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# Implementing Pillar Two in the EU – The Path Ahead

Peter Koerver Schmidt PhD, Academic Advisor / Professor WSR



# Agenda

- Pillar Two in a nutshell
- Three digressions
  - 1) EU Fundamental Freedoms
  - 2) International law and tax treaties
  - 3) The path ahead – A first step towards abandoning the Separate Entity Principle?



# From BEPS to the Pillars

## 2015

- BEPS Report on Action 1 – Addressing the Tax Challenges of the Digital Economy: More work to be done, solution in 2020...

## 2020

- Report on **Pillar One** Blueprint
  - New taxing rights to market jurisdictions (new nexus and profit allocation rules)
- Report on **Pillar Two** Blueprint
  - A right to “tax back” where other jurisdictions have not exercised their primary taxing rights (GloBE)

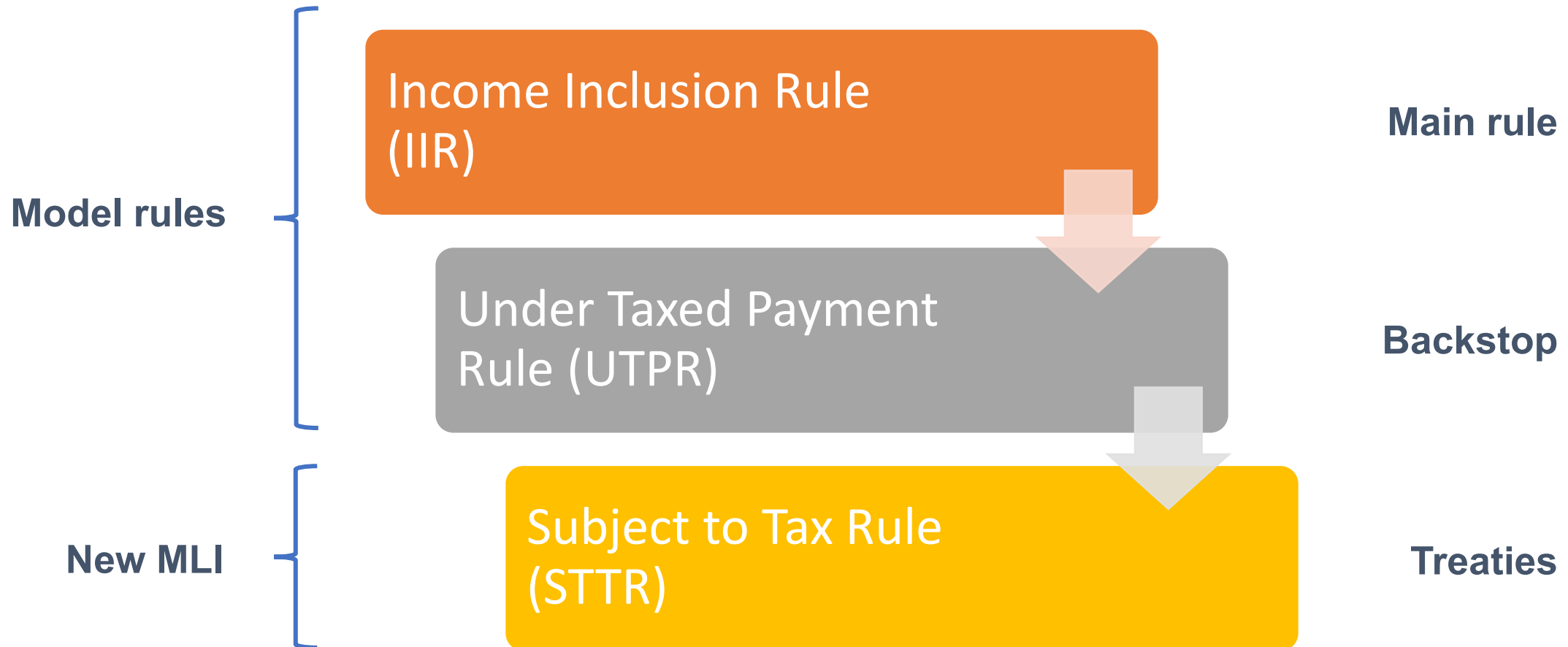
## 2021

- Political agreement (October) and Model Rules (December) on Pillar Two
- Proposal for a Directive (December)

## Background – Pillar Two

- **Aim**: To mitigate remaining profit shifting linked to the digitalization of the economy (and originally also to curb tax competition between states)
- **Idea**: To allow all countries to “tax back” profits where other countries have not sufficiently exercised their primary taxing rights
- **Design**: A systemic solution designed to ensure that all internationally operating businesses pay a minimum level of tax
- **Content**: New rules by way of changes to domestic law and DTTs

# Overview – Pillar Two



# Main Steps – Pillar Two

<b>1) Scope</b>	<ul style="list-style-type: none"> <li>• MNE Groups with consolidated revenue &gt; EUR 750 million</li> <li>• Constituent entities: All group entities and PEs</li> <li>• Excluded entities: Governmental entities, international organizations, non-profits, pensions funds, investment funds etc.</li> </ul>
<b>2) GloBE Income</b>	<ul style="list-style-type: none"> <li>• Constituent entity's GloBE Income = Accounting net income/loss</li> <li>• Adjustments and allocation between main offices and PEs</li> </ul>
<b>3) Covered Taxes</b>	<ul style="list-style-type: none"> <li>• Covered taxes = Current tax expense accrued for financial accounting</li> <li>• Adjustments and allocation to other constituent entities</li> </ul>
<b>4) ETR &amp; Top-up Tax</b>	$ETR = \frac{\text{Adjusted Covered Taxes}}{\text{Adjusted GloBE Income}}$ $(15\% - ETR, 0) * (\text{Adjusted GloBE Income} - SBIE) - QDMTT$
<b>5) IIR / UTPR</b>	<ul style="list-style-type: none"> <li>• Identify Parent Entity liable for top-up tax (top-down approach) and apply IIR</li> <li>• Identify remaining amount allocable under the UTPR and apply UTPR</li> </ul>



# Proposal for an EU Directive

- COM(2021) 823 final
  - Aims to ensure that Pillar Two is implemented in a coherent and consistent way across Member States
- The proposal closely follows the OECD Pillar Two Model Rules
- Certain deviations to ensure compliance with EU Law
  - The scope also includes domestic subsidiaries and PEs as well as (large) purely domestic groups
  - Option for Member States to apply the QDMTT





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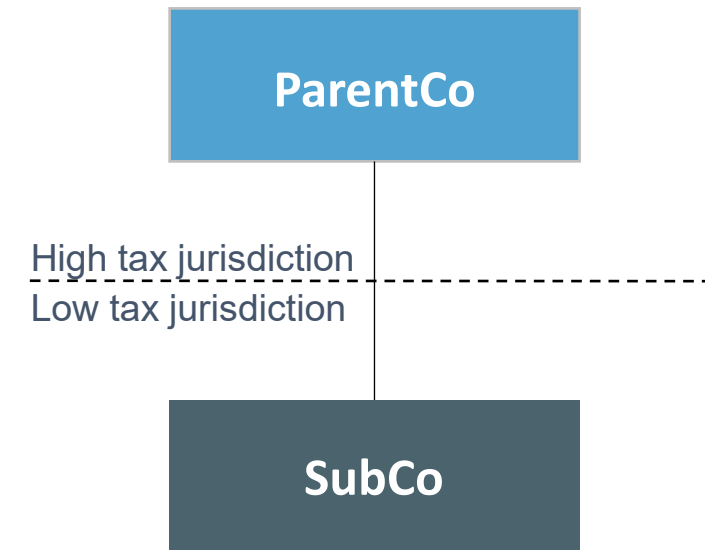
# Fundamental freedoms





# Main concern

- The IIR resembles CFC legislation...
- CJEU case law on CFC legislation:
  - The freedom of establishment to be respected
  - Entails different treatment of comparable situations
    - It does not matter that the group as such does not pay more tax than that which would have been payable if the income had been generated by a domestic subsidiary
  - Justification: Prevention of tax avoidance
  - Proportionality: May only target wholly artificial arrangements



IIR/CFC: ParentCo pays additional tax if SubCo has not been taxed sufficiently locally.

## Main concern (continued)

- Concern and options to overcome the concern discussed in the academic litterature
- One design option quickly attracted interest: Also applying the rules domestically to remove "different treatment of comparable situations"...

### Devereaux et al, Oxford U. Ctr. for Bus. Tax'n 57 (2020):

*"... de facto domestic companies are unlikely to become subject to any additional tax under the income inclusion rule. Hence, the proposed extended application would be at risk of being seen as mere window-dressing, making it vulnerable before the court..."*

See also Schmidt, 48 Intertax 11 (2020); de Broe & Maissant, 30 EC Tax Review 3 (2021); and de Pietro, 30 EC Tax Review 5/6 (2021).

### Nogueira, 12 World Tax Journal 3 (2020):

*"... the preferred option would be to extend the application of GloBE to also include purely domestic situations..."*

*"...domestic companies would also be effectively targeted, removing any suspicion of de facto discrimination..."*

See also Englisch, 30 EC Tax Review 3 (2021); and English & Becker, SSRN (2021).

# The Commission's proposal

## COM(2021) 823 final

"To ensure compatibility with primary Union law, and more precisely with the freedom of establishment, the rules of this Directive should apply to entities resident in a Member State as well as non-resident entities of a parent entity located in that Member State.

This Directive should also apply to very large-scale, purely domestic groups.

In this way, the legal framework would be designed to avoid any risk of discrimination between cross-border and domestic situations. All entities, including the parent entity that applies the IIR, which are located in a Member State that is low-taxed, would be subject to the top-up tax.

Equally, constituent entities of the same parent entity that are located in another Member State, which is low-taxed, would be subject to the top-up tax."

# My assessment

- The proposal will most likely not be considered in conflict with the freedom of establishment should the ECJ get the opportunity to decide on this matter
  - Schmidt, SR-skat 3 (2022 – forthcoming)
- 1) The ECJ has traditionally been very reluctant to strike down EU secondary legislation
- 2) Applying the IIR domestically may actually have real consequences (unlike applying classic CFC rules domestically)
- 3) The IIR and classical CFC rules may not have to be viewed in the exact same way

## My assessment (continued)

4) Recent case law indicates that the ECJ have raised the bar for finding indirect discrimination. For example the cases on progressive turnover taxes:

- C-75/18 Vodafone Magyarország
- C-323/18 Tesco-Global Áruházak

- If the disparate effects are “fortuitous” or “a matter of chance” the legislation does not restrict the free movement guarantees if it relies on objective criteria
- However, a clear protectionist or discriminatory motive by the legislator may exceptionally entail that a measure should be considered restrictive
  - See also the opinions of General Advocate Kokott
  - See also Englisch, 30 EC Tax Review 3 (2021)

# International law and tax treaties



# International law

- International law: Jurisdiction to tax requires a “genuine link”
  - Comprehensive link → Residence
  - Limited link → Source
- The IIR will lead to taxation of income that has a very limited link to the taxing jurisdiction (i.e. residence state of the UPE)
- Hongler, GlobTaxGov (2021)
  - The IIR stretches the boundaries of the international law framework too much and therefore constitutes an infringement hereof
  - Cannot be justified by “global interests”
  - Solved through explicit agreement? Probably not (coercive measure)

# Tax Treaties

- de Pietro, 30 EC Tax Review 5/6 (2021)
  - A conflict exists between the IIR and Art. 7(1) of the OECD Model
  - The IIR can only be applied (without breaching) in case of treaty abuse
  - A "fact and circumstances test" should be included as part of Pillar Two
- Chand et al., 14 World Tax Journal 1 (2022)
  - From a legal perspective several potential conflicts could arise with tax treaties, in particular when interpreted in a reasonable purposive manner
  - Widespread adoption of the saving clause can eliminate conflicts linked to art. 9(1) of the OECD Model (but not for conflicts related to the other provisions)
  - Suggest that an explicit safeguard clause, which authorizes the application of IIR/UTPR, is implemented in tax treaties
- My view
  - Valid points, but... the "CFC story" all over again?



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# Conclusions – The path ahead



## Conclusions – The path ahead

- EU law and international law obligations are not insurmountable
- Member States will need to unanimously agree in Council
  - National legislation in place by 31 December 2022
  - Application from 1 January 2023
- Growing concern that the EU moves too fast/slow
- Several unanswered questions – What will the consequences be?
  - (Member) States' tax revenues
  - Businesses
  - European/Global tax competition
  - Unilateral digital taxes
  - The international tax regime in a broader context
    - A first step towards abandoning the separate entity principle?

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