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To:
State Secretary for Tax Affairs and the Tax Administration
Mr. M.L.A. (Marnix) van Rij

January 31, 2023

Director-General Tax Matters at Ministry of Finance
Drs. J.K. (Jasper) Wesseling

Tax Policy Advisor at Ministry of Finance
Mr. M. (Mohamed) Maâtoug

Subject: **AmCham Netherlands – Pillar Two Consultation**

Dear Mr. van Rij, Mr. Wesseling and Mr. Maâtoug,

On December 2, 2022, AmCham Netherlands[1] submitted its observations with respect to the consultation document '*Conceptwetsvoorstel Wet minimumbelasting 2024 (Pijler 2)*'. We would like to follow-up on one of our observations, namely, the legal issues presented by the conversion of the Undertaxed Payment Rule into an Undertaxed Profits Rule ("UTPR").

In our earlier submission, we made reference to several articles of academics and tax (policy) experts with respect to the potential conflict between the amended UTPR and customary international law, EU law, and bilateral income tax treaties. As such potential conflicts cause significant legal uncertainty and may give rise to jurisdictional disputes, particularly affecting US companies, AmCham requested two expert tax research firms, namely, the Dutch firm of Lubbers, Boer & Douma and the Austrian firm of Bräumann Kofler Tumpel Tax Research GmbH, to review these issues. We summarized their preliminary views in our submission of December 2, 2022. In the meantime, they have finalized their opinion, which, as per your request, is enclosed. Unfortunately, as you will see, the experts confirm their earlier concerns.

It would be in the best interest of both governments and taxpayers if the legal uncertainties that are broadly recognized will be addressed prior to the effective date of the amended UTPR. In view hereof, we would encourage the Dutch government, as frontrunner on Pillar 2, to:

1. Work with the OECD to develop a Multilateral Instrument ("MLI") amending bilateral income tax treaties so that they allow for the UTPR;
2. Work with the European Union and OECD to create a UTPR safe harbor for treaty countries pending the adoption of a MLI; and
3. Initiate a judicial review by the European Court of Justice on the basis of Article 263 TFEU within the mandatory two months and 25 days timeframe.

[1] The American Chamber of Commerce in the Netherlands ("AmCham Netherlands") is a non-profit member organization. Our members include (amongst others) United States ("US") companies that are active in the Netherlands as employers, innovators, promotors of sustainability, taxpayers and investors. We see it as a joint interest of the Netherlands, these companies and their employees that the Netherlands is an attractive country for (new) investments that can serve as a catalyst for employment, diversity, innovation and sustainability.

In our view, the Netherlands can still vigorously support the overall goals of the Pillar 2 directive while, in the spirit of removing significant uncertainty, accelerate the legal review process on this specific aspect of the directive.

As these issues and the other issues addressed in our earlier submission particularly affect US companies doing business in the EU, we would welcome an opportunity to elaborate on our observations and the research on the legal issues conducted by Lubbers, Boer & Douma and Bräumann Kofler Tumpel Tax Research GmbH.

On behalf of AmCham Netherlands,

Sincerely yours,

Marc ter Haar,
Executive Director

Lodewijk Berger,
Chair Tax Committee

Lubbers
Boer
Douma

Tax Research GmbH

Assist.-Prof. MMag. Dr. Peter Bräumann
Univ.-Prof. DDr. Georg Kofler, LL.M.
Univ.-Prof. Dr. Michael Tumpel

American Chamber of Commerce in the
Netherlands
Attn. Marc ter Haar, Executive Director
Vijzelstraat 68-78
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The Hague / Vienna, 24 January 2023

Subject: Compatibility with international and European law of domestic laws implementing the Council Directive (EU) on ensuring a global minimum level of taxation for multinational enterprise groups and large-scale domestic groups in the Union, adopted 15 December 2022

Dear Mr. Ter Haar,

The American Chamber of Commerce in the Netherlands has commissioned Lubbers, Boer & Douma B.V. and Tax Research GmbH to jointly provide their independent and objective expert opinion on the compatibility of domestic laws implementing Council Directive (EU) on ensuring a global minimum level of taxation for multinational enterprise groups and large-scale domestic groups in the Union, adopted 15 December 2022 (**Pillar Two Directive**), with international law, including customary international law and tax treaties, and European Union (**EU**) law.[1] In this respect, you have requested us to analyse specifically the Undertaxed Profits Rule (**UTPR**) as it appears in the Pillar Two Directive. The American Chamber of Commerce in the Netherlands has requested our expert opinion in light of concerns expressed by academics, policy experts and practitioners about jurisdictional tax disputes and legal uncertainty that may arise from the UTPR for their members.

On 5 December 2022 we provided you with our preliminary conclusions. Since then, the Pillar Two Directive has been adopted. This means that some of these conclusions have lost (some of) their relevance. For this reason and for reason of better readability, we have restated our conclusions in the Executive Summary in Annex 1. Our full Analysis is included in Annex 2 to this letter. A bibliography is included in Annex 3.

In our Analysis we have reached the following conclusions.

1. The UTPR, as it appears in the Pillar Two Directive and in domestic implementing laws, arguably infringes customary international law in relation to third countries. Such infringement, however, is not likely to invalidate the Pillar Two Directive itself. It is left to the domestic constitutional laws of EU Member States to determine to what extent such infringement may lead to disapplication of the UTPR in relation to third countries.

[1] An example of such a domestic implementing law is the Dutch draft law proposal 'Wet minimumbelasting 2024' (**Dutch draft Pillar Two law**), available at www.internetconsultatie.nl/minimumbelasting2024.

2. A domestic law implementing the Pillar Two Directive likely violates bilateral tax treaties concluded by the EU Member State concerned with third countries.
3. The UTPR, as it appears in the Pillar Two Directive and in domestic implementing laws, likely does not infringe Article 49 of the Treaty on the Functioning of the EU (**TFEU**) insofar as it is applicable between Member States and Article 63 TFEU insofar the UTPR discourages portfolio investments from third countries, but this is not free from doubt.
4. EU Member States should not apply the UTPR in relation to third countries without a prior multilateral tax treaty implementing Pillar Two. Such a multilateral tax treaty would solve the legal problems described in 1-3 above.

Our Analysis does not constitute advice and contains no judgement as to the likelihood of success if the analysis included herein were to be presented before a court of law by a specific taxpayer in a specific situation.

We remain at your disposal should you wish to discuss this letter and Annexes.

Yours sincerely,

Prof. Dr. Sjoerd Douma

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Annex 1: Executive Summary and Conclusions
Annex 2: Full Analysis
Annex 3: Bibliography

Annex 1: Executive Summary and Conclusions

The UTPR

1. The Undertaxed Profits Rule (**UTPR**), as it appears in Council Directive (EU) on ensuring a global minimum level of taxation for multinational enterprise groups and large-scale domestic groups in the Union, adopted 15 December 2022 (**Pillar Two Directive**) and in the Dutch draft law proposal 'Wet minimumbelasting 2024' (**Dutch draft Pillar Two law**),[2] leads to a top-up tax in European Union (**EU**) Member States to the extent a third country i) has applied an effective tax rate on the profits of constituent entities of a qualifying multinational group (**MNE Group**) below 15% as described in the Pillar Two Directive (low taxed constituent entities or **LTCEs**); and ii) has not opted to introduce a qualified domestic top-up tax that would collect the difference between the 15% and the effective tax rate in respect of the LTCEs established in that third country. In this case, the UTPR allows the collection of additional tax until an effective tax rate of 15% on the profits of these LTCEs has been achieved. The allocation of the top-up tax to EU Member States, under the UTPR, is based on a formula including number of employees and the value of tangible assets. Thus, the UTPR leads to extraterritorial taxation of the income of LTCEs in third countries.

Customary international law

2. The fiscal sovereignty of a state implies that it need not tolerate interference by other states in the domain that it considers the core of its sovereignty. In this way, the scope of a state's sovereignty is to some extent limited by the sovereignty of other states. Based on this mechanism, rules of customary international law have emerged over the years that, in brief, include the following principles.
i) A state may impose a tax on worldwide income of its nationals, which includes entities incorporated or formed under its law.
ii) A state may impose a tax on worldwide income of aliens residing or established in its territory.
iii) A state may impose a tax on income of aliens who are not resident or established in its territory, but only in so far as they derive income from sources in the territory of that state.

3. The UTPR is at odds with these principles of customary international law. Indeed, in order for the UTPR to apply i) the state in which the LTCE is located and ii) the state(s) in which the ultimate parent entity and/or the partially-owned parent entity are located will have not decided to introduce and therefore subject their own nationals or residents to rules similar to the Pillar Two Directive and the Dutch draft Pillar Two law. These states may regard the application of the UTPR by EU Member States as an impermissible interference in the sphere which is the core of their sovereignty, since the UTPR leads to taxation of income generated by one of their own nationals or residents without these also being nationals or residents of the EU Member States applying the

[2] Dutch draft law proposal 'Wet minimumbelasting 2024', available at www.internetconsultatie.nl/minimumbelasting2024.

UTPR and without income being generated from sources in the territory of such EU Member States.

4. The question arises as to whether customary international law has evolved with the international 'Statement on a Two-Pillar Solution to Address the Tax Challenges Arising from the Digitalization of the Economy' of 8 October 2021 (**October Statement**) to the point where it permits an infringement of the Inclusive Framework (**IF**) members' sovereignty through the application of the UTPR. Such a development requires a change in state practice and *opinio juris*. In our view, the decisive evidence for such a development is currently lacking. On the one hand, the UTPR does not appear as such in the October Statement just mentioned (the October Statement speaks only of a measure equivalent to a deduction limitation of 'undertaxed payments'). On the other hand, the UTPR by its nature applies only if other states have not implemented a minimum tax as referred to in the October Statement. Further, the October Statement does not legally bind IF members.

5. To the extent the Pillar Two Directive infringes customary international law, it can only be disapplied if such an infringement is manifestly present. This is in our view not likely to be the case. Further, while a conflict of the UTPR with customary international law does not mean that it should be disapplied (see e.g., Articles 93 and 94 of the Dutch Constitution law '*Grondwet*'), the principle is that the legislature should not pass laws if and when such a conflict exists.

6. A multilateral tax treaty implementing Pillar Two would eliminate the possibility of a potential friction with customary international law.

Tax treaties

7. The UTPR under the Pillar Two Directive is bound to create friction with existing tax treaties, because it pursues objectives which are fundamentally different than those of tax treaties. Pillar Two (and consequently also the Pillar Two Directive) aims at limiting international tax competition and profit shifting. Tax treaties, however, allow international tax competition and profit shifting as long as the right to tax is allocated to the jurisdiction where value is created. The IF and the Organisation for Economic Co-operation and Development (**OECD**) have recognized that legal certainty would be enhanced though the conclusion of a multilateral tax treaty. It has also been recognized that tax treaty compatibility should be considered when the UTPR takes the form of a separate tax, such as in the Dutch Pillar Two law.

8. As a consequence, the UTPR is at odds with Articles 7 and 9 of the OECD Model Tax Convention (**OECD MC**), because it leads to taxation of entities or permanent establishments (**PEs**) beyond the profits which can be attributed to them under the arm's length principle. In our view, Article 1(3) OECD MC, which states that a tax treaty is without prejudice to the taxation by a contracting state of its residents, or a corresponding unwritten "general principle" that a tax treaty does not restrict a contracting state's right to tax its own residents except where this is intended, does not meaningfully change this conclusion. First, the UTPR may also apply to a PE of a non-resident taxpayer located in an EU Member State. Article 1(3) OECD MC, however, does not apply to non-residents. Second,

from a teleological and systematic perspective, Article 1(3) OECD MC specifically aims to allow the state of residence of a parent company to tax income earned by a subsidiary resident in another state, for example, by applying an anti-avoidance measure (such as controlled foreign companies rules). However, the UTPR tax can hardly be considered such a measure. Third, since the UTPR potentially applies to a portion of a pool of top-up taxes from various jurisdictions and LTCEs, it is unclear to which profits the charge under the UTPR relates and, as a consequence, which saving clause of which tax treaty and to what extent could potentially allow a state to apply its UTPR. Finally, many states, including the Netherlands, have made a reservation to Article 11 of the 'Multilateral Convention for the Implementation of Tax Treaty Related Measures to Prevent Base Deduction and Profit Shifting' and their tax treaties generally do not contain a provision similar to it. It is 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. It should be noted that, in the overall setup of Pillar Two, the inability of one state to apply the UTPR would not hinder other states to apply it (e.g., because of a tax treaty override under their domestic laws) and gain a larger portion of top-up-tax.

9. This leads to a tension in cases where the UTPR applies in respect of LTCEs within the EU, but this tension is arguably resolved through the supremacy of EU law and an *a contrario* reading of Article 351 of the Treaty on the Functioning of the EU (**TFEU**). A further and more complicated tension arises, however, with respect to LTCEs outside of the EU: tax treaties between EU Member States and third countries may oppose its application. The Pillar Two Directive cannot relieve EU Member States from the obligations of international law that they have assumed towards third countries. In any case, Article 351 TFEU does not seem to release EU Member States from their obligations under international law. In our view, the EU law principles of legal certainty and fiscal legality lead to the conclusion that taxpayers should continue to be able to rely on the international law obligations of EU Member States.

10. A multilateral tax treaty implementing Pillar Two would eliminate the friction with international tax treaty law.

EU law

11. The UTPR can, in principle, only be examined in the light of Article 49 TFEU (freedom of establishment), as it only applies to MNE Groups and thus builds upon a structure of control over other entities. The UTPR under the Pillar Two Directive, however, is applied to LTCEs which operate outside of the EU, which are not protected by Article 49 TFEU. Only in those – likely rare – situations where the UTPR also applies to intra-EU situations (because a Member State has opted not to apply the Pillar Two rules under Article 50 of Pillar Two Directive), it is unclear if the UTPR leads to an unjustified factual discrimination. Also, the UTPR has the effect of making investments made by portfolio shareholders into the EU less attractive. It is uncertain whether this effect is sufficiently direct to lead to an infringement of Article 63 TFEU (free movement of capital). In any event, the Pillar Two Directive has shielding effect, so that a Member State's implementation will only be tested against the Pillar Two Directive, while the

Pillar Two Directive itself may be subject to scrutiny in light of primary EU law, but under the quite relaxed standard of a manifest error.

Annex 2: Analysis

1. Introduction

The present Analysis examines to what extent domestic laws of EU Member States implementing Council Directive (EU) on ensuring a global minimum level of taxation for multinational enterprise groups and large-scale domestic groups in the Union, adopted 15 December 2022 (**Pillar Two Directive**),[3] are compatible with international law, including customary international law and tax treaties, and European Union (**EU**) law. Specifically, the Undertaxed Profits Rule (**UTPR**) as it appears in the Pillar Two Directive, will be analysed. Section 2 describes the UTPR. Section 3 analyses the compatibility thereof with customary international law. Section 4 examines how tax treaties relate to the UTPR. Section 5 contains an EU law analysis of the UTPR. Section 6 includes conclusions and final remarks.

2. The UTPR

Background

2.1. On 23 January 2019, the Members of the Organisation for Economic Co-operation and Development (**OECD**)/G20 Inclusive Framework on BEPS (**Inclusive Framework or IF**) approved the publication of the policy note 'Addressing the Tax Challenges of the Digitalisation of the Economy' (**Policy Note**).[4] The Policy Note *inter alia* states:

> "Under the second pillar, the Inclusive Framework agreed to explore on a 'without prejudice' basis taxing 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. These proposals recognise that in part the tax challenges of the digitalisation of the economy form part of the larger landscape relating to remaining BEPS challenges and further reflect more recent developments such as US tax reform.
> The proposal under this pillar would be designed to address the continued risk of profit shifting to entities subject to no or very low taxation through the development of two inter-related rules, i.e. an income inclusion rule and a tax on base eroding payments.
> The proposal under this pillar does not change the fact that countries or jurisdictions remain free to set their own tax rates or not to have a corporate income tax system at all. Instead, the proposal considers that in the absence of multilateral action there is a risk of un-coordinated, unilateral action, both to attract more tax base and to protect the existing tax base, with adverse consequences for all countries, large and small, developed and developing."

[3] An example of such a domestic implementing law is the Dutch draft law proposal '*Wet minimumbelasting* 2024' (**Dutch draft Pillar Two law**), available at www.internetconsultatie.nl/minimumbelasting2024.
[4] OECD/ G20, Policy Note - Addressing the Tax Challenges of the Digitalisation of the Economy, available at: https://www.oecd.org/tax/beps/policy-note-beps-inclusive-framework-addressing-tax-challenges-digitalisation.pdf.

On the basis of this statement, Pillar Two aims at addressing profit shifting and tax competition. To this effect, an income inclusion rule (**IIR**) and a tax on base eroding payments were envisaged.

2.2. In March 2019, the OECD launched a public consultation on a document entitled 'Addressing the Tax Challenges of the Digitalisation of the Economy'.[5] This document states, *inter alia*, the following:

> "92. The proposal seeks to address the remaining BEPS challenges through the development of two inter-related rules:
> 1. an income inclusion rule that would tax the income of a foreign branch or a controlled entity if that income was subject to a low effective tax rate in the jurisdiction of establishment or residence; and
> 2. a tax on base eroding payments that would deny a deduction or treaty relief for certain payments unless that payment was subject to an effective tax rate at or above a minimum rate.
> 93. These rules would be implemented by way of changes to domestic law and double tax treaties and would incorporate a co-ordination or ordering rule to avoid the risk of economic double taxation that might otherwise arise where more than one jurisdiction sought to apply these rules to the same structure or arrangements."

On this basis, the OECD envisaged the introduction of an IIR and a tax on base eroding payments that would deny a deduction or treaty relief for certain payments. The consultation document stressed that the proposals included in it did not represent the consensus views of the IF, the Committee on Fiscal Affairs (**CFA**) or their subsidiary bodies. Instead, they intended to provide stakeholders with substantive proposals for analysis and comment.

2.3. On 28-29 May 2019, the IF approved the 'Programme of Work to Develop a Consensus Solution to the Tax Challenges Arising from the Digitalisation of the Economy' (**Program of Work**).[6] The Program of Work states, *inter alia*, the following:

> "73. The second key element of the proposal is a tax on base eroding payments that complements the income inclusion rule by allowing a source jurisdiction to protect itself from the risk of base eroding payments. More specifically, this element of the proposal would explore:
> • 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.

[5] OECD/G20, Public Consultation Document - Addressing the Tax Challenges of the Digitalisation of the Economy, available at: https://www.oecd.org/tax/beps/public-consultation-document-addressing-the-tax-challenges-of-the-digitalisation-of-the-economy.pdf.
[6] OECD/ G20, Programme of Work to Develop a Consensus Solution to the Tax Challenges Arising from the Digitalisation of the Economy, available at: https://www.oecd.org/tax/beps/programme-of-work-to-develop-a-consensus-solution-to-the-tax-challenges-arising-from-the-digitalisation-of-the-economy.pdf.

> 74. The undertaxed payments rule denies a deduction or a proportionate amount of any deduction for certain payments made to a related party unless those payments were subject to a minimum effective rate of tax."

The Program of Work (p. 31) recognizes that the undertaxed payments rule requires coordination with existing rules in bilateral tax treaties.

2.4. In November 2019, the OECD published the public consultation document 'Global Anti-Base Erosion Proposal (**GloBE**) - Pillar Two'.[7] This document inter alia states:

> "5. The four component parts of the GloBE proposal are:
> a) an **income inclusion rule** that would tax the income of a foreign branch or a controlled entity if that income was subject to tax at an effective rate that is below a minimum rate;
> b) an **undertaxed payments rule** that would operate by way of a denial of a deduction or imposition of source-based taxation (including withholding tax) for a payment to a related party if that payment was not subject to tax at or above a minimum rate;
> c) a **switch-over rule** to be introduced into tax treaties that would permit a residence jurisdiction to switch from an exemption to a credit method where the profits attributable to a permanent establishment (PE) or derived from immovable property (which is not part of a PE) are subject to an effective rate below the minimum rate; and
> d) a **subject to tax rule** that would complement the undertaxed payment rule by subjecting a payment to withholding or other taxes at source and adjusting eligibility for treaty benefits on certain items of income where the payment is not subject to tax at a minimum rate.
> 6. These rules would be implemented by way of changes to domestic law and tax treaties and would incorporate a co-ordination or ordering rule to avoid the risk of double taxation that might otherwise arise where more than one jurisdiction sought to apply these rules to the same structure or arrangement."

The consultation document stressed that the proposals included in it had been prepared by the Secretariat and did not represent the consensus views of the IF, the CFA or their subsidiary bodies.

2.5. On 29-30 January 2020, the IF approved a 'Statement on the Two-Pillar Approach to Address the Tax Challenges Arising from the Digitalisation of the Economy'.[8] It affirmed commitment to reach an agreement on a consensus-based solution by the end of 2020 and welcomed the progress made on Pillar Two following from the Program of Work.

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[7] OECD, Public consultation document Global Anti-Base Erosion Proposal ("GloBE") - Pillar Two, available at: https://www.oecd.org/tax/beps/public-consultation-document-global-anti-base-erosion-proposal-pillar-two.pdf.pdf.

[8] OECD/G20, Statement by the OECD/G20 Inclusive Framework on BEPS on the Two-Pillar Approach to Address the Tax Challenges Arising from the Digitalisation of the Economy, available at: https://www.oecd.org/tax/beps/statement-by-the-oecd-g20-inclusive-framework-on-beps-january-2020.pdf.

2.6. On 8-9 October 2020, the IF approved the 'Cover Statement by the Inclusive Framework on the Reports on the Blueprints of Pillar One and Pillar Two' (**Cover Statement**).[9] The Cover Statement states:

> "7. We (…) approve the Report on the Pillar Two Blueprint for public release. It provides a solid basis for a systemic solution that would address remaining base erosion and profit shifting (BEPS) challenges and sets out rules that would provide jurisdictions with a right to "tax back" where other jurisdictions have not exercised their primary taxing rights, or the payment is otherwise subject to low levels of effective taxation. These rules would ensure that all large internationally operating businesses pay at least a minimum level of tax. We acknowledge that jurisdictions are free to determine their own tax systems, including whether they have a corporate income tax and the level of their tax rates, but also consider the right of other jurisdictions to apply an internationally agreed Pillar Two regime where income is taxed below an agreed minimum rate. Though no agreement has been reached , the Blueprint provides a solid basis for future agreement on:
> – the Income Inclusion Rule (IIR), the Undertaxed Payment Rule (UTPR), the Subject to Tax Rule (STTR), the rule order, the calculation of the effective tax rate and the allocation of the top-up tax for the IIR and the UTPR, including the tax base, the definition of covered taxes, mechanisms to address volatility, and the substance carve-out;
> – the IIR and UTPR as a common approach, including an acceptance of the right of all members of the IF to implement them as part of an agreed Pillar Two regime. It would nevertheless be recognised and accepted that there may be members that are not in a position to implement these rules. However, all those implementing them would apply them consistently with the agreed Pillar Two vis-à-vis all other jurisdictions (including groups headquartered therein) that also join this consensus. Furthermore, given the importance that a large number of IF members, particularly developing countries, attach to an STTR, we recognise that an STTR would be an integral part of a consensus solution on Pillar Two;
> – the basis on which the United States' Global Intangible Low Taxed Income Regime (GILTI) would be treated as a Pillar Two compliant income inclusion rule as set out in the Report on the Blueprint on Pillar Two;
> – the development of model legislation, standard documentation and guidance, designing a multilateral review process if necessary and exploring the use of a multilateral convention, which could include the key aspects of Pillar Two."

On this basis, the Cover Statement recognized that the use of a multilateral tax treaty including the key aspects of Pillar Two should be explored.

[9] OECD/G20, Cover Statement by the Inclusive Framework on the Reports on the Blueprints of Pillar One and Pillar Two, available at: https://www.oecd.org/tax/beps/cover-statement-by-the-oecd-g20-inclusive-framework-on-beps-on-the-reports-on-the-blueprints-of-pillar-one-and-pillar-two-october-2020.pdf

2.7. The just-mentioned Pillar Two Blueprint[10] states:

> "21. While the IIR and the UTPR do not require changes to bilateral treaties and can be implemented by way of changes to domestic law, both the STTR and the SOR can only be implemented through changes to existing bilateral tax treaties. These could be implemented through bilateral negotiations and amendments to individual treaties or as part of a multilateral convention."

Thus, the Pillar Two Blueprint was of the view that the introduction of a switch-over-rule requires changes to the tax treaty framework, presumably because it leads to taxation of income which is allocated for taxation to another jurisdiction. According to the Pillar Two Blueprint, the UTPR does not require such changes, as presumably it just denies the deductibility of payments without taxing income as such allocated to another jurisdiction:

> "687. The UTPR provides a coordinated mechanism to identify the maximum amount of top-up tax that can be allocated and that can be imposed on each UTPR Taxpayer. 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. The UTPR, however, does not provide any requirements as to how this top-up tax is collected. The adjustment in the payer jurisdiction could take the form of a denial or a limitation of a deduction for intra-group payments, or an equivalent tax computed by reference to those payments. The precise method under which the adjustment is made will be a matter of domestic law implementation left to the jurisdictions applying the UTPR (see Section 7.7).
> 688. Because the UTPR has the potential to apply in any jurisdiction where a UTPR taxpayer makes an intra-group payment, and because the outcomes under the UTPR will vary based on the amount of intra-group payments made by each entity, the UTPR is a more complex rule to apply and requires a greater amount of co-ordination between jurisdictions than the IIR. In practice, however, the scope for the application of the UTPR is expected to be relatively narrow. This is because the UTPR only applies where the entity is not otherwise subject to an IIR that is implemented in accordance with the GloBE rules under the laws of another jurisdiction (see Section 10.2 on rule order).
> 689. The UTPR would also, therefore, affect how a country taxes its own residents. Since a denial of a deduction under the UTPR could result in a higher taxable base than the base solely based on arm's length profits, some may question whether the denial could conflict with Article 9(1) (Associated Enterprises) or, where the UTPR applies to a PE, Article 7(2) MTC. 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. A frequently quoted illustration of this point, found in the domestic law of

[10] OECD/G20, Tax Challenges Arising from Digitalisation – Report on Pillar Two Blueprint, available at: https://www.oecd.org/tax/beps/tax-challenges-arising-from-digitalisation-report-on-pillar-two-blueprint-abb4c3d1-en.htm.

many countries, are rules denying a deduction for entertainment expenses. As mentioned above, this longstanding principle is now codified in Article 1(3) of the OECD Model Convention (**OECD MC**) (the "saving clause") and is further confirmed by paragraph 30 of the Commentary on Article 7 OECD MC, as follows:

> "Paragraph 2 determines the profits that are attributable to a permanent establishment for the purposes of the rule in paragraph 1 that allocates taxing rights on these profits. Once the profits that are attributable to a permanent establishment have been determined in accordance with paragraph 2 of Article 7, it is for the domestic law of each Contracting State to determine whether and how such profits should be taxed as long as there is conformity with the requirements of paragraph 2 and the other provisions of the Convention. Paragraph 2 does not deal with the issue of whether expenses are deductible when computing the taxable income of the enterprise in either Contracting State. The conditions for the deductibility of expenses are a matter to be determined by domestic law, subject to the provisions of the Convention and, in particular, paragraph 3 of Article 24 […]"

With respect to non-discrimination, the Pillar Two Blueprint, paragraphs 690 et seq, states that the UTPR does not violate Article 24(4) OECD MC mainly because the first step of the UTPR will only apply where a payment is made from a high tax jurisdiction to a low tax jurisdiction. As a consequence, the denial of a deduction under the first step of the UTPR would not be determined by the residence of the recipient of the payment but by the jurisdiction's classification as high or low tax on the basis of the local group's effective tax rate profile in the relevant period. According to the Pillar Two Blueprint, under the second step, deniability could arise in respect of any net related party expenditure, whether the payment is made to a domestic or foreign member of the group. The net related party expenditure is determined on an entity-by-entity basis. Under this step, therefore, the UTPR would apply in the same way to intra-group payments made to domestic and non-resident group entities without any distinction. The Pillar Two Blueprint arrives at the same conclusion with respect to Article 23(3) OECD MC:

> "696. The UTPR applies to a PE that is a UTPR Taxpayer, in the same way as to a UTPR Taxpayer that is a group entity, as a mechanism to allocate top-up tax resulting from a low-tax outcome within an MNE. The mechanism takes the form of a limitation (or denial) of the deduction of intra-group payments, or an equivalent adjustment, based on deductible payments to a low-tax entity or net related party expenditures in the relevant period. It is a rule designed to serve as a backstop to the IIR by allocating top-up tax among the Constituent Entities in an MNE Group when the IIR does not apply. The UTPR, therefore, does not discriminate against a PE situated in a state compared with a resident entity of that state which carries on the same activities merely because it is the PE of a non-resident entity."

The policy rationale of the UTPR is explained as follows:

> "457. The Undertaxed Payments rule (UTPR) has the same general purpose as the income inclusion rule (IIR). More specifically, the policy rationale of the UTPR is to protect jurisdictions against base erosion through intra-group payments to low-taxed entities while ensuring that, in aggregate, the application of the GloBE rules does not result in the MNE Group being subject to tax on its income in those jurisdictions where it operates in excess of the minimum rate. While the IIR and the UTPR have the same general purpose they have a different function and operate in a very different way. The IIR provides for a mechanism to collect the top-up tax based on a Parent's direct or indirect ownership of the low-tax Constituent Entities. The UTPR serves, in part, as a backstop to the IIR and reduces the incentives for tax driven inversions by providing a mechanism for making an adjustment in respect of any remaining top-up tax in relation to profits of a Constituent Entity that is not in scope of an applicable IIR. The UTPR also has the purpose of addressing base erosion through deductible intra-group payments. By operating as a backstop and targeting base eroding payments the UTPR serves a hybrid purpose and different aspects of the rules in this chapter may serve one or the other purpose, depending on the situation. The UTPR operates through an allocation key that is based on, and therefore limited in its application to the extent of, intra-group payments."

With respect to the desirability of a multilateral tax treaty, the Pillar Two Blueprint states:

> "705. Although it is not a prerequisite, a multilateral convention would be the only means to enshrine rule co-ordination in a legally binding form. Inclusive Framework on BEPS Members will therefore develop provisions that could be included in a new multilateral convention and that would be designed to ensure consistency, certainty and co-ordination in the application and operation of the IIR and UTPR. This would supplement the model legislation, guidance and multilateral review process with a legal overlay that underpins the political agreement on Pillar Two.
> 706. The provisions could contain the key elements and high-level principles of the GloBE rules that are necessary to ensure consistent and coordinated application across multiple jurisdictions, in particular rule order and the top-down approach for the IIR. They could also contain the key design elements of the GloBE rules that require common defined terms, including tax base, definition of covered taxes, jurisdictional blending approach, and the allocation rules for the UTPR. The model legislation would contain the detailed rules for the IIR and UTPR, which would sit alongside the multilateral convention as a source of further guidance and interpretation.
> 707. Unlike the MLI used to implement the tax treaty related BEPS measures, the provisions would not seek to modify existing treaty provisions. Instead, the provisions could be included in a new multilateral convention, which would be a standalone international public law instrument designed specifically for the purposes of ensuring consistent, coordinated and comprehensive application of the GloBE rules, and which would coexist with the existing tax treaty network. It may also be possible to include the GloBE provisions in the new multilateral instrument

> considered under Pillar One, which could also have the benefit of setting out the interaction between Pillar One and Pillar Two. Consideration could also be given to including the STTR and SOR in this new multilateral instrument.
> 708. A multilateral convention could also confirm the compatibility of the GloBE rules with existing double tax treaties providing further certainty for the operation of the GloBE rules. Furthermore it could contain exchange of information and dispute resolution mechanisms (see Section 10.6.2)."

On this basis, the Pillar Two Blueprint expressed the view that a multilateral tax treaty would enhance legal certainty in relation to the compatibility with existing double tax treaties.

October Statement

2.8. On 8 October 2021, the IF released a 'Statement on a Two-Pillar Solution to Address the Tax Challenges Arising from the Digitalisation of the Economy' (**October Statement**)[11]:

> "The OECD/G20 Inclusive Framework on Base Erosion and Profit Shifting (IF) has agreed a two-pillar solution to address the tax challenges arising from the digitalisation of the economy. The agreed components of each Pillar are described in the following paragraphs.
> (...)
> Pillar Two consists of:
> • two interlocking domestic rules (together the Global anti-Base Erosion Rules (GloBE) rules): (i) an Income Inclusion Rule (IIR), which imposes top-up tax on a parent entity in respect of the low taxed income of a constituent entity; and (ii) 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; and
> • a treaty-based rule (the Subject to Tax Rule (STTR)) that allows source jurisdictions to impose limited source taxation on certain related party payments subject to tax below a minimum rate. The STTR will be creditable as a covered tax under the GloBE rules."

On this basis, the October Statement defines the UTPR as a rule which denies deductions or requires an equivalent adjustment. According to the October Statement, "the UTPR allocates top-up tax from low-tax constituent entities including those located in the UPE jurisdiction."

The October Statement does not elaborate on the question what an 'equivalent adjustment' is or could be. The GloBE rules will have the status of a common approach:

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[11] OECD/G20, Statement on a Two-Pillar Solution to Address the Tax Challenges Arising from the Digitalisation of the Economy, available at: https://www.oecd.org/tax/beps/statement-on-a-two-pillar-solution-to-address-the-tax-challenges-arising-from-the-digitalisation-of-the-economy-october-2021.pdf

> "This means that IF 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 IF;
> • accept the application of the GloBE rules applied by other IF members including agreement as to rule order and the application of any agreed safe harbours."

2.9 On this basis, the IF has accepted the UTPR as described in the October Statement. With respect to further implementation steps, the October Statement says:

> "Model rules to give effect to the GloBE rules will be developed by the end of November 2021. (...) The model rules are supplemented by commentary that explains the purpose and operation of the rules, and addresses the need for a switch-over rule in certain treaties and in circumstances that otherwise commit the contracting parties to the use of the exemption method.
> A model treaty provision to give effect to the STTR will be developed by the end of November 2021. (...) A multilateral instrument (MLI) will be developed by the IF by mid-2022 to facilitate the swift and consistent implementation of the STTR in relevant bilateral treaties.
> At the latest by the end of 2022 an implementation framework will be developed that facilitates the coordinated implementation of the GloBE rules. This implementation framework will cover agreed administrative procedures (e.g. detailed filing obligations, multilateral review processes) and safe-harbours to facilitate both compliance by MNEs and administration by tax authorities. As part of the work on the implementation framework, IF members will consider the merits and possible content of a multilateral convention in order to further ensure co-ordination and consistent implementation of the GloBE rules."

Thus, the consideration of a multilateral tax treaty in order to further ensure co-ordination and consistent implementation of Pillar Two was repeated.

Model Rules and Model Rules Commentary

2.10. On 20 December 2021, the OECD released the 'Global Anti-Base Erosion Model Rules (Pillar Two)' (**Model Rules**)[12]. This report states:

> "This document was approved by the OECD/G20 Inclusive Framework on BEPS on 14 December 2021."

Article 2.4 (Application of the UTPR), paragraphs 1 and 2, of the Model Rules read:

[12] OECD/G20, Tax Challenges Arising from the Digitalisation of the Economy Global Anti-Base Erosion Model Rules (Pillar Two), available at: https://www.oecd.org/tax/beps/tax-challenges-arising-from-the-digitalisation-of-the-economy-global-anti-base-erosion-model-rules-pillar-two.pdf.

> "2.4.1. Constituent Entities of an MNE Group located in [insert name of implementing-Jurisdiction] shall be denied a deduction (or required to make an equivalent adjustment under domestic law) in an amount resulting in those Constituent Entities having an additional cash tax expense equal to the UTPR Top-up Tax Amount for the Fiscal Year allocated to that jurisdiction.
> 2.4.2. The adjustment mentioned in Article 2.4.1 shall apply to the extent possible with respect to the taxable year in which the Fiscal Year ends. If this adjustment is insufficient to produce an additional cash tax expense for this taxable year equal to the UTPR Top-up Tax Amount allocated to [insert name of implementing-Jurisdiction] for the Fiscal Year, the difference shall be carried forward to the extent necessary to the succeeding Fiscal Years and be subject to the adjustment mentioned in Article 2.4.1 to the extent possible for each taxable year."

Thus, the UTPR is still mainly regarded as a denial of a deduction, with the possibility of an equivalent adjustment.

2.11. The 'Commentary to the Global Anti-Base Erosion Model Rules (Pillar Two)' (**Model Rules Commentary**) was published by the OECD on 14 March 2022.[13] It states:

> "This document was approved by the OECD/G20 Inclusive Framework on BEPS on 11 March 2022 and prepared for publication by the OECD Secretariat."

With regard to Article 2.4.1 of the Model Rules, the Model Rules Commentary states, *inter alia*:

> "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".

This approach differs from the Pillar Two Blueprint, discussed above, which primarily regarded payments to low-taxed constituent entities (**LTCEs**). With respect to the notion of an equivalent adjustment, the Model Rules Commentary explains:

> "46. Article 2.4.1 further provides that the UTPR may take the form of an adjustment that is equivalent to a denial of a deduction. The UTPR does not prescribe the mechanism by which the adjustment must be made. This is a matter of domestic law implementation that is left to the UTPR Jurisdictions.

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[13] OECD/G20, Tax Challenges Arising from the Digitalisation of the Economy – Commentary to the Global Anti-Base Erosion Model Rules (Pillar Two), available at: https://www.oecd.org/tax/beps/tax-challenges-arising-from-the-digitalisation-of-the-economy-global-anti-base-erosion-model-rules-pillar-two-commentary.pdf.

> 47. 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 current or prior period or a jurisdiction could choose to reduce an allowance or deemed deduction to reflect an allocation of Top-up Tax."

It should be noted that the Model Rules Commentary states that the imposition of an equivalent adjustment should be coordinated with the bilateral tax treaties of the state concerned. This is *inter alia* the case if the adjustment takes the form of an additional tax levied directly on a resident taxpayer in an amount equal to the allocated UTPR Top-up Tax Amount. The Model Rules Commentary does not mention a multilateral tax treaty in this respect.

Adoption of the Pillar Two Directive

2.12. On 15 December 2022, the Council of the EU approved the Pillar Two Directive:

> "all delegations voted in favour of, except for Hungary that abstained, the adoption of the Council Directive on ensuring a global minimum level of taxation for multinational and large-scale domestic groups, as set out in document 8778/22".[14]

Under Article 238(4) of the Treaty on the Functioning of the EU (**TFEU**), the abstention of an EU Member State does not jeopardize the required unanimity. The Pillar Two Directive was published in the Official Journal of 22.12.2022, L 328/1.

The preamble to the Pillar Two Directive

2.13. The preamble to the Pillar Two Directive explains its operation as follows:

> "5. It is necessary to lay down rules in order to establish an efficient and coherent framework for the global minimum level of taxation at Union level. That framework creates a system of two interlocked rules, together referred to also as the 'GloBE rules', through which an additional amount of tax (a 'top-up tax') should be collected each time that the effective tax rate of an MNE in a given jurisdiction is below 15 %. In such cases, the jurisdiction should be considered to be low-taxed. Those two interlocked rules are called the Income Inclusion Rule (IIR) and the Undertaxed Profit Rule (UTPR). Under that system, the parent entity of an MNE located in a Member State should be obliged to apply the IIR to its share of top-up tax relating to any entity of the group that is low-taxed, whether that entity is located within or outside the Union. The UTPR should act as a backstop to

[14] Communication CM 5860/22 of 15 December 2022.

> the IIR through a reallocation of any residual amount of top-up tax in cases where the entire amount of top-up tax relating to low-taxed entities could not be collected by parent entities through the application of the IIR.
> 10. (…) when the ultimate parent entity is an excluded entity or is located in a jurisdiction without a qualified IIR, the constituent entities of the group should apply the UTPR to any residual amount of top-up tax that has not been subject to the IIR in proportion to an allocation formula based on their number of employees and tangible assets. (…) where the ultimate parent entity is located in a third-country jurisdiction with a qualified IIR, the constituent entities of the MNE group should apply the UTPR to the constituent entities located in that third-country jurisdiction, in cases where that third-country jurisdiction is low-taxed based on the effective tax rate of all constituent entities in that jurisdiction, including that of the ultimate parent entity."

It should be noted that the Pillar Two Directive defines a UTPR as an Undertaxed Profit Rule instead of an Undertaxed Payments Rule, which is the OECD terminology.

The Pillar Two Directive introduces the possibility to apply a qualified domestic top-up tax (**QDTT**):

> "13. In order to allow Member States to benefit from the top-up tax revenues collected on the low-taxed constituent entities located in their territory, Member States should be able to elect to apply a qualified domestic top-up tax system. Member States should notify the Commission when they elect to apply a qualified domestic top-up tax, with the objective of providing tax authorities of other Member States and third-country jurisdictions, as well as MNE groups, with sufficient certainty as regards the applicability of the qualified domestic top-up tax to low-taxed constituent entities in that Member State. Constituent entities of an MNE group that are located in a Member State which has elected to implement such a system in its own domestic tax system should pay the top-up tax to that Member State. Such system should ensure that the minimum effective taxation of the qualifying income or loss of the constituent entities is computed in the same way as the top-up tax is computed in accordance with this Directive."

As a consequence, an EU Member State which elects to apply a QDTT will neither be confronted with the application of an IIR by another EU Member State nor a UTPR by a third country.

With respect to the compatibility of the Pillar Two Directive with primary EU law, the preamble states:

> "6. It is necessary to implement the OECD Model Rules agreed by the Member States in a way that remains as close as possible to the global agreement, in order to ensure that the rules implemented by the Member States pursuant to this Directive are qualified within the meaning of the OECD Model Rules. This Directive closely follows the content and structure of the OECD Model Rules. To ensure compatibility with primary

> Union law, and in particular with the principle of freedom of establishment, the rules of this Directive should apply to entities resident in a Member State as well as to non-resident entities of a parent entity located in that Member State. This Directive should also apply to large-scale purely domestic groups. In that way, the legal framework would be designed to avoid any risk of discrimination between cross-border and domestic situations. All entities located in a Member State that is low-taxed, including the parent entity that applies the IIR, should be subject to the top-up tax. Equally, constituent entities of the same parent entity that are located in another Member State that is low-taxed should be subject to the top-up tax."

As a consequence of the mandatory implementation of an IIR, also in relation to domestic entities, the UTPR will, in principle, not be applicable to MNE Groups based exclusively in the EU.[15]

With respect to the nature of top-up tax, the preamble states:

> "Considering that MNE groups and large-scale domestic groups should pay tax at a minimum level in a given jurisdiction and for a given fiscal year, a top-up tax should exclusively aim to ensure that the profits of such groups be subject to tax at a minimum effective tax rate in a given fiscal year. For that reason, the rules on a top-up tax should not operate as a tax levied directly on the income of an entity but instead should apply to the excess profit in accordance with a standardised base and specific tax computation mechanics in order to identify low-taxed income within the groups concerned and impose a top-up tax that would bring a group's effective tax rate on that income up to the agreed minimum level of tax. The design of the IIR and UTPR as top-up taxes, however, does not prevent a jurisdiction from applying those rules under a corporate income tax system in its domestic law."

On this basis, the preamble does not regard the top-up tax as a tax levied directly on the income of an entity.

EU Member States will have to apply the UTPR in situations where a third country does not impose a qualified IIR. The preamble states in this regard:

> "26. (…) As regards the question of whether an IIR implemented by a third-country jurisdiction that adheres to the global agreement is a qualified IIR within the meaning of the global agreement, it is appropriate to refer to the assessment to be carried out at OECD level. Furthermore, and in support of legal certainty and efficiency of the global minimum tax rules, it is important to further delineate the conditions under which the rules implemented in a third-country jurisdiction which will not transpose the rules of the global agreement can be granted equivalence to a qualified IIR. The objective of the assessment of the equivalence is mainly to clarify and delineate the Member State's application of this Directive, in particular as

[15] Apart from the possibility introduced in the Pillar Two Directive that an EU Member State elects not to apply the IIR and the UTPR temporarily.

> regards the UTPR. To that end, this Directive should provide for an assessment, prepared by the Commission following the OECD assessment, of the equivalence criteria based on certain specific parameters. The determination of the third-country jurisdictions applying legal frameworks considered to be equivalent to a qualified IIR should directly result from the objective criteria set out in this Directive and should strictly follow the OECD assessment. It is therefore appropriate, in such a specific context, to provide for a delegated act."

On this basis, the determination of jurisdictions with a domestic legal framework which can be considered to be equivalent to a qualified IIR is delegated to the European Commission pursuant to Article 290 TFEU. According to paragraph 28 of the preamble, the Commission should carry out appropriate consultations during its preparatory work, including at expert level. As paragraph 30 of the preamble states, the UTPR should apply as of 2024 to enable third country jurisdictions to apply the IIR in the first phase of the implementation of the OECD Model Rules.

The rules of the Pillar Two Directive

2.14. Article 1 (Subject-matter) of the Pillar Two Directive states:

> "1. This Directive establishes common measures for the minimum effective taxation of multinational enterprise (MNE) groups and large-scale domestic groups in the form of:
> (a) an income inclusion rule (IIR) in accordance with which a parent entity of an MNE group or of a large-scale domestic group computes and pays its allocable share of top-up tax in respect of the low-taxed constituent entities of the group; and
> (b) an undertaxed profit rule (UTPR) in accordance with which a constituent entity of an MNE group has an additional cash tax expense equal to its share of top-up tax that was not charged under the IIR in respect of the low-taxed constituent entities of the group.
> 2. Member States may elect to apply a qualified domestic top-up tax in accordance with which top-up tax shall be computed and paid on the excess profit of all the low-taxed constituent entities located in their jurisdiction pursuant to this Directive."

As a consequence, a Member State which elects to introduce a QDTT will not be confronted with an IIR or a UTPR. Further, the UTPR will not apply to MNE Groups located exclusively in the EU, because of the mandatory implementation of the IIR. Finally, the UTPR will operate to tax in EU Member States profits of LTCEs in third countries.

2.15. Article 12 (Application of a UTPR across the MNE group) reads:

> "1. Where the ultimate parent entity of an MNE group is located in a third-country jurisdiction that does not apply a qualified IIR, or where the ultimate parent entity of an MNE group is an excluded entity, Member States shall ensure that the constituent entities located in the Union are subject, in the Member State in which they are located, to an adjustment

> equal to the UTPR top-up tax amount allocated to that Member State for the fiscal year in accordance with Article 14.
> For that purpose, such adjustment may take the form of either a top-up tax due by those constituent entities or a denial of deduction against the taxable income of those constituent entities resulting in an amount of tax liability necessary to collect the UTPR top-up tax amount allocated to that Member State.
> 2. Where a Member State applies the adjustment pursuant to paragraph 1 of this Article in the form of a denial of deduction against taxable income, such adjustment shall apply to the extent possible with respect to the taxable year in which the fiscal year for which the UTPR top-up tax amount was computed and allocated to a Member State in accordance with Article 14 ends.
> Any UTPR top-up tax amount that remains due with respect to a fiscal year as a result of the application of a denial of deduction against taxable income for that fiscal year shall be carried forward to the extent necessary and shall be subject, with respect to each following fiscal year, to the adjustment pursuant to paragraph 1 until the full UTPR top-up tax amount allocated to that Member State for that fiscal year has been paid.
> 3. Constituent entities that are investment entities shall not be subject to this Article."

Article 13(1) (Application of the UTPR in the jurisdiction of an ultimate parent entity) states:

> "1. Where the ultimate parent entity of an MNE group is located in a low-tax third country jurisdiction, Member States shall ensure that the constituent entities located in the Union are subject, in the Member State in which they are located, to an adjustment equal to the UTPR top-up tax amount allocated to that Member State for the fiscal year in accordance with Article 14.
> For that purpose, such adjustment may take the form of either a top-up tax due by those constituent entities or a denial of deduction against the taxable income of those constituent entities resulting in an amount of tax liability necessary to collect the UTPR top-up tax amount allocated to that Member State.
> The first subparagraph shall not apply where the ultimate parent entity in a low-tax third-country jurisdiction is subject to a qualified IIR in respect of itself and its low-taxed constituent entities located in that jurisdiction."

Thus, EU Member States may choose to introduce a UTPR i) through a top-up tax due by constituent entities or ii) a denial of deduction against the taxable income of those constituent entities. The Pillar Two Directive is silent with respect to the compatibility with tax treaties on the either option.

2.16. Under Article 3(2) of the Pillar Two Directive, 'constituent entity' means: (a) any entity that is part of an MNE Group or of a large-scale domestic group; and (b) any permanent establishment (**PE**) of a main entity that is part of an MNE Group referred to in point (a).

2.17. Article 14 (Computation and allocation of the UTPR top-up tax amount) states:

> "1. The UTPR top-up tax amount allocated to a Member State shall be computed by multiplying the total UTPR top-up tax, as determined in accordance with paragraph 2, by the Member State's UTPR percentage, as determined in accordance with paragraph 5.
> 2. The total UTPR top-up tax for a fiscal year shall be equal to the sum of the top-up tax computed for each low-taxed constituent entity of the MNE group for that fiscal year in accordance with Article 27, subject to the adjustments set out in paragraphs 3 and 4 of this Article.
> 3. The UTPR top-up tax of a low-taxed constituent entity shall be equal to zero where, for the fiscal year, all of the ultimate parent entity's ownership interests in such low-taxed constituent entity are held directly or indirectly by one or more parent entities that are required to apply a qualified IIR in respect of that low-taxed constituent entity for that fiscal year.
> 4. Where paragraph 3 does not apply, the UTPR top-up tax of a low-taxed constituent entity shall be reduced by a parent entity's allocable share of the top-up tax of that low-taxed constituent entity that is brought into charge under qualified IIR.
> 5. A Member State's UTPR percentage shall be computed, for each fiscal year and for each MNE group, according to the following formula:
>
> $$50\,\%x \frac{number\ of\ employees\ in\ the\ Member\ State}{number\ of\ employees\ in\ all\ UTPR\ jurisdictions} + 50\,\%x \frac{the\ total\ value\ of\ tangible\ assets\ in\ the\ Member\ State}{the\ total\ value\ of\ tangible\ assets\ in\ all\ UTPR\ jurisdictions}$$
>
> where:
> (a) the number of employees in the Member State is the total number of employees of all the constituent entities of the MNE group located in that Member State;
> (b) the number of employees in all UTPR jurisdictions is the total number of employees of all the constituent entities of the MNE group located in a jurisdiction that has a qualified UTPR in force for the fiscal year;
> (c) the total value of tangible assets in the Member State is the sum of the net book value of tangible assets of all the constituent entities of the MNE group located in that Member State;
> (d) the total value of tangible assets in all UTPR jurisdictions is the sum of the net book value of tangible assets of all the constituent entities of the MNE group located in a jurisdiction that has a qualified UTPR in force for the fiscal year.
> (…)"

Article 14 of the Pillar Two Directive – in particular the formula – operates such that an EU Member State will have to apply a UTPR in relation of undertaxed profits with which it has no direct relationship. Further, Article 14 of the Pillar Two Directive forces EU Member States to apply a 100% UTPR in third country situations, where in similar intra-EU situations the IIR due may be lower (compare Article 9 on allocable share in situations where an ultimate parent entity (**UPE**) owns more than 80% of shares, as a result of which no partially-owned parent entity (**POPE**) can be identified within the meaning of the Pillar Two Directive).

2.18. Under Article 52 (Assessment of equivalence) of the Pillar Two Directive, the European Commission is empowered to adopt delegated acts in order to determine the list of third countries that have implemented a legal framework in their domestic law which is considered to be equivalent to a qualified IIR.

Transposition of the Pillar Two Directive

2.19. Under Article 56 (Transposition) of the Pillar Two Directive, EU Member States shall have implemented the directive no later than 31 December 2023. They shall apply it in respect of the fiscal years beginning from 31 December 2023. The UTPR shall be applied in respect of the fiscal years beginning from 31 December 2024. Under Article 50 of the Pillar Two Directive, EU Member States in which no more than twelve ultimate parent entities of groups within the scope of the Pillar Two Directive are located may elect not to apply the IIR and the UTPR for six consecutive fiscal years beginning from 31 December 2023.

Dutch draft Pillar Two law

2.20. The Dutch draft Pillar Two law is intended to implement the Pillar Two Directive. Chapter 5 introduces the UTPR.

2.21. Article 5.3 of the Dutch draft Pillar Two law clarifies that the Netherlands will elect to implement the UTPR though a separate tax on Dutch constituent entities. The Explanatory Memorandum clarifies that this choice has been made for practical reasons of administrability.

2.22. The Explanatory Memorandum does not elaborate on the compatibility of the UTPR, in the form chosen by the Netherlands, with international and EU law.

Reactions on the Pillar Two Directive from the United States

2.23. In July 2022, a bill ('Build Back Better') that included changes to the global intangible low-taxed income regime to align with Pillar Two failed to get a majority in the United States (**US**) Senate. Instead, negotiations led to a scaled-down bill, the Inflation Reduction Act of 2022, which was adopted on 16 August 2022. One of the provisions of this bill is a corporate alternative minimum tax (**CAMT**) of 15%, which however is not aligned with Pillar Two in a number of ways.[16]

[16] "The CAMT is different from the 15% Pillar 2 global base erosion (GLoBE) tax proposed by the Organisation for Economic Co-operation and Development and G20 (OECD/G20) and endorsed by 130 countries. The CAMT 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 (GILTI) and BEAT—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%." See Congressional Research Service, The 15% Corporate Alternative Minimum Tax (December 7, 2022), 2 and 7-11.

2.24. On 14 December 2022, 15 Republican members of the Senate Finance and Foreign Relations committees and 17 GOP members of the House Ways and Means Committee wrote a letter to the Secretary of the Treasury (**US letter**) which, *inter alia,* states[17]:

> "While some may believe that implementation by foreign countries of the model rules, including the UTPR, will lead the United States to follow suit, Congress's hand will not be forced. Nor will Congress sit idly by as U.S. companies and profits are taxed in a manner inconsistent with U.S. law and our bilateral tax treaties. This should have been clear to both the Administration and its international negotiating partners before, but it should be even more apparent now with the incoming divided government in the United States.
> (…)
> Under the 2020 Pillar Two Blueprint, the UTPR, formerly known as the undertaxed payments rule, targeted base erosion by disallowing deductions on <u>payments</u> made by an entity to a lowtaxed affiliate. There was a clear connection between the jurisdiction asserting tax and the business activities of the taxpayer. As we have previously highlighted, the UTPR negotiated by this Administration – and sprung on the world when the Model Rules were released in December 2021 – is far more expansive. Now commonly known as the undertaxed <u>profits</u> rule, the UTPR would allow a jurisdiction to reallocate income and collect tax from entities that have no nexus to that jurisdiction. Foreign countries could collect tax from U.S. activities with which there is no economic or transactional connection. This type of extraterritorial taxation is not permitted under Article 7 (or any other Article) of U.S. bilateral tax treaties.

2.25. On 16 December 2022, the Secretary of the Treasury released the following statement following the adoption of the Pillar Two Directive[18]:

> "I welcome the decision by all 27 member states of the European Union to adopt a Directive implementing a global minimum tax on corporations. This momentous act means that the OECD/G20 Inclusive Framework political agreement on international tax will be implemented by one of the world's leading economic groupings.
>
> The rules we agreed on last year at the OECD/G20 Inclusive Framework will reform the international tax system and make it fit for purpose for the 21st century. The United States led the world in being the first to adopt a minimum tax on the foreign earnings of domestically parented multinational enterprises, and both I and the President remain deeply committed to take the additional steps needed to implement this agreement, too. This historic agreement helps level the playing field for U.S. business while protecting U.S. workers.

[17] Congress of the United States, Letter to the Secretary, Department of Treasury, United States, available at: https://www.finance.senate.gov/imo/media/doc/sfc-sfrc-wm-r_letter_to_secretary_yellen.pdf
[18] Statement from US Secretary of the Treasury, on the European Union Directive Implementing a Global Minimum Tax, available at: https://home.treasury.gov/news/press-releases/jy1170.

> Crucially, implementing this international tax deal will change the world's corporate tax system to benefit American workers and middle-class families. In the United States, rather than being rewarded for moving operations overseas, companies will be incentivized to keep jobs and headquarters at home. And rather than tax havens keeping the profits of U.S. companies, those profits can instead flow back to the United States, allowing us to further invest in our infrastructure, our economy, and our people."

The Secretary of the Treasury did not comment in this statement on the compatibility of the Pillar Two Directive with international and EU law nor on the fact that the Build Back Better bill failed to reach a majority in the US Senate.

2.26. We will now analyze the compatibility of the UTPR in its current form with customary international law.

3. Customary international law

Principle of sovereignty and customary international law

3.1. Article 38 (1) of the Statute of the International Court of Justice (**ICJ**) lists *inter alia* three sources of international law: i) international conventions, whether general or particular, establishing rules expressly recognised by the contesting states; ii) international custom, as evidence of a general practice accepted as law; and iii) the general principles of law recognised by civilized nations. Source ii), i.e., customary international law, refers to international obligations of states arising from established international practices. It is being created when two requirements are met: i) widespread, uniform, and consistent state practice; and ii) *opinio juris*, i.e., 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 that new state practice.

3.2. Sovereignty has been defined as the bundle of rights and competences which go to make up the nation state, as a consequence of which it can be equated with statehood.[19] It is generally accepted to be a principle of international law superior to the aforementioned three sources of international law: sovereignty is a legal precondition of the current legal order.[20] As part of sovereignty, jurisdiction denotes the power of a state to declare what the law is and to decide on the means of its enforcement.[21]

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[19] Sjoerd Douma, Chapter 5: The Principle of Direct Tax Sovereignty in Optimization of Tax Sovereignty and Free Movement (IBFD 2011), Books IBFD (accessed 14 Dec. 2022), para. 5.1 with references.
[20] Sjoerd Douma, Chapter 5: The Principle of Direct Tax Sovereignty in Optimization of Tax Sovereignty and Free Movement (IBFD 2011), Books IBFD (accessed 14 Dec. 2022), para. 5.1 with references; Peter Hongler, Justice in International Tax Law: A Normative Review of the International Tax Regime (IBFD 2019), Books IBFD (accessed 14 Dec. 2022), para. 4.1.2.2.
[21] Stjepan Gadžo, The Principle of 'Nexus' or 'Genuine Link' as a Keystone of International Income Tax Law: A Reappraisal, 46 Intertax 2018, 194-209.

3.3. A second principle, inherently interlinked with sovereignty, is equality of nations. The sovereignty of one state is limited by the sovereignty of another. This means that sovereignty can never be absolute. The extent of a state's sovereignty can be determined only if it is confronted with the sovereignty of other states or other principles or rules of international law.[22]

3.4. According to Brownlie[23], the principal corollaries of the principles of sovereignty and equality of states are: i) jurisdiction, *prima facie* exclusive, over a territory and the permanent population living there; ii) duty of non-intervention in the area of exclusive jurisdiction of other states; and iii) dependence of obligations arising from customary law and treaties on the consent of the obligor.[24]

3.5. Fiscal sovereignty can be defined as the part of a state's sovereignty that refers to its right to legislate, enforce and adjudicate in relation to fiscal matters. Extending Brownlie's view to fiscal sovereignty means that a state has the authority to tax subjects and objects with a genuine link or nexus with its territory (**nexus principle**).[25] At the same time, it has an obligation to respect the fiscal sovereignty of other states. Finally, a state's tax jurisdiction may be limited by customary international law and tax treaties (or other international agreements).

3.6. Therefore, as part of general international law, (fiscal) sovereignty sets the outer limits of tax jurisdiction.[26] The internal limit is comprised by the principle of territoriality, which requires a reasonable connection in territorial (spatial) terms with the subject or object of taxation. The external limit is comprised by the principle of non-interference, which inherently entails that any interference in the sovereignty of another state caused by the exercise of tax jurisdiction by a state is only possible if accepted by that other state. These two limits can also be seen as two sides of the same coin. Finally, limits can also be set by customary international law (i.e., unwritten binding rules) and international agreements, such as tax treaties (i.e., written binding rules).

[22] Sjoerd Douma, Chapter 5: The Principle of Direct Tax Sovereignty in Optimization of Tax Sovereignty and Free Movement (IBFD 2011), Books IBFD (accessed 14 Dec. 2022), para. 5.1; Peter Hongler, Justice in International Tax Law: A Normative Review of the International Tax Regime (IBFD 2019), Books IBFD (accessed 14 Dec. 2022), para. 4.1.1.3.2; Filip Debelva, International Double Taxation and the Right to Property: A Comparative, International and European Law Analysis (IBFD 2019), Books IBFD (accessed 14 Dec. 2022), para. 3.2.
[23] Ian Brownlie, *Principles of Public International Law*, New York: Oxford ~University Press 2003, p. 287.
[24] Sjoerd Douma, Chapter 5: The Principle of Direct Tax Sovereignty in Optimization of Tax Sovereignty and Free Movement (IBFD 2011), Books IBFD (accessed 14 Dec. 2022), para. 5.1 with references.
[25] See also Philip Baker, Chapter 11: Some Thoughts on Jurisdiction and Nexus in Current Tax Treaty Issues: 50th Anniversary of the International Tax Group (G. Maisto ed., IBFD 2020), Books IBFD (accessed 14 Dec. 2022), para. 11.3.
[26] This represents the prevailing view in the tax literature. For an overview of the supporters of the 'no limitation' view, i.e., that a state's exercise of tax jurisdiction is unlimited, subject to practical considerations, see Filip Debelva, International Double Taxation and the Right to Property: A Comparative, International and European Law Analysis (IBFD 2019), Books IBFD (accessed 14 Dec. 2022), chapter 3; Tarcísio Diniz Magalhães, Give Us the Law: Responses and Challenges to UTPR Resisters, 108 Tax Notes Int'l 1257. See also Sol Picciotto, Formulary Approach: The Last Best Hope for MNEs, 108 Tax Notes Int'l 437.

Tax jurisdiction

3.7. Tax literature generally identifies two fundamental links for purposes of exercising income tax jurisdiction.[27] A territorial link can be established by some sort of economic allegiance with the territory of a state. This includes tax residence or different forms of investment and business activities undertaken within that state's territory. A personal link can be found in the political ties between a state and a person. This includes nationality or citizenship. Different links justify different intensity of taxation. Unlimited taxation of a tax resident's (or in some cases national's) own earned income is justified on the assumption that the location of tax residence correlates with a higher level of person's participation in the economic and political dimensions of a state's community. The same cannot be assumed to exist in respect of non-resident aliens who only derive income from the business or investment activities in a state's territory; hence the imposition of limited taxation only in respect to the sources of income connected with the territory of that state.[28]

3.8. Other links that would justify tax jurisdiction may also apply[29] or emerge. This is especially true at current times when economic, technological, and political developments are more fast paced than ever. An example worth noting was provided by Advocate General (**AG**) Kokott in her opinion in the *Google Ireland* case of the European Court of Justice (**CJEU**). There she found that linking a tax to the language in which the service is provided can also be regarded a genuine link.[30]

3.9. Next to its relevance for the internal limit to tax jurisdiction (i.e., the principle of territoriality), the nexus principle is also relevant for the external limit to tax jurisdiction (i.e., the principle of non-interference). Taxation by a state of a person or object that does not have any link to that state is prohibited.[31] In the

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[27] Stjepan Gadžo, The Principle of 'Nexus' or 'Genuine Link' as a Keystone of International Income Tax Law: A Reappraisal, 46 Intertax 2018, 194-209; Céline Braumann, Taxes and Custom: Tax Treaties as Evidence for Customary International Law, Journal of International Economic Law, 2020, 23, 747–769; Wolfgang Schön, International Tax Coordination for a Second-Best World (Part I), 1 World Tax J. 1 (2009), Journal Articles & Opinion Pieces IBFD (accessed 14 Dec. 2022), para. 3.3.1; Joachim Englisch, John Vella & Anzhela Yevgenyeva, The Financial Transaction Tax Proposal Under the Enhanced Cooperation Procedure: Legal and Practical Considerations, 2 BTR 2013, 223-259, para. 2 (b).

[28] Stjepan Gadžo, The Principle of 'Nexus' or 'Genuine Link' as a Keystone of International Income Tax Law: A Reappraisal, 46 Intertax 2018, 194-209; Sjoerd Douma, Chapter 5: The Principle of Direct Tax Sovereignty in Optimization of Tax Sovereignty and Free Movement (IBFD 2011), Books IBFD (accessed 14 Dec. 2022), para. 5.2.1; Filip Debelva, International Double Taxation and the Right to Property: A Comparative, International and European Law Analysis (IBFD 2019), Books IBFD (accessed 14 Dec. 2022), para. 3.4.

[29] For instance, the functional link; the benefit principle; the protection principle. See respectively, Filip Debelva, International Double Taxation and the Right to Property: A Comparative, International and European Law Analysis (IBFD 2019), Books IBFD (accessed 14 Dec. 2022), para. 3.3.2.1; Peter Hongler, Is the Pillar 2 Agreement Infringing International Law Obligations?, GLOBTAXGOV, para. 2.3; Juliane Kokott, Chapter 1: Public International Law and Taxation: Nexus and Territoriality in Tax Nexus and Jurisdiction in International and EU Law (E. (Edoardo) Traversa ed., IBFD 2022), Books IBFD (accessed 14 Dec. 2022), para. 1.3.2.

[30] Opinion AG Kokott, 12 September 2019, in CJEU, 3 March 2020, Case C-482/18, *Google Ireland*, paras 48-55.

[31] Peter Hongler, Justice in International Tax Law: A Normative Review of the International Tax Regime (IBFD 2019), Books IBFD (accessed 14 Dec. 2022), para. 4.1.2.2.3; Sjoerd Douma, Chapter 5:

same vein, non-taxation 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]

3.10. An interesting example that illustrates the interaction between the two limits and the balancing role that the nexus principle is playing in this respect is controlled foreign companies (**CFC**) rules. In their typical operation, CFC rules allow a state to tax a resident parent company on non-distributed income generated by a controlled subsidiary that has not been subject to an adequate level of taxation (as prescribed by the state of the parent company). It does so by means of re-calculating the relevant income of the controlled subsidiary under the rules of the state of residence of the parent company and including it into the latter's profits.[33]

3.11. Hongler and Avi-Yonah concur that *prima facie* the nationality of the parent company is not a link that justifies taxation of the controlled subsidiary at the state of the parent.[34] There is also no territorial/source connection with the state of the parent company.[35] However, Hongler concludes that the nexus principle in relation to the parent company's state is arguably satisfied as in abusive circumstances the actual link of the controlled subsidiary's income is from a substance-over-form perspective with the parent company's state. He also notes that there is no opposing case law at international level and at least there is a link (i.e., ownership or control) to the parent company's state.[36]

3.12. We can follow this analysis. After all, due to the (in)direct ownership interest/control, the income of the CFC is in essence deferred (foreign) income of

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The Principle of Direct Tax Sovereignty in Optimization of Tax Sovereignty and Free Movement (IBFD 2011), Books IBFD (accessed 14 Dec. 2022), 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 (E. (Edoardo) Traversa ed., IBFD 2022), Books IBFD (accessed 14 Dec. 2022), para. 1.3.2; Philip Baker, Chapter 11: Some Thoughts on Jurisdiction and Nexus in Current Tax Treaty Issues: 50th Anniversary of the International Tax Group (G. Maisto ed., IBFD 2020), Books IBFD (accessed 14 Dec. 2022), para. 11.8.

[33] See also Michael Lindgren, "Two's Company, Three's a Crowd" - The triad of Controlled Foreign Company Rules and the Two-Sided Income Inclusion Rule under the OECD's Pillar Two Global Minimum Tax Proposal, 77 Bulletin for International Taxation 1 (2023).

[34] The American Law Institute has taken the position that the jurisdiction to tax nationals and residents implies that a state may tax a parent corporation on its worldwide income, including that of its branches and subsidiaries. See Sjoerd Douma, Chapter 5: The Principle of Direct Tax Sovereignty in Optimization of Tax Sovereignty and Free Movement (IBFD 2011), Books IBFD (accessed 14 Dec. 2022), para. 5.2.1 with references.

[35] Reuven S. Avi-Yonah, International Tax as International Law, Law & Economics Working Papers Archive: 2003-2009, PAPER #04-007; Reuven S. Avi-Yonah, Does Customary International Tax Law Exist?, Law & Economics Research Paper Series, Paper No. 19-005; Reuven S. Avi-Yonah, The UTPR and The Treaties, available at https://www.linkedin.com/posts/reuven-avi-yonah-b0a5992_the-utpr-and-the-treaties-activity-7007358888794574848-2zbY?utm_source=share&utm_medium=member_desktop (accessed 14 Dec. 2022); Peter Hongler, Justice in International Tax Law: A Normative Review of the International Tax Regime (IBFD 2019), Books IBFD (accessed 14 Dec. 2022), para. 4.1.2.2.5.

[36] As regards the requirement of ownership interest/control, see Jefferson VanderWolk, The UTPR is Inconsistent with the Nexus Requirement of Tax Treaties, Kluwer International Tax Blog, 26 Oct. 2022. Kokott also is of the view that the nexus principle is met by the state of the parent company applying CFC rules, however, in her article, this view is not motivated. Juliane Kokott, Chapter 1: Public International Law and Taxation: Nexus and Territoriality in Tax Nexus and Jurisdiction in International and EU Law (E. (Edoardo) Traversa ed., IBFD 2022), Books IBFD (accessed 14 Dec. 2022), para. 1.3.

the parent company and the latter has contributed – as a shareholder – to its generation.[37] However, Hongler also notes that this should be seen as an extreme case of extension of tax jurisdiction,[38] not only because the link with the parent company state is limited, but also because of the considerable interference that CFC rules have with the tax jurisdiction of the subsidiary' state. Avi-Yonah's view in this respect is that this extension of tax jurisdiction is possible because CFC rules have been – in the meantime – raised to the level of customary international law.[39]

3.13. This raises the issue of the importance of customary international law as a limitation to fiscal sovereignty. This has two facets. On the one hand, principles of customary international law can limit the exercise of tax jurisdiction. On the other hand, they can also permit such exercise if there is adequate evidence that its two conditions, namely state practice and *opinio juris*, have been met in respect of a "new" practice.

3.14. According to tax literature, the territorial and personal links to tax jurisdiction and their specific consequences, i.e., unlimited tax liability for own income earned by tax residents (and nationals) and limited tax liability for income earned by non-residents within the territory of a state form part of customary international law.[40] At the same time there is general agreement amongst these scholars that customary international law does not go as far as prescribing a common content to certain supplementary notions, such as residence or source.[41] This is left up to states to define, however when doing so they need to comply with the limitations prescribed by general international law, as set out above. It has also been argued that other tax treaty rules, such as the arm's

[37] This can also be viewed as an expression of the benefit principle. See Peter Hongler, Is the Pillar 2 Agreement Infringing International Law Obligations?, GLOBTAXGOV, para. 2.3.
[38] The same view is also shared in Filip Debelva & 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 Intertax 12, 1-9.
[39] Notably Hongler disagrees with this view, as he considers that the two requirements for the creation of customary law, i.e., state practice and *opinio juris*, have not been satisfied in the case of CFC rules.
[40] Filip Debelva, International Double Taxation and the Right to Property: A Comparative, International and European Law Analysis (IBFD 2019), Books IBFD (accessed 14 Dec. 2022), para. 3.4.1; Filip Debelva & 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 Intertax 12, 1-9; Sjoerd Douma, Chapter 5: The Principle of Direct Tax Sovereignty in Optimization of Tax Sovereignty and Free Movement (IBFD 2011), Books IBFD (accessed 14 Dec. 2022), para. 5.2.1; Wolfgang Schön, International Tax Coordination for a Second-Best World (Part I), 1 World Tax J. 1 (2009), Journal Articles & Opinion Pieces IBFD (accessed 14 Dec. 2022), para. 3.3; Stjepan Gadžo, The Principle of 'Nexus' or 'Genuine Link' as a Keystone of International Income Tax Law: A Reappraisal, 46 Intertax 2018, 194-209; Céline Braumann, Taxes and Custom: Tax Treaties as Evidence for Customary International Law, Journal of International Economic Law, 2020, 23, 747–769; Niek P. Schipper, De invloed van de woonplaats op de fiscale behandeling van grensoverschrijdende werknemers, Fiscale Monografieën nr. 158, Wolters Kluwer 2019, para. 2.2. This view has also been opposed. See Peter Hongler, Justice in International Tax Law: A Normative Review of the International Tax Regime (IBFD 2019), Books IBFD (accessed 14 Dec. 2022), para. 4.1.2.3.4.
[41] Tarcísio Diniz Magalhães, Give Us the Law: Responses and Challenges to UTPR Resisters, 108 Tax Notes Int'l 1257.

length principle and the PE limitation, also form part of customary international law.[42] However, the latter represents a minority view.[43]

Application to the UTPR

3.15. What does that mean for the UTPR? The UTPR is a strange animal. Unlike the majority of income tax rules (save for certain anti-abuse provisions, such as CFC rules), that result in taxation of the taxpayer on own earned income, the UTPR imposes top-up taxation on a UTPR taxpayer – which can be a tax resident subsidiary or a PE – on income that has in principle not been generated by itself, but by other LTCEs that belong to the same MNE Group.[44] The UTPR may take the form of a denial of deductions or of equivalent adjustment (e.g., a separate tax). The top-up tax is allocated on the basis of a formulaic key that takes into account two factors: number of employees and value of tangible assets of the UTPR taxpayer. The possibility of a UTPR state to apply the UTPR is activated by virtue of the following events: i) either the state of the LTCE has implemented Pillar Two but has not opted for a QDTT; or ii) both the states of the LTCE and the UPE (or POPE) have not implemented Pillar Two.

3.16. In relation to the compatibility of the UTPR with customary international law and in particular with the nexus principle, three views have so far been expressed in literature, which can be summarised as follows:

i) The link between the UTPR state and the UTPR taxpayer justifies the collection of the top-up tax. (Customary) international law does not limit the tax jurisdiction of a state over its own residents.[45]

[42] Reuven S. Avi-Yonah, International Tax as International Law, Law & Economics Working Papers Archive: 2003-2009, PAPER #04-007; Reuven S. Avi-Yonah, Does Customary International Tax Law Exist?, Law & Economics Research Paper Series, Paper No. 19-005.
[43] Reuven S.Avi-Yonah, UTPR's Dynamic Connection To Customary International Tax Law, 108 Tax Notes Int'l 951; Joanna C. Wheeler, Chapter 5: Do Taxpayers Have a Right to DTR? in Single Taxation? (J.C. Wheeler ed., IBFD 2018), Books IBFD (accessed 14 Dec. 2022), para. 5.3.1; Céline Braumann, Taxes and Custom: Tax Treaties as Evidence for Customary International Law, Journal of International Economic Law, 2020, 23, 747–769; G. 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 (D. (Dennis) Weber ed., IBFD 2017), Books IBFD (accessed 14 Dec. 2022). As regards the permanent establishment 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 (IBFD 2012), Books IBFD (accessed 14 Dec. 2022), para. 2.3.2.
[44] See also Allison Christians & Stephen E. Shay, The Consistency of Pillar 2 UTPR With U.S. Bilateral Tax Treaties, 109 Tax Notes Int'l 445.
[45] Heydon Wardell-Burrus, For Questions for UTPR Skeptics, 108 Tax Notes Int'l 699; Reuven S. Avi-Yonah, The UTPR and The Treaties, available at https://www.linkedin.com/posts/reuven-avi-yonah-b0a5992_the-utpr-and-the-treaties-activity-7007358888794574848-2zbY?utm_source=share&utm_medium=member_desktop (accessed 14 Dec. 2022). For a discussion see Filip Debelva & 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 Intertax 12, 1-9. In respect of the operation of the earlier version of the UTPR see F. 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 (E. (Edoardo) Traversa ed., IBFD 2022), Books IBFD (accessed 14 Dec. 2022), para. 6.4.2.

ii) The MNE Group is a single economic unit and therefore – as evidenced by the October statement[46] – there is a common consensus that any state that hosts 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.[47] It has also been argued that the aforementioned consensus is (on the way to become) new customary international law.[48] In a comparable vein, it has also been argued that the nexus principle is satisfied by the existence of common ownership amongst the constituent entities;[49] and by the clear pervasiveness of centrally managed groups.[50]

iii) The UTPR effectively leads to taxation of income generated by a foreign LTCE. Other than the fact that the UTPR taxpayer and the LTCE belong to the same MNE Group, there is no other (economic) link between the UTPR state and that income.[51]

3.17. It follows that the compliance of the UTPR with customary international law is still a hotly debated issue in the literature and given the lack of judicial guidance on the subject (or the interpretation of the nexus principle in general), no definitive positions can be taken. Nonetheless, the following thoughts can be expressed.

3.18. The sovereignty principle, which is an international law principle superior to other sources of international law has two facets: the principle of territoriality, which requires a nexus in territorial (spatial) terms with the subject or object of taxation; and the principle of non-interference, which inherently entails that any interference in the sovereignty of another state caused by the exercise of tax jurisdiction by a state is only possible if accepted by that other state. It also saves a role for customary international law, which is seen as a limit setter or extender. Until now, personal and territorial links with a state as well as their consequences (i.e., unlimited and/or limited income taxation) have been seen as satisfying both principles. This is also the reason that the strong view has been expressed in the tax literature that they have become part of customary

[46] Available at https://www.oecd.org/tax/beps/statement-on-a-two-pillar-solution-to-address-the-tax-challenges-arising-from-the-digitalisation-of-the-economy-october-2021.htm (accessed 14 Dec. 2022).
[47] Alisson Christians & Tarcísio Diniz Magalhães, Undertaxed Profits and the Use-It-or-Lose-It Principle, 108 Tax Notes Int'l 705. See also Sol Picciotto & Jeffery M. Kadet, The Transition to Unitary Taxation, 108 Tax Notes Int'l 453; Sol Picciotto, UTPR Critics Miss The Point of Tax Treaty Principles, 108 Tax Notes Int'l 153.
[48] Reuven S.Avi-Yonah, UTPR's Dynamic Connection To Customary International Tax Law, 108 Tax Notes Int'l 951.
[49] Rita Szudoczky, The New Meaning of 'Always-Somewhere' under Pillar Two in Rara Avis, Liber Amicorum Peter J. Wattel (O.C.R. Marres, D.M. Weber ed., Wolters Kluwer 2022), 165-170. A comparable argument is being made by Michael Schler, UTPR: The CFC Precedent, 109 Tax Notes Int'l 27.
[50] Jeffery M. Kadet, Defending the UTPR: Creative Corporate Structuring Can't Hide Real Connections, 108 Tax Notes Int'l 1071.
[51] Jefferson VanderWolk, The UTPR is Inconsistent with the Nexus Requirement of Tax Treaties, Kluwer International Tax Blog, 26 Oct. 2022; Jefferson VanderWolk, The UTPR Disregards the Need for Nexus, 108 Tax Notes Int'l 545; Robert Goulder, Confessions of a UTPR Skeptic, 108 Tax Notes Int'l 907; Jefferson VanderWolk, The UTPR: Taxing Rights Gone Wild, 108 Tax Notes Int'l 1369; Jefferson VanderWolk, The UTPR, Treaties, and CFC Rules: A reply to Avi-Yonah and Schler, 109 Tax Notes Int'l 187.

international law, as there has been so far sufficient state practice and *opinio juris* to support that.

3.19. The UTPR puts a strain on the balance established under the existing *status quo*. The top-up tax collected by a UTPR state from a UTPR taxpayer is *de facto* a tax on the foreign income earned by foreign LTCEs, which has not been collected either by the LTCE state or the UPE/POPE state. This creates a friction with the principle of territoriality.[52] The income of the LTCEs that is subject to the top-up tax, collected by the UTPR state, has no personal or geographical connection with that state. In particular as regards the absence of a personal connection, such income cannot be seen as deferred (foreign) income of the UTPR taxpayer for two reasons. First, due to the operation of the UTPR (i.e., aggregation of the top-up taxes of the LTCEs and allocation to constituent entities based on a formulaic key), it is very difficult to identify the existence of abuse – in the sense of diverting income that would in substance belong to the UTPR taxpayer – at the level of the LTCEs. Second, the absence of an (in)direct ownership interest/control between the UTPR taxpayer and the LTCEs makes it difficult to argue – and evidence – that the UTPR taxpayer has in any way contributed to the generation of that income. As regards the geographical connection with the UTPR state, the formulaic key uses factors that connect the UTPR taxpayer with the UTPR state (i.e., employees and tangible assets of the UTPR taxpayer). However, these factors are not *per se* indicative of the geographic link between the top-up tax – and the income that gave rise to it – and the UTPR state that collects it.[53]

3.20. That does not mean that tax jurisdiction cannot be established by virtue of another link with the UTPR state. Indeed, as per view ii) common ownership/control between the UTPR taxpayer and the LTCEs is seen as a plausible justification for the UTPR state's exercise of tax jurisdiction. However, even if this is indeed a link that complies with the principle of territoriality – which at a minimum is a not settled issue[54] – it should also satisfy the principle of non-interference. Therefore, the feasibility of the UTPR would depend on the extent to which LTCEs and UPE/POPE states would be prepared to accept the UTPR state's extended exercise of tax jurisdiction in a way that goes beyond the current *status quo*. However, notably the mere reason why the UTPR would be applicable in the first place would be the (temporary) refusal of the LTCEs and

[52] It should be noted that the operation of the UTPR under the Model Rules is such that it is not made dependent on whether the UTPR taxpayer is itself a LTCE (see articles 2.4-2.6 Model Rules). Hence, it is possible that a UTPR taxpayer may be collecting top-up tax partially relating to its own income (as calculated under the Pillar Two Directive and the Model Rules). In this case it would be difficult to argue that, at least for the portion of top-up tax relating to own income, the nexus principle is not satisfied. On the other hand, given that the total UTPR top-up tax amount is the sum of the top-up taxes relating to all LTCEs that have not been (partially) collected via the IIR (or the QDTT), it would be in most cases difficult to identify which portion of the top-tax collected from one of the LTCEs of the MNE Group relates to income generated by such LTCE.
[53] *Contra* Sol Picciotto, The Long and Winding Road Leads to the Unitary Approach, 108 Tax Notes Int'l 1065.
[54] Rita Szudoczky, The New Meaning of 'Always-Somewhere' under Pillar Two in Rara Avis, Liber Amicorum Peter J. Wattel (O.C.R. Marres, D.M. Weber ed., Wolters Kluwer 2022), 165-170; Peter Hongler, Is the Pillar 2 Agreement Infringing International Law Obligations?, GLOBTAXGOV, para. 2.3; Filip Debelva & 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 Intertax 12, 1-9.

UPE/POPE states to implement Pillar Two and share with other states taxing rights on persons and income geographically connected with their own territory.

3.21. This inherent tension could be resolved if Pillar Two and the UTPR in particular gain the status of/represent a development in customary international law and are consequently considered an accepted limitation to the tax sovereignty of the LTCEs and UPE/POPE states. The October Statement, which, by 4 November 2021, according to the OECD, was agreed to by 137 IF member jurisdictions, refers 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."

It also states that:

> "The GloBE rules will have the status of a common approach. This means that IF 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 IF;
> - accept the application of the GloBE rules applied by other IF members including agreement as to rule order and the application of any agreed safe harbours."

3.22. As already noted, the view has been supported in the literature that the October Statement reflects a development in customary international law.[55] This view has also been clearly opposed.[56] The main opposing arguments are listed below:

[55] Reuven S. Avi-Yonah, The UTPR and The Treaties, available at https://www.linkedin.com/posts/reuven-avi-yonah-b0a5992_the-utpr-and-the-treaties-activity-7007358888794574848-2zbY?utm_source=share&utm_medium=member_desktop (accessed 14 Dec. 2022); Reuven S. Avi-Yonah, UTPR's Dynamic Connection To Customary International Tax Law, 108 Tax Notes Int'l 951. Notably, Magalhães argues that the October 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 Two having obtained the status of customary international law. See Tarcísio Diniz Magalhães, Give Us the Law: Responses and Challenges to UTPR Resisters, 108 Tax Notes Int'l 1257; Alisson Christians & Tarcísio Diniz Magalhães, Undertaxed Profits and the Use-It-or-Lose-It Principle, 108 Tax Notes Int'l 705.

[56] Filip Debelva & 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 Intertax 12, 1-9; Jefferson VanderWolk, The UTPR Is Far From Becoming Part of Customary International Tax Law, 108 Tax Notes Int'l 106. It is interesting to note that the view has been taken in literature that there are no indicators that Base Erosion and Profit Shifting (BEPS) project and the legal measures implementing it constitute customary international law. Pasquale Pistone, Chapter 8: International Tax Coordination through the BEPS Project and the Exercise of Tax Sovereignty in the European Union in International Tax Law: New Challenges to and from Constitutional and Legal Pluralism (Joachim Englisch ed., IBFD 2016), Books IBFD (accessed 14 Dec. 2022), para. 8.3.4.

i) The UTPR does not meet the customary law requirement of state practice as it has not yet been implemented by sufficient states.[57] In contrast, Debelva and De Broe argue that the October Statement could demonstrate extensive state practice by the 'relevant' states.[58]
ii) The UTPR does not meet the customary law requirement of *opinio juris*. The October Statement is a soft law instrument and the common approach described therein is not factually binding on the IF members.[59] In addition, the October Statement, which referred to an undertaxed payments rule did not reflect the current design of the UTPR, whose application and objective are not dependent on the existence of a payment.[60]

3.23. According to the guidance adopted in 2018 by the International Law Commission of the United Nations,[61] in order for *opinio juris* to be demonstrated, state practice must be undertaken with a sense of legal obligation, that is, 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 certain way because they felt or believed themselves legally compelled or entitled to do so by reason of customary international law. *Opinio juris* is to be sought with respect to all states engaging in the relevant practice and those in a position to react to it. 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 contribute to or reflect customary international law. Finally, an act adopted by an international organisation cannot, of itself, create a rule of customary international law. It may, however, provide evidence for determining the existence and content of customary international law, or contribute to its development.

3.24. On the basis of this guidance, it can be argued that it is unclear whether the October Statement – at least for now – meets the high standard of the customary international law requirement of *opinio juris*. The October Statement does not itself create a rule of customary international law. In addition, the October Statement does not provide conclusive evidence that the IF members will

[57] Jefferson VanderWolk, The UTPR Is Far From Becoming Part of Customary International Tax Law, 108 Tax Notes Int'l 106.
[58] Filip Debelva & 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 Intertax 12, 1-9. While accepting the controversial nature of this issue, it is submitted that in our view the position of Debelva & De Broe on this matter has higher merits than that of VanderWolk and is in line with the conclusions on the identification of customary international law of the International Law Commission. See Draft conclusions on identification of customary international law, with commentaries (2018), available at https://legal.un.org/ilc/texts/instruments/english/commentaries/1_13_2018.pdf (accessed 14 Dec. 2022), p. 132-138.
[59] Filip Debelva & 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 Intertax 12, 1-9.
[60] Jefferson VanderWolk, The UTPR Is Far From Becoming Part of Customary International Tax Law, 108 Tax Notes Int'l 1069; Jefferson VanderWolk, The UTPR: Taxing Rights Gone Wild, 108 Tax Notes Int'l 1369.
[61] Draft conclusions on identification of customary international law, with commentaries (2018), available at https://legal.un.org/ilc/texts/instruments/english/commentaries/1_13_2018.pdf (accessed 14 Dec. 2022).

implement or accept the consequences of other states' implementation of Pillar Two because of a conviction that they are legally entitled or obliged to do so. In other words, there is no adequate indication that Pillar Two and its consequences are accepted as law for the purposes of identifying customary international law.

3.25. The situation could be considered different in respect of EU Member States, which adopted the Pillar Two Directive. The fact that EU Member States, as IF members, are not legally bound by the October Statement, but nonetheless have chosen to adopt the Pillar Two Directive, could be evidence that they accept as new (or development in) customary international law – at least in their intra-EU relationships – the extension of tax jurisdiction beyond the currently required personal or geographical connection with their states. However, the same cannot be said to apply in their relations with third countries, only in respect of which the UTPR will come into play under the Pillar Two Directive. This is because *opinio juris* is to be sought not only with respect to all states engaging in the relevant practice (in this case: the EU Member States), but also those in a position to react to it (in this case: all the states that could potentially be affected by the UTPR application under the Pillar Two Directive). As already mentioned, at the moment conclusive evidence that the October Statement represents *opinio juris* is lacking. Characteristic in this respect is the failure to adopt the bill Build Back Better, which aimed at aligning current US rules with Pillar Two and the US letter highlighting disagreement with Pillar Two and the UTPR in particular and noting that any Treasury's actions in the context of the IF do not compel the US Congress to act. The Secretary of the Treasury, however, has welcomed the Pillar Two Directive.

Concluding remarks on the UTPR

3.26. As is clear from the discussion in section 2 above, the Pillar Two Blueprint did not cause obvious friction with customary international law, because both the IIR and the UTPR – designed as a denial of a deduction of payments to LTCEs – seemed to stay with the boundaries of customary international law and the nexus principle. The October Statement and the subsequent Model Rules do lead to a tension, because the UTPR has been redesigned into a measure which effectively taxes the income of non-resident alien companies in a UTPR state. The redesigned UTPR will apply in EU Member States as from 1 January 2025, with the explicit possibility to apply it as a separate tax on constituent entities in the EU Member States concerned (i.e., resident companies as well as Pes of non-resident companies). It is too early to say that customary international law and the nexus principle developed under it have changed, because such a change is dependent on the actual behaviour of states (will they actually implement the UTPR or accept its application, in its current form, by other states).

Collision of the Pillar Two Directive with customary international law

3.27. Even if the Pillar Two Directive and its consequences in respect of the nexus principle are not considered new or a development in current customary international law as far as the relationship between the EU Member States is concerned, the primacy of EU law has, as a consequence, that Member States cannot invoke current customary international law in order to circumvent or escape obligations arising from the Pillar Two Directive.[62] That is different as regards the relationship with third countries.

3.28. Article 3(5) of the Treaty on the European Union (**TEU**) provides the general obligation of the EU to respect international law. It reads as follows:

> "In its relations with the wider world, the Union shall uphold and promote its values and interests and contribute to the protection of its citizens. It shall contribute to peace, security, the sustainable development of the Earth, solidarity and mutual respect among peoples, free and fair trade, eradication of poverty and the protection of human rights, in particular the rights of the child, as well as to the strict observance and the development of international law, including respect for the principles of the United Nations Charter."

Article 19(1) TEU reads:

> "The Court of Justice of the European Union shall include the Court of Justice, the General Court and specialised courts. It shall ensure that in the interpretation and application of the Treaties the law is observed."

Observation of "the law" includes customary international law.

3.29. It is established case law of the CJEU that the powers of the EU and its institutions should be exercised in line with international law, including customary international law and international agreements, in so far 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 the light of the relevant rules of international law.[63]

3.30. The question that arises, particularly in relation to the application of the Pillar Two Directive in respect of third countries, is whether its validity as an act of an EU institution may be challenged due to its incompatibility with the rules of international law in general, and particularly with customary international law. It is generally admitted that the nature and characteristics of customary international law, i.e., its unwritten form (unlike treaties) and the fact that it is addressed to states make it less likely that principles thereof may be clear and precise enough to be self-executing and create subjective rights that can be directly invoked by an individual before a court.[64] In its judgment in *ATAA*,[65] which concerned the compatibility of an EU directive with principles of customary international law relating to aviation, the CJEU ruled that there are

[62] See for instance, CJEU, 14 February 1984, Case 278/82, *Rewe*, para. 29.
[63] CJEU, 3 September 2008, Joined Cases C-402/05 P and C-415/05 P, *Kadi and Al Barakaat International Foundation v Council and Commission*, para. 291; CJEU, 3 June 2008, Case C-308/06, *Intertanko and Others*, para. 51; CJEU, 16 June 1998, Case C-162/96, *Racke v Hauptzollamt Mainz*, para. 51; CJEU, 25 February 2010, Case C-386/08, *Brita*, paras 41-42.
[64] Dagmara Kornobis-Romanowska, Effects of International Customary Law in The Legal Order of the European Union, 8:2 Wroclaw Review of Law 405; Joachim Englisch, John Vella & Anzhela Yevgenyeva, The Financial Transaction Tax Proposal Under the Enhanced Cooperation Procedure: Legal and Practical Considerations, 2 BTR 2013, 223-259, para. 2 (a).
[65] CJEU, 21 December 2011, Case C-366/10, *Air Transport Association of America and Others*, paras 107-111.

two conditions that need to be justified in order for an individual to rely on a principle of customary international law to challenge the validity of an act of an EU institution. First, such principle is capable of calling into question the competence of the EU to adopt that act. Second, the act in question is liable to affect rights which the individual derives from EU law or to create obligations under EU law in this regard. Even if both conditions are met, since a principle of customary international law does not have the same degree of precision as a provision of an international agreement, judicial review must necessarily be limited to the question whether, in adopting the act in question, the institutions of the EU made manifest errors of assessment concerning the conditions for applying those principles.

3.31. As discussed in the earlier paragraphs, the strong view has been expressed in tax literature that the exercise of tax jurisdiction by a state under the nexus principle, i.e., based on specific personal (i.e., nationality and citizenship) and territorial (i.e., tax residence and source) links with that state as well as their consequences (i.e., unlimited tax liability for tax residents (or nationals/citizens) and limited tax liability for income of non-residents that is sourced within the territory of the state), is considered part of customary international law. Taking this as a reference point would mean that the current *status quo* of customary international law could arguably call into question the consequences of Pillar Two and in particular the UTPR, and hence also the competence of the EU institutions (in this case: the Council) to adopt the Pillar Two Directive. In addition, the Pillar Two Directive will create – both formal and administrative – obligations for the in-scope MNE Groups. Accordingly, it could be argued that at least *prima facie* the conditions set out by the ECJ in the *ATAA* case could be met and the legality of the Pillar Two Directive could be challenged by virtue of its potential incompatibility with customary international law,[66] albeit a potential review would be restrained and limited to a manifest error test. Such manifest error is in our view unlikely to be found to be present.

Collision of the Dutch draft law and customary international law

3.32. From a practical perspective, under Articles 93 and 94 of the Dutch Constitution law '*Grondwet*', as customary international law is not published, a potential tension with the Dutch draft Pillar Two law, and in particular the UTPR implementation contained therein, cannot render the latter inapplicable.[67] Nonetheless, the starting point remains that the Dutch legislator should respect customary international law and should not enact laws when such tension exists.

4. Tax treaty law

Introduction

4.1. Customary international law may change over time based on the actual behaviour of states, because it is based on principles rather than rules. This is

[66] See also Filip Debelva & 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 Intertax 12, 1-9.
[67] Similar issues may arise in other states. See for instance for Canada, Nathan Boidman, Pillar 2 - The Ironic Circularity of the UTPR Debate, 109 Tax Notes Int'l 29.

different for tax treaties which are based on rules which allocate tax jurisdiction. Those rules can not only be invoked by states but, more importantly, also by taxpayers who are the most important enforcers of tax treaty law in their domestic courts. Indeed, as De Broe has argued, the top-up tax collected though the UTPR should be regarded as an income tax within the meaning of Article 2 OECD MC, a position that has also been taken by the IF (see section 2 above).[68]

4.2. The issue to what extent the UTPR is in conformity with the current tax treaty framework has been addressed a number of times, as is clear from the discussion in section 2 above. The Cover Statement recognized that the use of a multilateral tax treaty implementing the key aspects of Pillar Two should explored. The Pillar Two Blueprint subsequently stated that, although the IIR and the UTPR – in its previous form – did not require tax treaty changes, a multilateral tax treaty would enhance legal certainty in relation to the compatibility of the Pillar Two rules with existing tax treaties. In particular, the Pillar Two Blueprint took the position that a state party to a tax treaty may determine the taxable profits of its residents and of PEs of non-residents on its territory according to its own internal rules. In this view, the deduction of payments under a UTPR would not violate Articles 7 or 9 OECD MC. According to the Pillar Two Blueprint, this view is confirmed by the saving clause of Article 1(3) OECD MC. The UTPR would also not violate Article 24 paragraphs 3 and 4 OECD MC because the non-deductibility of the top-up tax is not based solely on the residence of the recipient of the payment nor is different for PEs in comparison with resident companies. At the same time, the Pillar Two Blueprint expressed the view that a multilateral tax treaty would enhance legal certainty in relation to the compatibility with existing double tax treaties. In the October Statement, the consideration of a multilateral tax treaty in order to further ensure co-ordination and consistent implementation of Pillar Two was repeated. Finally, the Model Rules Commentary states that the imposition of an equivalent adjustment should be coordinated with the tax treaties of the state concerned.

4.3. The present section will analyze to what extent the UTPR in its current form of the Pillar Two Directive and the Dutch draft Pillar Two law infringes tax treaties.

The fundamental problem of the UTPR

4.4. The problem of Pillar Two in general and of the UTPR in particular is that they pursue objectives which are fundamentally different from those pursued by the tax treaty framework.[69,70]

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[68] Luc De Broe, Some EU and Tax Treaty Law Considerations on the Draft EU Directive on Global Minimum Taxation for Multinationals in the Union, 50 Intertax 12, p. 8-9.
[69] The departing point for this analysis is that the UTPR is a tax covered under tax treaties (see Article 2(2) OECD MC). See in this respect, Ana Paula Dourado, The Pillar Two Top-Up Taxes: Interplay, Characterization, and Tax Treaties, 50 Intertax 5, 388; Luc De Broe, Some EU and Tax Treaty Law Considerations on the Draft EU Directive on Global Minimum Taxation for Multinationals in the Union, 50 Intertax 12. However, the opposite view has also been taken in literature, thereby concluding that no conflicts arise between the application of the UTPR and existing tax treaties. See Allison Christians & Stephen E. Shay, The Consistency of Pillar 2 UTPR With U.S. Bilateral Tax Treaties, 109 Tax Notes Int'l 445.
[70] See also Jinyan Li, The Pillar 2 Undertaxed Payments Rule departs from international consensus and tax treaties, 105 Tax Notes International 1401; Maarten F. de Wilde, Why Pillar Two Top-Up

4.5. 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.[71] To this end, a tax treaty allocates jurisdiction to tax to one or both of the contracting states with the obligation for the residence state to avoid double taxation. The profits of undertakings are so allocated in accordance with the arm's length principle which broadly says that jurisdiction to tax business profits should be allocated to the state where value is created. At the same time, the preamble to the OECD MC clarifies that tax treaties do not intend to create opportunities for non-taxation or reduced taxation through tax evasion or avoidance. In this respect, Article 29(9) OECD MC states:

> "Notwithstanding the other provisions of this Convention, a benefit under this Convention shall not be granted in respect of an item of income or capital if it is reasonable to conclude, having regard to all relevant facts and circumstances, that obtaining that benefit was one of the principal purposes of any arrangement or transaction that resulted directly or indirectly in that benefit, unless it is established that granting that benefit in these circumstances would be in accordance with the object and purpose of the relevant provisions of this Convention."

As a consequence, double non-taxation or reduced taxation may be the result of the application of a tax treaty as long as i) value is created in the state which decides not to tax, or to tax at a low rate, and ii) the taxpayer did not have the principle purpose of obtaining a tax treaty benefit contrary to its purpose (which will normally not be the case where value is actually created in the low-tax state). As a result, tax treaties fundamentally allow tax competition and non-taxation or reduced taxation in a state where value is created.

4.6. As discussed in section 2 above, the object and purpose of Pillar Two is to limit tax competition and to counter profit shifting to low tax jurisdictions. These objectives are fundamentally different from the objectives pursued by the current tax treaty framework. As De Wilde has put it:

> "The [current] thinking focuses on the consideration that corporate profit, viewed in its implicitly assumed true nature, geographically belongs to the jurisdiction(s) where the value was created, and where it is then up to that jurisdiction to decide on whether or not to tax the income concerned or at a level of its autonomous choosing, for the income being respected as being produced within its geographical territories. The rationale here focuses on (i) the location of value creation and (ii) the addressing of any aggressive tax planning or artificial tax avoidance. Any tax-induced competition for operational investments is permitted without any restriction because such is considered to fall within the autonomous area of competences of the relevant jurisdiction(s) concerned ('BEPS 1.0').
> (...)

Taxation Requires Tax Treaty Modification, SSRN, available at: https://papers.ssrn.com/abstract=4018341.

[71] See the Introduction to the OECD MC, para. 15.2.

> The Pillar Two top-up taxation system aims to subject foreign source income, regardless of its nature, to a minimum tax-charge. From the perspective of the existing situation, the international tax framework as it currently stands that is, the envisaged additional tax aims to create an anomaly. The thinking here addresses the consideration that corporate profit, viewed in its implicitly assumed true nature, geographically belongs primarily to the jurisdiction(s) where the value was created, and then – and it is to this end that we now introduce Pillar Two – to another jurisdiction to guarantee an imposition of company taxation at a certain minimum level, i.e., if and to the extent that the former jurisdiction does not do so ("I'll tax if you don't"). The rationale here focuses on (i) the location of value creation and (ii) the addressing of tax-competitive responses of countries. Any tax-induced competition for operational investments is no longer permitted without any restriction because such is no longer considered to fall within the autonomous area of competences of the relevant jurisdiction(s) concerned, regardless of whether the income has been produced within its geographical territories ('BEPS 2.0'). This is a fundamental difference."[72]

As a result, Pillar Two is bound to create friction with existing tax treaties.

4.7. Article 7(1&2) OECD MC reads:

> "1. Profits of an enterprise of a Contracting State shall be taxable only in that State unless the enterprise carries on business in the other Contracting State through a permanent establishment situated therein. If the enterprise carries on business as aforesaid, the profits that are attributable to the permanent establishment in accordance with the provisions of paragraph 2 may be taxed in that other State.
> 2. For the purposes of this Article and Article [23 A] [23 B], the profits that are attributable in each Contracting State to the permanent establishment referred to in paragraph 1 are the profits it might be expected to make, in particular in its dealings with other parts of the enterprise, if it were a separate and independent enterprise engaged in the same or similar activities under the same or similar conditions, taking into account the functions performed, assets used and risks assumed by the enterprise through the permanent establishment and through the other parts of the enterprise."

As a result, the profits of a company resident in a contracting state shall be taxable only in that state, unless some of those profits are attributable to a PE in the other contracting state.

Article 9(1) OECD MC allows a contracting state to verify whether the profits reported by a company in its state of residence respect the arm's length principle:

> "1. Where

[72] Maarten F. de Wilde, Why Pillar Two Top-Up Taxation Requires Tax Treaty Modification, SSRN, available at: https://papers.ssrn.com/abstract=4018341, para. 4.

> a) an enterprise of a Contracting State participates directly or indirectly in the management, control or capital of an enterprise of the other Contracting State, or
> b) the same persons participate directly or indirectly in the management, control or capital of an enterprise of a Contracting State and an enterprise of the other Contracting State,
> and in either case conditions are made or imposed between the two enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises, then any profits which would, but for those conditions, have accrued to one of the enterprises, but, by reason of those conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly."

In abusive situations not remedied by Article 9 OECD MC, a contracting state may apply CFC legislation to a subsidiary in the other contracting state of a parent company resident in the own state, as the Commentary on Article 7 clarifies:

> "13. The purpose of paragraph 1 is to provide limits to the right of one Contracting State to tax the business profits of enterprises of the other Contracting State. The paragraph does not limit the right of a Contracting State to tax its own residents under controlled foreign companies provisions found in its domestic law even though such tax imposed on these residents may be computed by reference to the part of the profits of an enterprise that is resident of the other Contracting State that is attributable to these residents' participation in that enterprise. Tax so levied by a State on its own residents 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".

On this basis, CFC rules which prevent the erosion of the domestic tax base are generally respected under tax treaties.[73] According to the OECD, this is the case whether or not a tax treaty contains a saving clause (Article 1(3) OECD MC):

> "Since such legislation results in a State taxing its own residents, paragraph 3 of Article 1 confirms that it does not conflict with tax conventions. The same conclusion must be reached in the case of conventions that do not include a provision similar to paragraph 3 of Article 1; for the reasons explained in paragraphs 14 of the Commentary on Article 7 […], the interpretation according to which these Articles would prevent the application of controlled foreign company provisions does not accord with the text of paragraph 1 of Article 7 […]. It also does not hold when these provisions are read in their context. Thus, whilst some countries have felt it useful to expressly clarify, in their conventions, that controlled foreign company legislation did not conflict with the Convention, such clarification is not necessary. It is recognised that

[73] Compare also the Commentary on Article 1 OECD MC, at para. 81. See also Luc De Broe, Some EU and Tax Treaty Law Considerations on the Draft EU Directive on Global Minimum Taxation for Multinationals in the Union, 50 Intertax 12, 10.

> controlled foreign company legislation structured in this way is not contrary to the provisions of the Convention."[74]

4.8. As discussed above, the UTPR operates in a fundamentally different way.[75] By no means it respects the arm's length principle which is a core element of tax treaties. As shown above, the Pillar Two Blueprint has argued that the denial of deduction of payments under the UTPR merely determines the calculation for tax purposes of profits allocated to the UTPR state. While it is clear that a denial of deduction goes much further than that, this statement is certainly incorrect in respect of states, such as the Netherlands, which will implement the UTPR as a separate tax. As a result, the UTPR should be justified on another legal basis. In this respect, the Pillar Two Blueprint offers Article 1(3) OECD MC, to which we shall now turn.

The saving clause of Article 1(3) OECD MC

4.9. Article 1(3) OECD MC 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 Article 7, paragraph 2 of Article 9 and Articles 19, 20, 23 [A] [B], 24, 25 and 28."

4.10. As a starting point, it should be noted that Article 1(3) OECD MC does not apply to non-residents. To the extent the UTPR leads to taxation of a non-resident taxpayer by virtue of its PE being a LTCE, Article 1(3) OECD MC cannot be used as a justification.

4.11. Second, the Commentary to the OECD MC states with respect to Article 1(3) OECD MC:

> "18. Paragraph 3 confirms the general principle that the Convention does not restrict a Contracting State's right to tax its own residents except where this is intended and lists the provisions with respect to which that principle is not applicable."

The question, therefore, is in which situations a tax treaty does not intend to restrict a state from taxing its residents.

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[74] See Commentary on Article 1 OECD MC, at para. 81, and for a detailed analysis in the context of BEPS Action 6 Georg Kofler, Some Reflections on the 'Saving Clause', 44 Intertax 8 & 9.
[75] See Jefferson VanderWolk, The UTPR: Taxing Rights Gone Wild, 108 Tax Notes Int'l 1369; Angelo Nikolakakis, Bait and Switch — A Reply to Casey Plunket, 106 Tax Notes Int'l 191; Ana Paula Dourado, The Pillar Two Top-Up Taxes: Interplay, Characterization, and Tax Treaties, 50 Intertax 5, 388. Filip Debelva & 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 Intertax 12; Maarten F. de Wilde, Why Pillar Two Top-Up Taxation Requires Tax Treaty Modification, SSRN, available at: https://papers.ssrn.com/abstract=4018341. Some authors do not completely agree with this view, see Michael Schler, UTPR: The CFC Precedent, 109 Tax Notes Int'l 27; Allison Christians & Tarcísio Diniz Magalhães, Undertaxed Profits and the Use-It-or-Lose-It Principle, 108 Tax Notes Int'l 705.

4.12. The saving clause has its origin in the US treaty practice and was mainly intended to safeguard US taxing rights over US nationals living abroad.[76]

4.13. Article 11(1) (Application of Tax Agreements to Restrict a Party's Right to Tax its Own Residents) of the 'Multilateral Convention for the Implementation of Tax Treaty Related Measures to Prevent Base Deduction and Profit Shifting' (**MLI**) reads:

> "1. A Covered Tax Agreement shall not affect the taxation by a Contracting Jurisdiction of its residents, except with respect to the benefits granted under provisions of the Covered Tax Agreement:
> (…)
> j) which 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 Memorandum to the MLI explains:

> "150. Subparagraph j) is intended to broadly cover provisions that expressly limit taxation rights of the residence jurisdiction or expressly allow taxation rights exclusively to the source jurisdiction. That subparagraph would also cover provisions that provide for exemption of income in both jurisdictions."

Again, the question arises is in which situations a tax treaty expressly limits the right of a state of residence to tax its own residents or expressly provides that the state in which an item of income arises has the exclusive right to tax that item of income.

4.14. The Explanatory Memorandum to the MLI clarifies that the "saving clause" is based on Article 1(3) OECD MC as set out in paragraph 63 (page 86) of the Base Erosion and Profit Shifting Action 6 Report which states:

> "61. The majority of the provisions included in tax treaties are intended to restrict the right of a Contracting State to tax the residents of the other Contracting State. In some limited cases, however, it has been argued that some provisions that are aimed at the taxation of non-residents could be interpreted as limiting a Contracting State's right to tax its own residents. Such interpretations have been rejected in paragraph 6.1 of the Commentary on Article 1, which deals with a Contracting State's right to tax partners who are its own residents on their share of the income of a partnership that is treated as a resident of the other Contracting State, as well as in paragraph 23 of the same Commentary, which addresses the case of controlled foreign companies rules (see also paragraph 14 of the Commentary on Article 7, which deals with the same issue).
> 62. It was concluded that the principle reflected in paragraph 6.1 of the Commentary on Article 1 should be applicable to the vast majority of the

[76] Alexander Rust, in Reimer & Rust (Eds.) Klaus Vogel on Double Taxation Conventions, 5th edn (2021), Kluwer Law International 2022, Article 1 at m.no. 63.

> 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) OECD MC is (also) intended to prevent interpretations of the tax treaty intended to circumvent the application of a contracting state's domestic anti-abuse rules (as illustrated by the example of CFC rules).[77] The other two examples provided relate to partners in a (hybrid) partnership and to US citizens living outside of the US. A teleological interpretation of Article 1(3) OECD MC leads to the conclusion that it is aimed at providing the "real" or "economic" residence state, in a top-down approach, with a taxing right on income in another "source" state.[78] This is different in respect of the UTPR: its application does not depend on a "top-down approach", direct or indirect ownership or (deemed) control; and the UTPR state that is allocated the top-up tax might have "real" or "economic" presence, but such presence is typically not connected with the generation of the income giving rise to the top-up 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".[79] This perspective is obviously shared in the US letter, which concludes that "[t]his 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 as the UTPR raises the quite novel issue of "downward" or "sideward" taxation. In the past months, an intense debate about the treaty-compatibility of the UTPR in light of an explicit saving clause (Article 1(3) OECD MC) or the OECD's underlying unwritten "general principle that the Convention does not restrict a Contracting State's right to tax its own residents except where this is intended"[80] has emerged in literature. While some reflect on the – largely accepted – permissibility of CFC rules under tax treaties and argue that a residence state's right to tax under a UTPR is likewise not hindered by a tax treaty, especially in light of a saving clause,[81] others distinguish between CFC rules (and perhaps the

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[77] See also Jinyan Li, The Pillar 2 Undertaxed Payments Rule departs from international consensus and tax treaties, 105 Tax Notes Int'l 1401; Jefferson VanderWolk, Tax Treaties Pose Problems for the UTPR, 108 Tax Notes Int'l 20; Jefferson VanderWolk, Much Ado About Pillar 2, 108 Tax Notes Int'l 821; Ana Paula Dourado, The Pillar Two Top-Up Taxes: Interplay, Characterization, and Tax Treaties, 50 Intertax 5, 388. For a more cautious approach see Luc De Broe, Some EU and Tax Treaty Law Considerations on the Draft EU Directive on Global Minimum Taxation for Multinationals in the Union, 50 Intertax 12, 11-12.
[78] See Georg Kofler, Some Reflections on the 'Saving Clause', 44 Intertax 8 & 9.
[79] See, e.g., David G. Noren, Modifying Bilateral Income Tax Treaties to Accommodate Pillar Two UTPR Rules (November 14, 2022) 3 et seq.
[80] Commentary on Article 1 OECD MC, at para. 18.
[81] See, e.g., Michael Schler, UTPR: The CFC Precedent, 109 Tax Notes Int'l 27; Reuven S. Avi-Yonah, The UTPR and The Treaties (Dec. 10, 2022); Reuven S. Avi-Yonah, UTPR's Dynamic Connection to

IIR) and the UTPR and argue that neither Article 1(3) OECD MC nor the unwritten "general principle" supposedly underlying the saving clause do not cover "bottom-up" taxation of profits of any entity just because it belongs to the same group.[82] As noted before, we share the latter perspective. A proper construction of the current state of tax treaties does not allow a person's residence state to tax arm's length profits of its shareholder or other related entities just because they belong to a "group" under accounting standards.

4.15. Third, it is unclear to the profits of which LTCE the UTPR applies and, as a consequence, which saving clause of which tax treaty could allow a state to apply its UTPR. As Wardell-Burrus wrote:

> "the UTPR imposes a proportionate share of a total top-up tax liability from pooling together all the undertaxed excess profits of undertaxed jurisdictions of the multinational enterprise (…). This pooling effect means that one cannot necessarily 'trace' from the undertaxed profits of an undertaxed enterprise in an undertaxed tax jurisdiction to the UTPR liability."[83]

We agree with this statement. While Wardell-Burrus seems to use this as an argument for the UTPR's treaty compatibility, it shows clearly that too little thought has been put into the treaty questions by the IF. Indeed, and even accepting the OECD's view, it is difficult to pinpoint which saving clause should actually justify the application of the UTPR by a state, knowing that many tax treaties do not contain a saving clause. However, it should be noted that in the overall setup of Pillar Two, the inability of one state to apply the UTPR would not

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Customary International Tax Law, 108 Tax Notes Int'l 951; Sol Picciotto, Justifying the UTPR: Nexus and Economic Connection, 108 Tax Notes Int'l 667; Sol Picciotto, Rebutting the Logic of UTPR Skeptics, 108 Tax Notes Int'l 1371; Sol Picciotto, UTPR Critics Miss the Point of Tax Treaty Principles, 108 Tax Notes Int'l 153; Tarcísio Diniz Magalhães, Give Us the Law: Responses and Challenges to UTPR Resisters, 108 Tax Notes Int'l 1257; Tarcísio Diniz Magalhães, UTPR Opposition: A Game of Whack-a-Mole, 108 Tax Notes Int'l 1531. See also Heydon Wardell-Burrus, For Questions for UTPR Skeptics, 108 Tax Notes Int'l 699; Heydon Wardell-Burrus, The UTPR as a Rule of Recognition, 108 Tax Notes Int'l 1527; Allison Christians & Stephen E. Shay, The Consistency of Pillar 2 UTPR With U.S. Bilateral Tax Treaties, 109 Tax Notes Int'l 449-450.

[82] See, e.g., Ana Paula Dourado, The Pillar Two Top-Up Taxes: Interplay, Characterization, and Tax Treaties, 50 Intertax 5, 395; David G. Noren, Modifying Bilateral Income Tax Treaties to Accommodate Pillar Two UTPR Rules (November 14, 2022); Jefferson VanderWolk, Much Ado About Pillar 2, 108 Tax Notes Int'l 821; Jefferson VanderWolk, Tax Treaties Pose Problems for the UTPR, 108 Tax Notes Int'l 20; Jefferson VanderWolk, The UTPR Disregards the Need for Nexus, 108 Tax Notes Int'l 545; Jefferson VanderWolk, The UTPR Is Flawed: A Response to Prof. Picciotto, 108 Tax Notes Int'l 285; Jefferson VanderWolk, The UTPR is Inconsistent with the Nexus Requirement of Tax Treaties, Kluwer International Tax Blog (Oct. 26, 2022); Jefferson VanderWolk, The UTPR, Treaties, and CFC Rules: A Reply to Avi-Yonah and Schler, 109 Tax Notes Int'l 187; Jefferson VanderWolk, The UTPR: Taxing Rights Gone Wild, 108 Tax Notes Int'l 1369; Jinyan Li, The Pillar 2 Undertaxed Payments Rule Departs From International Consensus and Tax Treaties, 105 Tax Notes Int'l 1401; Maarten F. de Wilde, Why Pillar Two Top-Up Taxation Requires Tax Treaty Modification, Kluwer International Tax Blog (Jan. 12, 2022); Robert Goulder, Confessions of a UTPR Skeptic, 108 Tax Notes Int'l 907; Robert Goulder, Old Man Yells at Clouds and Other Responses to the UTPR, 109 Tax Notes Int'l 157; Robert Goulder, Pillar 2 and Tax Treaties: MLI, Where Art Thou? 108 Tax Notes Int'l 775. See also Michael Lebovitz, Gary B. Wilcox, Warren S. Payne, Lucas Giardelli, Juan F. Lopez Valek, & Megan K. Hall, If Pillar 1 Needs an MLI, Why Doesn't Pillar 2? 107 Tax Notes Int'l 1009.

[83] Heydon Wardell-Burrus, For Questions for UTPR Skeptics, 108 Tax Notes Int'l 699. See also Robert Goulder, Pillar 2 and Tax Treaties - MLI, Where Art Thou?, 108 Tax Notes Int'l 775.

hinder other states to apply it (e.g., because of a tax treaty override under their domestic laws) and gain a larger portion of top-up-tax.

4.16. As a result, neither Article 1(3) OECD MC nor the "general principle" supposedly underlying it can safeguard the UTPR.

4.17. In addition, and as a final point, many states, including the Netherlands,[84] have made a reservation to Article 11 MLI and their tax treaties generally do not contain a provision similar to it. However, even in cases where a saving clause is contained in tax treaties, it should be examined what the states were intending the coverage of that clause to be. For instance, in the tax treaty between the Netherlands and the US, it follows from the text of the saving clause (article 24(1) of the tax treaty) and the Technical Explanations of 1993 and 2004 that such clause was introduced with the intention to capture specific situations (e.g., taxation of US citizens and partnerships). Such intention did not extend beyond a top-down approach and did not cover the outcomes of the application of a UTPR. Moreover, it is doubtful that these states would accept a "general principle" that tax treaties would not limit a residence state's taxing rights if the wording of a treaty would not provide so.

Article 9 OECD MC

4.18. As discussed above, Article 9(1) OECD MC allows a contracting state to verify whether the profits reported by an enterprise in its state of residence respect the arm's length principle. The question arises whether this means that a state of residence is prohibited from taxing the profits of an entity present in its jurisdiction on profits which exceed an arm's length amount. Some would answer this question positively, others negatively.[85] For tax treaties which include a saving clause, Article 9(1) OECD MC should likely not be interpreted as a restrictive measure.[86] The position has been taken in the literature that Article 9 OECD MC, if applicable, would prevent a charge of top-up tax under a UTPR.[87] Conversely, one might argue that the Article 9(1) OECD MC serves as a provision that merely quantifies profits for purposes of Article 7 OECD MC (and restricts this quantification by the arm's length principle), and that such quantification was already effectuated before application of the UTPR.[88] Even so, as analyzed in the earlier paragraphs, Article 7(1) OECD MC would still prevent a tax charge under the UTPR, as the taxing right for – the properly allocated profits (including under Article 9 OECD MC) – belongs exclusively to an enterprise's residence state, unless allocated to a PE in the other contracting state under Article 7(2) OECD MC.

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[84] Instrument of Ratification by The Netherlands, Article 11 of the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting, available at: https://www.oecd.org/tax/treaties/beps-mli-position-netherlands-instrument-deposit.pdf.
[85] Georg Kofler & Jens Wittendorff, in Reimer & Rust (Eds.) Klaus Vogel on Double Taxation Conventions, 5th edn (2021), Kluwer Law International 2022, Article 9 at m.no. 13.
[86] Alexander Rust, in Reimer & Rust (Eds.) Klaus Vogel on Double Taxation Conventions, 5th edn (2021), Kluwer Law International 2022, Article 1 at m.no. 67.
[87] Vikram Chand, Alessandro Turina & Kinga Romanovska, Tax Treaty Obstacles in Implementing the Pillar Two Global Minimum Tax Rules and a Possible Solution for Eliminating the Various Challenges, 14 World Tax Journal 1 (2022), 30-31.
[88] See also Allison Christians & Stephen E. Shay, The Consistency of Pillar 2 UTPR With U.S. Bilateral Tax Treaties, 109 Tax Notes Int'l 445.

Article 24(5) OECD MC

4.19. Article 24(5) OECD MC reads:

> "Enterprises of a Contracting State, the capital of which is wholly or partly owned or controlled, directly or indirectly, by one or more residents of the other Contracting State, shall not be subjected in the first-mentioned State to any taxation or any requirement connected therewith which is other or more burdensome than the taxation and connected requirements to which other similar enterprises of the first-mentioned State are or may be subjected."

Vikram Chand, Alessandro Turina & Kinga Romanovska, wrote:

> "it could be argued that the UTPR applies only to domestic companies (which are in high-tax states) that are owned and controlled by UPEs in other states. Thus, there is a conflict. Put differently, it is accepted that the object of comparison for this provision is a domestic company with domestic shareholders (both in the high-tax state). As the latter are not subject to the UTPR, the non-applicability needs to be extended to a domestic company with foreign shareholders. On the other hand, one could argue against this proposition as the UTPR applies to payments made to all associated enterprises situated in low-tax jurisdictions as opposed to being applicable to associated enterprises who only own/control the capital of the payor. The different treatment does not seem to be based directly on ownership per se.
> (…)
> In order to avoid such conflicts, the Model Rules now indicate that, once a top-up tax is allocated to a UTPR jurisdiction, then that country can collect the tax, for example, by denying the deduction from the local tax base. According to article 2.4, an entity "shall be denied a deduction … in an amount resulting in those Constituent Entities having an additional cash tax expense equal to the UTPR Top-up Tax Amount for the Fiscal Year allocated to that jurisdiction". It seems that denial of deduction applies to all payments made by the UTPR taxpayer (domestic or cross border to low-tax or high-tax entities). If the denial is linked to all payments, then discrimination issues may not arise."[89]

We tend to agree with this conclusion.[90] For similar reasons, it is in our opinion the better view that the UTPR in its current form does not violate Article 24(3) or Article 24(4) OECD MC either.

Collision of the Pillar Two Directive with tax treaty obligations between EU Member States

[89] Vikram Chand, Alessandro Turina & Kinga Romanovska, Tax Treaty Obstacles in Implementing the Pillar Two Global Minimum Tax Rules and a Possible Solution for Eliminating the Various Challenges, 14 World Tax Journal 1 (2022).
[90] See also Allison Christians & Stephen E. Shay, The Consistency of Pillar 2 UTPR With U.S. Bilateral Tax Treaties, 109 Tax Notes Int'l 445.

4.20. 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 [FEU] Treaty”.[91] In other words, the provisions of such a convention between EU Member States are applicable in so far as they are compatible with the EU Treaties.

4.21. As AG Wathelet has observed, this is consistent with Article 30(3) of the Vienna Convention on the Law of Treaties (**Vienna Convention**) according to which “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”.[92]

4.22. In our view, the Pillar Two Directive – adopted by EU Member States – should be regarded as such a later treaty, which clearly has the objective of being applied notwithstanding any tax treaties in place. As a consequence, the Pillar Two Directive takes precedence over tax treaties between the EU Member States. It follows that taxpayers cannot rely on such tax treaties anymore to avoid application of the Pillar Two Directive, because tax treaties do not – horizontally – give rise to international rights and obligations between the EU Member States in this respect, as a result of which taxpayers cannot – vertically – invoke such rights and obligations anymore.

4.23. The principles of legal certainty and fiscal legality do not alter this conclusion, since it should be clear to taxpayers that the Pillar Two Directive legally takes precedence over tax treaties applicable between the EU Member States.

Collision of the Pillar Two Directive with tax treaty obligations between EU Member States and third countries

4.24. The situation is different in the relation between EU Member States and third countries. Article 30(3,4) of the Vienna Convention states:

> “3.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.
> 4.When the parties to the later treaty do not include all the parties to the earlier one:
> (a) as between States Parties to both treaties the same rule applies as in paragraph 3;
> (b) as between a State party to both treaties and a State party to only one of the treaties, the treaty to which both States are parties governs their mutual rights and obligations.”

[91] CJEU, 20 May 2003, Case C-469/00, *Ravil*, para. 37.
[92] Opinion AG Wathelet, 19 September 2017, in CJEU, 20 April 2018, Case C-284/16, *Achmea*, para. 47. Compare also CJEU, 27 September 1988, Case 235/87, *Matteuci*, para. 22; CJEU, 27 February 1962, Case 10/61, *Commission/Italy*, para. II B; and CJEU, 7 June 1973, Case 82/72, *Walder,* para. 8.

On this basis, EU Member States remain bound to their tax treaties with third countries. As a consequence, taxpayers continue to be able to rely on them.

4.25. The question arises whether EU law prevents taxpayers from relying on the international law obligations of an EU Member State towards a third country. Article 351 TFEU states:

> "The rights and obligations arising from agreements concluded before 1 January 1958 or, for acceding States, before the date of their accession, between one or more Member States on the one hand, and one or more third countries on the other, shall not be affected by the provisions of the Treaties.
>
> To the extent that such agreements are not compatible with the Treaties, the Member State or States concerned shall take all appropriate steps to eliminate the incompatibilities established. Member States shall, where necessary, assist each other to this end and shall, where appropriate, adopt a common attitude.
>
> In applying the agreements referred to in the first paragraph, Member States shall take into account the fact that the advantages accorded under the Treaties by each Member State form an integral part of the establishment of the Union and are thereby inseparably linked with the creation of common institutions, the conferring of powers upon them and the granting of the same advantages by all the other Member States."

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 Two Directive, on the one hand, and a tax treaty between that EU Member State and a third country, on the other hand.

4.26. It remains unclear if and under what conditions an EU Member State's post-accession tax treaties with third countries would be covered through a *mutatis mutandis* application of Article 351 TFEU, if those tax treaties have been compliant with EU law at the time of their conclusion, but became substantively incompatible with a subsequent Directive.[93] It is similarly unclear, if the caution

[93] That issue was, e.g., explicitly left open in the Opinion AG Kokott, 13 March 2008, in CJEU, 24 June 2008, Case C-188/07, *Total France*, paras 94-98. Favoring such an analogy, e.g., Alexander Rust, Controlled Foreign Company Rule (Articles 7 and 8 ATAD), in: Werner Haslehner, Katerina Pantazatou, Georg Kofler & Alexander Rust (eds), A Guide to the Anti-Tax Avoidance Directive (2020) 174 (182–183); Ilaria Panzeri, Tax Treaties versus EU Law: Which Should Prevail? 61 European Taxation 2021, 147 (150–155). *Contra* such analogy based on the clear wording of Article 351 TFEU, e.g., Allan Rosas, The Status in EU Law of International Treaties Concluded by EU Member States, 34 Fordham Law Journal 1304 (1322) (2011); Luc De Broe, Some EU and Tax Treaty Law Considerations on the Draft EU Directive on Global Minimum Taxation for Multinationals in the Union, 50 Intertax 12. 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 Adolfo Martín Jiménez (ed.), The External Tax Strategy of the EU in a Post-BEPS Environment (2019) 187 (199-214); Isabella M. de Groot, Implementation of the Controlled Foreign Company Rules in the Netherlands, 47 Intertax 2019, 770 (782); Werner Haslehner, The General Scope of the ATAD and Its Position in the EU Legal Order, in: Werner Haslehner, Katerina Pantazatou, Georg Kofler &

the Commission uses not to interfere with tax treaties in certain of its proposals[94] is an argument for or against an analogous application of Article 351 TFEU.

4.27. In our view, however, the EU law principles of legal certainty and fiscal legality arguably require that the Pillar Two Directive does not have detrimental effects for third-country taxpayers in a situation where the EU Member State concerned continues to have international law obligations.

Concluding remarks

4.28. In the present section, we have concluded that the UTPR in its current form likely violates tax treaties. A multilateral tax treaty implementing Pillar Two would solve this issue. We have also concluded that taxpayers cannot rely on tax treaties concluded between EU Member States. It is, however, likely that they are able to rely on tax treaties concluded between an EU Member State and a third country prior to the adoption of the Pillar Two Directive.

5. EU law

Preliminary Comments

5.1. The Pillar Two rules apply to "groups", which are defined as collections of entities "that are related through ownership or control" and consolidated, e.g., under IFRS 10 or similar rules (Art 1.2.2. Model Rules and Article 3(3)(a) of the Pillar Two Directive), including situations involving foreign PEs (Art 1.2.3. Model Rules and Article 3(3)(b) of the Pillar Two Directive). By design, therefore, the Pillar Two rules apply to "control situations". From an EU law perspective, this scope relates (exclusively) to the freedom of establishment (Articles 49, 54 TFEU), which, *inter alia*, protects the cross-border establishment of PEs and

Alexander Rust (eds), A Guide to the Anti-Tax Avoidance Directive (2020) 32 (61-62); Georg Kofler, Legislative Tax Treaty Overrides in Austrian, German, and EU Law, BTR 2022, 64 (86-89).

[94] See, e.g., Article 53 of the Commission's proposal for a CCTB, COM(2016)685, under which the switch-over 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, e.g., the Commission's proposal for a significant digital presence (COM(2018)147), 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 to Member States to (bilaterally) amend their tax treaties with third countries and to include provisions on significant digital presences (see the Commission's Recommendation of 21.3.2018 relating to the corporate taxation of a significant digital presence, C(2018)1650). Another example is Article 9(5) ATAD 2 (Council Directive (EU) 2017/952, [2017] *OJ L 144/1*), which generally provides that, "[t]o 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".

subsidiaries as well as generally shareholdings which enable the holder to exert a definite influence on the company's decisions and to determine its activities.[95] 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 such to assume a "definite influence";[96] rather, the CJEU looks at the "intention to influence the management and control of the undertaking".[97]

5.2. Within its territorial, EU-limited scope, the freedom of establishment under Article 49 TFEU allows resident subsidiaries to contest a restriction of a freedom of an EU parent company which is linked to it in so far as that restriction affects its own taxation.[98] This protection also extends to the European Economic Area (**EEA**) (Article 31 EEA Agreement). In essence, and focusing on the UTPR, the EU freedom of establishment might be triggered where the EU constituent entity (**CE**) is owned by a parent company resident in another EU/EEA Member State,[99] whether or not the UPE is also resident in an EU Member State.[100] A typical case would be where a low-taxed UPE in an EU Member State has exercised its freedom to establish a CE in another EU Member State. However, given the Pillar Two Directive, it is only in exceptional cases that this other EU Member State

[95] See for the exclusive application of the freedom of establishment, e.g., Peter K. Schmidt, A General Income Inclusion Rule as a Tool for Improving the International Tax Regime – Challenges Arising from EU Primary Law, Intertax 2020, 983 (986-987); Joachim Englisch and Johannes Becker, Implementing an international effective minimum tax in the EU, Materialien zu Wirtschaft und Gesellschaft No. 224 (July 2021) 48-49; Joachim Englisch, Non-harmonized Implementation of a GloBE Minimum Tax: How EU Member States Could Proceed, EC Tax Rev. 2021, 207 (207); Johanna Hey, Global Minimum Taxation (GloBE): What Is It About and What Could be a European Answer?, in: Georg Kofler, Ruth Mason, Alexander Rust (eds.), Thinker, Teacher, Traveler – Reimagining International Tax, Essays in Honor of H. David Rosenbloom (2021) 247 (261-264); Arne Schnitger, Die globale Mindestbesteuerung und deren unionsrechtliche Beurteilung, in: Norbert Herzig, Guido Förster, Arne Schnitger and Christian Levedag (eds.), Besteuerung im Wandel, FS Kessler (2021) 169 (176); Arne Schnitger, Vereinbarkeit der Vorschläge zur Einführung von GloBE-Regelungen mit den Grundfreiheiten des AEUV, IStR 2022, 741 (741). See also See Pt. 6 of the Preamble to the 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 Pt. 6 in the Preamble in Doc. 10497/22 [21 June 2022] and in Doc. 8778/22 [25 November 2022]); Joachim Englisch & Johannes Becker, International Effective Minimum Taxation – The GLOBE Proposal, WTJ 2019, 483 (524-525). Sceptical, however, João Félix Pinto Nogueira& Alessandro Turina, Pillar Two and EU Law, in: Andreas Perdelwitz & Alessandro Turina (eds.), Global Minimum Taxation? An Analysis of the Global Anti-Base Erosion Initiative (2021) Chapter 10.3.1., who argue that "control" that leads consolidation does not necessarily require a "definite influence" so that (mainly) the freedom of capital movement should be applicable.

[96] Indeed, the CJEU has accepted the application of the freedom of establishment for shareholdings as low as 34% (CJEU, 21 January 2010, Case C-311/08, *Société de Gestion Industrielle (SGI)*, paras 34 et seq.) or even 25% (CJEU, 10 May 2007, Case C-492/04, *Lasertec*, para. 21; CJEU, 19 July 2012, Case C-31/11, *Scheunemann*, paras 25 et seq.). See for that discussion in light of the consolidation rules under IFRS also on the one hand João Félix Pinto Nogueira & Alessandro Turina, Pillar Two and EU Law, in: Andreas Perdelwitz & Alessandro Turina (eds.), Global Minimum Taxation? An Analysis of the Global Anti-Base Erosion Initiative (2021) Chapter 10.3.1.; and Joachim Englisch & Johannes Becker, Implementing an international effective minimum tax in the EU, Materialien zu Wirtschaft und Gesellschaft No. 224 (July 2021) 48-49, on the other.

[97] See, e.g., CJEU, 24 November 2016, Case C-464/14, *SECIL*, para. 40.

[98] See, with regard to the freedom of establishment, e.g., CJEU, 3 March 2020, Case C-75/18, *Vodafone Magyarország Mobil Távközlési Zrt.*, paras 40-41, referring to CJEU,1 April 2014, Case C-80/12, *Felixstowe Dock and Railway Company and Others*, para. 23.

[99] See, with regard to the freedom of establishment, e.g., CJEU, 1 April 2014, Case C-80/12, *Felixstowe Dock and Railway Company and Others*, para. 23; CJEU, 3 March 2020, Case C-75/18, *Vodafone Magyarország Mobil Távközlési Zrt.*, paras 40-41.

[100] See also Joachim Englisch, Is an METR Compatible With EU/EEA Free Movement Guarantees? 102 Tax Notes Int'l 219.

would apply the UTPR and charge the UTPR top-up tax (because the Member State of the UPE does not apply an IIR based on Article 50 of the Pillar Two Directive). Conversely, where the parent company is resident in a third country, Article 49 TFEU does not apply, even if the UTPR would lead to a top-up tax relating to a LTCE in another EU Member State.[101]

5.3. The Model Rules, which apply only to cross-border groups, contain numerous areas of such potential friction with the EU's freedom of establishment: Focusing on the UTPR, under the Model Rules, domestic CEs (e.g., subsidiaries or PEs) face a higher tax burden because they are part of an MNE Group with worldwide revenues in excess of € 750 million that has LTCEs in low tax states (triggering top-up tax), unless another state already picks up the top-up tax via an IIR or the low tax state applies a QDTT. Such higher tax burden on a domestic CE would be in obvious tension with decisions by the CJEU that found that higher tax rates on PEs of non-residents infringe upon the freedom of establishment (e.g., *Royal Bank of Scotland*[102] and *CLT-UFA*).[103] Likewise, the CJEU has not accepted detrimental tax treatment of cross-border transactions based on foreign low- or non-taxation of certain payments (e.g., *Eurowings,*[104] *Ramstedt*,[105] *SIAT*[106] and *Lexel*[107]),[108] arguing that "[s]uch compensatory tax arrangements prejudice the very foundations of the single market".[109] Finally, the CJEU has rejected a minimum tax base that was applicable only to non-residents (*Talotta*).[110] This case law chimes well with the CJEU's case law on CFC regimes, where foreign low taxation alone does not justify an immediate income inclusion at the level of the domestic parent entity (e.g., *Cadbury Schweppes*,[111] *Olsen*[112] and *X GmbH*[113]).

[101] See, by analogy, Opinion AG Geelhoed, 29 June 2006, in CJEU, 13 March 2007, Case C-524/04, *Thin Cap Group Litigation*, paras 95-96.
[102] CJEU, 29 April 1999, Case C-311/97, *Royal Bank of Scotland* (concerning higher taxation of PEs of non-residents).
[103] CJEU, 23 February 2006, Case C-253/03, *CLT-UFA* (concerning higher taxation of PEs of non-residents).
[104] CJEU, 26 October 1999, Case C-294/97, *Eurowings* (concerning a trade tax exemption that was inapplicable to the lessee where the proprietor of the goods leased is established in another Member State and is therefore not liable to the tax).
[105] CJEU, 26 June 2003, Case C-422/01, *Ramstedt* (concerning the deduction of insurance premiums).
[106] CJEU, 5 July 2012, Case C-318/10, *Société d'investissement pour l'agriculture tropicale SA (SIAT)* (concerning the non-deductibility of cross-border payments for supplies of services if the non-resident service provide is not subject to tax on income or is subject to an advantageous tax regime).
[107] CJEU, 20 January 2021, Case C-484/19, *Lexel*.
[108] See also – and with respect to distinguishing *Schempp* (CJEU, 12 July 2005, Case C-403/03), which concerned a domestic linking rule – Joachim Englisch, Is an METR Compatible With EU/EEA Free Movement Guarantees? 102 Tax Notes Int'l 219); and A. Schnitger, Die globale Mindestbesteuerung und deren unionsrechtliche Beurteilung, in: Norbert Herzig, Guido Förster, Arne Schnitger & Christian Levedag (eds.), Besteuerung im Wandel, FS Kessler (2021) 169 (179-180); further João Félix Pinto 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, WTJ 2020, 465 (478).
[109] CJEU, 26 October 1999, Case C-294/97, *Eurowings*, para. 45 ("solche kompensatorischen Abgaben [würden] den Binnenmarkt in seinen Grundlagen beeinträchtigen"); CJEU, 26 June 2003, Case C-422/01, *Ramstedt*, para. 52.
[110] CJEU, 22 March 2007, Case C-383/05, *Talotta*.
[111] CJEU, 12 September 2006, Case C-196/04, *Cadbury Schweppes*.
[112] EFTA Court, 9 July 2014, E-3/13 & E-20/13, *Olsen*.
[113] CJEU, 26 February 2019, Case C-135/17, *X GmbH*.

5.4. While the freedom of establishment under Article 49 TFEU is limited to intra-EU situations, the freedom of capital movement under Article 63 TFEU would also extend to third countries. 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 without any intention to influence the management and control of the company.[114] As noted before, however, in light of the focus on "control situations" in the Model Rules and the Pillar Two Directive it is generally argued that Article 63 TFEU would and could not apply to Pillar Two.[115] It is, however, unclear if the applicability of Article 63 TFEU is excluded as a general matter in all situations, as the UTPR can also affect the earnings of minority shareholders. In, e.g., the very simple case, where a UPE in a low-tax state owns 81% of an EU CE that has to apply the Pillar Two Directive, this EU CE would have to apply the UTPR to the total (100%) of the top-up tax arising on the earnings of its parent entity under Articles 2.4. and 2.5. Model Rules and Article 14 of the Pillar Two Directive[116] (whereas an IIR in a reversed constellation - and without a QDTT applied by the EU MS of the LTCE – would only cover the proportionate share of the group, i.e., 81%, under Article 2.1. Model Rules and Article 9 of the Pillar Two Directive). As the EU CE faces the top-up tax burden arising from the low taxation of the UPE, the 19% minority shareholders (that may be residents of other EU Member States or third countries that have merely exercised their outbound freedom of capital movement) do also (indirectly) face a higher tax burden on the profits resulting from their investment into the EU CE, which might deter them from investing.[117] The Model Rules and the Pillar Two Directive give rise to many such situations, where the tax burden on mere portfolio investors might be increased because of the Pillar Two rules' split-ownership provisions and jurisdictional blending.

[114] 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., CJEU, 13 November 2012, Case C-35/11, *Test Claimants in the FII Group Litigation*, para. 99; CJEU, 3 October 2013, Case C-282/12, *Itelcar*, paras 16 et seq.; CJEU, 11 September 2014, Case C-47/12, *Kronos International Inc.*, paras 37 et seq.; CJEU, 24 November 2016, Case C-464/14, *SECIL*, para. 33.
[115] See for the exclusive application of the freedom of establishment, e.g., Peter K. Schmidt, A General Income Inclusion Rule as a Tool for Improving the International Tax Regime – Challenges Arising from EU Primary Law, Intertax 2020, 983 (986-987); Joachim Englisch and Johannes Becker, Implementing an international effective minimum tax in the EU, Materialien zu Wirtschaft und Gesellschaft No. 224 (July 2021) 48-49; Joachim Englisch, Non-harmonized Implementation of a GloBE Minimum Tax: How EU Member States Could Proceed, EC Tax Rev. 2021, 207 (207); Johanna Hey, Global Minimum Taxation (GloBE): What Is It About and What Could be a European Answer?, in: Georg Kofler, Ruth Mason, Alexander Rust (eds.), Thinker, Teacher, Traveler – Reimagining International Tax, Essays in Honor of H. David Rosenbloom (2021) 247 (261-264); Arne Schnitger, Die globale Mindestbesteuerung und deren unionsrechtliche Beurteilung, in: Norbert Herzig, Guido Förster, Arne Schnitger and Christian Levedag (eds.), Besteuerung im Wandel, FS Kessler (2021) 169 (176); Arne Schnitger, Vereinbarkeit der Vorschläge zur Einführung von GloBE-Regelungen mit den Grundfreiheiten des AEUV, IStR 2022, 741 (741). See also See Pt. 6 of the Preamble to the 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 Pt. 6 in the Preamble in Doc. 10497/22 [21 June 2022] and in Doc. 8778/22 [25 November 2022]); Joachim Englisch & Johannes Becker, International Effective Minimum Taxation – The GLOBE Proposal, WTJ 2019, 483 (524-525). Sceptical, however, João Félix Pinto Nogueira& Alessandro Turina, Pillar Two and EU Law, in: Andreas Perdelwitz & Alessandro Turina (eds.), Global Minimum Taxation? An Analysis of the Global Anti-Base Erosion Initiative (2021) Chapter 10.3.1., who argue that "control" that leads consolidation does not necessarily require a "definite influence" so that (mainly) the freedom of capital movement should be applicable.
[116] See the Council draft in Doc. 8778/22 (25 November 2022).
[117] This, in principle, can constitute a "restriction" of the freedom of capital movement under Article 63 TFEU. See, e.g., CJEU, 16 July 2020, Case C-686/18, *Adusbef and Others*, para. 102.

However, it might be asked if this increase in the (indirect) tax burden truly is a relevant "restriction" under Article 63 TFEU, because it is neither levied on the investors in the EU CE or the profits distributed to them (but rather the CE's "pre-tax profits"),[118] 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[119] and would, if Article 63 TFEU were found to be applicable, raise similar issues with regard to the comparability and justification analysis as discussed below. A potential conflict with the freedom of capital movement, however, is not as obvious or well-established in the CJEU's case law as the aforementioned frictions with the freedom of establishment.

Domestic Implementation is Not Based on a Directive

5.5. While agreement on the Pillar Two Directive has been reached on 15 December 2022, it seems sensible to first analyze the potential conflicts of unilateral Pillar Two rules, specifically the UTPR, as if the Pillar Two Directive did not exist (and examine in a second step how the existence of the Pillar Two Directive influences these findings). Against this background, the Dutch draft Pillar Two law – in line with the Pillar Two Directive[120] – would extend the Pillar Two rules to (purely) domestic situations, including large-scale domestic groups, hence aiming at eliminating the difference in treatment between domestic and cross-border situations and the potential friction with the freedom of establishment.[121] While one might ask if such extension to domestic situations is sensible from a policy perspective,[122] this was a path chosen by some EU Member States in the past regarding, e.g., thin capitalization rules.[123] The extension of thin capitalization rules to domestic situations has arguably brought

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[118] See, however, e.g., CJEU, 28 September 2006, Joined Cases C-282/04 and C-283/04, *Commission v. Netherlands*, para. 27 concerning "golden shares" and the relevance of an impact on the value of shares for the free movement of capital.
[119] See Ana Paula Dourado, Pillar Two from the Perspective of the European Union, British Tax Review 2022 (5), 573 (585 and 591–592), 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 CE will all be subjected to top-up taxes.
[120] See *infra* Chapter IV.C. and Articles 5(2), 6(2) and (3), 8(2) and (3) of the Pillar Two Directive regarding domestic UPEs, IPEs, POPEs and CEs and Art 5(2) of the Pillar Two Directive (as of Doc. 8778/22 [25 November 2022]) regarding domestic large-scale domestic groups.
[121] See recital 6 of the Pillar Two Directive's preamble: "To ensure compatibility with primary Union law, and more precisely with the freedom of establishment, the rules of this Directive should apply to entities resident in a Member State as well as non-resident entities of a parent entity located in that Member State. This Directive should also apply to very large-scale, purely domestic groups. In this way, the legal framework would be designed to avoid any risk of discrimination between cross-border and domestic situations. All entities, including the parent entity that applies the IIR, which are located in a Member State that is low-taxed, would be subject to the top-up tax. Equally, constituent entities of the same parent entity that are located in another Member State, which is low-taxed, would be subject to the top-up tax." See also, e.g., Luc De Broe, Some EU and Tax Treaty Law Considerations on the Draft EU Directive on Global Minimum Taxation for Multinationals in the Union, 50 Intertax 12, 875 et seq.
[122] See also Opinion AG Geelhoed, 29 June 2006, in CJEU, 13 March 2007, Case C-524/04, *Thin Cap Group Litigation*, para. 68 (concerning thin-capitalization rules); and Luc De Broe, Some EU and Tax Treaty Law Considerations on the Draft EU Directive on Global Minimum Taxation for Multinationals in the Union, 50 Intertax 12, 875 et seq.
[123] See, e.g., Opinion AG Geelhoed, 29 June 2006, in CJEU, 13 March 2007, Case C-524/04, *Thin Cap Group Litigation*, paras 44 and 68, discussing such extension in Germany and the United Kingdom (**UK**).

such rules in line with the freedom of establishment,[124] and a similar discussion was led with regard to the extension of CFC rules to domestic situations to avoid scrutiny under *Cadbury Schweppes*.[125] In that regard, such solution was not only proposed by the OECD,[126] but is also widely accepted in the scholarly discussion,[127] and that acceptance has been transferred to the Model Rules.[128]

5.6. However, there are doubts if such reasoning is valid at least where the extension to domestic situations is largely formalistic: As for Pillar Two, it could be argued that an extension to domestic situations would not remove *factual* ("hidden") discrimination of cross-border situations where either a high-tax jurisdiction is involved (so that a top-up tax would hardly ever arise in that jurisdiction) and/or where none or only few large-scale domestic groups exist (e.g., in smaller economies), as, in reality, the Pillar Two rules may well apply only to international groups.[129] Moreover, there would still be potentially relevant differences in treatment between domestic and cross-border situations: first, in cross-border situations the UTPR top-up tax would be charged at the level of the domestic CE, while in domestic situations any top-up tax would be charged under the IIR at the level of the (domestic) UPE – a distinction that the CJEU found to be discriminatory in *Cadbury Schweppes*.[130] Second, if there is a domestic UPE,

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[124] See, e.g., Opinion AG Geelhoed, 29 June 2006, in CJEU, 13 March 2017, Case C-524/04, *Thin Cap Group Litigation*, EU:C:2006:436, paras 44 and 68, discussing such extension in Germany and the UK.
[125] CJEU, 12 September 2006, Case C-196/04, *Cadbury Schweppes*.
[126] OECD, Designing Effective Controlled Foreign Company Rules, Action 3 – 2015 Final Report (2015) 17-18, noting that "[a] CFC rule will only be found inconsistent with the freedom of establishment if the rule itself discriminates against non-residents. This was made clear in *Cadbury Schweppes*, where the ECJ focused on the difference in treatment under UK CFC rules between a UK controlled company and a non-resident controlled company. […] Therefore, if a CFC rule treats domestic subsidiaries the same as cross-border subsidiaries, it arguably should not be treated as discriminatory under the case law of the ECJ, and no justification is needed. Such an approach would attribute the allocable income of any controlled company, whether foreign or domestic, to its resident shareholders."
[127] For an extensive analysis of the different positions in legal scholarship see Peter K. Schmidt, A General Income Inclusion Rule as a Tool for Improving the International Tax Regime – Challenges Arising from EU Primary Law, Intertax 2020, 983 (993-994); and Joachim Englisch, Implementation of the GloBE common approach on minimum taxation by individual EU Member States in compliance with EU fundamental freedoms (2021) 14-15.
[128] See, e.g., Joachim Englisch & Johannes Becker, International Effective Minimum Taxation – The GLOBE Proposal, WTJ 2019, 483 (524-525) (however, limiting this conclusion to cases where the income inclusion rule were to apply to all foreign and domestic subsidiaries regardless of the level of effective taxation); João Félix Pinto 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, WTJ 2020, 465 (487-489); João Félix Pinto Nogueira & Alessandro Turina, Pillar Two and EU Law, in: Andreas Perdelwitz and Alessandro Turina (eds.), Global Minimum Taxation? An Analysis of the Global Anti-Base Erosion Initiative (2021) Chapter 10.8.; Joachim Englisch, Implementation of the GloBE common approach on minimum taxation by individual EU Member States in compliance with EU fundamental freedoms (2021) 9-14; Joachim Englisch & Johannes Becker, Implementing an international effective minimum tax in the EU, Materialien zu Wirtschaft und Gesellschaft No. 224 (July 2021) 53-54; Joachim Englisch, Implementation of the GloBE common approach on minimum taxation by individual EU Member States in compliance with EU fundamental freedoms, EC Tax Rev. 2021, 136 (138-139); Joachim Englisch, Non-harmonized Implementation of a GloBE Minimum Tax: How EU Member States Could Proceed, EC Tax Rev. 2021, 207 (212-217).
[129] Critical therefore Arne Schnitger, Vereinbarkeit der Vorschläge zur Einführung von GloBE-Regelungen mit den Grundfreiheiten des AEUV, IStR 2022, 741 (744).
[130] CJEU, 12 September 2006, Case C-196/04, *Cadbury Schweppes*, para. 45, where the Court highlighted that the discriminatory effect of UK's CFC rules does not relate to the level of taxation, but rather on the fact "that under such legislation the resident company is taxed on profits of another legal person. That is not the case for a resident company with a subsidiary taxed in the United

only the allocable share of the top-up tax (simplified, e.g., 90% of the top-up tax in case of a 90% beneficial ownership) would be charged (Article 2.1. Model Rules and Article 9 of the Pillar Two Directive),[131] while in the cross-border case the UTPR would be based on the total (100%) top-up tax amount (Articles 2.4. and 2.5. Model Rules and Article 14 of the Pillar Two Directive).

5.7. That said, even if such "factual" discrimination existed, many argue that it would not amount to a prohibited infringement on the freedom of establishment.[132] The CJEU's case law in *Vodafone*[133] and *Tesco*[134] (and, regarding State aid, in *Commission v. Poland*[135] and *Commission v. Hungary*[136]) has dealt with turnover-based sectoral taxes with steeply progressive tax brackets, which factually affected foreign-owned service providers most. In those cases, the CJEU held that a turnover-based threshold is a neutral (rather than an "inherently" discriminatory) criterion and did not find a "factual" discrimination, irrespective of a legislature's potential discriminatory intent.[137] This reasoning, it is broadly argued, is not only transferable to Commission's proposal for a Digital Services Tax[138] (which used a scoping rule that relied on a € 750 million threshold of worldwide revenues),[139] but also valid with respect to the Pillar Two rules.[140]

Kingdom or a subsidiary established outside that Member State which is not subject to a lower level of taxation."

[131] There would not be an additional application of the UTPR to "pick up" the portion of the top-up tax not charged under the IIR. See Art 2.5.2. Model Rules (excluding application of the UTPR where "all of the" UPE's ownership interests in such LTCE – rather than "all of the" ownership interests in the LTCE in general – "are held directly or indirectly" by one or more parent entities that are required to apply a qualified IIR) and in essence identically Art 13(3) of the Pillar Two Directive).

[132] See, e.g., João Félix Pinto 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, WTJ 2020, 465 (479-481); Joachim Englisch, Implementation of the GloBE common approach on minimum taxation by individual EU Member States in compliance with EU fundamental freedoms (2021) 14-19; João Félix Pinto Nogueira & Alessandro Turina, Pillar Two and EU Law, in: Andreas Perdelwitz and Alessandro Turina (eds.), Global Minimum Taxation? An Analysis of the Global Anti-Base Erosion Initiative (2021) Chapter 10.7.3.; Joachim Englisch & Johannes Becker, Implementing an international effective minimum tax in the EU, Materialien zu Wirtschaft und Gesellschaft No. 224 (July 2021) 53-54; Joachim Englisch, Implementation of the GloBE common approach on minimum taxation by individual EU Member States in compliance with EU fundamental freedoms, EC Tax Rev. 136 (138-139); Joachim Englisch, Non-harmonized Implementation of a GloBE Minimum Tax: How EU Member States Could Proceed, EC Tax Rev. 2021, 207 (213-217); Ana Paula Dourado, Is There A Need for A Directive on Pillar Two? Intertax 2022, 521 (526); Luc De Broe, Some EU and Tax Treaty Law Considerations on the Draft EU Directive on Global Minimum Taxation for Multinationals in the Union, Intertax 2022, 874 (875 et seq.); Ana Paula Dourado, The proposal for a EU Directive on pillar two: critical assessment, in: *Otto Marres & Dennis Weber* (eds.), Rara Avis, Liber Amicorum Peter J. Wattel (2022) 73 (79). *Contra* Arne Schnitger, Vereinbarkeit der Vorschläge zur Einführung von GloBE-Regelungen mit den Grundfreiheiten des AEUV, IStR 2022, 741 (744).

[133] CJEU 3 March 2020, Case C-75/18, *Vodafone Magyarország Mobil Távközlési Zrt.*

[134] CJEU 3 March 2020, Case C-323/18, *Tesco-Global Áruházak Zrt.*

[135] CJEU, 16 March 2021, Case C-562/19 P, *Commission v. Poland.*

[136] CJEU, 16 March 2021, Case C-596/19 P, *Commission v. Hungary.*

[137] 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, ET 2020, 555 (555 et seq.).

[138] See the 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 (21 March 2018).

[139] See, e.g., Ruth Mason, What the CJEU's Hungarian Cases Mean for Digital Taxes, 98 Tax Notes Int'l 161.

[140] See, e.g., Joachim Englisch & Johannes Becker, International Effective Minimum Taxation – The GLOBE Proposal, WTJ 2019, 483 (524-525) (however, limiting this conclusion to cases where the

5.8. 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 Two rules to domestic situations: First, *Vodafone* and *Tesco* only concerned domestic turnover, whereas the Pillar Two rules look at the worldwide revenues of the consolidated group. Second, the acceptance of revenue-based tax bracket structure in *Vodafone* and *Tesco* stands in a largely unexplained relationship with the CJEU's decision in *Hervis*,[141] where 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.[142] Third, *Vodafone* and *Tesco* have accepted revenue-based thresholds as a neutral differentiation in light of revenue being a relevant indicator of a (single) taxable person's ability to pay,[143] whereas the Pillar Two threshold refers to the group's revenues (in *Hervis*, the CJEU even referred to the relevance of group turnover for the taxation of a single entity as a taxation "on the basis of a fictitious turnover"[144]). 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, e.g., in the Commission's proposal for a Common Consolidated Corporate Tax Base (CCCTB),[145] the Commission's proposal for a Digital Services Tax (DST),[146] Country-by-Country-Reporting[147] and Public Country-by-Country-Reporting,[148] and that such thresholds are, in principle, justified based on the aims and objectives of the respective legal instruments.

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income inclusion rule were to apply to all foreign and domestic subsidiaries regardless of the level of effective taxation); João Félix Pinto 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, WTJ 2020, 465 (487-489); João Félix Pinto Nogueira & Alessandro Turina, Pillar Two and EU Law, in: Andreas Perdelwitz and Alessandro Turina (eds.), Global Minimum Taxation? An Analysis of the Global Anti-Base Erosion Initiative (2021) Chapter 10.8.; Joachim Englisch, Implementation of the GloBE common approach on minimum taxation by individual EU Member States in compliance with EU fundamental freedoms (2021) 9-14; Joachim Englisch & Johannes Becker, Implementing an international effective minimum tax in the EU, Materialien zu Wirtschaft und Gesellschaft No. 224 (July 2021) 53-54; Joachim Englisch, Implementation of the GloBE common approach on minimum taxation by individual EU Member States in compliance with EU fundamental freedoms, EC Tax Rev. 2021, 136 (138-139); Joachim Englisch, Non-harmonized Implementation of a GloBE Minimum Tax: How EU Member States Could Proceed, EC Tax Rev. 2021, 207 (212-217).

[141] CJEU, 5 February 2014, Case C-385/12, *Hervis*.

[142] For discussion 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, ET 2020, 555 (555 et seq.).

[143] CJEU 3 March 2020, Case C-75/18, *Vodafone Magyarország Mobil Távközlési Zrt.*, para. 49.

[144] CJEU, 5 February 2014, Case C-385/12, *Hervis*, para. 36.

[145] See Article 2 of the Proposal for a Council Directive on a Common Consolidated Corporate Tax Base (CCCTB), COM(2016)683 (25 October 2016).

[146] See Article 4 of the 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 (21 March 2018).

[147] Council Directive (EU) 2016/881 of 25 May 2016 amending Directive 2011/16/EU as regards mandatory automatic exchange of information in the field of taxation, [2016] OJ L 146/8.

[148] 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, [2021] OJ L 429/1.

5.9. Finally, if a "factual" discrimination indeed exists, the respective EU Member State would need to justify it based on overriding reasons in the public interest. Many "traditional" grounds of justification would clearly not be applicable, most notably a justification based on anti-avoidance or the argument that compensatory taxation serves the coherence of the tax system.[149] To the contrary, e.g., the CJEU in *Eurowings* and *Ramstedt* has unequivocally rejected the latter argument and further noted that "[s]uch compensatory tax arrangements prejudice the very foundations of the single market".[150]

5.10. There are, however, two yet untested arguments that certainly warrant attention:

- First, AG Kokott has recently argued that the "objective of ensuring a minimum level of taxation […] is regarded as an overriding reason in the public interest",[151] and explicitly referred to the minimum level of taxation in "the second pillar of measures recommended by the OECD to combat tax avoidance".[152] While the CJEU has not yet addressed this argument,[153] it remains to be seen whether such new ground of justification will be accepted in the future. This may require a change in the CJEU's perspective on tax competition, as, in the reverse situation, it has so far consistently found that "any advantage resulting from the low taxation to which a subsidiary established in a Member State other than the one in which the parent company was incorporated is subject cannot by itself authorise that Member State to offset that advantage by less favourable tax treatment of the parent company".[154]

- Second, it may be argued that the international consensus set out in the October Statement may provide sufficient justification. While not an international agreement, such international consensus could facilitate the argument that the Pillar Two rules are not about protectionism by *single* EU Member States, which would be in

[149] See, e.g., João Félix Pinto 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, WTJ 2020, 465 (482-486); João Félix Pinto Nogueira and Alessandro Turina, Pillar Two and EU Law, in: Andreas Perdelwitz and Alessandro Turina (eds.), Global Minimum Taxation? An Analysis of the Global Anti-Base Erosion Initiative (2021) Chapters 10.3.3. and 10.5.; Joachim Englisch and Johannes Becker, Implementing an international effective minimum tax in the EU, Materialien zu Wirtschaft und Gesellschaft No. 224 (July 2021) 51-52; Arne Schnitger, Die globale Mindestbesteuerung und deren unionsrechtliche Beurteilung, in: Norbert Herzig, Guido Förster, Arne Schnitger and Christian Levedag (eds.), Besteuerung im Wandel, FS Kessler (2021) 169 (182-185).
[150] CJEU, 26 October 1999, C-294/97, *Eurowings*, EU:C:1999:524, para. 45 ("solche kompensatorischen Abgaben [würden] den Binnenmarkt in seinen Grundlagen beeinträchtigen"); CJEU, 26 June 2003, C-422/01, *Ramstedt*, EU:C:2003:380, para. 52.
[151] Opinion AG Kokott, 6 May 2021, C-545/19, *Allianzgi-Fonds*, EU:C:2021:372, para. 97.
[152] Opinion AG Kokott, 6 May 2021, C-545/19, *Allianzgi-Fonds*, EU:C:2021:372, para. 96.
[153] Notably, the Court did not mention this argument in CJEU, 17 March 2022, C-545/19, *Allianzgi-Fonds*, EU:C:2022:193.
[154] See CJEU, 17 September 2015, C-589/13, *F.E. Familienprivatstiftung Eisenstadt*, EU:C:2015:612, para. 76, which referred to CJEU, 12 September 2006, C-196/04, *Cadbury Schweppes*, EU:C:2006:544, para. 49, which in turn relied, *inter alia*, on CJEU, 26 October 1999, C-294/97, *Eurowings*, EU:C:1999:524, para. 44, and CJEU, 26 June 2003, C-422/01, *Ramstedt*, EU:C:2003:380, para. 52.

conflict with the notion of the Internal Market (Article 26 TFEU) and the fundamental freedoms serving it, but rather about the creation of an international "level playing field" and hence not objectionable from the perspective of the fundamental freedoms.[155] A similar internationally-oriented argument is espoused in the preamble to the Pillar Two Directive, which refers to putting a "floor on competition over corporate income tax rates through the establishment of a global minimum level of taxation",[156] and it has been pointed out that – in a context relating to tax treaties – the CJEU has "occasionally referred to OECD standards when assessing the legitimacy of some tax measures".[157] This argument, however, needs to be put in context as well: first, the consensus on the October Statement concerned the "two-pillar solution to address the tax challenges arising from the digitalisation of the economy", implying that such consensus refers to the overall "package", which implies that no consensus exists at all if one of the two pillars fails or if serious modifications take place. Second, the October Statement still had the "Undertaxed Payment Rule (UTPR)" in mind, "which denies deductions or requires an equivalent adjustment", which is arguably something different from an Undertaxed Profits Rule that simply charges top-up tax (irrespective to any deductible payments). Third, the October Statement clearly lays out that the Pillar Two rules are not binding, but rather have the "status of a common approach", meaning that a state may either adopt them or accept their application by other states; this is clearly not seem to be same as a consensus on the domestic implementation of the Pillar Two rules, especially in light of the fact that some members of the OECD's IF – such as the US – are arguably not willing or able to comply with the Model Rules. Fourth, it might be doubted that even if one were to assume a relevant consensus on the international level, that such consensus would be enough to overcome the set-up of the EU's internal market, for which the CJEU has consistently held that permitting taxation based on the disparity in the rates of corporation tax in effect within the Union "would manifestly lead to a result contrary to the very notion of "single market". Fifth, and finally, and since the UTPR merely serves as the "backstop" for minimum taxation, it is also a rule that upsets the traditional allocation of taxing powers by allocating top-up tax to a jurisdiction which has no connection to the underlying income other than being part of an MNE Group.[158]

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[155] See for that discussion, e.g., Joachim Englisch & Johannes Becker, Implementing an international effective minimum tax in the EU, Materialien zu Wirtschaft und Gesellschaft No. 224 (July 2021) 48-49 (quite correctly pointing out that "it is ultimately unclear whether the CJEU would be accommodating enough to allow for an effective implementation of GloBE within the EU, and any predictions to this effect are speculative"); Arne Schnitger, Die globale Mindestbesteuerung und deren unionsrechtliche Beurteilung, in: Norbert Herzig, Guido Förster, Arne Schnitger & Christian Levedag (eds.), Besteuerung im Wandel, FS Kessler (2021) 169 (186-188).
[156] Recital 2 of Pillar Two Directive's preamble.
[157] See Joachim Englisch, Is an METR Compatible With EU/EEA Free Movement Guarantees? 102 Tax Notes Int'l 219.
[158] Critical therefore Arne Schnitger, Vereinbarkeit der Vorschläge zur Einführung von GloBE-Regelungen mit den Grundfreiheiten des AEUV, IStR 2022, 741 (746).

Domestic Implementation is Based on a Directive

5.11. The existence of the Pillar Two Directive changes the picture. Two core issues stand out: first, the Pillar Two Directive would put an obligation on EU Member States of any UPE, POPE, or intermediate parent entity (**IPE**) to apply the IIR and, second, extend this treatment to its own entities ("domestic application of the IIR") to guarantee non-discriminatory treatment of cross-border vis-à-vis domestic situations.[159] The latter aspect has the following effects:

- First, all LTCEs established in a low-tax EU Member State (including UPEs and POPEs, but also IPEs, unless covered by a qualified IIR somewhere else) are subject to the IIR top-up tax (Article 5(2) of the Pillar Two Directive) if the group meets the € 750 million revenue threshold; similarly, purely domestic "large-scale domestic groups" are to be covered. Here, one might again raise the argument of a *factual* discrimination, as the extension to domestic situations might largely be formalistic (either because there will hardly be any LTCEs in a high-tax EU Member State or because hardly any "large-scale domestic groups" exist).[160]

- Second, within the EU and as a result of the priority of the IIR over the UTPR, the application of the UTPR in other EU Member States and elsewhere is irrelevant and primarily reserved for when the UPE (possibly with other subsidiaries) is based in a third country that is a low-tax state (Articles 12 & 13 of the Pillar Two Directive).[161] However, there is the potential exception of situations where an EU Member State opts not to apply the IIR for a certain period of time under the so-called "Estonian clause" (Article 50 of the Pillar Two Directive). Article 50 of the Pillar Two Directive provides EU Member States with an option: EU Member States in which no more than twelve ultimate parent entities of groups within the scope of the Pillar Two Directive are located may elect not to apply the IIR and the UTPR for six consecutive fiscal years beginning from 31 December 2023. However, in that case the other EU Member States must apply the UTPR to LTCEs in the EU Member State that has made such election (Article 50(2) of the Pillar Two 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.

- Third, however, the domestic application of the Pillar Two rules is delayed for "large-scale domestic groups", which are exempt from the IIR "in the first five years, starting from the first day of the fiscal year in which the large-scale domestic group falls within the scope of this Directive for the first time" (Article 49(1)(b) of the Pillar Two

[159] See recitals 4 and 6 of the Pillar Two Directive's Preamble.
[160] See also *supra* Chapter IV.B.
[161] See also Luc De Broe, Some EU and Tax Treaty Law Considerations on the Draft EU Directive on Global Minimum Taxation for Multinationals in the Union, 50 Intertax 12, 875 et seq.

Directive[162]), whereas established MNE Groups (i.e., those not in the initial phase of international activity under Article 49(1)(a) and (2) of the Pillar Two Directive[163]) are not; while this could be a critical point of discrimination, it is only relevant with regard to the IIR and will hence not examined further.[164]

5.12. That said, and even if certain features of the Pillar Two Directive would turn out to be discriminatory in light of the freedom of establishment (which also applies to the EU legislature[165]), it is also established case law of the CJEU that the level of scrutiny shifts:

- First, if EU legislation has achieved so-called “exhaustive” (“full”, ”complete”) harmonization, a national measure “must be assessed in the light of the provisions of the harmonizing measure and not those of the Treaty”.[166] Recent case law demonstrates that “exhaustive” harmonization not only relates to an “area”,[167] a “sector”,[168] a “sphere”,[169] a “matter”[170] or a “field“,[171] but also to singular (mandatory) rules, i.e., if no down- or upward derogation is permitted from that “floor” or “ceiling” (i.e., even if it is so-called “minimum harmonization”).[172] In the tax area, e.g., the CJEU has not only found the rules on indirect taxation of the raising of capital to be exhaustive,[173] but also singular provisions of the VAT-Directive.[174] Arguably, therefore, the Pillar Two Directive, which provides a stand-alone, mandatory set of rules without options for EU Member States to deviate, could be considered as “exhaustive” harmonization.

- Second, and once “exhaustive harmonization” is achieved, national tax law will only be tested against the secondary EU law it seeks to

[162] Art. 47(1)(b) in Doc. 10497/22 (21 June 2022).
[163] Art. 47(1)(a) and (2) in Doc. 10497/22 (21 June 2022).
[164] See, however, Luc De Broe, Some EU and Tax Treaty Law Considerations on the Draft EU Directive on Global Minimum Taxation for Multinationals in the Union, 50 Intertax 12, 875 et seq.
[165] See, e.g., CJEU, 1 October 2009, Case C-247/08, *Gaz de France*, para. 53; CJEU, 25 June 1997, Case C-114/96, *René Kieffer and Romain Thill*, para. 27; CJEU, 26 October 2010, Case C-97/09, *Schmelz*, para. 50; for detailed analysis see, e.g., Georg Kofler, The Relationship between the Fundamental Freedoms and Directives in the Area of Direct Taxation, Dirrito E Pratica Tributaria Internazionale (DPTI) 2009, 471 (471-514).
[166] See, e.g., CJEU, 12 October 1993, Case C-37/92, *Vanacker and Lesage*, para. 9; CJEU, 11 December 2003, Case C-322/01, *DocMorris*, para. 64; CJEU, 1 October 2009, Case C-569/07, *HSBC*, para. 25-26; CJEU, 19 October 2017, Case C-573/16, *Air Berlin*, paras 27-29; CJEU, 14 December 2004, Case C-210/03, *Swedish Match AB*, para. 81.
[167] CJEU, 16 December 2008, Case C-205/07, *Lodewijk Gysbrechts*, para. 33; ECJ, 12 November 2015, Case C-198/14, *Visnapuu*, paras 40-48.
[168] CJEU, 30 April 2014, Case C-475/12, *UPC DTH Sàrl*, para. 63.
[169] CJEU, 11 December 2003, Case C-322/01, *DocMorris*, para. 64; CJEU, 18 July 2013, Case C-265/12, *Citroën Belux*, para. 31.
[170] CJEU, 13 December 2001, Case C-324/99, *DaimlerChrysler*, paras 32, 42-43.
[171] CJEU, 9 March 2006, Case C-421/04, *Matratzen Concord AG*, para. 20.
[172] Opinion of AG Kokott, 13 July 2017, in CJEU, 23 November 2017, Case C-292/16, *A Oy*, para. 22 (“duty” versus “entitlement”).
[173] See CJEU, 1 October 2009, Case C-569/07, *HSBC*, paras 25-26; CJEU, 19 October 2017, Case C-573/16, *Air Berlin*, paras 27-29.
[174] See on Articles 282, 283 of the VAT Directive CJEU, 26 October 2010, Case C-97/09, *Schmelz*,.

implement, but not against primary EU law,[175] i.e., the national measure "must be assessed in the light of the provisions of the harmonizing measure and not those of the Treaty".[176] The issue then becomes a question of validity of secondary EU Law (Articles 263, 267 TFEU), i.e., the focus would shift to the question whether the Pillar Two Directive itself complies with the fundamental freedoms. However, the CJEU exercises quite some restraint when evaluating secondary EU law in light of primary EU law. From a policy perspective, the CJEU seems to assume that in case of EU secondary legislation there is less risk of protectionism and more expression of common interests ("harmonized European value"), which is also relevant for justification and proportionality of EU law measures.[177] Indeed, the EU legislature enjoys a much broader discretion than domestic legislatures with regard to shaping of the internal market.[178] 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".[179] 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".[180] Since the EU legislature enjoys such broad discretion, this also "implies limited judicial review of its exercise",[181] which is hence "limited to review as to manifest error".[182] It seems to be against that background that the Pillar Two Directive's notes that "a common framework, designed to be compatible with the fundamental freedoms guaranteed by the Treaty", would provide legal certainty[183] and that the Pillar Two Directive's extension to domestic situations is to "ensure compatibility with primary Union law, and more precisely with the freedom of establishment".[184]

[175] See, e.g., CJEU, 8 March 2017, Case C-14/16, *Euro Park Service*, para. 19; CJEU, 20 December 2017, Joined Cases C-504/16 and C-613/16, *Deister Holding and Juhler Holding*, para. 45.
[176] CJEU, 12 October 1993, Case C-37/92, *Vanacker and Lesage*, para. 9; CJEU, 11 December 2003, Case C-322/01, *DocMorris*, paras 63-65; CJEU, 16 December 2008, Case C-205/07, *Lodewijk Gysbrechts*, para. 33; CJEU, 18 July 2013, Case C-265/12, *Citroën Belux*, para. 31; CJEU, 30 April 2014, Case C-475/12, *UPC DTH Sàrl*, para. 63.
[177] See, e.g., CJEU, 13 May 1997, Case C-233/94, *Germany v. Parliament and Council* ("deposit-guarantee schemes"); CJEU, 26 October 2010, Case C-97/09, *Schmelz*.
[178] See, e.g., CJEU, 17 October 2013, Case C-203/12, *Billerud*, paras 34-37; CJEU, 7 March 2017, Case C-390/15, *Rzecznik Praw Obywatelskich (RPO)*, paras 37-72; CJEU, 8 December 2020, Case C-620/18, *Hungary v. Parliament and Council*, paras 104-117; CJEU, 8 December 2020, Case C-626/18, *Poland v. Parliament and Council*, paras 87-100.
[179] CJEU, 17 October 2013, Case C-203/12, *Billerud*, para. 34-37; CJEU, 7 March 2017, Case C-390/15, *RPO*, para. 34; CJEU, 8 December 2020, Case C-620/18, *Hungary v. Parliament and Council*, para. 112.
[180] CJEU, 8 December 2020, Case C-620/18, *Hungary v. Parliament and Council*, para. 112.
[181] CJEU, 8 December 2020, Case C-620/18, *Hungary v. Parliament and Council*, para. 114.
[182] See, e.g., CJEU, 10 December 2002, Case C-491/01, *British American Tobacco (Investments) and Imperial Tobacco*, para. 123; CJEU, 17 October 2013, Case C-203/12, *Billerud*, para. 35; CJEU, 7 March 2017, Case C-390/15, *RPO*, para. 54.
[183] Recital 4 in the preamble in Doc. 10497/22 (21 June 2022).
[184] See recitals 4 and 6 in the preamble in Doc. 10497/22 (21 June 2022). Similarly, the ATAD's preamble 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, [2016] OJ L 193/1).

- Third, even those who take a more narrow view and would see "exhaustive harmonization" only where a complete field (e.g., corporate taxation) has been harmonized accept that "Directives benefit from a presumption of legality", 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", so that the CJEU "only sanctions manifest or disproportional breaches of primary Union law".[185]

5.13. In light of the broad discretion of the EU legislature, it seems unlikely that the CJEU would accept a challenge to the Pillar Two Directive and/or its domestic implementation in light of the fundamental freedoms, even if it contained certain discriminatory features (e.g., the delayed application of the IIR for established "large-scale domestic groups" vis-à-vis established EU groups).[186] What remains therefore, would be a challenge to the validity of the Pillar Two Directive in light of a lack of competence of the EU. The Commission has claimed that the internal market competence under Article 115 TFEU is a suitable basis[187] to remove the "inconsistency" of the "absence of rules ensuring minimum effective corporate taxation across the Single Market" and that the Directive also complies with the requirements of subsidiarity[188] and proportionality under Article 5 TEU.[189] Especially the qualification of Article 115 TFEU as a sound legal basis is disputed: some argue that the Pillar Two Directive would not improve the functioning of the internal market[190] (also a common objection to the ATAD[191]), whereas others focus on the removal of distortions and argue for the Union's competence.[192] The CJEU did not yet have the opportunity to scrutinize the recent wave of anti-tax planning Directives (such as the ATAD or the Directives

[185] See Luc De Broe, Some EU and Tax Treaty Law Considerations on the Draft EU Directive on Global Minimum Taxation for Multinationals in the Union, 50 Intertax 12, 875 et seq.
[186] See also Luc De Broe, Some EU and Tax Treaty Law Considerations on the Draft EU Directive on Global Minimum Taxation for Multinationals in the Union, 50 Intertax 12, 875 et seq.
[187] Commission's Proposal for a Council Directive on ensuring a global minimum level of taxation for multinational groups in the Union, COM(2021)823, 2.
[188] It might be noted here that subsidiarity may also exclude EU action when action is already being taken at international level and proving just as effective as Union 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 Two) into EU law. See, e.g., Georg Kofler, EU Power to Tax: Competences in the Area of Direct Taxation, in: Christiana HJI Panayi, Werner Haslehner & Edoardo Traversa (eds.), Research Handbook on European Union Taxation Law (2020) 11 (29); Joachim Englisch & Johannes Becker, Implementing an international effective minimum tax in the EU, Materialien zu Wirtschaft und Gesellschaft No. 224 (July 2021) 45.
[189] See the Commission's Proposal for a Council Directive on ensuring a global minimum level of taxation for multinational groups in the Union, COM(2021)823, 2-3.
[190] Arne Schnitger, Vereinbarkeit der Vorschläge zur Einführung von GloBE-Regelungen mit den Grundfreiheiten des AEUV, IStR 2022, 741 (743); Ana Paula Dourado, Pillar Two from the Perspective of the European Union, British Tax Review 2022 (5), 573 (590).
[191] For a detailed discussion see Georg Kofler, EU Power to Tax: Competences in the Area of Direct Taxation, in: Christiana HJI Panayi, Werner Haslehner and Edoardo Traversa (eds.), Research Handbook on European Union Taxation Law (2020) 11 (23-26).
[192] See, e.g., João Félix Pinto 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, WTJ 2020, 465 (493-494); Joachim Englisch &Johannes Becker, Implementing an international effective minimum tax in the EU, Materialien zu Wirtschaft und Gesellschaft No. 224 (July 2021) 41-48.

on Administrative Cooperation) in light of the competence discussion, so that it remains to be seen how far the EU's internal market competence reaches.[193]

5.14. One final issue should be considered: State aid under Articles 107 and 108 TFEU. Back in 2018, when the Commission proposed a Digital Services Tax[194] with a scoping that also relied on a € 750 million revenue threshold, it has been argued that such threshold in unilateral measures may be viewed as granting aid to smaller (EU) taxpayers below the thresholds, which would be prohibited under Articles 107 and 108 TFEU.[195] While the CJEU has not yet addressed the question of a threshold relating to worldwide revenues, the decisions in *Commission v. Poland*[196] and *Commission v. Hungary*[197] relating to the State aid dimension of sectoral, turnover-based taxes (at issue also in *Vodafone*[198] and *Tesco*[199]) are generally viewed as implying that thresholds for taxability – even if they are high – do not face any objection from a State aid perspective because they are understandable based on administrative reasons and the wish to tax an undertaking's activity only when that activity reaches a certain level.[200] However, such thresholds may raise similar questions to those based on "factual" discrimination under the fundamental freedoms. Again, the existence of the Pillar Two Directive changes the picture: State aid is not a problem at all (with regard to the mandatory IIR and UTPR), as any aid would not be imputable to an EU Member State (but rather to the EU) and consequently not fall under the prohibition of Articles 107 and 108 TFEU.[201]

6. Conclusions and final remarks

6.1. Annex 1 above contains an executive summary and the main conclusions.

[193] With regard to the third country reach of the Pillar Two Directive, it may be noted that the EU's competence under Article 4(2)(a) and Article 115 TFEU not only covers purely internal situations, but that 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., Georg Kofler, Doppelbesteuerungsabkommen und Europäisches Gemeinschaftsrecht (2007), 322–323; Daniel S. Smit, "The Influence of EU Tax Law on the EU Member States' External Relations" in: Werner Haslehner, Georg Kofler & Alexander Rust (eds), EU Tax Law and Policy in the 21st Century (2017) 215 (221 and 223–224).
[194] See the 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 (21 March 2018).
[195] See, e.g., Ruth Mason & Leopoldo Parada, Digital Battlefront in the Tax Wars, 92 Tax Notes Int'l 1183; Ruth Mason & Leopoldo Parada, Company Size Matters, BTR 2019, 610; R. Mason, What the CJEU's Hungarian Cases Mean for Digital Taxes, 98 Tax Notes Int'l 161; Ruth Mason & Leopoldo Parada, The Legality of Digital Taxes in Europe, 40 Virginia Tax Rev. 175 (2020).
[196] CJEU, 16 March 2021, Case C-562/19 P, *Commission v. Poland*.
[197] CJEU, 16 March 2021, Case C-596/19 P, *Commission v. Hungary*.
[198] CJEU 3 March 2020, Case C-75/18, *Vodafone Magyarország Mobil Távközlési Zrt*.
[199] CJEU 3 March 2020, Case C-323/18, *Tesco-Global Áruházak Zrt*.
[200] See also Ruth Mason, What the CJEU's Hungarian Cases Mean for Digital Taxes, 98 Tax Notes Inter'l 161; Robert Goulder, The Futility of Challenging DSTs Under State Aid Doctrine, 100 Tax Notes Int'l 725.
[201] See, e.g., Court of First Instance, 5 April 2006, T-351/02, *Deutsche Bahn*, paras 101-103; CJEU, 23 April 2009, Case C-460/07, *Sandra Puffer*, para. 70; para. 44 of the 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] OJ C 262/1; see also 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, ET 2020, 555 (564); Luc De Broe, Some EU and Tax Treaty Law Considerations on the Draft EU Directive on Global Minimum Taxation for Multinationals in the Union, 50 Intertax 12, 875 et seq.

6.2. Our main conclusion is that the UTPR, as included in the Pillar Two directive and national implementing laws of EU Member States, such as the Dutch draft Pillar Two law, is likely to lead to tensions with tax treaties and is arguably at odds with customary international law, and, to some limited extent, potentially with EU law. To safeguard legal certainty and remedy such potential conflicts, a conclusion of a multilateral tax treaty should be considered.

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