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Much Ado About Pillar 2

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To the Editor:

Your November 7 issue provided plenty of food for thought regarding pillar 2, particularly the UTPR. Heydon Wardell-Burrus raised lots of questions,[1] Allison Christians and Tarcísio Diniz Magalhães argued that the UTPR rests on a "use it or lose it" principle of international taxation,[2] Sol Picciotto said some interesting things,[3] and Robert Goulder helpfully walked through the debate and concluded with the sensible idea of a multilateral instrument for pillar 2.[4] Plus, Mindy Herzfeld suggested a new approach for addressing a crucial pillar 2 issue — namely, whether the United States has implemented a qualifying income inclusion rule.[5]

Before responding to the questions posed to the "UTPR skeptics" — of which I am one — I encourage readers to look at Jinyan Li's March 21 article,[6] Casey Plunket's March 28 responsive letter to the editor,[7] and Angelo Nikolakakis's April 11 letter to the editor responding to Plunket.[8] They address the same UTPR questions under debate now, and they are well worth reading.

Picciotto's latest letter on this topic took me back a few years, to the day when he, Pascal Saint-Amans, and I spent an hour in my office at the OECD debating the pros and cons of global formulary apportionment (GFA). Ultimately, Saint-Amans and I couldn't agree with Picciotto's proposition that a controlled group that contains different business lines operating in different countries through separate legal and operational structures should be viewed as a single business enterprise for income tax purposes. The discussion was entirely about whether GFA would be better than the current system, which, in the international sphere, respects separate entities in a controlled group as separate taxpayers.

Now, however, Picciotto asserts that "the separate-entity principle . . . has no basis in tax treaties." A quick perusal of articles 1, 3, and 4 of the OECD model treaty suffices to establish beyond doubt that tax treaties apply to persons that are residents of the contracting states; the definition of the term "person" includes a company, which in turn means a body corporate, and the term "enterprise of a contracting state" means a business carried on by a resident of a contracting state. Readers wanting more evidence may recall that when launching the base erosion and profit-shifting project in 2013, the OECD said the project's goals (which included changes to model treaty provisions) did not include any departure from the separate-entity principle.

Picciotto concludes that the allocation of the UTPR top-up tax to UTPR countries based on employee head count and the net book value of tangible assets is as defensible from a policy perspective as allocating a group's global profits to different countries based on those factors (plus local sales) in a GFA system. However, there's a crucial difference between the two scenarios. Under GFA, each country receiving an allocation of income imposes its own tax laws on that income. In contrast, under the UTPR, what's being allocated isn't profits, but rather the total amount of top-up tax to be collected on profits that have been taxed at a low effective rate in other countries according to normal principles of income taxation.

[1] Wardell-Burrus, "Four Questions for UTPR Skeptics," *Tax Notes Int'l*, Nov. 7, 2022, p. 699.

[2] Christians and Magalhães, "Undertaxed Profits and the Use-It-or-Lose-It Principle," *Tax Notes Int'l*, Nov. 7, 2022, p. 705.

[3] Picciotto, "Justifying the UTPR: Nexus and Economic Connection," *Tax Notes Int'l*, Nov. 7, 2022, p. 667.

[4] Goulder, "Pillar 2 and Tax Treaties: MLI, Where Art Thou?" *Tax Notes Int'l*, Nov. 7, 2022, p. 775.

[5] Herzfeld, "How Many Minimum Taxes Are Enough?" *Tax Notes Int'l*, Nov. 7, 2022, p. 647.

[6] Li, "The Pillar 2 Undertaxed Payments Rule Departs From International Consensus and Tax Treaties," *Tax Notes Int'l*, Mar. 21, 2022, p. 1401.

[7] Plunket, "What's in a Name? The Undertaxed Profits Rule," *Tax Notes Int'l*, Mar. 28, 2022, p. 1507.

[8] Nikolakakis, "Bait and Switch — A Reply to Casey Plunket," *Tax Notes Int'l*, Apr. 11, 2022, p. 191.

The effective rate differential is the sole basis for the UTPR allocation. As Li and others have pointed out, that may result in UTPR countries collecting tax in respect of income from activities having no economic or transactional connection to those countries.

To justify that, it is necessary to come up with a theory other than GFA. Christians and Magalhães offer the use-it-or-lose-it principle. That appears to be based on the idea that 137 countries in the BEPS inclusive framework have agreed to either impose tax on large multinational enterprises operating in their countries at an effective rate of at least 15 percent or allow the UTPR to give other countries the right to impose top-up tax on the profits arising in their countries, so that in-scope MNEs pay an effective rate of 15 percent on their global profits. Thus, the UTPR detaches income taxation from the traditional bases of source and residence, but it's not a problem because everybody has agreed to do it.

Christians and Magalhães argue that the use-it-or-lose-it principle underlies controlled foreign corporation and other rules that attribute a controlled entity's income to the controlling shareholders, so we shouldn't think of it as a novel concept. But there's a key difference between taxing controlling shareholders with respect to a CFC's income and taxing a company with respect to the income of an uncontrolled foreign affiliate with which the taxpayer has had no dealings. Controlling shareholders can obtain the CFC's income whenever they like. A lower-tier group company can't obtain the earnings of uncontrolled affiliates.

But that difference doesn't matter if the separate-entity concept no longer exists. According to Christians and Magalhães, the OECD's global anti-base-erosion (GLOBE) regime advances the view that:

> the MNE is a single economic unit so the low-tax status (call it a tax attribute) of any one of the entities under common control may be treated as that of any of the others. If this premise seems impossible to accept, it may be because we are still devoted to two ideas: first, that each entity in an MNE is a separate legal person; and second, that only a controlling interest can create the bond — namely, nexus — needed to transfer a tax attribute from one entity to another in the group for purposes of imposing a tax.

As I see it, those two ideas are valid in the world that we live in, so we need to accept them until they cease to be true. Until now, inclusive framework members haven't amended their tax laws or treaties to invalidate either idea. Nor have they expressed any form of agreement on the premise in the first sentence of the quoted passage.

The inclusive framework's October 2021 statement on the two-pillar agreement described the UTPR as an "undertaxed payments rule" premised on negating the effect of base-eroding payments to the extent necessary to top up the local effective tax rate to 15 percent. That is how the UTPR was described in the inclusive framework's 2020 report on the pillar 2 blueprint, and how the world expected it to operate — until the GLOBE model rules were issued in late December 2021, revealing a new UTPR delinked from base-eroding payments. The model rules were prepared very quickly, entirely hidden from public view before publication. Nothing was said in the launch of the model rules to call attention to the new form of the UTPR. It is impossible to see any of that as advancing the view that an MNE is a single economic unit such that no transactional or other economic link to a country is needed for a country hosting a group company to have taxing rights over low-taxed income arising in any other group company anywhere in the world.

Wardell-Burrus asks UTPR skeptics to respond to a number — a large number — of questions, under four headings. The first heading asks whether there is anything in international law, apart from tax treaties, to suggest that a country cannot tax a resident company on the profits of an offshore affiliate with which the taxpayer has had no dealings. I will confine my response to a single citation to what appears to be an authoritative source.

According to the Restatement (Third) of Foreign Relations Law of the United States ("a comprehensive and authoritative summary of the American approach to international law and diplomacy," in the words of the Yale Law Library's website), a country has jurisdiction to prescribe law only for: (1) conduct that wholly or

in substantial part takes place within its territory; the status of persons, or interests in things, within its territory; and conduct outside its territory that has or is intended to have substantial effect within its territory; (2) the activities, interests, status, or relations of its nationals both within and outside its territory; and (3) specific conduct outside its territory by persons who aren't nationals that is directed against its security or a limited class of other state interests.

Based on that, it seems impossible to conclude that a state has jurisdiction to impose tax on one of its nationals simply because low-taxed income has been earned by uncontrolled persons who are not its nationals and are simply pursuing their own business wholly outside the state. Taxation based on that income is not related to the status of persons, or interest in things, within the state's territory, nor to activities, interests, status, or relations of nationals either in or outside the territory.

That in turn answers Wardell-Burrus's question regarding why UTPR skeptics argue that the saving clause in tax treaties doesn't authorize taxing a resident under the UTPR in respect of profits of an uncontrolled resident of the other contracting state if the profits have no economic or transactional connection to the taxing country. Treaty negotiators cannot reasonably be assumed to have thought that such taxation of a resident was a possibility. In contrast, it seems reasonable to conclude that the saving clause doesn't interfere with taxing a resident, under CFC rules, on profits of a controlled resident of the other contracting state. The controlling shareholder controls the business and disposition of the profits of the controlled subsidiary, creating nexus between the taxpayer and the country where the profits were earned. Moreover, nothing in the operation of the CFC rules prevents the controlled subsidiary's country from imposing tax on its own resident however it wants, so treaty negotiators would be unlikely to object to the use of CFC rules (although some have done so).

Finally, under his third and fourth headings, Wardell-Burrus raises a plethora of unanswerable questions about how the UTPR would work if the view of the skeptics was correct. He effectively illustrates what a mess it would be, and how much uncertainty and chaos would result. That is precisely what UTPR skeptics are worried about. We're not inventing a problem that would disappear if we stopped talking about it. We're saying there's a problem with the way the rules have been written, and something needs to be done to address that before practical consequences start to occur.

This brings us to Goulder's prescription: The inclusive framework should address the UTPR's nexus issue through a multilateral instrument. For those who like the idea of global implementation of the GLOBE model rules, this is an eminently sensible suggestion. For others, including an increasingly vocal contingent of inclusive framework members, the model rules need more modifications than just an MLI.

The real problem with global implementation at this point is that the United States isn't going to enact in the foreseeable future any international tax legislation that will bring U.S. law into line with the model rules. Thus, the UTPR could be applicable, on its face, to U.S.-sourced profits of many U.S. MNEs, given the significant business tax credits under U.S. law that aren't qualified refundable credits as defined in the model rules. Herzfeld notes that the United States already imposes three different minimum taxes on cross-border income of MNEs and argues in favor of a more flexible approach to determining whether the United States has a qualifying income inclusion rule (QIIR) for model rule purposes. It seems possible that if the inclusive framework were to agree that the U.S. rules, in their totality, constitute a QIIR, the potential for chaos posed by the UTPR would be greatly reduced, if not eliminated. ■

Yours sincerely,
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