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FOCUS

NEW ORDERS AND ROUTINES OF INTERNATIONAL ECONOMIC GOVERNANCE: PROGRESS AND PROSPECTS

TAXING DIGITAL ECONOMY: A CRITICAL VIEW AROUND THE GLOBE (PILLAR TWO)

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Abstract The Organisation for Economic Co-operation and Development (OECD) proposal for taxation of digital economy constitutes one of the most ambitious projects in the field of taxation and may lead to the most significant reform to international tax rules in the 20th century. Based on a two-pillar approach, Pillar Two of the proposal suggests the adoption of Global Anti-Base Erosion (GloBE) provisions that are aimed at introducing a worldwide minimum tax. In this article, a critical analysis is based that the GloBE proposal suggests that it represents a shift in the OECD policy. As compared to base erosion and profit shifting (BEPS), it jeopardizes the tax sovereignty of jurisdictions and it raises fundamental challenges of implementation, both in terms of amendments to domestic law and conflicts with tax treaties.

Keywords Organisation for Economic Co-operation and Development (OECD), base erosion and profit shifting (BEPS), digital economy, minimum tax, Pillar Two, Global Anti-Base Erosion (GloBE), Global Intangible Low-Taxed Income (GILTI), Base Erosion Anti-Abuse Tax (BEAT), tax treaties

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The opinions are my own; the usual disclaimer applies.

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INTRODUCTION

The global economy is undergoing a digital transformation and it is happening at breakneck speed. The digital economy has been widely regarded as the single most important driver of innovation, competitiveness, and growth in the world. At the same time, the digital economy has undermined conventional notions about how businesses are structured, how firms interact, and how consumers obtain services, information, and goods. These fundamental changes have impacted the tax system. The current international tax rules can no longer cope with the way digital businesses are structured.[1] It is hard to believe that these current rules date back to the early 1920s.[2]

Therefore, in an increasingly digital era, it has become urgent to rethink the current tax systems (essentiality designed to deal with a traditional economy) to adapt to the digital economy. This is particularly relevant in Asia where many countries have become important players in the digital economy. For example, China now surpasses the United States as the largest e-commerce (B2C) consumer market in the world. India and Indonesia have also experienced rapid growth in the e-commerce sector.

Since the inception of the OECD/G20 Base Erosion and Profit Shifting (BEPS) Project, addressing the challenges of the digital economy has been a high priority on the OECD agenda. It is not a coincidence that first among the 15 action plans is "Action 1" to address the tax challenges of the digital economy. Though 15 action plans were delivered in October 2015, Action 1 was the only deliverable for which no real proposals were submitted.[3] The tax challenges posed by the digital economy are difficult to address and

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[1] See for an overview, Rifat Azam & Orly Mazur, *Cloudy with a Chance of Taxation*, 22(1) Florida Tax Review, 500 (2019). See also Lorraine Eden, *Transfer Pricing Challenges in Digital Economy: Hic Sunt Dracones?* 48(1) Tax Management International Journal, 1 (2019) or Lilian V. Faulhaber, *Taxing Tech: The Future of Digital Taxation*, 39(2) Virginia Tax Review, 150 (2019).

[2] See in this regard Brett Wells & Cym Lowell, *Tax Base Erosion: Reformation of Section 482's Arm's Length Standard*, 15 Florida Tax Review, 737 (2014). Noting for instance that the arm's length principle has been the global standard since the 1920s. For a brief history of the arm's length principle in the United States, see Lorraine Eden, *The Arm's Length Standard Is Not the Problem*, 48 Tax Management International Journal, 1–2 (2019).

[3] OECD, *Addressing the Tax Challenges of the Digital Economy, Action 1 — 2015 Final Report*, OECD/G20 Base Erosion and Profit Shifting Project, available at https://doi.org/10.1787/9789264241046-en (last visited Feb. 3, 2020).

technically complex.[4]

Since then, and particularly since 2019, new advances have been made to the two-pillar approach.[5] Pillar One focuses on the allocation of taxing rights and Pillar Two focuses on the remaining BEPS issues. More recently, the OECD Secretariat submitted two new proposals for consultation.[6] The existing proposals demonstrate the complexity of matters and their far-reaching effects. These proposals extend beyond digital businesses and initiate significant changes in the international tax rules as we know them. They suggest a departure from some of the most fundamental rules of the international tax system from the last 100 years.

The purpose of this article is to provide analysis regarding the existing proposal under Pillar Two (also referred to as the "Global Anti-Base Erosion" or "GloBE"). For this purpose, I will first start by describing the background of the OECD proposal regarding Pillar Two. Then, I will analyze its main features and assess potential issues in its current design. Finally, I offer conclusions.

I. BACKGROUND OF THE GLOBE PROPOSAL

A. Background

In January 2019, the Inclusive Framework (IF) on BEPS issued Addressing the Tax Challenges of the Digitalisation of the Economy — Policy Note. According to that Note, the IF agreed to work on a two-pillar approach. The development of Pillar Two:[7]

> *focuses on the remaining BEPS issues and seeks to develop 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.*

According to the OECD,[8] Pillar Two is driven by:

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[4] See in this regard also the OECD, *Tax Challenges Arising from Digitalisation — Interim Report 2018: Inclusive Framework on BEPS*, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing (Paris), available at https://doi.org/10.1787/9789264293083-en (last visited Jan. 31, 2020).

[5] OECD, *Addressing the Tax Challenges of the Digitalisation of the Economy Policy Note, as Approved by the Inclusive Framework on BEPS*, (Jan. 2019), available at https://www.oecd.org/tax/beps/policy-note-beps-inclusive-framework-addressing-tax-challenges-digitalisation.pdf (last visited Feb. 2, 2020).

[6] See *Public Consultation Document Secretariat Proposal for a "Unified Approach" under Pillar One*, available at https://www.oecd.org/tax/beps/public-consultation-document-secretariat-proposal-unified-approach-pillar-one.pdf (last visited Feb. 2, 2020); see *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 (last visited Feb. 3, 2020).

[7] See OECD, fn. 5.

[8] See *OECD/G20 Base Erosion and Profit Shifting Project Programme of Work to Develop a Consensus Solution to the Tax Challenges Arising from the Digitalisation of the Economy*, at 25 (2019).

52. […] the global anti-base erosion (GloBE) proposal which seeks to address remaining BEPS risk of profit shifting to entities subject to no or very low taxation […]

53. While the measures set out in the BEPS package have further aligned taxation with value creation and closed gaps in the international tax architecture that allowed for double non-taxation, certain members of the Inclusive Framework consider that these measures do not yet provide a comprehensive solution to the risk that continues to arise from structures that shift profit to entities subject to no or very low taxation. These members are of the view that profit shifting is particularly acute in connection with profits relating to intangibles, prevalent in the digital economy, but also in a broader context; for instance group entities that are financed with equity capital and generate profits, from intra-group financing or similar activities, that are subject to no or low taxes in the jurisdictions where those entities are established.

The OECD also justifies this proposal based on efficiency considerations[9] aiming at reducing:[10]

the distortive impact of direct taxes on investment and business location decisions.

And also:[11]

effectively shield developing countries from the pressure to offer inefficient incentives and in doing so help them in better mobilising resources by ensuring that they will be able to effectively tax returns on investments made in their countries.

This was later reaffirmed in the public consultation document in which the OECD outlined specific technical issues in respect of the GloBE proposal.[12] When describing the purpose of and need for Pillar Two, it stated that:[13]

[…] Pillar Two represents a substantial change to the international tax architecture. This Pillar seeks to comprehensively address remaining BEPS challenges by ensuring that the profits of internationally operating businesses are subject to a minimum rate of tax. A minimum tax rate on all income reduces the incentive for taxpayers to engage in profit shifting and establishes a floor for tax competition among jurisdictions. In doing so, the

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[9] Efficiency constitutes one of the three fundamental principles of a tax system together with simplicity and equality. See in this regard, Peter A. Harris, *Corporate Shareholder/Income Taxation and Allocating Taxing Rights between Countries*, IBFD (Amsterdam), at 6–26 (1997) or H. David Rosenbloom, *From the Bottom up: Taxing the Income of Reign Controlled Corporations*, 26(4) Brooklyn Journal of International Law, 1526–1530 (2000).

[10] See *OECD/G20 Base Erosion and Profit Shifting Project Programme of Work to Develop a Consensus Solution to the Tax Challenges Arising from the Digitalisation of the Economy*, fn. 8 at 26.

[11] Id.

[12] 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 (last visited Feb. 2, 2020).

[13] Id. at 6.

GloBE proposal is intended to address the remaining BEPS challenges linked to the digitalisation of the economy, but it goes even further and addresses these challenges more broadly. The GloBE proposal is expected to affect the behaviour of taxpayers and jurisdictions. It posits that global action is needed to stop a harmful race to the bottom on corporate taxes, which risks shifting the burden of taxes onto less mobile bases and may pose a particular risk for developing countries with small economies.

From the overall reading of the OECD proposals, it appears that the GloBE can be justified by two reasons.[14] First of all, there are jurisdictions that adopt low or zero corporate income tax rates that will incentivize the adoption of BEPS practices that cannot be entirely dealt with by the BEPS Actions; second, jurisdictions create perverse effects when implementing tax incentives that compete with other jurisdictions to attract foreign direct investment.

Therefore, it can be assumed that the OECD's motivation behind the GloBE is to address BEPS practices that arise from inflated profits in low tax jurisdictions. This shall be achieved through the adoption of a coordinated multilateral action to stop the harmful race to the bottom of corporate income tax rates and subjecting multinational enterprises (MNEs) to a (global) minimum rate of tax.[15]

B. Main Features

In order to achieve these goals, the GloBE comprises four components:[16]

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.

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[14] See identically Lorraine Eden, *Taxing Multinationals: The GloBE Proposal for a Global Minimum Tax*, 49(1) Tax Management International Journal, (2020).

[15] Id. at 54.

[16] See OECD, fn. 12 at 6.

Therefore, Pillar Two was developed around two sets of rules: Two rules aimed at the jurisdiction of residence of the shareholder that combines an income inclusion rule and a switch-over rule; two rules addressed the source of the payment, combining a subject to tax rule and an undertaxed payments rule.

The income inclusion rule operates as a minimum tax, by requiring a shareholder of a corporation to include income earned by that corporation in the shareholder's own income, if that income has not been subject to an effective rate of tax above the minimum rate. This rule appears to minimize substitution, changes in taxpayer decisions, and tax avoidance behaviors. The distribution of production factors should take place on the basis of market mechanisms with minimum government policy interference. From the tax policy perspective, taxation should follow business decisions and should not determine them in any (positive or negative) way.[17] Taxation should follow the economic operator and its business; it should not affect their choices. In other words, taxation should be neutral.[18] A tax system is efficient if it minimizes substitution effects by being neutral at key decisional boundaries and thereby giving taxpayers no reason to change their decisions or behaviors.[19] By ensuring that income is subject to a minimum tax rate, the GloBE proposal expects to reduce the incentive to allocate income for tax reasons to low taxed entities.[20] The inclusion rule operates as a top-up tax to a minimum rate that is calculated as a fixed percentage.[21] This measure is justified as a way to protect the tax base of the jurisdiction where the parent company is located — as well as other jurisdictions where a group operates. It reduces the incentive to shift profits to group entities that are located in jurisdictions where the effective rate is below the minimum rate.

The income inclusion rule is inspired by the US Global Intangible Low-Taxed Income (GILTI) which applies to every foreign subsidiary that is taxed below a certain rate.[22]

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[17] See *inter alia*, Klaus Vogel, *Worldwide vs. Source Taxation of Income: A Review and Re-Evaluation of Arguments (Part II)*, 16(10) Intertax, 310 (1988); Maarten F. Wilde, *A Step towards a Fair Corporate Taxation of Groups in the Emerging Global Market*, 39(2) Intertax, 64 (2011).

[18] David. A Weisbach, *Line Drawing, Doctrine, and Efficiency in the Tax Law*, 84 Cornell Law Review, 1651–1652 (1999).

[19] Daniel N. Shaviro, *An Efficiency Analysis of Realization and Recognition Rules under Federal Income Tax*, 48 Tax Law Review, 56 (1992).

[20] See OECD, fn. 12 at 6.

[21] The actual rate to be applied under the GloBE proposal has not been determined yet but possibly will be either 10%, 12% or 15%. I agree with Eden that the minimum rate should be a sufficiently low percentage that most countries (at least 90%) would have an effective tax rate above such minimum tax. See Eden, fn. 14 at 9.

[22] The rate should be below 13,125% determined based on the following two features of the GILTI regime: (i) the US rate imposed on GILTI income (equal to half of the US standard corporate income tax rate of 21%) and (ii) the fact that the US foreign tax on GILTI earnings is limited to 80% of the foreign taxes paid on that income. See in this regards Mindy Herzfeld, *Can GILTI+BEAT=GLOBE?* 47(5) Intertax, 507 (2019).

GILTI requires that a US shareholder of a controlled foreign subsidiary pay its annual share of the global intangible low-taxed income.[23]

The income inclusion rule is complemented by a switch-over rule. The purpose is to ensure that the income inclusion rule will also apply to foreign branches identically as it applies to foreign controlled subsidiaries. It will only apply to jurisdictions that opted to apply the exemption method to their double tax treaties. As mentioned above, the income inclusion rule will operate by replacing the application of the exemption method for income derived by a foreign branch (and also income from foreign exempt immovable property) pursuant to the applicable tax treaty by the credit method whenever that income has been subject to a low effective tax rate in the foreign jurisdiction.

The undertaxed payments rule operates from the perspective of the source jurisdiction: While the income inclusion rules involve taxing a parent company for the low taxed income of its foreign controlled subsidiaries, the undertaxed payments rule operates by adjusting payments that otherwise give rise to base erosion (typically deductible interests or royalties for intra-group payments). Under this rule, certain payments will be denied when made to a related party that was not subject to tax at a minimum rate.[24]

This rule is inspired by the US Base Erosion Anti-Abuse Tax (BEAT)[25], which discourages related party payments that facilitate profit shifting. The BEAT is applicable when the US taxable income of a US company is excessively reduced due to deductions attributable to base erosion payments made to a 25% owned foreign related party. It imposes on each applicable taxpayer a tax equal to the base erosion minimum tax amount for the tax year.[26] To be an applicable taxpayer, a US corporation and its related parties must meet certain criteria; notably, the US corporation must have a base erosion percentage of at least 3%.[27] Overall, the BEAT implements an inbound corporate minimum tax.

The GloBE also includes a subject to tax rule that subjects a payment to withholding (or other taxes) at the source and denies treaty benefits at the source for income that is not

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[23] Section 951A of the Internal Revenue Code (I.R.C.). For a description see Itai Grinberg, *International Taxation in an Era of Digital Disruption: Analysing the Current Debate*, at 14, available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3275737 (last visited Dec. 28, 2019).

[24] Although in the OECD Programme of Work a question is raised whether the application should be extended to all payments not subject to tax at a minimum rate even if made to non-related parties. See *OECD/G20 Base Erosion and Profit Shifting Project Programme of Work to Develop a Consensus Solution to the Tax Challenges Arising from the Digitalisation of the Economy*, fn. 8 at 30. However, payments made to related parties are often perceived as the ones posing more risks to BEPS practices. Although payments to unrelated parties can also address possible BEPS situations such as the cases where payments are made to residents in low or no taxed jurisdictions.

[25] Section 59A of the I.R.C.

[26] Corresponding to the excess of 10%.

[27] See Grinberg, fn. 23 at 17.

subject to a minimum tax rate. This rule will be included in tax treaties that apply certain treaty benefits to items of income that have already been sufficiently taxed in other jurisdictions.

The second group of rules constitute therefore another form of a minimum tax imposing taxation on one side of the payment (payor) if the other side of the payment (recipient) is not subject to a minimum level of taxation.[28]

It is apparent that, apart from its four components, the GloBE triggers several technical and design issues. One of them is the level of income blending, *i.e.* the extent to which an MNE can combine high-tax and low-tax income from different sources by taking into account the relevant taxes on such income for the purposes of determining the effective tax rate on such blended income. Another aspect refers to carve-outs and thresholds that trigger the application of the GloBE. I will detail these aspects in Part III below.

II. GENERAL COMMENTS ON THE GLOBE

A. The GloBE Is Not about BEPS

The primary issue when analyzing the GloBE proposal is to determine the policy reasons that may justify its adoption. The OECD work that led to the BEPS action plans was aimed at submitting proposals to ensure that profits are taxed where profit-earning activities are performed and where value is created.[29] The statement of the OECD 2013 Action Plan Report reads as follows:[30]

> *No or low taxation is not per se a cause of concern, but it becomes so when it is associated with practices that artificially segregate taxable income from the activities that generate it. In other words, what creates tax policy concerns is that, due to gaps in the interaction of different tax systems, and in some cases because of the application of bilateral tax treaties, income from cross-border activities may go untaxed anywhere, or be only unduly lowly taxed.*

From this statement it can be inferred that from the origination of the BEPS project, supported by the IF, the issue was not about "no or low taxation of the income" but rather BEPS has been concerned to address cases of double non-taxation or no or low taxation associated with practices that artificially segregate taxable income from the activities that generate it. In other words, while the BEPS work was driven by the perception of some jurisdictions that they were suffering from the tax practices of others,[31] those practice

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[28] See Faulhaber, fn. 1 at 175.

[29] Orli Mazur, *Transfer Pricing Challenges in the Cloud*, 57(2) Boston College Law Review, 679 (2016).

[30] OECD, *Action Plan on Base Erosion and Profit Shifting*, at 10 (2013).

[31] Allisson Christians & Stephen E. Shay, *Assessing BEPS: Origins, Standards and Responses*, IFA General Report, in 102A Cahiers de Droit Fiscal International (International Tax Law Books), at 30 (2017).

were mostly aggressive structuring that often lacked economic reality.[32] This is further reflected in the following G20 statement:[33]

> *We fully endorse the ambitious and comprehensive Action Plan — originated in the OECD — aimed at addressing base erosion and profit shifting with a mechanism to enrich the Plan as appropriate. We welcome the establishment of the G20/OECD BEPS project and we encourage all interested countries to participate. Profits should be taxed where economic activities deriving the profits are performed and where value is created.*

Therefore, defining the scope of Pillar Two as a GloBE proposal which seeks to address remaining BEPS risk of profit shifting to entities subject to no or very low taxation appears misleading and it does not fit into the original definition and the original mandate of the BEPS project. Pillar Two is a deviation from the well-established tax principle — the genesis of BEPS — which taxes income where value is created. If low or no taxation is not a concern of BEPS, then Pillar Two does not align with BEPS nor does it address BEPS-related risks. A new BEPS 2.0 project is still under consideration, while BEPS 1.0 has not yet been fully implemented in many countries and economic outcomes generated by the measures are still being evaluated.[34]

Overall, it is too early to discuss, much less codify, a new set of rules.[35] If these new rules are addressing the same concerns as the original BEPS project, it is, therefore, premature to adopt new rules without the full implementation of the previous ones.[36] Otherwise, at this stage, we are in the process of adopting new rules based on new goals, which appear to be unclear and questionable. In fact, it appears clear now that the fundamental goal of the GloBE is to create a minimum tax; this represents a change in the OECD's prior policy direction.[37]

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[32] Jeffrey M. Kadett, *BEPS: A Primer on Where It Came from and Where It's Going*, 150 Tax Notes International, 793 (2016).

[33] G20 leaders declaration issues on September 6, 2013, St. Petersburg.

[34] This should be the determined based on BEPS Action Plan 11 regarding *Measuring and Monitoring of BEPS* and which established methodologies to collect and analyze data on the economic and fiscal effects of tax avoidance behaviors and on the impact of measures proposed under the BEPS project.

[35] See in this regard the comments submitted by the author together with other co-authors to the OECD Secretariat proposal on Pillar Two, available at https://www.oecd.org/tax/beps/public-comments-received-on-the-global-anti-base-erosion-globe-proposal-under-pillar-two.htm (last visited Feb. 3, 2020).

[36] It may be actually be questioned the need to adopt these rules considering that many of the GloBE measures find some resemblance in existing Actions of the BEPS project such as Action 3 (CFC), Action 2 (anti-hybrid rules that determined the need to include income in the absence of taxation on the other side of the transaction) or Action 4 (on interest deduction limitations). See similarly, Faulhaber, fn. 1 at 176.

[37] See identically Eden, fn. 14. In this regard Eden stresses the marked change in the policy direction from the OECD BEPS action plan stamping out no or very low tax jurisdictions and therefore taking away the states' sovereign rights to set their respective corporate income tax rates. See also Joachim Becker & Johannes Englisch, *International Effective Minimum Taxation — The GLOBE Proposal*, 11(4) World Tax Journal, 4 (2019), stressing that the policy rationale is about removing tax competition below a certain agreed rate rather than aimed at addressing tax avoidance practices.

B. The Benefits of the GloBE

From the analysis made so far, it is clear that the adoption of the GloBE will have several implications for the design, structure, and function of the international tax regime. Apart from the discussion of the changes, it is relevant to assess the potential benefits of the adoption of a minimum tax (along the lines of the GloBE). In this context, some arguments have been raised.[38]

First, the GloBE will improve efficiency in the allocation of capital: Decisions to locate investments will be driven less by tax reasons, since there will be fewer incentives to place investments in low tax jurisdictions or to engage in transfer pricing (or other) practices that shift profits to low tax jurisdictions. Therefore, as profit shifting decreases, businesses will be increasingly motivated to allocate capital in the most efficient way. Empirical research demonstrates that multinationals are sensitive to income inclusions under the traditional controlled foreign corporation (CFC) rules.[39] Nevertheless and in order for the minimum tax to be effective it must be complemented with a tax on outbound payments (the proposed undertaxed payments rule) to foreign related parties. Otherwise there would be an incentive to change headquarters residence of a multinational group in order to avoid the minimum tax via the income inclusion rule.

Second, there will be reduced incentives for a race to the bottom: With a minimum tax, there will be less incentive for governments to lower their tax rates to attract investment. Therefore, less tax competition should be expected. As a consequence the race to the bottom by jurisdictions as to offer the lowest and thus more attractive tax rate would be discouraged.

Third, a minimum tax will not discourage investment: Without fear of a negative impact on foreign investment, developing countries and jurisdictions will be able to raise or impose tax up to the minimum tax. Therefore arguments have been made that some developing countries may feel encouraged to raise taxes to the minimum tax.

Finally, the minimum tax would still be necessary, as there will still be risk of profit shifting after the BEPS action plan is implemented. This is due to the fact that: (i) The majority of the BEPS actions are not minimum standards; (ii) some BEPS recommendations limit, but do not eliminate, certain profit shifting opportunities (*e.g.* the interest deduction limitations under Action 4); and (iii) new substance rules following Actions 8–10 can often be met by making modest investments and do not set a robust link between value creation and taxing rights allocation.[40]

Arguably, there may be some advantages to the adoption of the minimum tax.

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[38] See Eden, fn. 14 at 9.

[39] See Becker & Englisch, fn. 37.

[40] Id.

However, the fact that there are significant costs to adopting a minimum tax, as per the GloBE proposal. Furthermore, it remains doubtful in my view whether the claimed advantages will indeed happen as described above.

In fact it is highly debatable that the minimum tax will prevent or significantly reduce profits shifting practices. It may actually legitimize profit shifting to the extent of the difference between the agreed minimum tax rate and the country's regular corporate income tax rate.[41] It is hardly conceivable that companies resident in countries adopting corporate income tax rates around 20% or higher will not establish CFCs in other countries or jurisdictions with a substantially lower income tax rate therefore allowing to pay significantly less tax if the same income had been obtained directly by the resident companies. The minimum tax will still incentivize multinationals to inflate the income in low-taxed jurisdictions where CFCs are located and therefore engage into aggressive transfer pricing practices.[42] This is due to the fact that the income obtained by the foreign companies will only be subject to the minimum tax either because the foreign country has leveled its income tax rate to the minimum tax or otherwise because the residence country imposes additional tax on the foreign company income in order to top up the foreign tax to the minimum tax.[43]

Furthermore, the minimum tax does not fix the aforementioned weaknesses of the BEPS action plan. In the absence of any empirical evidence following Action 11, it is premature to argue that significant profit shifting risks still exist. In addition, it appears inconsistent to rely on the constraints of the BEPS action plan, because not all the actions were adopted as minimum standards. The OECD and the remaining members of the BEPS IF have the discretion to adopt the standards. If they feel it is insufficient, the most logical approach would be to agree on extending some (of all) of the BEPS actions as minimum standards rather than simply enacting new measures that will bring a considerable degree of uncertainty and unpredictability.

It is not convincing to submit a criticism to the substance rules, particularly in the context of transfer pricing amendments under Actions 8–10. There are two reasons for this: (i) The problem does not rely on transfer pricing rules themselves, but on the existing international tax rules; and (ii) the adoption of a minimum tax will not remove the incentives for profit shifting practices, as explained below.

The adoption of the GloBE will certainly entail a loss of tax sovereignty, as

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[41] Brian J. Arnold, *The Evolution of Controlled Foreign Corporations Rules and Beyond*, 73 Bulletin for International Taxation, 12 (2019). Similarly discussing the minimum tax, but discussing specifically in the context of GILTI, see J. Clifton Fleming Jr., Robert J. Peroni & Stephen E. Shay, *Expanded Worldwide versus Territorial Taxation after the TCJA*, 161 Tax Notes, 1187 (2018).

[42] Id. Fleming Jr., Peroni & Shay.

[43] See Arnold, fn. 41.

jurisdictions become pressured to adopt a new corporate income tax level.[44] As discussed in detail below, taxation constitutes one of the most fundamental areas of national sovereignty rights.

Finally, there is also a potential shift of revenue from the source to the residence jurisdiction where the multinational group resides. Whenever the host jurisdiction does not raise (or comply with) the minimum tax level, the proceeds generated there will be captured and taxed by the residence jurisdiction (likely in favor of capital exporting countries).

Ultimately, it has been suggested that the minimum tax under the GloBE proposal constitutes a second-best option.[45] Ideally countries that are home to the multinational groups should adopt a worldwide taxation regime on an annual basis with no tax deferral. If the underlying idea is to address income-shifting activities, I suggest that reforms require governments to adopt a residence-based taxation regime on worldwide-earned income. No deferral should be provided for offshore corporate income and foreign income tax credits should be applied at the source.[46] As argued above, the minimum tax will not remove incentives to locate businesses in low-tax jurisdictions or provide special tax regimes.[47] Conversely, the adoption of a worldwide taxation regime would remove such an incentive.[48]

C. It Is All about Sovereignty

No area is closer to the subject of sovereignty than taxation.[49] Tax has been used as a tool to attract investment by many jurisdictions. Lower tax rates or tax incentives that attract investment contribute to economic development, increase employment, and increase

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[44] Dissenting see Becker & Englisch, fn. 37. According to these authors, tax sovereignty is not absolute whenever the tax policies of some countries are affected by the tax policy of other countries. They argue that: "the tax sovereignty of the potential 'losers' in the tax competition game — high tax jurisdictions and many developing and emerging economies — is being undermined by the policy choices of tax havens and other countries […]"

[45] See Eden, fn. 14. Arnold suggests that extending the CFC rules would also be a better response than the minimum tax. See Arnold, fn. 41.

[46] See for this proposal Lorraine Eden, *The Arm's Length Standard: Making It Work in a 21st-Century World of Multinationals and Nation States*, 153 Global Tax Fairness, 157–158 (2016) or Reuven S. Avi-Yonah, *Hanging Together: A Multilateral Approach to Taxing Multinationals*, 5 Michigan Business & Entrepreneurial Law Review, 137 (2016).

[47] See Fleming Jr., Peroni & Shay, fn. 41 at 1188. I acknowledge that the effectiveness of a worldwide taxation regime would still depend on being adopted on a large scale by countries as otherwise there could be an incentive to re-domicile multinationals headquarters to countries that adopt a territorial system or an otherwise classic worldwide taxation system with deferral. Similarly see Avi-Yonah, Id.

[48] See Eden, fn. 46 at 157. Actually as noted by Avi-Yonah, the adoption of a worldwide taxation regime would contribute to the simplification of the tax system and to the elimination of fundamental tax planning techniques used for corporate tax avoidance purposes. See Avi-Yonah, fn. 46.

[49] H. David Rosenbloom, *Sovereignty and the Regulation of International Business in the Tax Area*, 20 Canada–United States Law Journal, 267 (1994).

the consumption of goods and services. Certainly, a lower rate or a tax break does not always support the tax base. In a highly integrated and globalized world, corporate tax rates are fundamental tools of jurisdictions' domestic economic policy. Therefore, as a matter of principle, the sovereign policy of a jurisdiction to choose their respective tax rate must be acknowledged and accepted. Recent developments demonstrate that even advanced and developed countries have reduced tax rates or provided tax breaks and incentives to attract investment.[50] Tax competition is not necessarily negative, so long as tax incentives are linked to effective business activities in the location where value and income are generated. As previously highlighted, this is the essence of the BEPS project.

The GloBE proposal may represent a significant encroachment on the sovereignty of jurisdictions and their right to opt for the corporate tax rate. Features of the tax system may be more suitable for their specific economic circumstances. The effect of the income inclusion rule, under the GloBE proposal, represents that a residence jurisdiction will impose a minimum tax on the income of low taxed foreign companies; effectively, those companies would be deprived of the tax incentives offered by the source jurisdiction. Any reduction in the tax offered by a source jurisdiction will effectively increase (*i.e.* shift) income tax to the residence jurisdiction. This is traditionally argued to be an infringement on sovereignty, since it deprives a jurisdiction of its discretion to offer tax incentives:[51] When a jurisdiction gives a tax benefit to a CFC, the residence jurisdiction where the parent company is located will be entitled to collect taxes at a stipulated minimum tax rate.

Based on the above, it is easy to predict which countries may find a minimum tax proposal, such as the GloBE, attractive: export-driven economies, such as the US (which already adopted it via the GILTI), Japan, and Germany. To the extent that other initiatives[52] deal with source taxation, these countries prioritize alternatives to such source taxation. Export-driven economies may find a minimum tax attractive, as it supports their residence-based income tax system.[53]

III. SPECIFIC COMMENTS ON THE GLOBE

A. Carve Outs

Compliance with BEPS Action 5 may still mean that a jurisdiction is targeted under the GloBE. Most likely, the majority — if not all — of the preferential tax regimes that

[50] Commonly accepted recent incentives involve tax credits for R&D or other identical types of incentives.

[51] As noted by Arnold this is the type of argumentation that has been raised by developing countries in the context of tax-sparing clauses and which is essentially the same as regards the proposed minimum tax under the GloBE proposal. See Arnold, fn. 41.

[52] Such as initiatives by some EU member states, the Commission proposals or the measures adopted by India (equalization levy) or Israel.

[53] See in this regard, Grinberg, fn. 23 at 47.

meet this BEPS minimum standard will fall under Pillar Two. This could undermine efforts made by jurisdictions to introduce BEPS compliant regimes and may ultimately de-value the minimum standards, themselves.

It is worth recalling that Action 5 outputs were guided by concerns about preferential tax regimes being used for artificial profit shifting.[54] Therefore, Action 5 specifically required substantial activity for any preferential tax regime aimed to align taxation with substance. In this regard, for intellectual property regimes, the substantial activity requirement established a link between qualifying expenditures and IP-related income. For non-IP regimes, the substantial activity requirement would establish a link between the income that qualifies for the benefits and the "core activities" necessary to earn the income. The report acknowledges what is considered a relevant, core activity needs to consider the context of the specific IP regime.

Paragraph 24 of the Action 5 final report clearly stated that:[55] *Action 5 specifically requires substantial activity for any preferential regime.* Seen in the wider context of the work on BEPS, this requirement contributes to the second pillar of the BEPS project, which aligns taxation with substance, by ensuring that taxable profits can no longer be artificially shifted away from the countries where value is created.[56] Again this demonstrates that regimes that are compliant with Action 5 minimum standard should be carved out, as they meet BEPS concerns as defined by the original premise of the 2013 BEPS project. Including these regimes under the GloBE represents a contradiction: If Pillar Two aims to address other BEPS risks, but Action 5 already addresses BEPS risks related with preferential tax regimes, it can be assumed that such regimes are automatically compliant under Pillar Two.

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[54] OECD, *Action 5: Countering Harmful Tax Practices More Effectively, Taking into Account Transparency and Substance*, (2015).

[55] OECD, *Countering Harmful Tax Practices More Effectively, Taking into Account Transparency and Substance, Action 5 — 2015 Final Report*, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris.

[56] Differently see Eden, fn. 14 at 9. Eden proposes that the minimum tax should be fixed with no exceptions for substance as otherwise this may allow both multinationals and also states to play around the substance rules as to escape the scope of the minimum tax. As an example Eden suggests that an MNE could create an offshore principal centre in a jurisdiction that has substance rules, but a very low effective tax rate. I believe it is possible to distinguish and separate arguments raised by Eden:

• the possibility of "gaming" with the substance rules. In my view this concerned may be addressed by following the substance standards endorsed under BEPS Action Plan 5. While substance analysis is not always easy to determine and certainly has some elements of subjectivity, the existence of *Peer-Reviews* may guarantee a certain level playing field as to what constitutes substance.

• it allows to set up companies in low taxed jurisdictions complying with the substance requirements therefore escaping the application of the minimum tax. I understand this argument and I agree with Eden that, conceptually, this will allow departure from the goal of the minimum tax. But my objection, as I develop above, is that this contradicts and departs from the original BEPS goals.

It is acknowledged that carving-out regimes meeting Action 5 minimum standards may create contradictory situations: A preferential tax regime with no taxation will be carved out, while a general tax system with low (but, still some) taxation may be subject to Pillar Two. But this is the consequence of the approach to Pillar Two, which focuses on minimum taxation rather than taxing value creation; the latter was the original purpose of BEPS practices. Therefore, when there is enough local substance to justify the non-application of Pillar Two, there should be a general carve-out.[57] As reflected in the following statement, such a carve-out would be consistent with the BEPS goals:[58]

> *[…] the G20 and OECD member countries embarked on the BEPS Project, which was launched amid the worst financial and economic crisis of our lifetimes, with an ambitious goal to revise the rules and align them to developments in the world economy, thereby ensuring that profits are taxed where economic activities are actually carried out and where value is created.*

While defining substance may not be an easy task, a starting point can be the criteria adopted by the OECD in the context of Action 5.[59] Fundamentally, there should be a distinction between a simple tax haven that operates to facilitate tax avoidance and a jurisdiction that provides lower tax rates or special exemptions for certain types of resources, skillsets, locational advantages, historical background, development agendas, transparency models, etc. It does not seem fair to address them in the same way. It would be more balanced and effective to identify tactics normally deployed for profit shifting and to address them appropriately. Adopting a minimum tax for all types of activities seems arbitrary.

Another type of carve-out should ensure that the GloBE would only apply to multinational groups that fall under the country-by-country reporting (CbCR) thresholds. This would ensure that the GloBE would only be applicable to large multinational groups that could respond to the anticipated compliance burdens.

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[57] A typical example may be extractive industries, which are typically strictly regulated in the respective host country. They are dependent on obtaining a license, prices are publicly available, and the risk of BEPS concerns is substantially low. The fundamental issue when opting to exclude certain activities may be that this leads to distorted competitiveness of some activities or companies, at the expense of others. Equity concerns may arise in some countries, particularly those with industries and taxation regulations that are protected in their respective Constitutions.

[58] Pascal Saint-Amans & Raffaele Russo, *The BEPS Package: Promise Kept*, 70 Bulletin for International Taxation, 236 (2016).

[59] In this regard, substance may be defined based on several criteria that take into account the variety of activities and business models. These criteria could include the amount of local revenue (*e.g.* revenue collected from local customers significant or exceed 50% of revenues), the presence of tangible assets (*i.e.* infrastructure) (especially relevant for asset-based businesses), the number of local employees (a threshold could be determined), the type of business carried out (public services or regulated businesses could be carved-out, such as heating and cooling distribution networks, sanitation, water distribution, etc.).

B. Blending Income

A fundamental issue for the application of the income inclusion rule is the question of blending, *i.e.* combining low-tax and high-tax income to determine the effective tax rate. There are three policy options: a per-entity approach; per-country or jurisdiction approach; and a worldwide approach. Each offers different challenges of implementation, as outlined below. Fundamentally, the blending approach to calculate effective, average tax rate of multinational group requires a trade-off between effectiveness (neutrality) and simplicity. In fact, income blending implies several challenges that increase compliance burdens and costs.

The abstract approach is to calculate the effective tax rate, per separately taxable business unit. This approach gives rise to higher compliance burdens and administrative complexities for highly de-centralized companies with multiple business lines. Overall, the entity blending approach appears to be too extreme: It would simply not meet the balance needed between policy objectives and compliance burdens.

From a practical perspective, the worldwide income approach appears to be the easiest solution to administer. According to some analysis, the effects of the GILTI are expected to be particularly subtle precisely because the adoption of a worldwide approach allows for leveling earnings from high tax jurisdictions with income from low taxed jurisdictions.[60] Since companies can blend low and high taxed income, they effectively reduce or even eliminate the payment of US minimum tax. That is why it was said that the GILTI would be more effective on a country-by-country (or jurisdiction) approach; if were adopted in this way, it would preclude the possibility of cross-crediting low taxed income against income from other jurisdictions.[61]

The third option would be by jurisdiction or per-country blending. Among the numerous difficulties that may be encountered, one can point out — in the context of a jurisdiction blending — the issue of costs that are not allocated by country in consolidated accounts (*e.g.* corporate costs, part of the financial costs).

The jurisdictional approach could rely on the existing CbCR platform. Yet, in comparison to the worldwide approach, this approach could entail a higher level of complexity for businesses and tax administrations. It is difficult to use the existing CbCR information to derive effective tax rates by country. A low effective tax rate could be justified by different accounting standards or local generally accepted accounting principles (GAAPs) may not converge with CbCR data. It could also lead to double taxation. Currently, it is not feasible to determine globally effective tax rates, but tax

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[60] Kimberly A. Clausing, *Fixing Five Flaws of the Tax Cuts and Jobs Act*, at 25, available at https://ssrn.com/abstract=3397387 (last visited Jan. 10, 2020).

[61] Kimberly A. Clausing, *Profit Shifting before and after the Tax Cuts and Jobs Act*, at 32, available at https://ssrn.com/abstract=3274827 (last visited Jan. 10, 2020).

accounting rules could be internationally standardized as part of the GloBE proposal. If jurisdiction-based blending were to be required, external auditors could provide Effective Tax Rates (ETRs) per jurisdiction on an annual basis: These ETRs per jurisdiction should be made available to the tax authority of the parent company and external auditors should indicate which group entities are affected by the recalculation of the tax base.

The OECD choice should carefully consider all these challenges. Furthermore, it should also consider that there is the serious risk that some jurisdictions will use the worldwide blending (*i.e.* the US GILTI rules follow a worldwide approach) and the GloBE solution will follow the jurisdictional (or entity) blending approach. In this case, it may be more favorable for companies to relocate headquarters to the jurisdictions following the worldwide blending approach, because the overall tax rate and tax compliance burdens may be considerably lower.

Another fundamental issue refers to foreign tax credits and the related complexity that the current proposal involves. Calculating foreign tax credits depends on whether the effective taxes are calculated for the worldwide aggregate, or on a country-by-country basis. Unless resolved at the design stage, incongruities in tax accounting rules and the timing of the tax credits could potentially lead to over-taxation. The retroactive adjustment of foreign tax credits is already quite complex and difficult to administer.

C. Interaction of Rules

As described throughout this contribution, the GloBE proposal includes rules that apply at the level of the parent company jurisdiction — the income inclusion and the switch over rules — and at the level of the source of payment — the undertaxed payments and the subject to tax rules. It is crucial to determine which of these rules will take precedence and which are meant to operate in tandem. It is also important to understand how rules are expected to interact with other rules in the broader international tax framework. Still, co-ordination may be required among several countries.

There seems to be a broad consensus[62] that the income inclusion rule should be the primary rule, *i.e.* countries are only able to employ the denial of deduction or withholding elements of the undertaxed payments rule when payment is made to an entity not subject (directly, or in the hands of its parent) to an income inclusion regime. This is based on the premise that it is simpler to allow countries to operate the undertaxed payments rule as a primary rule; disputes and double taxation would dramatically decrease.[63]

The OECD proposal is not yet clear on which rules will take precedence (the "rule order"). Still there are strong suggestions that the income inclusion rule will be indeed the

[62] At least relying on the multiple public comments submitted by stakeholders to the OECD Secretariat proposal on Pillar Two. See OECD, fn. 12.

[63] See in this sense Grinberg, fn. 23 at 51.

priority rule applicable over the undertaxed payments rule. This has been justified by both conceptual and pragmatic reasons.[64] Conceptually, an undertaxed payments rule only becomes relevant when the payer jurisdiction does not regularly tax the income related with the payment. Pragmatically, the income inclusion rule would more precisely establish the desired minimum level of taxation than the withholding tax (on gross revenue). Therefore, the denial of the deduction and the subject to tax rules will only secondarily apply, *i.e.* for cases of multinational groups whose parent entities are not subject to an otherwise qualifying outbound minimum tax.[65] Therefore, the purpose of the undertaxed payments rule would be to prevail when the income inclusion rule is not effective, *i.e.* when an MNE changes its headquarter. In such situations, irrespective of the jurisdiction in which the MNE is headquartered, the undertaxed payments rule can guarantee that a minimum level of taxation applies. Again, the adoption of such a wide-spread rule of order will require unprecedented economic coordination among the tax regimes of several jurisdictions.[66]

The income inclusion rule emerges when jurisdictions around the world shift from residence taxation to source taxation.[67] The adoption of the minimum tax (with a priority on the income inclusion rule and securing residence-based taxation) would rely on the concepts favored by developed jurisdictions. Therefore, generally speaking such a proposal is likely to favor these developed countries over developing countries, by granting the former taxing rights at the expense of the latter.[68]

D. The GLoBE Requires Tax Treaty Amendments

Amendments to tax treaties will be required if a general *income inclusion rule* established an effective rate below a minimum rate. The income inclusion rule is based on CFC provisions. This income inclusion rule would attribute to the shareholder the proportionate share of income that it holds in a corporation that has not been subject to an effective rate of tax above a certain minimum. Whether CFC legislation is in line with tax

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[64] See Becker & Englisch, fn. 37.

[65] See in this regard the decision of the French Conseil d'etat in case *Ministre de L'Economie, des Finances et de l'Industrie v. Societe Schneider Electric* of June 28, 2002. In this case the French Court decided that Article 7 of the Tax Treaty between France and Switzerland prevented the application of the French CFC rules as they lead to the taxation of the profits of the Swiss subsidiary in France. Differently, in the UK case *Bricom Holdings v. C.I.R.* of July 25, 1997 where the Court accepted that the imputation of income from a foreign subsidiary to the UK shareholders.

[66] See Herzfeld, fn. 22 at 513.

[67] Concurrently, see Itai Grinberg, *The BEAT Is a Pragmatic and Geopolitically Savy Inbound Base Erosion Rule*, at 2 (2017), available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3069770 (last visited Dec. 21, 2019). Grinberg refers in particular to some measures adopted by some EU member states as well as in Israel or Italy. Ultimately Grinberg concludes that the international tax architecture focused on residence taxation is shifting to source taxation.

[68] Similarly see Faulhaber, fn. 1 at 188.

treaties has been the subject of substantial academic debate[69] and its application in the context of a tax treaty has been controversial. This was also reflected worldwide, in contradictory case-law.[70] Also, the successive amendments to the Commentary on the OECD Model Tax Convention aimed at clarifying whether the provisions of tax treaties prevented or limited the application of CFC rules.

The initial position of the 1977 OECD Model Tax Convention was that CFC rules were generally incompatible with the provisions of tax treaties and that countries wishing to preserve its application should include a specific provision in the treaty. As stated in paragraph 7 of the Commentary to that Model:

> *The purpose of double taxation conventions is to promote, by eliminating international double taxation, exchanges of goods and services, and the movement of capital and persons; they should not, however, help tax avoidance or evasion. True, taxpayers have the possibility, double taxation conventions being left aside, to exploit the differences in tax levels as between States and the tax advantages provided by various countries' taxation laws, but it is for the States concerned to adopt provisions in their domestic laws to counter possible manoeuvres. Such States will then wish, in their bilateral double taxation conventions, to preserve the application of provisions of this kind contained in their domestic laws.*

The 1992 Commentary to the Model was amended to reflect that CFC rules could be applied, though this position was not unanimous. The Commentary stressed the anti-avoidance character of those provisions:

> *23. The large majority of OECD Member countries consider that such measures are part of the domestic rules set by national tax law for determining which facts give rise to a tax liability. There rules are not addressed in tax treaties and are therefore not affected by them. […]*
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> *24. […] On the dissenting view, it is argued that to give domestic rules precedence over treaty rules as to who, for tax purposes, is regarded as the recipient of the income shifted to a base company would erode the protection of taxpayers against double taxation (e.g. whereby applying these rules, base company income is taxed in the country of the shareholders even though there is no permanent establishment of the base company there). However, it is the view of the wide majority that such rules, and the underlying principles, do not have to be confirmed in the text of the convention to be applicable.*
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> *25. While there and other counteracting measures described in the reports mentioned in paragraph 11 above are not inconsistent with the spirit of tax treaties, there is*

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[69] See among other, Michael Lang, *CFC Regulations and Double Taxation Treaties*, 57(2) Bulletin for International Fiscal Documentation, (2003); Luc de Broe, *International Tax Planning and Prevention of Abuse: A Study under Domestic Tax Law, Tax Treaties, and EC Law in relation to Conduit and Base Companies*, 14 IBFD Doctoral Series, 624 (2008).

[70] See the case-law referred above, fn. 65.

agreement that Member countries should carefully observe the specific obligations enshrined in tax treaties, as long as there is no clear evidence that the treaties are being improperly used.

The 2003 Commentary to the Model stressed the general compatibility of CFC rules with tax treaties, while including a caveat in its paragraph 26:[71]

22.1 Such rules are part of the basic domestic rules set by domestic tax laws for determining which facts give rise to a tax liability; these rules are not addressed in tax treaties and are therefore not affected by them. […]

22.2 Whilst these rules do not conflict with tax conventions, there is agreement that Member countries should carefully observe the specific obligations enshrined in tax treaties to relieve double taxation as long as there is no clear evidence that the treaties are being abused.

23. The use of base companies may also be addressed through controlled foreign companies provisions. A significant number of Member and non-member countries have now adopted such legislation. Whilst the design of this type of legislation varies considerably among countries, a common feature of these rules, which are now internationally recognised as a legitimate instrument to protect the domestic tax base, is that they result in a Contracting State taxing its residents on income attributable to their participation in certain foreign entities. It has sometimes been argued, based on a certain interpretation of provisions of the Convention such as paragraph 1 of Article 7 and paragraph 5 of Article 10, that this common feature of controlled foreign companies legislation conflicted with these provisions. For the reasons explained in paragraphs 10.1 of the Commentary on Article 7 and 37 of the Commentary on Article 10, that interpretation does not accord with the text of the provisions. 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 companies legislation did not conflict with the Convention, such clarification is not necessary. It is recognised that controlled foreign companies legislation structured in this way is not contrary to the provisions of the Convention.

[…]

26. States that adopt controlled foreign companies provisions or the anti-abuse rules referred to above in their domestic tax laws seek to maintain the equity and neutrality of these laws in an international environment characterised by very different tax burdens, but such measures should be used only for this purpose. As a general rule, these measures should not be applied where the relevant income has been subjected to taxation that is comparable to that in the country of residence of the taxpayer.

The 2017 Commentary provided a general statement of compatibility of CFC rules

[71] See for more Brian Arnold & Stef van Weeghel, *Relationship between Tax Treaties and Domestic Anti-Abuse Measures*, in Guglielmo Maisto ed. *Tax Treaties and Domestic Law*, IBFD (Amsterdam), (2006).

with tax treaties. This position is reflected in the OECD Commentary to Articles 7 and 10[72] that state:

> *14. The purpose of paragraph 1 is to limit the right of one Contracting State to tax the business profits of enterprises of the other Contracting State. As confirmed by paragraph 3 of Article 1, the paragraph does not limit the right of a Contracting State to tax its own residents under controlled foreign companies provisions founds 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 (see also paragraph 81 of the Commentary on Article 1). […]*

And, it is particularly reinforced by paragraph 81 of the Commentary on Article 1 dealing specifically with CFCs:

> *81. A significant number of countries have adopted controlled foreign company provisions to address issues related to the use of foreign base companies. Whilst the design of this type of legislation varies considerably among countries, a common feature of these rules, which are now internationally recognised as a legitimate instrument to protect the domestic tax base, is that they result in a Contracting State taxing its residents on income attributable to their participation in certain foreign entities. It has sometimes been argued, based on a certain interpretation of provisions of the Convention such as paragraph 1 of Article 7 and paragraph 5 of Article 10, that this common feature of controlled foreign company legislation conflicted with these provisions. 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 and 37 of the Commentary on Article 10, 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 and paragraph 5 of Article 10. 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 controlled foreign company legislation structured in this way is not contrary to the provisions of the*

[72] Paragraph 37 of the Commentary to Article 10 reads as follows: As confirmed by paragraph 3 of Article 1, paragraph 5 cannot be interpreted as preventing the state of residence of a taxpayer from taxing that taxpayer, pursuant to its controlled foreign companies legislation or other rules with similar effect, on profits which have not been distributed by a foreign company. Moreover, it should be noted that the paragraph is confined to taxation at source and, thus, has no bearing on the taxation at residence under such legislation or rules. In addition, the paragraph concerns only the taxation of the company and not that of the shareholder.

Convention.

Therefore, it could be argued that since an income inclusion rule is identical to a CFC provision, such a rule may apply even if a tax treaty is in force. CFC provisions are applicable — following the OECD's position — even in a tax treaty context. Now, the OECD/UN Model Conventions explicitly accept the application of CFC,[73] even in the absence of a saving clause. My understanding, however, is that such application should be based on the existence of abusive practices, which are the situations that the CFC provisions aim to eradicate.[74]

Therefore, I argue that in order to provide stability and certainty of tax treaty application, the inclusion of a saving clause into a specific tax treaty amendment will actually be required. This will settle any conflicts that might arise. The introduction of the saving clause under paragraph 3 of Article 1 of the (current) 2017 OECD/UN Models should ensure such goal.[75] This provision states that treaties do not alter the domestic rules on the taxation of its own residents. In order words, the provision saves the application of the domestic tax law of a contracting state as regards its own residents.[76] At the same time, it also provides an exception to the general principle that the tax treaty of a contracting state may have to provide treaty benefits to its own residents. Under the current paragraph 3 of Article 1 of the OECD/UN Model Tax Conventions, this is the case of the benefits under paragraph 3 of Article 7, paragraph 2 of Article 9 and Articles 19, 20, 23, 24, 25 and 28.

Including the saving clause in a bilateral treaty (and taking into account that Article 7(1) (as well as Article 10 or 21) does not constitute an exception to such clause) should guarantee the application of the income inclusion rule, without any potential conflict.[77]

Also, the introduction of a *switch over clause* will involve treaty amendments. As

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[73] See Arnold, fn. 41.

[74] This can be inferred from the final sentence of paragraph 81 of the Commentary to Article 1 when referring to provisions "*structured in this way.*"

[75] Similarly see Becker & Englisch, fn. 37.

[76] Patricia A. Brown, *Come on in, the Water's…Choppy: The Expansion of the Saving Clause beyond the United States*, in Brian Arnold ed. *Tax Treaties after the BEPS Project: A Tribute to Jacques Sasseville*, Canadian Tax Foundation (Toronto), at 57 (2018).

[77] Similarly see Arnold, fn. 41. Paragraph 17 of the Commentary to the OECD MTC clarifies that the inclusion of the saving clause makes clear that tax treaties to not limit the application of domestic CFCs. Therefore, a similar reasoning may also apply as regards the income inclusion rule. See also Brown, Id. Becker and Englisch, while agreeing, suggest that for tax treaties without a saving clause, an amendment to the Commentary to Article 1 of both the OECD and UN Models may be sufficient to clarify that treaties will not prevent the application of the saving clause. See Becker & Englisch, fn. 37. Fundamentally, one may argue against this suggestion is that amendment to the Commentary (without the express inclusion of the saving clause) may not remove the uncertainty and the possibility that national courts consider that tax treaties do preclude imposing a minimum tax. Similar terms contradictory decisions were made regarding the application of CFC rules.

previously discussed, the switch over rule allows the state of residence to apply a credit, instead of an exemption, when profits attributable to a permanent establishment or derived from immovable property that is not part of PE are subject to tax at an effective rate below the minimum rate.[78]

Once again, the introduction of a switch-over clause raises questions about its need: Article 23A-4 of the Model Tax Convention as well as Article 5 of the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting (MLI) already provide options to switch from the exemption to the credit mechanism.

The GloBE envisages 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. Again, this may add excessive complexity to tax treaties. For example, there may be the need to provide additional amendments (through a multilateral agreement) during a time when the first amendments via MLI are not yet in place in the majority of jurisdictions. Furthermore, it appears that BEPS concerns are already reflected in the current OECD/UN Model Tax Conventions and in the MLI. The new preamble says that a tax treaty is intended:

> *[…] to eliminate double taxation with respect to taxes covered by this Agreement without creating opportunities for non-taxation or reduced taxation through tax evasion or avoidance (including through treaty shopping arrangements aimed at obtaining reliefs provided in this Agreement for the indirect benefit of residents of third jurisdictions).*

As the Preamble already acknowledges that double non-taxation or reduced taxation, through tax evasion or avoidance, is to be eliminated. Furthermore, combined with the Principal Purpose Test (which will also create challenges in application and interpretation), it remains unclear why the subject to tax rule is necessary.

The inclusion of the *undertaxed payments rule*, which is a rule that effectively precludes the deductibility of certain payments, will also require tax treaty amendments.[79] This base erosion payments rule prohibits the deduction of payments which are made to a

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[78] Despite the similarity of their objectives (fight against profit shifting towards low-tax jurisdictions), switch-over clauses and CFC rules remain substantially different. In the case of the switch-over clause, the state of the taxpayer taxed the income of a foreign source by switching from the more favorable exemption method to the less advantageous credit method. But, this is still income that flows into its territory and is earned by one or more taxpayers.

[79] Furthermore, the rule may also raise issues in terms of other principles which are common to many countries worldwide such as the taxation based on the ability to pay or the principle of equality. These principles are typically assessed from the perspective of a taxpayer and do not take into account the relationship with other taxpayers (or to whom those payments have been made). In this regard, disallowing the deduction of certain payments may pose problems, like the ability to pay and equal application across many countries. In this regard and in the context of the BEAT provisions, it has already been argued that the denial of a deduction for payments to related foreign persons is potentially inconsistent with the net income requirements under Section 901 I.R.C. See H. David Rosenbloom & Fadi Shaheen, *The BEAT and the Treaties*, 92(1) Tax Notes International, 55 (2018).

non-resident related party that is not sufficiently taxed. Concretely, this rule may collide with Article 9 of the OECD/UN Model Tax Conventions, as well as with paragraphs 4 and 5 of the non-discrimination provision in Article 24.[80]

Article 9(1) of the OECD/UN Model Tax Conventions provides for the arm's length principle, which is the fundamental principle to determine the pricing of intercompany transactions within multinationals. It requires that the pricing of transactions between associated companies match the price that would be charged in similar or comparable transactions between unrelated parties.[81] Otherwise, tax authorities may adjust the profits of the related enterprises to reflect the real profits, as if in an arm's length transaction. Overall, this provision is aimed at ensuring a proper allocation of profits among states where the related parties are located. This raises the issue of a potential conflict between the undertaxed payments rule and with Article 9. The adjustment of the non-deductibility payments is not based on arm's length, but rather on the fact that the payments in question are not sufficiently taxed on the side of the recipient.

When analyzing Article 9(1) in the context of rules providing for deduction limitations that departure from the arm's length principle, there are two fundamental issues: First, whether this provision is permissive or restrictive. Under the first approach, a state is entitled to make profit adjustments based on domestic law, even if they go beyond an arm's length adjustment. Under the second approach, Article 9(1) effectively precludes any adjustment other than those based on the arm's length principle. The OECD itself recognizes this issue in the "Thin Capitalisation" report that says that:[82]

> *[…] the answer to the question whether Article 9 may inhibit the operation of relevant thin capitalization rules may depend on whether Article 9 is held to be "restrictive" or merely "illustrative" in its scope. There is some diversity of opinion about this.*

This controversy is reflected in the OECD Model itself and its Commentary: While paragraph 1 of Article 9 suggests that the provision is permissive,[83] the Commentary itself supports a restrictive approach[84] when stating that:[85]

> *[…] No rewriting of accounts of associated enterprises is authorized if the transactions between such enterprises have taken place on normal open market commercial terms (on an arm's length basis).*

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[80] See for an overview, Becker & Englisch, fn. 37.

[81] See Eden, fn. 46 at 154.

[82] See the OECD Report on Thin Capitalisation, (Nov. 26, 1986), in OECD, *Model Tax Convention on Income and on Capital 2010* (*Full Version*), OECD Publishing, at para. 49 (2012).

[83] Similarly see Jacques Sasseville, *A Tax Treaty Perspective: Special Issues*, in Maisto ed. fn. 71.

[84] See in this regard Otto Marres, *Interest Deduction Limitations: When to Apply Articles 9 and 24(4) of the OECD Model?* in Dennis Weber & Pasquale Pistone eds. *Non-Discrimination in Tax Treaties: Selected Issues from a Global Perspective*, IBFD (Amsterdam), (2016).

[85] See paragraph 4 of the Commentary to the OECD Model Tax Convention (2017) to Article 9.

While there are conflicting views on this topic, I assert that Article 9(1) is indeed restrictive. The purpose of this provision is to prevent economic double taxation and a suggestive approach will likely render the provision meaningless.[86]

The second issue is to determine if Article 9 itself is at all relevant for deduction limitations. In this regard, it is imperative to interpret the expression "*conditions made or imposed*" and discern whether such an expression refers only to situations of profit shifting derived from the pricing of a transaction — such as the amount of interest or royalties charged between related parties — or if it covers the tax treatment of a transaction itself (therefore, the deductibility of the payments). The fundamental point in this discussion should be that Article 9 refers to the — correct — amount of profits that should be allocated to a company in a certain state; that should be in conformity with the arm's length principle. This is supported by paragraph 2 that requires the other state perform a corresponding adjustment to ensure the proper amount allocation of the income and to prevent economic double taxation. This means that, in general, deduction limitations should not be covered by Article 9, because they are not related to those deductions, are not attributable to a particular taxpayer, and also are not linked to the requirement of making a corresponding adjustment in another state.[87] I agree that this conclusion may be different for deduction limitations that target profit shifting between associated companies (through non-arm's length dealings).[88] However, in the context of the undertaxed payments rule the restriction on the payments deductibility is not related with the pricing of the transactions, but rather with the effective minimum tax. Therefore, I believe that there is no potential conflict of this rule with Article 9.[89]

Nevertheless, if it is considered that Article 9 would apply in this context, the inclusion of a saving clause could solve the issue. As the OECD/UN Models Article 1(3) does not exclude the use of the saving clause, such a clause will effectively allow a state to apply the undertaxed payments rule and limit deductions of a resident company — notwithstanding a possible interpretation of paragraph 1 of Article 9 that could suggest otherwise.[90]

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[86] See in this regard J. Wittendorff, *Transfer Pricing and the Arm's Length Principle in International Tax Law*, Wolters Kluwer (Amsterdam), at 196–199 (2010) or see Marres, fn. 84.

[87] See Marres, fn. 84.

[88] See Sasseville, fn. 83.

[89] Reaching a similar conclusion, but with a different argument in the context of the BEAT, see Bret Wells, *Get With the Beat*, 158(8) Tax Notes, 1025 (2018). Wells argues that since the BEAT corresponds to the base erosion minimum tax (approximately 50% of the statutory US Corporate Income Tax rate) it can be justified as an arm's length adjustment, based on a 50/50 Profit Split Method.

[90] If, in the context of thin capitalization provisions providing for a debt to equity ratio.

Article 24[91] establishes the principle of non-discrimination in tax treaties. This provision is potentially applicable to a non-deductibility payments rule. Considering that such a rule only targets cross-border payments made to foreign related parties, it will provide for a difference between cross-border and domestic interest payments. This discriminatory treatment can potentially be addressed by both Article 24(4) and (5).

According to the OECD Commentary, paragraph 4 provides for a non-discrimination principle to be applicable to deductible payments made to residents of the other contracting state. It states that interest, royalties, or other deductible payments made in the residence state of the debtor to a resident creditor of the other state should be deducted in the first state under the same conditions, as if they had been paid to a resident of that country. This means that, sums may be deducted upon satisfaction of all conditions that residents also must satisfy, except that the person paying those sums is not a resident of the same state where payment is made. For the purpose of paragraph 4, the reference to conditions means the legal requirements that must be satisfied for the sums to be deductible. This deductibility discrimination principle is subject to an exception, allowing a state to deny a deduction based on the arm's length principle, reflected in Articles 9(1), 11(5) and 12(4) of the OECD Model — even if such denial is discriminatory in the sense that the arm's length requirement applies only to cross-border payments.

In turn, the standard non-discrimination article in tax treaties includes a paragraph 5 (also known as the "foreign ownership" or "capital ownership" non-discrimination provision), which prohibits that a domestic enterprise whose capital is wholly or partially owned or controlled directly or indirectly by residents of the other contracting state to be subject to other or more burdensome taxation or connected requirements than a similar enterprise whose capital is owned by residents of the taxing country.[92] Therefore, paragraph 5 is applicable if the deduction is denied because the company paying the

[91] It reads: "Except where the provisions of paragraph 1 of Article 9, paragraph 6 of Article 11, or paragraph 4 of Article 12, apply, interest, royalties and other disbursements paid by an enterprise of a Contracting State to a resident of the other Contracting State shall, for the purpose of determining the taxable profits of such enterprise, be deductible under the same conditions as if they had been paid to a resident of the first-mentioned State. Similarly, any debts of an enterprise of a Contracting State to a resident of the other Contracting State shall, for the purpose of determining the taxable capital of such enterprise, be deductible under the same conditions as if they had been contracted to a resident of the first-mentioned State."

[92] It 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."

interest is owned or controlled by a resident of another contracting state.[93] Again, it is relevant to stress that the reason for the different treatment should be based on foreign ownership and not on any other factor.[94]

In principle, and since each tax treaty's non-discrimination clause has a narrow scope and addresses a particular case, there is no overlapping of different clauses applying to the same situation. But, in the particular case of paragraphs 4 and 5 of Article 24, both these clauses can apply to the same situation,[95] *i.e.* based on a single reason for the disadvantageous treatment: the non-deduction of certain payments via interest deduction limitation rules — which target only cross-border payments — in case of loans granted by a foreign parent company to its subsidiary. Paragraph 4 is applicable, as it requires interest paid to a foreign entity to be deducted in the same circumstances as interest paid in a domestic situation. Paragraph 5 could also apply, as an enterprise of one state should

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[93] A fundamental issue in the analysis of paragraph 5 as per comparison with paragraph 4 is whether the arm's length exception is similarly applicable under the capital ownership provision. Putting it differently: Do interest deduction rules that operate on the basis of the non-resident capital ownership apply without any limitation or also subject to the qualification of the arm's length standard? Do paragraph 4 and paragraph 5 have the same threshold standard? Clearly, the wording of the provision does not provide for such a limitation. The OECD in its Thin Capitalisation report of 1986 acknowledged that the Commentary did not address this issue (see paragraph 46 of the OECD Report on Thin Capitalisation, (Nov. 26, 1986), in OECD, *Model Tax Convention on Income and on Capital 2010* (*Full Version*), OECD Publishing, (2012). Later, in 2008, the OECD decided to clarify this point, concluding that interest deduction limitation rules do not violate paragraph 5 to the extent that they merely result in arm's length adjustments to profits. In accordance, the following wording was added to paragraph 79 of the Commentary: Since the provisions of paragraph 1 of Article 9 or paragraph 6 of Article 11 form part of the context in which paragraph 5 must be read (as required by Article 31 of the Vienna Convention on the Law of Treaties), adjustments which are compatible with these provisions could not be considered to violate the provisions of paragraph 5.

So, the OECD conclusion is that paragraph 5 is also constrained by the arm's length standard exceptions similarly to paragraph 4. Still, the amendment to the 2008 Commentary raises several questions. First of all, whether these exceptions indeed apply when one compares the express wording in the text of paragraph 4 with the absence of such wording in paragraph 5. In fact, while a contextual interpretation is generally accepted, as regards general rules it is hardly conceived for exceptions to those rules as well. In addition, and even assuming that the position sustained by the OECD applies, there is the additional issue whether the 2008 commentaries may apply to previously concluded treaties. For a more extensive analysis of this issue see Bruno da Silva, *Revisiting the Application of the Capital Ownership Non-Discrimination Provision in Tax Treaties*, in Weber & Pistone eds. fn. 84.

[94] A good example can be found in the decision of the US Court of Appeals for the 7th Circuit in *Square D Company and Subsidiaries v. Commissioner of the Internal Revenue Service*, Case No. 04-4302, Feb. 13, 2006, in which it was stated: "The regulation requires that all interest payments to foreign related party must use the cash method of accounting without regard to the nationality of the owner. The regulation does not impose the cash method simply because of foreign ownership would be prohibited, but rather for payments to a foreign related party…The requirement, therefore, hinges on the nationality of the related party to whom the payment goes and does not fluctuate based on nationality of the ultimate owner. It is merely fortuitous that, in this case, the foreign related party to which the payment was made also happened to be the owner."

[95] See, *inter alia*, Werner Haslehner, *Tackling Complex Discrimination in International Taxation*, British Tax Review, 609–610 (2012); Alexander Rust, *International Tax Neutrality and Non-Discrimination — A Legal Perspective*, in Michael Lang, Pasquale Pistone & Jesef Schuch et al. eds. *Tax Treaties: Building Bridges between Law and Economics*, IBFD (Amsterdam), at 643–644 (2010) or de Broe, fn. 69 at 560–564.

not be subject to other or more burdensome taxation due to the fact that it is owned or controlled by a company resident in the other state.[96] This potential overlap of these two clauses was recognized by the OECD. It concluded[97] that paragraph 5 was, in fact, also relevant to thin capitalization but, since it was drafted in more general terms, it would take second place to paragraph 4, which is a more specific provision. Therefore, the position assumed by the OECD was that paragraph 4 constituted *lex specialis* over paragraph 5.[98] This was subject to criticism:[99] While paragraph 4 is indeed more specific as it applies only to payments of interest, royalties, and other disbursements and contains an (express) exception adjustment in accordance with the arm's length principle, it could also be argued that paragraph 5 is more specific regarding payments of interest to a non-resident shareholder.[100] In other words, paragraph 5 could constitute *lex specialis*, when compared with paragraph 4, which would apply to payments made to any non-resident.

The subsequent changes to the Commentary[101] placed a different emphasis on the relationship between these two paragraphs. The application of either paragraph 4 or 5 depends on identifying the proper *grounds for the discriminatory treatment*. If the deductibility of the payment is denied due to the fact that the company is owned or controlled by a resident of the other contracting state (company-shareholder relationship), paragraph 5 is applicable; if the deduction of the payment is denied because the recipient is in the other contracting state (debtor-creditor relationship), then paragraph 4 applies. In principle, the application of one or the other clauses remedies the discriminatory treatment, depending on the relevant factor for such treatment.[102]

In principle, the undertaxed payments rule will be applicable only to foreign related parties. The concept of related party is still unclear. Furthermore, the OECD also considers the possibility of extending the application of the undertaxed payments rule to

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[96] Similarly see Mary C. Bennett, *The David R. Tillinghast Lecture — Nondiscrimination in International Tax Law: A Concept in Search of a Principle*, 59 Tax Law Review, 455 (2006).

[97] See paragraph 66 of OECD Report on Thin Capitalisation, (Nov. 26, 1986), in OECD, *Model Tax Convention on Income and on Capital 2010* (*Full Version*), OECD Publishing, (2012). This statement was also included in paragraph 58 of the Commentary to Article 24 of the OECD MTC.

[98] Klaus Vogel, *On Double Taxation Conventions: A Commentary to the OECD, UN and U.S. Model Conventions for the Avoidance of Double Taxation of Income and Capital, With Particular Reference to German Treaty Practice* (3rd edition), Kluwer Law International (London & Boston), at 1276 (1997).

[99] See de Broe, fn. 69 at 560–564; Detlev J. Piltz, *General Report*, in *International Aspects of Thin Capitalization*, 81 Cahiers de droit fiscal international (International Tax Law Books), 134 (1996), or Fred C. de Hosson & Geerten M. M. Michielse, *Treaty Aspects of the "Thin Capitalisation" Issue — A Review of the OECD Report*, 11 Intertax, 483 (1989).

[100] Guglielmo Maisto, F. Avery Jones John & R. Depret Henry et al., *The Non-Discrimination Article in Tax Treaties I*, 10(2) British Tax Review, 421 (1991).

[101] See paragraph 79 of the Commentary to Article 24 of the OECD MTC, included with the 2008 amendments. For an overview of the amendments regarding the non-discrimination article, see Silke Burns, *Taxation and Non-Discrimination: Clarification and Reconsideration by the OECD*, 9 European Taxation, 484–492 (2008).

[102] For a more detailed analysis, see da Silva, fn. 93.

all foreign parties. As the design of the undertaxed payments rule is not known at this stage, either of these non-discrimination provisions may potentially apply. Therefore, I will briefly analyze the potential discriminatory treatment under both paragraph 4 and paragraph 5.

Regarding paragraph 4, since this provision requires that payments made to residents of another contracting state are deductible in the same conditions as payments made to a resident of the same state, the undertaxed payments rule potentially breaches this provision. The undertaxed payments rule disallows the deductions for payments made to foreign related persons, while no disallowance is applicable for identical payments made to domestic related persons.[103] In other words, payments made by certain taxpayers to related foreign persons resident in a tax treaty partner are not deductible under the same conditions as if they had been paid in a domestic situation to a related party.[104] Therefore, the undertaxed payments would collide with the non-discrimination obligation under

[103] Similarly, in the context of the US BEAT regulations, see Rosenbloom & Shaheen, fn. 79 at 54. Disagreeing see Reuven S. Avi-Yonah, *BEAT It: Tax Reform and Tax Treaties*, 587 University of Michigan Public Law Research Paper, 4–5 (2018); Reuven S. Avi-Yonah & Bret Wells, *The BEAT and Treaty Overrides: A Brief Response to Rosenbloom and Shaheen*, 92(4) Tax Notes International, 386 (2018). These authors argue that the BEAT is not in breach of this US tax treaty non-discrimination provision based on the fact that: (i) the BEAT is not in fact equivalent to a denial of a deduction since effectively denying a deduction would increase the tax base of US payers on the deductible item by 21% and not by 10%; (ii) the BEAT is applicable to payments from US companies to its foreign subsidiaries so it is not limited to payments made by foreign multinationals meaning that both US and foreign multinationals are affected by the BEAT and (iii) foreign related parties are simply not comparable to US related parties because the first are not subject to US tax jurisdiction while the second are. In my view, Avi-Yonah & Wells arguments are incorrect for the following reasons which I briefly summarize: (i) the requirement under paragraph 4 is that the deductibility should be allowed in the "same circumstances" the wording being clear that any differences as regards allowing the deduction of the payments leads to discriminatory tax treatment. It is therefore irrelevant that the added-back to the tax base of the payor is 10% rather than 21%; the discriminatory tax treatment exists as from the moment that in a purely US domestic situation there is no limitation while such limitation exists for cross-border payments; (ii) the BEAT applies as long as the recipient of the payment is a foreign related party as defined in accordance with the applicable regulations. Therefore, the difference in treatment arises because the beneficiary is a resident in other state and not US resident leading precisely to the discriminatory tax treatment that paragraph 4 aims to protect; (iii) it is incorrect that for the purposes of paragraph 4 domestic and foreign related parties are "simply not comparable." It is precisely the opposite: for the purposes of paragraph 4 what is relevant is the tax treatment when the payment is made to a foreign recipient when compared with a hypothetical situation when the payment is made in a purely domestic situation. That is precisely the genesis of the testing the existence of discriminatory taxation under the paragraphs 4 and 5 of Article 24: compare the situation at stake with an hypothetical situation in which all the elements of the situation are identical other than the recipient of the payment being a resident in other state but rather a resident in the same state. If in that hypothetical situation the taxpayer would benefit from the application of the relevant legislation, then the non-discrimination provision is being breached. It is not required that all circumstances are entirely identical except in what refers to the specific factor protected under one of the non-discrimination provisions. The requirement is that "the relevant factor" for the adverse treatment is within one of the paragraphs of article 24 even if other conditions that are merely incidental are not exactly the same. See for a detailed analysis, Bruno da Silva, *Non-Discrimination in Tax Treaties vs EU Law: Recent Trends and Issues for the Years Ahead*, in Dennis Weber & Guglielmo Maisto eds. *EU Income Tax Law: Issues for the Years Ahead*, IBFD (Amsterdam), (2013). Similarly see Bennett, fn. 96 at 453.

[104] Similarly see Benett, Id. at 454.

paragraph 4 of Article 24 of tax treaties, following the OECD/UN Model Tax Conventions.

In reference to paragraph 5, this provision restricts the source country from treating foreign-owned businesses worse than a source-country business.[105] The undertaxed payments rule, in the sense that it denies certain deductions may lead to a potential breach of the capital ownership paragraph of the non-discrimination provision based on the fact that had the payer been entitled to deduct the income paid to its domestic related party, but not to its foreign parent company (or a sister company owned by a common foreign parent company), there is a discrimination based on foreign ownership as protected by paragraph 5.

However, the income inclusion rule may be applied through inserting the saving clause under paragraph 3 of Article 1. The undertaxed payments rule and the potential breach to the nondiscrimination under Article 24 will not be prevented with the insertion of such clause. This is because, as referenced above, Article 24 is included in the list of exceptions to the saving clause patterned under the OECD/UN Model Tax Conventions. This means that, under this provision, a state is effectively precluded from discriminatory treatment protected under the different paragraphs of Article 24. Therefore, it may be relevant to adopt a modified form of the saving clause to prevent the non-discrimination provision of tax treaties from restricting the right to tax its own residents using the undertaxed payments rule.[106]

CONCLUSION

The GloBE, under Pillar Two of the OECD proposal, constitutes one of the most ambitious and revolutionary changes to the international tax system in the 20th century. As discussed throughout this article, this proposal is highly controversial and offers a lot of scope for discussion, because it is technically challenging, administratively complex, and difficult to implement.

First and foremost, the rationale for the GloBE is hard to understand in the context of the BEPS project, which departed from addressing tax avoidance to focus on tax competition. In so doing, it removes the tax sovereignty of jurisdictions to freely set their respective corporate income tax rates. Furthermore, the GloBE implementation may represent significant costs in terms of legislative complexity, uncertainty, and international coordination. It is even debatable if the minimum tax proposed by the GloBE will actually reduce or prevent profit shifting practices. In addition, I have demonstrated that the components of the GloBE pose potential conflicts with tax treaties. Taking into account the several technical, legal, and even political challenges surrounding this proposal, one may wonder if it will actually reach consensus; and, if so, will it reach

[105] See da Silva, fn. 93.

[106] See in general Sasseville, fn. 83. Sasseville stresses the need of countries to spend considerable attention when drafting their saving clauses and the list of exceptions provided therewith.

wide-spread adoption among the members of the BEPS Inclusive Framework?

I argue that it would simply be better to adopt a worldwide, annual taxation regime without tax deferral. If the goal is to address income-shifting activities, this solution allows all income to be taxed as earned, without deferral for offshore income.

As an alternative to this scenario and to a minimum tax, one can imagine that alternative jurisdictions could adopt broad CFC regulations. In my expert opinion, this option would still be preferable to the minimum tax proposal under the GloBE.[107] First, CFC rules have the immediate advantage of being familiar international tax rules when compared with the novelty and uncertainty surrounding an innovative minimum tax.[108] Second, expanding CFC rules avoids duplication and added legislation for jurisdictions that already have CFC rules in place. Also, some jurisdictions may have both those rules and the minimum tax framework running in parallel. In addition, for the jurisdictions that already have CFC legislation in place, it may be easier to make amendments to existing rules rather than adopting entirely new legislation. Third, the application of the minimum tax regime leads to a (hardly justifiable) policy in which certain foreign income caught by the income inclusion rule would be taxed at a lower than the regular corporate income tax rate of the jurisdiction of residence where the multinational is headquartered.[109] For instance, it would be simpler to prevent potential conflicts between tax treaties and CFC rules. Similarly, the CFC rules could make the adoption of the source rules of the GloBE proposal (the undertaxed payments rule and the subject to tax rule) far less relevant. The payments received by a CFC in low tax jurisdictions from entities located in highly taxed jurisdictions would be caught under broadly drafted CFC rules that would address those sorts of payments under the CFC attribution regime.[110]

Finally, and from a perspective of legitimacy, it is also arguable that it would be easier to elect Action 3 as a new (eventually minimum) standard with a widespread adoption, rather than creating a minimum tax that is difficult to understand and unjustifiable in the context of BEPS.

To conclude, I suggest that further reflection on the GloBE proposal should consider whether changes are actually needed, whether there are alternatives, and if this is an appropriate time to embark on such fundamental changes. The world is still in the aftermath of the BEPS action plans implementation and an assessment of its results still needs to be completed before adopting additional measures.

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[107] See in more detail, Arnold, fn. 41. Similarly see Avi-Yonah, fn. 46 at 155 reference that CFC rules already act as a de facto worldwide system with a minimum tax.

[108] The first CFC rules were enacted in the United States dating back to 1962. See on this Lawrence Lokken, *Whatever Happened to Subpart F? U.S. CFC Legislation after the Check-the-Box Regulations*, 186(7) Florida Tax Review, (2005).

[109] See Arnold, fn. 41.

[110] While it is acknowledges the likelihood of adopting the source rules in certain cases for countries that headquarter multinational groups and that opt not to implement CFC rules.