
The UTPR is Inconsistent with the Nexus Requirement of Tax Treaties

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The GloBE Model Rules were issued in final form in December 2021. No public consultation was undertaken regarding any draft Model Rules, as there was a need for speed in light of the tight timeline for implementation of Pillar Two's 15% global minimum tax that had been agreed by the Inclusive Framework in October 2021. However, the OECD had consulted the public regarding certain proposed aspects of Pillar Two in late 2019, and had published a Report on the Pillar Two Blueprint in October 2020. Consequently, much of the content of the Model Rules was consistent with expectations based on the earlier documents.

There were some surprises, however, one of which was a significant change in the so-called "backstop" rule, dubbed the Undertaxed Payments Rule in the 2020 Blueprint. The backstop rule is a set of provisions intended to ensure that top-up tax will be collected in respect of undertaxed income of an in-scope MNE when no Qualified Income Inclusion Rule (QIIR) is applicable. The rule provides for top-up tax to be collected by countries in which the MNE does business through one or more local taxpayer entities, through the denial of deductions for outbound payments or an equivalent adjustment under local law. In the Blueprint, the amount of top-up tax to be collected under this rule was allocated to the local taxpayers primarily on the basis of their deductible payments to low-taxed foreign affiliates. Hence the name "Undertaxed Payments Rule."

In the Model Rules, however, the backstop rule, now simply called the UTPR (not as an acronym but rather as a standalone name), is significantly different. It allocates to UTPR jurisdictions an MNE's global top-up tax amount that is not covered by one or more QIIRs on the basis of the MNE's employees (by number) and tangible business assets (by net book value) in those jurisdictions. No economic or transactional connection is required between the UTPR taxpayers and the foreign affiliates earning the low-taxed income that gives rise to the top-up tax liability.

Thus, for example, if a country (say, Japan) has not enacted the GloBE rules and thus does not have a QIIR, then any low-taxed income of a Japanese-owned MNE group will give rise to top-up tax to be allocated among countries that have enacted the GloBE rules (which include the UTPR), on the basis of the group's employees and tangible business assets in those countries. Let's say that only France, Germany, and Malaysia have enacted the GloBE rules. Assume further that there is a large Japanese MNE earning most of its income in countries other than those three jurisdictions, and a portion of its global income is taxed at an effective rate of less than 15% (e.g., in countries where nonrefundable tax credits are available for qualifying investments under local law). The amount of top-up tax necessary to bring the effective tax rate on the low-taxed income up to 15% will be allocated to France, Germany, and Malaysia based on the group's employees and tangible assets in each of the three countries. The group's operations that produced the low-taxed income might have no economic connection whatsoever to the three UTPR jurisdictions. Nevertheless, the UTPR provides for

each jurisdiction to collect its share of the MNE group's global top-up tax liability from the locally resident group company, simply because it is part of the MNE group.

Now let's assume that one of the group entities with low-taxed income is located in a country (call it Ruritania) that has a tax treaty with France that conforms to the OECD Model Convention. Assume further that the Ruritanian company conducts business only in Ruritania and has no dealings of any kind with anyone in France. Under Article 7 of the treaty, France cannot tax business profits of a resident of Ruritania unless the profits are attributable to a permanent establishment in France through which the Ruritanian resident conducts part or all of its business. Assuming that no such permanent establishment exists, then it can be argued that France's imposition of top-up tax on the MNE's French subsidiary is a violation of Article 7 of the France-Ruritania treaty to the extent that the top-up tax is based on low-taxed income of the Ruritanian affiliate.

The OECD's 2020 Blueprint on Pillar Two stated that treaties should not prevent the imposition of top-up tax under the UTPR because Article 1(3) of most treaties provides that the treaty shall not affect each contracting state's right to impose tax on its residents, save for certain enumerated treaty articles, not including Article 7. Common sense suggests, however, that treaty negotiators do not contemplate the possibility that a resident of a contracting state will be taxed by that contracting state on income that does not belong to it, but rather belongs to a resident of the other contracting state conducting no business of any kind with anyone in the first contracting state. Thus it seems unlikely that the treaty should be interpreted as permitting France to collect tax from a French resident in respect of business profits of a Ruritanian resident having no nexus to France.

Nexus is an essential element in the establishment of taxing rights with regard to nonresidents' income. The UTPR radically departs from international tax norms in providing for top-up taxation in UTPR jurisdictions in respect of income of nonresidents that have no connection to the taxing jurisdiction.

Some argue that nexus with a jurisdiction exists if a nonresident enterprise is a member of a controlled multinational group that includes a resident of the jurisdiction. Under this theory, in our example France can properly impose tax on the French member of the group in respect of profits of any other member of MNE group worldwide, regardless of any connection between France and the profits in question. Mere common ownership is viewed as somehow creating a taxing right with respect to the group's global income.

Call me crazy, but that argument seems nonsensical. Proponents of group-based income taxation using global formulary apportionment have always advocated the use of apportionment factors based on an economic connection of one kind or another with the jurisdiction to which the income is being allocated. The factors may include sales, employees (by either number or by payroll), or assets (whether tangible intangible, or both) located in the jurisdiction. Never—until the advent of the UTPR—has anyone argued for a country's right to tax business income arising from operations having no connection at all to the country in question.

What about CFC rules, you may ask. Treaties do not prevent a country from taxing profits of a controlled subsidiary in the hands of a resident controlling shareholder, even though the CFC's business may be entirely confined to its jurisdiction of residence. The answer to this question is that a controlling shareholder effectively participates in the business of the CFC whose business it controls. Therefore, in substance the nonresident has a real economic connection to the CFC's jurisdiction and to the profits earned there by the CFC. This is clearly not the case when top-up tax is payable under the UTPR by a company in respect of profits of an uncontrolled nonresident affiliate.

Time will tell whether the UTPR is ever utilized in practice and, if it is, whether its use will be permitted if challenged on the basis of tax treaties. Considered in light of established principles of income taxation and common sense, the UTPR appears to be flawed insofar as it allows taxation of income where there is no economic nexus to the taxing jurisdiction.

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