to whether, in adopting the act in question, the institutions of the EU made manifest

[61]Similar issues may arise in other jurisdictions. For a Canadian perspective, see, *e.g.*, Boidman, "Pillar 2 — The Ironic Circularity of the UTPR Debate," *Tax Notes Int'l*, Jan. 2, 2023, p. 29.

[62]*See, e.g.*, *Rewe-Handelsgesellschaft Nord mbH*, C-278/82 (CJEU 1984), para. 29.

[63]*Kadi and Al Barakaat International Foundation v. Council and Commission*, joined cases C-402/05 P and C-415/05 P (CJEU 2008), para. 291; *Intertanko and Others*, C-308/06 (CJEU 2008), para. 51; *Racke v. Hauptzollamt Mainz*, C-162/96 (CJEU 1998), para. 51; *Brita*, C-386/08 (CJEU 2010), paras. 41-42.

[64]*Air Transport Association of America and Others*, C-366/10 (CJEU 2011), paras. 107-111.

errors of assessment concerning the conditions for applying those principles.

Irrespective of whether the conditions set out by the CJEU in *ATAA* could be met and whether the legality of the pillar 2 directive could be challenged by virtue of its potential incompatibility with customary international law,[65] a potential judicial review would be restrained and limited to a manifest error test. That manifest error is, however, unlikely to be found.

Tax Treaty Law

A Rapidly Evolving Debate

Customary international law may change over time based on the actual behavior of states because it is based on principles rather than rules. This is different for tax treaties that are based on rules that allocate tax jurisdiction. Those rules can be invoked not only by states but, more importantly, also by taxpayers, who are the most important enforcers of tax treaty law in their domestic courts. Hence the question of the UTPR's compatibility with tax treaties is very important from a conceptual perspective, but even more so from a practical one.

As already mentioned, the OECD inclusive framework has expressed its view on this question only in the blueprint. The blueprint does not assume that the UTPR — in its previous form as a payments rule — infringes on tax treaties. The blueprint takes the position that the UTPR is merely an example of the principle that a state can — even as a party to a tax treaty — determine the taxable profits of residents and PEs of nonresidents in its territory according to its own domestic rules. This view, the inclusive framework argued, was confirmed by the saving clause of article 1(3) of the OECD model convention. Consequently, the UTPR would not violate articles 7 or 9 of the OECD model convention. It also would not go against the nondiscrimination rules in article 24 of the OECD model convention, because factors other than the residence of a payment recipient triggered the UTPR application. Since then, the inclusive framework has only restated — without any further elaboration — its view that the UTPR is compatible with tax treaties in the recently released administrative guidance on pillar 2, explicitly noting that the GLOBE rules are "designed so that the imposition of top-up tax in accordance with those rules will be compatible with the provisions" of the U.N. and the OECD model conventions.[66]

This 2023 restatement is likely connected to the relatively recent debate across tax and political circles on this precise question, which shows no signs of slowing down and continues to divide academics, practitioners, and politicians into two groups: the "UTPR Skeptics"[67] and the "UTPR Supporters" (sometimes also referred to as "Treaty Problem Deniers"[68]). A recent article by Angelo Nikolakakis and Jinyan Li provides a comprehensive overview of the different arguments the two groups raise,[69] including whether the UTPR:

- is a covered tax under tax treaties;
- is in line with tax treaty articles patterned after articles 7, 9, and 10(5) of the OECD model convention;
- can be protected by a saving clause patterned after article 1(3) of the OECD model convention or the unwritten principle presumably underlying this provision; and
- is in line with the tax treaty nondiscrimination article patterned after article 24 of the OECD model convention.

In the next section we explain our views of why the UTPR leads to a number of fundamental tax treaty problems.

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[65] *See also* Debelva and De Broe, *supra* note 34.

[66] OECD, *supra* note 17, executive summary, para. 2.

[67] There has been some semantical discussion about this notion and whether it should be seen to refer to those questioning the UTPR's ability to achieve the intended outcomes or to those in opposition to the UTPR for legal or ethical reasons (*see, e.g.*, Wardell-Burrus, "The Meaning of 'UTPR Skeptic': A Response to Nikolakakis and Li," *Tax Notes Int'l*, Feb. 20, 2023, p. 973). While there is certainly overlap between these groups, we will use the notion as referring largely to those who are skeptical of the UTPR with regard to its compliance with international law.

[68] *See* Nikolakakis and Li, *supra* note 33.

[69] *Id.*

The Fundamental Problem

Before we tackle this problem, let's take a step back and look at this question: Is the UTPR top-up tax collected under pillar 2 a covered tax under tax treaties? If the answer is no, then tax treaties — with the exception of the nondiscrimination article — cannot pose any challenge against the UTPR.

According to the majority view in the literature, any UTPR top-up tax collected should be regarded as an income tax within the broad meaning of article 2 of the OECD model convention.[70] In general terms, this position is clearly shared by the inclusive framework not only because tax treaty compatibility of the IIR and the UTPR was discussed in the pillar 2 blueprint[71] and restated in the administrative guidance on pillar 2, but also because the OECD has consistently argued that a treaty-based switchover rule is necessary to apply the IIR in the context of treaty-exempt PEs.[72] We see no reason to view the character of the top-up tax as a covered tax under article 2 of the OECD model convention differently depending on whether it is charged under the IIR or the UTPR. Recently, however, the view that the UTPR is not in the nature of an income tax, but rather an excise tax, has also been put forward.[73] The core of the argument seems to be that the top-up tax charged under a UTPR is unconnected to the income of the UTPR taxpayer, any income allocated to it, and any income tax liability of another entity.[74] Rather, it is argued, the UTPR top-up tax is "an arbitrary amount determined in part on income of an affiliate, in part on the affiliate's effective tax rate (ETR) in another country, and in part on apportionment metrics that take no account of the factors of the affiliate with the income and other affiliates in countries not applying the UTPR."[75] While this might be true, it is arguably not determinative, because the top-up tax — however charged under the IIR or UTPR — has its foundation in income and is determined as a "top-up" on the corporate income tax paid by LTCEs. Indeed, objections to the coverage by article 2 of the OECD model convention seem to struggle with the novelty of the pillar 2 concept being about the allocation of a top-up tax itself (and not of a tax base). Nonetheless, as stated earlier, irrespective of the formal aspects of how the tax is collected, the UTPR top-up tax is de facto a tax on the *foreign* income of a *foreign* LTCE (or, to be more precise, a substance-based share of a potentially multijurisdictional pool of foreign top-up taxes arising because of the low profit taxation of foreign MNE group entities)[76] charged to the UTPR taxpayer.[77] Therefore, in our view, the discussion on compatibility of the UTPR with tax treaties is a legitimate one.

The problem of pillar 2 in general, and of the UTPR in particular, is that they pursue objectives that are fundamentally different from those pursued by the existing tax treaty framework.[78] A main objective of tax treaties is the avoidance of double taxation in order to reduce tax obstacles to cross-border services, trade, and investment.[79] To this end, under provisions patterned after articles 7 and 10(5) of the OECD model convention, a tax treaty allocates tax jurisdiction to one or both of the contracting states with the obligation for the residence state to resolve any remaining double taxation. In accordance with article 9 of the OECD model convention, the profits of undertakings are

[70] De Broe, "Some EU and Tax Treaty Law Considerations on the Draft EU Directive on Global Minimum Taxation for Multinationals in the Union," 50(12) *Intertax* 874 (2022). In this respect, see Ana Paula Dourado, "The Pillar Two Top-Up Taxes: Interplay, Characterization, and Tax Treaties," 50(5) *Intertax* 388 (2022); J.R. Goudsmit and L.C. van Hulten, "Pijler 2: enkele verdragsaspecten," WFR 2023/41. The Netherlands has also taken this view; see Tweede Kamer, Kamerstukken II (explanatory memorandum), 22112, no. 3339, at 5 (2021-2022). Avi-Yonah implicitly takes this view. *See* Avi-Yonah, *supra* note 43.

[71] Admittedly, however, at a stage when the UTPR was still an undertaxed *payments* rule.

[72] *See, e.g.*, OECD, *supra* note 12, at para. 72; OECD, *supra* note 14, at paras. 21 and 677; and article 2, no. 2 of the commentary to the OECD model rules.

[73] *See* Christians and Stephen E. Shay, "The Consistency of Pillar 2 UTPR With U.S. Bilateral Tax Treaties," *Tax Notes Int'l*, Jan. 23, 2023, p. 445.

[74] *Id.*

[75] *Id.*

[76] While Nikolakakis and Li seem to implicitly agree with this view, they also mention in their article that the UTPR top-up tax is in effect a coercion measure, and that forms the basis for an argument that it does not impose a tax but an economic sanction for the fact that another jurisdiction does not impose the tax. *See* Nikolakakis and Li, *supra* note 33. In a similar spirit, Boidman calls the UTPR "an invalid expropriation or illegal confiscation." Boidman, *supra* note 8.

[77] On the UTPR taxpayer, see, *e.g.*, article 12 of the pillar 2 directive.

[78] *See also* Li, "The Pillar 2 Undertaxed Payments Rule Departs From International Consensus and Tax Treaties," *Tax Notes Int'l*, Mar. 21, 2022, p. 1401; Maarten F. de Wilde, "Why Pillar Two Top-Up Taxation Requires Tax Treaty Modification" (2022).

[79] *See* introduction to the OECD model convention, para. 15.2.

allocated in accordance with the arm's-length principle, which broadly says that the right to tax business profits should be allocated to the state where value is created.[80] At the same time, the preamble to the OECD model convention (after the BEPS project) clarifies that tax treaties do not intend to create opportunities for nontaxation or reduced taxation through tax evasion or avoidance. Still, tax treaties generally allow tax competition and nontaxation or reduced taxation in the absence of tax avoidance in the state where value is actually created.

CFC rules, which apply in abusive situations not remedied by article 9 of the OECD model convention, in principle align with these objectives.[81] This is because they aim at reintegrating in the residence state of the parent entity — the state of value creation — profits that have been artificially diverted from the domestic tax base of that state to the state of a low-tax subsidiary. According to paragraph 13 of the OECD model commentary on article 7, this "does not reduce the profits of the enterprise of the other State and may not, therefore, be said to have been levied on such profits."

The pillar 2 rules, however, pursue a fundamentally different objective of limiting tax competition. As Maarten F. De Wilde puts it, under pillar 2, the principle of taxing where value is created is supplemented by the rule that corporate profits must be taxed at a minimum rate, regardless of their geographic origin. Unrestricted tax competition for corporate investments is no longer permitted because taxation below the minimum level should no longer be within the "autonomous area of competences of the jurisdiction(s) concerned."[82] This is also reflected in the operation of the UTPR,[83] which imposes a top-up tax on the low-taxed profits of foreign LTCEs that have been determined in compliance with the arm's-length principle. In doing so, the UTPR does not rely on traditional links underlying the application of CFC rules (and the IIR), such as direct or indirect ownership or control, that also imply economic entitlement to the profits,[84] but merely requires membership of the same MNE group as defined under accounting standards.

As a result, pillar 2 is bound to create friction with existing tax treaties, especially with articles 7 and 9 of the OECD model convention, which enshrine the original, value-creation-oriented profit attribution rules to subsidiaries and PEs under the arm's-length principle. The pillar 2 blueprint has argued that a denial of deduction of payments under the previous version of the UTPR merely determines the profit tax calculation for the entity (or entities) resident in the UTPR jurisdiction. This, however, can no longer be held under the current version of the UTPR that calls for domestic rules that can go far beyond the non-deduction of intragroup payments and can even be implemented as a separate tax.

The Saving Clause

The saving clause has its origin in the U.S. treaty practice and was mainly intended to safeguard U.S. taxing rights over U.S. nationals living abroad.[85] Article 1(3) of the OECD model convention reads:

> This Convention shall not affect the taxation, by a Contracting State, of its residents except with respect to the benefits granted under paragraph 3 of

[80] Particularly for article 9(1) of the OECD model convention, the view has been that, if applicable, it will prevent a UTPR top-up tax charge. *See* Vikram Chand, Alessandro Turina, and Kinga Romanovska, "Tax Treaty Obstacles in Implementing the Pillar Two Global Minimum Tax Rules and a Possible Solution for Eliminating the Various Challenges," 14(1) *World Tax J.* 3 (2022). Conversely, it has also been argued that it serves as a provision that merely quantifies profits for purposes of article 7 of the OECD model convention (and restricts this quantification by the arm's-length principle) and was already effectuated before application of the UTPR. *See* Christians and Shay, *supra* note 73.

[81] *See also* commentary on article 1 of the OECD model convention, at para. 81. However, tax treaty compatibility of CFC rules is not universally accepted. *See* De Broe, *supra* note 70; Goudsmit and van Hulten, *supra* note 70.

[82] De Wilde, *supra* note 78, at para. 4.

[83] *See* VanderWolk, "Gone Wild," *supra* note 48; Nikolakakis, "Bait and Switch — A Reply to Casey Plunket," *Tax Notes Int'l*, Apr. 11, 2022, p. 191; Dourado, *supra* note 70; Debelva and De Broe, *supra* note 34; de Wilde, *supra* note 78; Goudsmit and van Hulten, *supra* note 70; and Szudoczky, *supra* note 42. Some authors do not completely agree with this view. *See* Schler, *supra* note 46; and Christians and Magalhães, *supra* note 44.

[84] The term "direct or indirect economic entitlement" to the profits has been criticized as "new expressions with no record in the available international tax law literature or the official sources of international law." Magalhães and Christians, *supra* note 42.

[85] Alexander Rust, "Article 1 at m.no. 63" in *Klaus Vogel on Double Taxation Conventions* (2022).

> Article 7, paragraph 2 of Article 9 and Articles 19, 20, 23 [A] [B], 24, 25 and 28.

As a starting point, it should be noted that article 1(3) of the OECD model convention does not apply to nonresidents. To the extent that the UTPR leads to taxation of a nonresident taxpayer by virtue of a PE being part of an MNE group under the pillar 2 rules, article 1(3) of the OECD model convention cannot be invoked to safeguard taxation.[86] As a second point, paragraph 18 of the OECD model commentary on article 1 clearly states that article 1(3) of the OECD model convention still restricts a contracting state's right to tax its residents "where this is intended and lists the provisions with respect to which that principle is not applicable."

Even article 11(1)(j) of the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting, which, among other things, aims for the multilateral implementation of the saving clause, excludes from the saving clause treaty provisions that "otherwise expressly limit a Contracting Jurisdiction's right to tax its own residents or provide expressly that the Contracting Jurisdiction in which an item of income arises has the exclusive right to tax that item of income." The explanatory statement to the MLI clarifies that this saving clause is based on article 1(3) of the OECD model convention as set out in paragraph 63 of the BEPS action 6 final report. The BEPS action 6 report states that the principle behind the saving clause:

> should be applicable to the vast majority of the provisions of the Model Tax Convention in order to prevent interpretations intended to circumvent the application of a Contracting State's domestic anti-abuse rules (as illustrated by the example of controlled foreign companies rules). This corresponds to the practice long followed by the United States in its tax treaties, where a so-called "saving clause" confirms the Contracting States' right to tax their residents (and citizens, in the case of the United States) notwithstanding the provisions of the treaty except those, such as the rules on relief of double taxation, that are clearly intended to apply to residents.

It must be concluded that article 1(3) of the OECD model convention is primarily intended to prevent interpretations of the tax treaty that would circumvent the application of a contracting state's domestic antiabuse rules, such as CFC rules.[87] The other two examples provided in paragraphs 61 and 62 of the OECD BEPS action 6 report relate to partners in a hybrid partnership and to U.S. citizens living outside of the United States. A teleological interpretation of article 1(3) of the OECD model convention leads to the conclusion that it is aimed at providing the "real" or "economic" residence jurisdiction, in a top-down approach, with a taxing right on income earned in another jurisdiction.[88] This is clearly evidenced by the fact that neither article 7(1) nor article 9(1) of the OECD model convention is listed among the exceptions from the saving clause.

The same rationale, however, cannot be applied to the UTPR: It does not depend on a top-down approach, direct or indirect ownership, (deemed) control, or (indirect) economic entitlement to profits; and the UTPR jurisdiction that is allocated a UTPR top-up tax typically has no real link to the generation of the income that gave rise to the tax. Arguably, and unlike CFC rules or the IIR, the UTPR "cannot be defended as a tax imposed on a resident shareholder's participation in the ownership of a subsidiary."[89] This perspective is obviously shared in the aforementioned letter to the Treasury secretary that concludes that "this type of extraterritorial taxation is not permitted under Article 7 (or any other Article) of U.S. bilateral tax treaties," all of which contain a saving clause.

It should be noted, however, that this conclusion is heavily discussed because the UTPR

[86] *See, e.g.*, Avi-Yonah, *supra* note 43; Nikolakakis and Li, *supra* note 33.

[87] *See also* Li, *supra* note 78; VanderWolk, "Tax Treaties Pose Problems for the UTPR," *Tax Notes Int'l*, Oct. 3, 2022, p. 29; VanderWolk, "Much Ado About Pillar 2," *Tax Notes Int'l*, Nov. 14, 2022, p. 821; Dourado, *supra* note 70. For a more cautious approach, see De Broe, *supra* note 70.

[88] *See* Georg Kofler, "Some Reflections on the 'Saving Clause,'" 44(8/9) *Intertax* 574 (2016).

[89] *See, e.g.*, David G. Noren, "Modifying Bilateral Income Tax Treaties to Accommodate Pillar Two UTPR Rules," 63 *Tax Mgmt. Mem.* 25 (Dec. 5, 2022).

raises the novel issue of downward or sideward taxation. The debate has intensified recently about the tax treaty compatibility of the UTPR in light of an explicit saving clause (modeled after article 1(3) of the OECD model convention) or the presumably underlying unwritten principle.[90] While some reflect on the (largely accepted) permissibility of CFC rules under tax treaties and argue that a residence jurisdiction's right to tax under a UTPR is likewise not hindered by a tax treaty, especially in light of a saving clause,[91] others distinguish between CFC rules (and perhaps the IIR) and the UTPR and argue that neither article 1(3) of the OECD model convention nor the general principle supposedly underlying this provision can cover bottom-up taxation of profits of any entity just because it belongs to the same MNE group.[92]

We share the latter perspective. A rule that would allow a jurisdiction to increase the domestically collected tax by de facto taxing nondomestic profits of any foreign MNE group entity or PE to which there is a remote MNE group link would contradict the idea of any treaty-based profit attribution that aims to protect taxpayers against double taxation. A proper construction of the current state of tax treaties does not allow a taxpayer's residence jurisdiction to tax arm's-length profits of its shareholders or other related entities just because they belong to the same MNE group under accounting standards. Indeed, a different reading would mean that a saving clause would enable states "to subject any taxable group entity to corporate tax on effectively the worldwide profits of the multinational firm involved — . . . on any arbitrarily founded taxable basis or . . . — without any restriction under the tax treaties concluded."[93] This reading would, however, render tax treaties meaningless, implying that a "reasonable interpretation of the saving clause must restrain its scope by limiting its application to income that has some meaningful connection to the taxing jurisdiction."[94] We also do not share the view that the UTPR might be likened to CFC rules, because they have quite different underlying concepts. CFC rules follow a top-down approach, typically require some form of control, and are conceptually based on indirect economic entitlement so that they might be viewed as leading to a direct tax on indirect income, none of which is true for the UTPR. Further, and unlike CFC rules, the UTPR is neither about traditional antiavoidance or income shifting nor about base erosion (as could have been argued for a "payments rule").

This is further emphasized by the bilateral nature of tax treaties. The UTPR is applied to all LTCEs across an MNE group as a whole. It is unclear to which LTCE's profits a UTPR applies, and therefore which saving clause of which tax treaty could allow a jurisdiction to apply its UTPR. Indeed, "the UTPR imposes a proportionate share of a total top-up tax liability from pooling together all the undertaxed excess profits from undertaxed jurisdictions of the multinational enterprise. . . . This pooling effect means that one cannot necessarily 'trace' from the undertaxed profits of an enterprise in an undertaxed jurisdiction to the UTPR liability."[95] While some argue that this pooling speaks against treaty applicability to the UTPR,[96] we find that it

[90] *See* article 1, no. 18 of the commentary on the OECD model convention; and OECD, "Preventing the Granting of Treaty Benefits in Inappropriate Circumstances, Action 6 — 2015 Final Report" (2015), especially para. 59 regarding changes to the commentary on the OECD model convention, and para. 54 on the rejection of the argument that "Article 7 and/or Article 10(5) prevent the application of CFC rules."

[91] *See, e.g.*, Schler, *supra* note 46; Avi-Yonah, *supra* note 43; Avi-Yonah, *supra* note 41; Picciotto, "Justifying the UTPR: Nexus and Economic Connection," *Tax Notes Int'l*, Nov. 7, 2022, p. 667; Picciotto, "Rebutting the Logic of UTPR Skeptics," *Tax Notes Int'l*, Dec. 12, 2022, p. 1371; Picciotto, "UTPR Critics," *supra* note 44; Magalhães, *supra* note 29; Magalhães, "UTPR Opposition: A Game of Whack-a-Mole," *Tax Notes Int'l*, Dec. 19, 2022, p. 1531. *See also* Wardell-Burrus, *supra* note 43; Wardell-Burrus, "The UTPR as a Rule of Recognition," *Tax Notes Int'l*, Dec. 19, 2022, p. 1527; Christians and Shay, *supra* note 73.

[92] *See, e.g.*, Dourado, *supra* note 70; Noren, *supra* note 89; VanderWolk, "Much Ado," *supra* note 87; VanderWolk, "Tax Treaties," *supra* note 87; VanderWolk, "Need for Nexus," *supra* note 48; VanderWolk, "The UTPR Is Flawed: A Response to Prof. Picciotto," *Tax Notes Int'l*, Oct. 17, 2022, p. 285; VanderWolk, "Inconsistent," *supra* note 48; VanderWolk, "A Reply," *supra* note 48; VanderWolk, "Gone Wild," *supra* note 48; Li, *supra* note 78; de Wilde, *supra* note 78; Goulder, *supra* note 48; Goulder, "Old Man Yells at Clouds and Other Responses to the UTPR," *Tax Notes Int'l*, Jan. 2, 2023, p. 157; Goulder, "Pillar 2 and Tax Treaties: MLI, Where Art Thou?" *Tax Notes Int'l*, Nov. 7, 2022, p. 775; Michael Lebovitz et al., "If Pillar 1 Needs an MLI, Why Doesn't Pillar 2?" *Tax Notes Int'l*, Aug. 29, 2022, p. 1009; Szudoczky, *supra* note 42; Goudsmit and van Hulten, *supra* note 70; Nikolakakis and Li, *supra* note 33.

[93] De Wilde, *supra* note 78. *See also* Szudoczky, *supra* note 42.

[94] Szudoczky, *supra* note 42.

[95] Wardell-Burrus, *supra* note 43. *See also* Goulder, "MLI, Where Art Thou?" *supra* note 92.

[96] Wardell-Burrus, *supra* note 43; Goulder, "MLI, Where Art Thou?" *supra* note 92.

shows that too little thought by the inclusive framework has been put into the treaty question raised by the current form of the UTPR.

Considering all this, neither article 1(3) of the OECD model convention nor the general principle supposedly underlying it can truly safeguard the UTPR from a tax treaty standpoint. Finally, it should be noted that many jurisdictions have made a reservation to article 11 of the multilateral convention, and their tax treaties generally do not contain a provision similar to it. That said, it seems doubtful that these states would accept an unwritten general principle that tax treaties would not limit a residence state's taxing rights if the wording of a treaty would not provide so.

Nondiscrimination

Besides articles 7 and 9 of the OECD model convention, the tax treaty nondiscrimination article is of particular importance, especially against the background of the discussion on whether the UTPR top-up tax is a covered tax. Even if the answer to that question is negative, the nondiscrimination article in tax treaties patterned after article 24 of the OECD model convention would still be applicable, because the latter is not limited to covered taxes.

Two paragraphs of article 24 of the OECD model convention are of potential relevance.[97] Paragraph 3 prohibits a more burdensome treatment of a PE of a foreign enterprise that is located in that contracting state as compared with the treatment of a local enterprise. Arguably, the UTPR would not apply differently in those two situations because both a local PE and a local entity are considered constituent entities for the purposes of the pillar 2 rules and might be subject to the UTPR.[98]

The analysis might be more complicated for article 24(5) of the OECD model convention, which "forbids a Contracting State to give less favourable treatment to an enterprise, the capital of which is owned or controlled, wholly or partly, directly or indirectly, by one or more residents of the other Contracting State."[99] At first glance, the difference in treatment seems obvious under the UTPR: A foreign-parented MNE group entity would be subject to the UTPR, while a domestically owned subsidiary would not. But is this discriminatory? Some have argued so,[100] whereas others have tried to show that those situations are not comparable.[101] This comparison might seem slightly artificial in a two-jurisdiction setting because it assumes the applicability of the IIR in domestic situations.[102] Allison Christians and Stephen E. Shay focus their analysis on a multiple-jurisdiction comparison involving an LTCE in a third state (under the assumption that the U.S. UPE is not subject to the IIR):

> A local corporation that is a member of a locally parented MNE group that has a low-taxed constituent entity in a third country would not be subject to the UTPR because its UPE would pay the top-up tax under the IIR, but a U.S.-parented local corporation would be subject to the UTPR because the U.S. group would not pay top-up tax under an IIR. In that case, application of the UTPR by the treaty partner to a U.S.-owned resident constituent entity should not be considered discriminatory because the corporations being compared are in different circumstances. In other words, a constituent entity of an MNE group parented from a non-pillar 2 country is not in the same circumstances as a constituent entity of an MNE group parented from a pillar 2 country.[103]

Overall, Christians and Shay conclude that the MNE group entity is in different circumstances depending on where the UPE is established[104] — an argument resembling the blueprint's analysis

[97] Compatibility with article 24(4) of the OECD model convention, which was also addressed by the blueprint, has lost its relevance as a result of the UTPR no longer being a payments rule, but a profits rule. For an analysis, see Chand, Turina, and Romanovska, *supra* note 80.

[98] *See also* Christians and Shay, *supra* note 73.

[99] See article 24, no. 76 of the commentary on the OECD model convention.

[100] *See, e.g.*, Li, *supra* note 78.

[101] Christians and Shay, *supra* note 73.

[102] As is, for example, prescribed in article 5 of the pillar 2 directive, but not in the OECD model rules.

[103] Christians and Shay, *supra* note 73.

[104] *Id.*

of the undertaxed *payments* rule in light of article 24(4) of the OECD model convention.[105] Indeed, the question will boil down to the comparability of situations and whether the application of the IIR at the parent level can offset the application of the UTPR at the level of a foreign-owned local subsidiary. This combined perspective, however, seems to have so far been rejected by the OECD (in the context of tax consolidation) because it "would require comparing the combined treatment of a resident enterprise and the nonresident that owns its capital with that of a resident enterprise of the same State and the resident that owns its capital, something that clearly goes beyond the taxation of the resident enterprise alone."[106] Also, there are further nuances that might raise doubts regarding article 24(5) of the OECD model convention. This might be of particular importance in the context of minority shareholdings, because the top-up tax amount charged under the IIR might differ from the one charged under the UTPR in cases in which the LTCE is not wholly owned by the MNE group.[107] The possible incompatibility of the UTPR with article 24(5) of the OECD model convention certainly deserves a closer and case-by-case examination and cannot be outright excluded.

The Special Case of EU Member States

The CJEU has held "that the provisions of a convention between two member states cannot apply in the relations between those States if they are found to be contrary to the rules of the Treaty" on the Functioning of the European Union.[108] In other words, the provisions of a convention among EU member states are applicable insofar as they are compatible with the EU treaties. As Advocate General Melchior Wathelet has observed, this is consistent with article 30(3) of the Vienna Convention on the Law of Treaties, which states that "when all the parties to the earlier treaty are parties also to the later treaty but the earlier treaty is not terminated or suspended in operation under Article 59, the earlier treaty applies only to the extent that its provisions are compatible with those of the later treaty."[109] Following the same logic, and as also implied by article 351 TFEU, the supremacy of EU law also applies with regard to secondary EU law, such as the pillar 2 directive, which clearly has the objective of being applied notwithstanding any tax treaties in place. Consequently, the pillar 2 directive takes precedence over tax treaties among the EU member states, all of which have agreed to the pillar 2 directive (article 115 TFEU).

EU member states, however, remain bound to their tax treaties with third-country jurisdictions, which, in turn, are not bound by EU law. This potential conflict is addressed by article 351 TFEU, which states that treaty obligations of EU member states from before their accession into the EU shall principally not be affected by the EU treaties. The question arises whether this provision may be applied by analogy to the situation of a conflict between a domestic law of an EU member state implementing the pillar 2 directive on the one hand, and a tax treaty between that EU member state and a third-country jurisdiction on the other hand. It remains unclear if and under what conditions an EU member state's post-accession tax treaties with third-country jurisdictions would be covered through a *mutatis mutandis* application of article 351 TFEU if those tax treaties had been compliant with EU law at the time of their conclusion but became substantively incompatible with a

[105] *See* pillar 2 blueprint, para. 691.

[106] See article 24, no. 77 of the commentary to the OECD model convention.

[107] This is indeed relevant in non-partially-owned parent entities cases of less than 100 percent ownership in the LTCE. For example, in the two-entity scenario above, if the UPE were to own 81 percent of the MNE group entity, the IIR would only apply the proportionate share of top-up tax (that is, 81 percent under article 2.1 of the OECD model rules and article 9 of the pillar 2 directive), while the UTPR would apply to 100 percent of the top-up tax (articles 2.4 and 2.5 of the OECD model rules and article 14 of the pillar 2 directive).

[108] *Ravil*, C-469/00 (CJEU 2003), para. 37.

[109] Opinion of AG Wathelet in *Achmea*, C-284/16 (2017), para. 47, quoting the Vienna Convention on the Law of Treaties. Compare also *Matteucci*, C-235/87 (CJEU 1988), para. 22; *Commission v. Italy*, C-10/61 (CJEU 1962), para. IIB; and *Walder*, C-82/72 (CJEU 1973), para. 8.

subsequent directive.[110] It is similarly unclear if the caution the European Commission uses not to interfere with tax treaties with third countries in some of its proposals[111] is an argument for or against an analogous application of article 351 TFEU. Arguably, however, the EU law principles of legal certainty, fiscal legality, and respect for the international commitments of the EU member states imply that tax treaties with third-country jurisdictions can indeed stand in the way of an unfettered application of the pillar 2 directive, and especially the UTPR, because a different understanding would indeed lead to a wholesale, EU-mandated treaty override even in a situation in which the use of an EU competence was hardly foreseeable.[112]

Additional Remarks

This section has shown that the UTPR in its current form likely violates tax treaties. It has also been concluded that, in light of the pillar 2 directive, taxpayers cannot rely on tax treaties concluded among EU member states. Against the background of article 351 TFEU, they should, in our view, be able to rely on tax treaties concluded between an EU member state and a third-country jurisdiction before the adoption of the pillar 2 directive. However, it should be noted that in the overall setup of pillar 2, the inability of one state to apply the UTPR would not prevent other states from applying it (for example, because of a tax treaty override under their domestic laws) and thus gaining a larger portion of top-up tax.[113] Depending on the concrete MNE group, treaty-based challenges might be moot from the perspective of the burdened group.

EU Law

Fundamental Freedoms

The pillar 2 rules apply to MNE groups, which are defined as collections of entities "that are related through ownership or control" and consolidated, for example, under international financial reporting standard 10 or similar rules,[114] including situations involving foreign PEs.[115] By design, the pillar 2 rules thus apply to so-called

[110]That issue was explicitly left open in the opinion of AG Kokott in *Commune de Mesquer v. Total France SA*, C-188/07 (2008), paras. 94-98. Those favoring this analogy include Rust, "Controlled Foreign Company Rule (Articles 7 and 8 ATAD)" in *A Guide to the Anti-Tax Avoidance Directive* 174, 182-183 (2020); Ilaria Panzeri, "Tax Treaties Versus EU Law: Which Should Prevail?" 61(4) *European Taxation* 147 (2021). Compare this analogy, *e.g.*, with Allan Rosas, "The Status in EU Law of International Treaties Concluded by EU Member States," 34(5) *Fordham Law J.* 1304 (2011); De Broe, *supra* note 70. For a discussion of the various arguments for and against precedence of tax treaties in scholarship, see, *e.g.*, Paolo Arginelli, "The ATAD and Third Countries" in *The External Tax Strategy of the EU in a Post-BEPS Environment* 187-218 (2019); Isabella M. de Groot, "Implementation of the Controlled Foreign Company Rules in the Netherlands," 47(8/9) *Intertax* 770 (2019); Werner Haslehner, "The General Scope of the ATAD and Its Position in the EU Legal Order" in *A Guide to the Anti-Tax Avoidance Directive* 32-65; Kofler, "Legislative Tax Treaty Overrides in Austrian, German, and EU Law," 67 *Brit. Tax Rev.* 64 (2022). For extensive analysis and further references see Valentin Bendlinger, "Art 351 TFEU: The Relation of International Agreements of the Member States to the Provisions of the Treaties" in *Smit & Herzog on the Law of the European Union* section 351.04[3][d] (2022).

[111]*See, e.g.*, article 53 of the European Commission's proposal for a common corporate tax base, COM(2016) 685, under which the switchover clause would "not apply where a convention for the avoidance of double taxation between the member state in which the taxpayer is resident for tax purposes and the third country where that entity is resident for tax purposes does not allow switching over from a tax exemption to taxing the designated categories of foreign income." Another example is the commission's proposal for a significant digital presence (European Commission, "Proposal for a Council Directive Laying Down Rules Relating to the Corporate Taxation of a Significant Digital Presence," COM(2018) 147 final (Mar. 21, 2018)), where article 2 specifies that the directive would, "in the case of entities that are resident for corporate tax purposes in a third country with which the particular Member State in question has a convention for the avoidance of double taxation," only apply "if that convention includes provisions similar to Articles 4 and 5 of this Directive in relation to the third country and those provisions are in force." Complementing this delimitation of the directive's scope, the commission has simultaneously issued a recommendation that member states (bilaterally) amend their tax treaties with third countries and include provisions on significant digital presences (see European Commission, "Commission Recommendation Relating to the Corporate Taxation of a Significant Digital Presence," C(2018) 1650 final (Mar. 21, 2018)). Another example is article 9(5) of the second antiavoidance directive (Council Directive (EU) 2017/952), which generally provides that, "to the extent that a hybrid mismatch involves disregarded permanent establishment income which is not subject to tax in the Member State in which the taxpayer is resident for tax purposes, that Member State shall require the taxpayer to include the income that would otherwise be attributed to the disregarded permanent establishment," but also postulates that this does not apply if "the Member State is required to exempt the income under a double taxation treaty entered into by the Member State with a third country."

[112]Indeed, it is sometimes argued that the *mutatis mutandis* application of article 351 TFEU should only apply to the extent that the accumulation of competence by the Union was not foreseeable at the time the respective treaty in conflict had been concluded (for an extensive review of literature, see Bendlinger, *supra* note 110). Given the nearly unlimited breadth of the EU's internal market competence under article 115 TFEU, which the EU shares with the EU member states, however, one should not automatically assume that EU legislation is always and automatically "foreseeable," especially with regard to concepts as the fast-evolved GLOBE rules. *Id.*

[113]If there is more than one UTPR jurisdiction, the nontaxing UTPR jurisdiction will not receive any UTPR allocation (article 2.6.3 of the OECD model rules and article 14(8) of the pillar 2 directive) — that is, the "UTPR pie" would be divided among the other UTPR jurisdictions (because they can override tax treaties in their constitutional frameworks).

[114]Article 1.2.2 of the OECD model rules and article 3(3)(a) of the pillar 2 directive.

[115]Article 1.2.3 of the OECD model rules and article 3(3)(b) of the pillar 2 directive.

control situations. From an EU law perspective, this means that the scope relates exclusively to the freedom of establishment (articles 49 and 54 TFEU), which, among other things, protects the cross-border establishment of PEs and subsidiaries and generally relates to shareholdings that enable the holder to exert a definite influence on the company's decisions and to determine its activities.[116] While it is true that the control required for consolidation does not necessarily require a majority shareholding, the CJEU's case law does not require it to assume a definite influence[117]; rather, the CJEU looks to distinguish purely financial investments from those made with the "intention to influence the management and control of the undertaking."[118]

Within its territorial, EU-limited scope, the freedom of establishment under article 49 TFEU allows resident subsidiaries to contest the restriction of a freedom of an EU parent company that is linked to it insofar as that restriction affects its own taxation.[119] This protection also extends to the European Economic Area (specifically, article 31 of the EEA Agreement). Focusing on the UTPR, the EU freedom of establishment would theoretically be triggered when the EU MNE group entity is owned by a parent company resident in another EU/EEA member state,[120] whether or not the UPE is also resident in an EU member state.[121] A typical case might be when an LTCE in an EU member state has exercised its freedom to establish an MNE group entity in another EU member state.

Viewed in isolation and without regard to the pillar 2 directive, the OECD's pillar 2 rules would indeed contain multiple areas of potential friction with the EU's freedom of establishment:[122] Under the UTPR, domestic MNE group entities (for example, subsidiaries or PEs) might face a higher tax burden than domestic enterprises simply because they are part of an MNE group with worldwide revenues in excess of €750 million that has LTCEs in low-tax jurisdictions (triggering UTPR top-up tax, unless another jurisdiction picks up the top-up tax via an IIR or a QDMTT). A higher tax burden on the domestic MNE group entity would be in obvious tension with decisions by the CJEU finding that higher tax rates on PEs of nonresidents infringe on the freedom of establishment (for example, *Royal Bank of Scotland*[123] and *CLT-UFA*[124]). Likewise, the CJEU has not accepted detrimental tax treatment of cross-border transactions based on foreign low taxation or nontaxation of some payments (for

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[116] For the exclusive application of the freedom of establishment, see, *e.g.*, Peter Koerver Schmidt, "A General Income Inclusion Rule as a Tool for Improving the International Tax Regime — Challenges Arising From EU Primary Law," 48(11) *Intertax* 983 (2020); Englisch and Johannes Becker, "Implementing an International Effective Minimum Tax in the EU" (2021); Englisch, "Non-Harmonized Implementation of a GloBE Minimum Tax: How EU Member States Could Proceed," 30(5/6) *EC Tax Rev.* 207 (2021); Johanna Hey, "Global Minimum Taxation (GloBE): What Is It About and What Could Be a European Answer?" in *Thinker, Teacher, Traveller: Reimagining International Tax — Essays in Honor of H. David Rosenbloom* 247-264 (2021); Arne Schnitger, "Die globale Mindestbesteuerung und deren unionsrechtliche Beurteilung" in *Besteuerung im Wandel* 169, 176 (2021) (in German); Schnitger, "Vereinbarkeit der Vorschläge zur Einführung von GloBE-Regelungen mit den Grundfreiheiten des AEUV," 31 *IStR* 741 (2022) (in German). *See also* part 6 of the preamble to the European Commission's proposal for a council directive on ensuring a global minimum level of taxation for multinational groups in the Union, COM(2021) 823 (and recital 6 in the preamble in Doc. 10497/22 (June 21, 2022) and in Doc. 8778/22 (Nov. 25, 2022)); Englisch and Becker, "International Effective Minimum Taxation — The GLOBE Proposal," 11(4) *World Tax J.* 483 (2019). Skeptical, however, João Félix Pinto Nogueira and Turina, "Pillar Two and EU Law" in *Global Minimum Taxation? An Analysis of the Global Anti-Base Erosion Initiative* (2020), argue that "control" that leads to consolidation does not necessarily require a "definite influence" so that (mainly) the freedom of capital movement should be applicable.

[117] Indeed, the CJEU has accepted the application of the freedom of establishment for shareholdings as low as 34 percent (*Société de Gestion Industrielle SA (SGI)*, C-311/08 (CJEU 2010), paras. 34 et seq.), or even 25 percent (*Lasertec*, C-492/04 (CJEU 2007), para. 21; and *Scheunemann*, C-31/11 (CJEU 2012), paras. 25 et seq.). For a discussion in light of the consolidation rules under the international financial reporting standards, see Nogueira and Turina, *supra* note 116; and Englisch and Becker, "Implementing," *supra* note 116.

[118] *See, e.g.*, *SECIL*, C-464/14 (CJEU 2016), para. 40; and *Gallaher Ltd.*, C-707/20 (CJEU 2023), para. 54 et seq.

[119] With regard to the freedom of establishment, see, for example, *Vodafone Magyarország Mobil Távközlési Zrt.*, C-75/18 (CJEU 2020), paras. 40-41, referring to *Felixstowe Dock and Railway Co. and Others*, C-80/12 (CJEU 2014), para. 23.

[120] With regard to the freedom of establishment, see, e.g., *Felixstowe Dock*, C-80/12, at para. 23; and *Vodafone*, C-75/18, at paras. 40-41.

[121] *See also* Englisch, "Is an METR Compatible With EU/EEA Free Movement Guarantees?" *Tax Notes Int'l*, Apr. 12, 2021, p. 219.

[122] For a detailed analysis of potential frictions with the EU fundamental freedoms in the case of a unilateral implementation of the OECD model rules by an EU member state, see the submission of our independent expert opinion by the American Chamber of Commerce in the Netherlands (Feb. 1, 2023).

[123] *Royal Bank of Scotland*, C-311/97 (CJEU 1999) (concerning higher taxation of PEs of nonresidents).

[124] *CLT-UFA*, C-253/03 (CJEU 2006) (concerning higher taxation of PEs of nonresidents).

example, *Eurowings*,[125] *Skandia*,[126] *SIAT*,[127] and *Lexel*[128]),[129] arguing that "such compensatory tax arrangements prejudice the very foundations of the single market."[130] Finally, the CJEU has rejected a minimum tax base that was applicable only to nonresidents (*Talotta*).[131] This case law aligns well with the CJEU's case law on CFC rules, under which foreign low taxation alone does not justify an immediate income inclusion at the level of the domestic parent entity (for example, *Cadbury Schweppes*,[132] *Olsen*,[133] and *X GmbH*[134]).

However, as will be shown below, the pillar 2 directive goes beyond the OECD model rules across several dimensions. One of them is that all EU member states must apply the IIR. It is hence only in exceptional cases that an EU member state would apply the UTPR to an entity whose parent is in another EU member state and charge the UTPR top-up tax. That situation might only arise, for example, because the EU member state of the UPE does not apply an IIR based on the temporary exception provided in article 50 of the pillar 2 directive. The UTPR is thus largely irrelevant in intra-EU situations.[135] Conversely, as stated above, when the parent company is resident in a third-country jurisdiction, the freedom of establishment under article 49 TFEU does not apply for territorial reasons, even if the UTPR would lead to a top-up tax relating to an LTCE in another EU member state.[136]

While the freedom of establishment under article 49 TFEU is limited to intra-EU situations, the freedom of capital movement under article 63 TFEU also extends to third-country jurisdictions. However, article 63 TFEU is only relevant with regard to national legislation intended to apply to shareholdings acquired solely with the intention of making an investment and without any intention to influence the management and control of the company.[137] As noted before, however, in light of the focus on control situations in the OECD model rules and the pillar 2 directive, it is generally argued that article 63 TFEU would and could not apply to pillar 2.[138] It is, however, unclear if the applicability of article 63 TFEU is excluded as a general matter in all situations, because the UTPR can also affect the earnings of minority shareholders. In the very simple case in which a UPE in a low-tax jurisdiction owns 81 percent of an EU MNE group entity that has to apply the pillar 2 directive, this EU MNE group entity would have to apply the UTPR to the total (100 percent) of the top-up tax arising on the earnings of its parent entity.[139] As a consequence, the 19 percent minority shareholders (that may be residents of other EU member states or third-country jurisdictions that have merely exercised their outbound freedom of capital movement) also, indirectly, face a higher

[125] *Eurowings*, C-294/97 (CJEU 1999) (concerning a trade tax exemption that is inapplicable to the lessee where the proprietor of the goods leased is established in another member state and is therefore not liable for the tax).

[126] *Skandia*, C-422/01 (CJEU 2003) (concerning the deduction of insurance premiums).

[127] *Société d'investissement pour l'agriculture tropicale SA (SIAT)*, C-318/10 (CJEU 2012) (concerning the nondeductibility of cross-border payments for supplies of services if the nonresident service provider is not subject to tax on income or is subject to an advantageous tax regime).

[128] *Lexel*, C-484/19 (CJEU 2021).

[129] See also — and with respect to distinguishing *Schempp*, C-403/03 (CJEU 2005), which concerned a domestic linking rule — Englisch, *supra* note 121; and Schnitger, "Die globale Mindestbesteuerung," *supra* note 116, at 179-180; further Nogueira, "GloBE and EU Law: Assessing the Compatibility of the OECD's Pillar II Initiative on a Minimum Effective Tax Rate With EU Law and Implementing It Within the Internal Market," 12(3) *World Tax J.* 465 (2020).

[130] *Eurowings*, C-294/97, at para. 45; *Skandia*, C-422/01, at para. 52.

[131] *Talotta*, C-383/05 (CJEU 2007).

[132] *Cadbury Schweppes*, C-196/04 (CJEU 2006).

[133] *Olsen*, joined cases E-3/13 and E-20/13 (EFTA 2014).

[134] *X GmbH*, C-135/17 (CJEU 2019).

[135] *See also* De Broe, *supra* note 70.

[136] See, by analogy, Opinion of Advocate General Leendert A. Geelhoed, *Test Claimants in the Thin Cap Group Litigation*, C-524/04 (CJEU 2006), paras. 95-96.

[137] According to the CJEU's more recent case law it is, therefore, national legislation, and not the facts, that determine which freedom is applicable in third-country situations. *See, e.g.*, *Test Claimants in the FII Group Litigation*, C-35/11 (CJEU 2012), para. 99; *Itelcar*, C-282/12 (CJEU 2013), paras. 16 et seq.; *Kronos International Inc.*, C-47/12 (CJEU 2014), paras. 37 et seq.; and *SECIL*, C-464/14, at para. 33.

[138] For the exclusive application of the freedom of establishment, see, *e.g.*, Schmidt, *supra* note 116; Englisch and Becker, "Implementing," *supra* note 116; Englisch, "Non-Harmonized," *supra* note 116; Hey, *supra* note 116; Schnitger, "Die globale Mindestbesteuerung," *supra* note 116, at 176; Schnitger, "Vereinbarkeit," *supra* note 116, at 741. *See also* recital 6 of the preamble to COM(2021) 823 (and recital 6 in the preamble in Doc. 10497/22 and Doc. 8778/22), *supra* note 116; Englisch and Becker, "International," *supra* note 116. Skeptical, however, Nogueira and Turina, *supra* note 116, argue that "control" that leads to consolidation does not necessarily require a "definite influence" so that (mainly) the freedom of capital movement should be applicable.

[139] Under articles 2.4 and 2.5 of the OECD model rules and article 14 of the pillar 2 directive. Also note that an IIR in a reversed constellation would only cover the proportionate share of the group — that is, 81 percent — under article 2.1 of the OECD model rules and article 9 of the pillar 2 directive.

tax burden on the profits resulting from their investment in the EU MNE group entity, which might deter them from investing.[140]

The OECD model rules and the pillar 2 directive give rise to many situations like this, in which the tax burden on mere portfolio investors might be increased. However, it seems doubtful whether this increase in the indirect tax burden truly is a relevant restriction under article 63 TFEU, because it is levied neither on the investors in the EU MNE group entity nor the profits distributed to them (but rather that entity's pretax profits),[141] nor is the discriminatory impact obvious (as domestic and foreign investors face the same increase in the indirect tax burden that was moreover not specifically caused by the minority investments). These situations certainly warrant closer examination[142] and would, if article 63 TFEU were found to be applicable, raise similar issues about the comparability and justification as discussed below.

The Role of the Pillar 2 Directive

The existence of the pillar 2 directive has silenced many concerns about a clash between pillar 2 and EU fundamental freedoms. The pillar 2 directive puts an obligation on EU member states to apply the IIR: It must be charged not only on foreign LTCEs (article 5(1)), but also, in principle, on the parent of an MNE group itself and all its domestic constituent entities,[143] and on a "large-scale domestic group" (article 5(2)), which is defined as "any group of which all constituent entities are located in the same Member State" (article 3(5)). The directive's provisions likewise cover partially owned parent entities and intermediate parent entities (articles 6-8). With regard to the UTPR, this has at least two interlinked effects:

- First, within the directive's scope, LTCEs established in a low-tax EU member state (including UPEs and partially owned parent entities, but also intermediate parent entities, unless covered by a qualified IIR somewhere else) are subject to the IIR top-up tax if the MNE group meets the €750 million revenue threshold. Purely domestic large-scale groups are also covered.
- Second, within the EU, and as a result of the priority of the IIR over the UTPR, the application of the UTPR in typical group structures is largely irrelevant and primarily reserved for third-country situations in which either the UPE itself is based in a low-tax jurisdiction or if it does not apply an IIR with regard to its LTCEs.[144] However, there is the potential exception of situations in which an EU member state opts not to apply the IIR for a period of time under the so-called Estonian clause (article 50 of the pillar 2 directive).[145]

Broadly speaking, the expansion of the OECD model rules to domestic situations is aimed at guaranteeing nondiscriminatory treatment of cross-border situations vis-à-vis domestic situations, if an MNE group meets the €750 million revenue threshold. Indeed, the pillar 2 directive's preamble notes that those rules are "designed to be compatible with the fundamental freedoms guaranteed by the Treaty on the Functioning of the European Union."[146] One might, however, still raise the argument of *factual*

[140]This, in principle, can constitute a "restriction" of the freedom of capital movement under article 63 TFEU. *See, e.g.*, *Adusbef and Others*, C-686/18 (CJEU 2020), para. 102.

[141]However, see *Commission v. Netherlands*, joined cases C-282/04 and C-283/04 (CJEU 2006), para. 27, concerning golden shares and the relevance of an impact on the value of shares for the free movement of capital.

[142]See Dourado, "Pillar Two From the Perspective of the European Union," 5 *Brit. Tax Rev.* 573 (2022), who argues for a restriction in conflict with article 63 TFEU that could, however, be justified with arguments of cohesion under the assumption that domestic, EU, and third-country MNE group entities will all be subjected to top-up taxes.

[143]This situation is mentioned in art. 2, para. 24 of the commentary to the OECD model rules commentary, where it is noted that art. 2.1.6 of the OECD model rules merely "requires the application of the IIR by the Parent Entity to Low-Taxed Constituent Entities that are located outside the implementing jurisdiction," but also "recognised, however, that some [inclusive framework] members may wish to extend the application of the IIR domestically in order to avoid discriminating between domestic and foreign Constituent Entities that are members of the same MNE Group."

[144]Articles 12 and 13 of the pillar 2 directive. *See also* De Broe, *supra* note 70.

[145]Article 50 of the pillar 2 directive provides EU member states with an option: Member states in which no more than 12 UPEs of groups within the scope of the pillar 2 directive are located may elect not to apply the IIR and the UTPR for six consecutive fiscal years beginning from December 31, 2023. However, in that case, the other EU member states must apply the UTPR to LTCEs in the EU member state that has made the election (article 50(2) of the pillar 2 directive). That said, from the perspective of the UTPR state and its *obligation* to charge top-up tax, the below analysis on the exhaustiveness of the harmonization remains unchanged.

[146]*See* recitals 4 and 6 of the pillar 2 directive's preamble.

discrimination because the extension to domestic situations might largely be formalistic (either because there will hardly be any LTCEs in a specific EU member state or because hardly any large-scale domestic groups exist in that state). Even if that factual discrimination existed, many hold that this would not amount to a prohibited infringement on the freedom of establishment.[147] The CJEU's case law in *Vodafone*[148] and *Tesco*[149] (and, regarding state aid, in *Commission v. Poland*[150] and *Commission v. Hungary*[151]) has dealt with turnover-based sectoral taxes with steeply progressive tax brackets, which most affected foreign-owned service providers. In those cases, the CJEU held that a turnover-based threshold is a neutral (rather than inherently discriminatory) criterion and did not find factual discrimination, irrespective of a legislature's potential discriminatory intent.[152] This reasoning, it is broadly argued, is transferable to the pillar 2 rules.[153]

There are, however, several angles on how *Vodafone* and *Tesco* could be distinguished from the issues of factual discrimination raised by an extension of the pillar 2 rules to domestic situations. First, *Vodafone* and *Tesco* only concerned domestic turnover, whereas the pillar 2 rules look at the worldwide revenues of the consolidated MNE group. Second, the acceptance of a revenue-based tax bracket structure in *Vodafone* and *Tesco* stands in a largely unexplained relationship with the CJEU's decision in *Hervis*,[154] in which it found a so-called aggregation rule under Hungarian law — according to which, for members of a group, the progressive tax was calculated based on the consolidated Hungarian turnover of all the linked taxable persons of the group (before division of the total tax in proportion to the turnover of each taxable person) — to infringe on the freedom of establishment.[155] Third, *Vodafone* and *Tesco* have accepted revenue-based thresholds as a neutral differentiation in light of revenue being a relevant indicator of a taxable person's ability to pay,[156] whereas the pillar 2 threshold refers to the MNE group's revenues (in *Hervis*, the CJEU even referred to the relevance of group turnover to the taxation of a single entity as a tax "on the basis of a fictitious turnover"[157]). While there might be good reasons to distinguish *Vodafone* and *Tesco* from the issue at hand, it should nevertheless be pointed out that at least the €750 million worldwide revenue threshold has found broad acceptance for scoping in EU law. For example, the €750 million threshold is utilized in the European Commission's proposal for a common consolidated corporate tax base,[158] the commission's proposal for a digital services tax,[159] country-by-country reporting,[160] and public country-by-country reporting.[161] This arguably shows that revenue-based thresholds are, in principle, acceptable based on the aims and objectives of the respective legal instruments.

[147] *See, e.g.*, Nogueira, *supra* note 129; Nogueira and Turina, *supra* note 116, at ch. 10.7.3; Englisch and Becker, "Implementing," *supra* note 116; Englisch, "Designing a Harmonized EU-GloBE in Compliance With Fundamental Freedoms," 30(3) *EC Tax Rev.* 136 (2021); Englisch, "Non-Harmonized," *supra* note 116; Dourado, "Is There a Need for a Directive on Pillar Two?" 50(6/7) *Intertax* 521, 526 (2022); De Broe, *supra* note 70; Dourado, "The Proposal for a EU Directive on Pillar Two: Critical Assessment" in *Rara Avis: Liber Amicorum Peter J. Wattel* 73, 79. *Contra* Schnitger, "Vereinbarkeit," *supra* note 116, at 744.

[148] *Vodafone*, C-75/18.

[149] *Tesco-Global Áruházak Zrt*, C-323/18 (CJEU 2020).

[150] *Commission v. Poland*, C-562/19 P (CJEU 2021).

[151] *Commission v. Hungary*, C-596/19 P (CJEU 2021).

[152] *See* CFE ECJ Task Force, "Opinion Statement ECJ-TF 2/2020 on the ECJ Decision of 3 March 2020 in *Vodafone Magyarország Mobil Távközlési Zrt*. (Case C-75/18) on Progressive Turnover Taxes," 60(12) *European Taxation* 555 (2020).

[153] *See, e.g.*, Englisch and Becker, "International," *supra* note 116 (however, limiting this conclusion to cases in which the IIR were to apply to all foreign and domestic subsidiaries regardless of the level of effective taxation); Nogueira, *supra* note 129; Nogueira and Turina, *supra* note 116, at ch. 10.8; Englisch, "Implementation of the GloBE Common Approach on Minimum Taxation by Individual EU Member States in Compliance With EU Fundamental Freedoms," *Steuerrechtliches Gutachten* (2021); Englisch and Becker, "Implementing," *supra* note 116; Englisch, "Designing," *supra* note 147; Englisch, "Non-Harmonized," *supra* note 116.

[154] *Hervis*, C-385/12 (CJEU 2014).

[155] For discussion, see CFE ECJ Task Force, *supra* note 152.

[156] *Vodafone*, C-75/18, at para. 49.

[157] *Hervis*, C-385/12, at para. 36.

[158] *See* article 2 of European Commission, "Proposal for a Council Directive on a Common Consolidated Corporate Tax Base (CCCTB)," COM(2016) 683 (Oct. 25, 2016).

[159] *See* article 4 of European Commission, proposal for a council directive on the common system of a digital services tax on revenues resulting from the provision of certain digital services, COM(2018) 148 (Mar. 21, 2018).

[160] Council Directive (EU) 2016/881 of May 25, 2016, amending Directive 2011/16/EU as regards mandatory automatic exchange of information in the field of taxation.

[161] Directive (EU) 2021/2101 of the European Parliament and of the Council amending Directive 2013/34/EU as regards disclosure of income tax information by certain undertakings and branches.

Even if some features of the pillar 2 directive turn out to be discriminatory in light of the freedom of establishment (which also applies to the EU legislature[162]), it is also established CJEU case law that the level of scrutiny shifts in light of EU legislation:

- First, if EU legislation has achieved so-called full harmonization that tightly aligns the domestic rules on a specific matter in all member states, a national measure "must be assessed in the light of the provisions of the harmonising measure and not those of the" TFEU.[163] Recent case law demonstrates that exhaustive harmonization not only relates to an "area,"[164] a "sector,"[165] a "sphere,"[166] a "matter,"[167] or a "field,"[168] but also to singular, mandatory rules if no downward or upward derogation is permitted from that "floor" or "ceiling," even if it is so-called minimum harmonization.[169] In the tax area, for example, the CJEU has found to be exhaustive not only the rules on indirect taxation of the raising of capital,[170] but also singular provisions of the VAT directive.[171] Arguably, the pillar 2 directive, which provides a stand-alone, mandatory set of rules for EU member states, could be considered exhaustively harmonized.
- Second, if exhaustive harmonization is achieved, national tax law will be tested against the secondary EU law it seeks to implement, but not against primary EU law.[172] The national measure must be assessed in the light of the provisions of the harmonizing measure and not those of the TFEU.[173] The issue then becomes a question of validity of secondary EU law (articles 263, 267 TFEU); the focus would shift to the question whether the pillar 2 directive itself complies with the fundamental freedoms. However, the CJEU exercises restraint when evaluating secondary EU law in light of primary EU law. From a policy perspective, the CJEU seems to assume that in EU secondary legislation there is less risk of protectionism and more expression of common interests, which is also relevant for justification and proportionality of EU law measures.[174] Thus, the EU legislature enjoys a much broader discretion than domestic legislatures with regard to shaping the internal market.[175] As the CJEU frequently notes, the EU legislature enjoys "broad discretion when it is asked to intervene in an area" (such as taxation) "which entails political, economic and social choices on its part, and in which it is called upon to undertake complex assessments."[176] Indeed, the legality of a measure (in light of equality and proportionality, but also competence) can "be affected only if the measure is manifestly inappropriate having regard to the objective which the competent institutions are seeking to pursue."[177] Because the EU legislature enjoys this broad discretion, this also "implies limited judicial review of its exercise,"[178] which is hence

[162] *See, e.g.*, *Gaz de France*, C-247/08 (CJEU 2009), para. 53; *Kieffer and Thill*, C-114/96 (CJEU 1997), para. 27; *Schmelz*, C-97/09 (CJEU 2010), para. 50. For detailed analysis, see, *e.g.*, Kofler, "The Relationship Between the Fundamental Freedoms and Directives in the Area of Direct Taxation," VI(2) *Dirrito E Pratica Tributaria Internazionale* 471 (2009).

[163] *See, e.g.*, *HSBC*, C-569/07 (CJEU 2009), paras. 25-26; *see also Vanacker and Lesage*, C-37/92 (CJEU 1993), para. 9; *DocMorris*, C-322/01 (CJEU 2003), para. 64; *Air Berlin*, C-573/16 (CJEU 2017), paras. 27-29; *Swedish Match AB*, C-210/03 (CJEU 2004), para. 81.

[164] *Lodewijk Gysbrechts*, C-205/07 (CJEU 2008), para. 33; *Visnapuu*, C-198/14 (CJEU 2015), paras. 40-48.

[165] *UPC DTH Sàrl*, C-475/12 (CJEU 2104), para. 63.

[166] *DocMorris*, C-322/01, at para. 64; *Citroën Belux*, C-265/12 (CJEU 2013), para. 31.

[167] *DaimlerChrysler*, C-324/99 (CJEU 2001), paras. 32, 42-43.

[168] *Matratzen Concord AG*, C-421/04 (CJEU 2006), para. 20.

[169] Opinion of AG Kokott in *A Oy*, C-292/16 (2017), para. 22 ("duty" versus "entitlement").

[170] *See HSBC*, C-569/07, at paras. 25-26; *Air Berlin*, C-573/16, at paras. 27-29.

[171] *See* articles 282, 283 of the VAT directive (2006/112/EC); *Schmelz*, C-97/09 (CJEU 2010).

[172] *See, e.g.*, *Euro Park Service*, C-14/16 (CJEU 2017), para. 19; *Deister Holding and Juhler Holding*, joined cases C-504/16 and C-613/16 (CJEU 2017), para. 45.

[173] *Vanacker and Lesage*, C-37/92, at para. 9; *DocMorris*, C-322/01, at paras. 63-65; *Lodewijk Gysbrechts*, C-205/07, at para. 33; *Citroën Belux*, C-265/12, at para. 31; *UPC DTH Sàrl*, C-475/12, at para. 63.

[174] *See, e.g.*, *Germany v. Parliament and Council*, C-233/94 (CJEU 1997) (deposit-guarantee schemes); *Schmelz*, C-97/09.

[175] *See, e.g.*, *Billerud*, C-203/12 (CJEU 2013), paras. 34-37; *Rzecznik Praw Obywatelskich (RPO)*, C-390/15 (CJEU 2017), paras. 37-72; *Hungary v. Parliament and Council*, C-620/18 (CJEU 2020), paras. 104-117; *Poland v. Parliament and Council*, C-626/18 (CJEU 2020), paras. 87-100.

[176] *Billerud*, C-203/12, at para. 34-37; *RPO*, C-390/15 (CJEU 2017), at para. 34; *Hungary v. Parliament and Council*, C-620/18, at para. 112.

[177] *Hungary v. Parliament and Council*, C-620/18, at para. 112.

[178] *Id.*

"limited to review as to manifest error."[179] It seems to be against this background that the pillar 2 directive notes that "a common Union framework, designed to be compatible with the fundamental freedoms guaranteed by the Treaty," would provide legal certainty, and that the pillar 2 directive's extension to domestic situations is to "ensure compatibility with primary Union law, and in particular with the principle of freedom of establishment."[180]

- Third, even those who take a narrower view and would see exhaustive harmonization only where a complete field (such as corporate taxation) has been harmonized accept that "Directives benefit from a presumption of legality" and that the CJEU review of the "compliance of Directives with Union law is limited and process-oriented," with the CJEU affording "a broad margin of discretion to the Union institutions" such that the CJEU "only sanctions manifest or disproportional breaches of primary Union law."[181]
- Fourth, state aid is not a problem at all with regard to the mandatory IIR and UTPR because any aid would not be imputable to an EU member state (but rather to the EU) and consequently would not fall under the prohibition of articles 107 and 108 TFEU.[182]

In light of the broad discretion of the EU legislature, it seems unlikely that the CJEU would accept a fundamental freedoms challenge to the pillar 2 directive or its domestic implementation even if it contained discriminatory features.[183]

Even for some more obvious remaining concerns regarding the directive's transitional rules and temporary exemptions from the IIR in intra-EU situations based on the so-called initial-phase relief under article 49 of the pillar 2 directive,[184] it is highly doubtful that this would amount to a "manifest error."[185]

What remains is a potential challenge to the validity of the pillar 2 directive on grounds of the EU's lack of competence. The commission has claimed that the internal market competence under article 115 TFEU is a suitable basis to remove the "inconsistency" of the "absence of rules ensuring minimum effective corporate taxation across the Single Market"[186] and that the pillar 2 directive also complies with the requirements of subsidiarity[187] and proportionality under article 5 TEU.[188] It is, however, disputed if article 115 TFEU is indeed a sound basis for the EU's competence: Some argue that the pillar 2 directive would not improve the functioning of the internal market[189] (also a common objection to the anti-tax-avoidance directive[190]), whereas others focus on distortions and argue that the EU indeed has the competence

[179] *See, e.g.*, *RPO*, C-390/15, at para. 54, referring to *British American Tobacco (Investments) and Imperial Tobacco*, C-491/01 (CJEU 2002), para. 123 ("manifestly inappropriate"), and *Billerud*, C-203/12, at para. 35 ("manifestly incorrect").

[180] See recitals 4 and 6 in the preamble to the pillar 2 directive. Similarly, the preamble to the anti-tax-avoidance directive notes that "national implementing measures which follow a common line across the Union would provide taxpayers with legal certainty in that those measures would be compatible with Union law" (see recital 2 of the preamble to Council Directive (EU) 2016/1164).

[181] *See* De Broe, *supra* note 70.

[182] *See, e.g.*, *Deutsche Bahn*, T-351/02 (2006), paras. 101-103; *Puffer*, C-460/07 (CJEU 2009), para. 70; European Commission, "Commission Notice on the Notion of State Aid as Referred to in Article 107(1) of the Treaty on the Functioning of the European Union," 2016/C 262/01, para. 44; *see also* CFE ECJ Task Force, *supra* note 152; De Broe, *supra* note 70.

[183] *See also* De Broe, *supra* note 70.

[184] While that rule simply transposes the OECD model rules with regard to third-country parented groups and the UTPR (article 49(2)), it creates concerns for intra-EU situations: It provides a five-year exemption from the IIR for domestic entities of cross-border groups that are in the initial phase of the international activity (article 49(1)(a)) as well as for large-scale domestic groups (article 49(1)(b)), while no such exception is provided for foreign constituent entities of groups that are in the initial phase of the international activity and, more generally, for MNEs with a large cross-border footprint (those that are not in the initial phase of international activity).

[185] For detailed analysis, see Kofler and Schnitger, "Does 'Initial Phase Relief' Make the EU Minimum Taxation Directive (2022/2523) Invalid?" 63(5) *European Taxation* (2023). *See also* De Broe, *supra* note 70.

[186] COM(2021) 823, *supra* note 116, at 2.

[187] It might be noted here that subsidiarity may also exclude EU action when action is already being taken at the international level and proving just as effective as EU action, but it does not seem that this would exclude the implementation of internationally agreed or discussed standards (such as in the OECD BEPS project or the "common approach" on pillar 2) into EU law. *See, e.g.*, Kofler, "EU Power to Tax: Competences in the Area of Direct Taxation" in *Research Handbook on European Union Taxation Law* 11-50 (2020); Englisch and Becker, "Implementing," *supra* note 116.

[188] *See* COM(2021) 823, *supra* note 116, at 2-3.

[189] Schnitger, "Vereinbarkeit," *supra* note 116, at 743; Dourado, *supra* note 142. It should be noted that a challenge regarding the EU's competence has also been made in an action for annulment of the directive, which is pending before the European General Court under *VF v. Council*, T-143/23.

[190] For a detailed discussion, see Kofler, *supra* note 187.

to remove them.[191] The CJEU has not yet had the opportunity to rule on whether article 115 TFEU is an appropriate legal basis for the recent wave of anti-tax-planning directives, including the pillar 2 directive, so it remains to be seen how far the EU's internal market competence reaches.[192]

Final Remarks

The UTPR leads to tensions with tax treaties and could be at odds with both customary international law. Frictions with EU law seem less likely. In the overall setup of pillar 2, the inability of one jurisdiction to apply the UTPR (for example, because of a successful legal challenge) would not prevent other jurisdictions from applying it (for example, because of a tax treaty override under their domestic laws) and gaining a larger portion of UTPR top-up tax. To safeguard legal certainty and remedy potential conflicts, the conclusion of a multilateral convention should be considered. ■

[191] *See, e.g.*, Nogueira, *supra* note 129; Englisch and Becker, "Implementing," *supra* note 116.

[192] With regard to the third-country reach of the pillar 2 directive, it may be noted that the EU's competence under articles 4(2)(a) and 115 TFEU not only covers purely internal situations, but the EU can also use its internal competence to specify the treatment of non-EU taxpayers or third-country investments or activities. *See, e.g.*, Kofler, *Doppelbesteuerungsabkommen und Europäisches Gemeinschaftsrecht* 322-323 (2007) (in German); Daniel S. Smit, "The Influence of EU Tax Law on the EU Member States' External Relations" in *EU Tax Law and Policy in the 21st Century* 215-230 (2017).