3-21-2022

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Source Publication:
Tax Notes Federal, March 21, 2022, p. 1695

taxnotes federal

Volume 174, Number 12 ■ March 21, 2022

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Reprinted from *Tax Notes Federal*, March 21, 2022, p. 1695

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In this article, Li argues that the OECD's model undertaxed payments rule is in effect an undertaxed profits rule and thus departs from the global consensus reached in October 2021 and is incompatible with existing tax treaties.

The OECD released pillar 2 model rules[1] last December to provide a template for domestic legislation to implement the agreement reached on October 8, 2021, by almost 140 inclusive framework members on a two-pillar solution to address global tax challenges. The model rules are limited to the income inclusion rule (IIR) and undertaxed payments rule (UTPR) (collectively known as the global anti-base-erosion (GLOBE) regime) in the October agreement. However, and rather surprisingly, the meaning of the letter "P" in the UTPR was effectively changed from payments to profits in the model rules.[2] There was little, if any, public discussion about this variation. The acronym UTPR is not truly defined in the model rules; chapter 10 merely defines it to mean "the rules set out in Article 2.4 to Article 2.6," and those rules do not refer to payments or profits. The model rules do not even fully spell out UTPR and use the acronym from the very beginning.

HM Revenue & Customs is more transparent in its pillar 2 consultation paper by defining its UTPR as an undertaxed profits rule. There is no reason to think that the U.K. wording is not a truthful translation of the meaning of the UTPR in the model rules because the United Kingdom genuinely supported pillar 2 by playing a key role in forging consensus among G-7 countries in July 2021. HMRC sought comments on the translation of model rules into U.K. domestic law as opposed to the policy rationale of the rules or main design features of the UTPR.[3]

What does the variation from undertaxed payments rule to undertaxed profits rule mean? Does it spell problems for pillar 2?

[1]Similar rules were included in the European Commission's proposal for a council directive to ensure a global minimum level of taxation for multinational groups in the EU (COM(2021) 823 final), as well as in the pillar 2 consultation paper released in January by HM Revenue & Customs; U.K. HMRC, "OECD Pillar 2: Consultation on Implementation" (Jan. 2022) (hereinafter "U.K. consultation paper").

[2]Also surprisingly, the model rules allow countries to introduce a qualified domestic minimum top-up tax (QDMTT) based on the GLOBE mechanics and reduce the amount of top-up tax that is due to be collected under the IIR or UTPR by the amount of QDMTT (see article 5.2.3). The QDMTT is another innovation because it is not mentioned in the October agreement. Some commentators argue that "the addition of QDMTT effectively alters the rule order of Pillar 2. It moves 'source' countries to the head of the queue to collect the top-up tax generated by Pillar 2." *See* Michael P. Devereux, John Vella, and Heydon Wardell-Burrus, "Pillar 2: Rule Order, Incentives, and Tax Competition," *Policy Brief*, at 3 (Jan. 14, 2022).

[3]U.K. consultation paper, *supra* note 1, at 1.24 and 1.25.

This article argues that the variation changes the nature of UTPR from the original anti-base-erosion (or tax-base-protection) rule to a tax-base-sharing (or anti-tax-competition) rule. It delinks the rule from any intragroup base-eroding payments so that the erosion of the tax base of the UTPR jurisdiction is no longer a precondition for the imposition of the top-up tax. It is true that the modified UTPR can reduce the incentive to shift profits to low- or no-tax jurisdictions by creating a floor on tax competition among jurisdictions. However, by not requiring the low-taxed profits to have any nexus with the taxing jurisdiction, the model rule effectively creates a new basis for tax jurisdiction. Thus, it arguably departs from the consensus in the October agreement, the existing international tax consensus based on the economic allegiance theory[4] and value creation principle and contradicts existing tax treaty provisions. Adopting the model UTPR may be inconsistent with a country's obligation to implement its bilateral tax treaties in good faith as required by the Vienna Convention on the Law of Treaties. Those legal problems will likely add more uncertainty in implementing pillar 2.

I. The Different 'P' in the Model UTPR

The UTPR is intended to backstop the IIR.[5] If there is any top-up tax of an in-scope corporate group, arising in any jurisdiction, the group's ultimate or intermediary parent can charge the top-up tax. If the IIR is not charged on the full amount of the top-up tax, a jurisdiction where a constituent entity is located can charge a top-up tax under the UTPR through denying deductions in computing corporate income tax or by way of an equivalent adjustment. Together, the IIR and UTPR ensure the global profit of an in-scope corporate group is taxed at the minimum 15 percent effective tax rate (ETR). The computation is largely based on financial accounting values as opposed to tax laws. The amount of top-up tax is determined jurisdiction by jurisdiction.

Effectively replacing the word "payments" with "profits" in the model UTPR may appear harmless, but in income tax law, those words represent very different concepts. In international taxation, the replacement is tantamount to creating a new basis for a country to tax profit that is not earned by its resident company or sourced in its jurisdiction. This new basis is based on having a constituent entity located in its jurisdiction and the corporate group's income not being taxed by another country up to the minimum tax rate. Even though each constituent entity may be presumed to contribute to the creation of group residual profit, including synergetic benefit, existing domestic laws or tax treaties do not recognize the right to tax that profit in the absence of specific intragroup transactions. Therefore, the change is revolutionary as it can permit a country to tax income that has no connection to it.

A. The Agreement's Payments-Based Rule

In the October agreement, UTPR refers to undertaxed payments rule. The original UTPR was modeled on the U.S. base erosion and antiabuse tax. Even though the BEAT is not exactly a tax on base-eroding payments per se, its application is tied to base-eroding payments by a U.S. resident corporation to foreign related persons. As an alternative minimum tax, the BEAT is intended to protect the U.S. tax base that is otherwise eroded by related-party payments and not caught by subpart F. In other words, the source[6] of the undertaxed income can be presumed to be in the United States, so the United States is not a "stranger" to the income.

Until the publication of the model rules, the OECD used the word "payments" in various phrases in discussing the UTPR. For example:

- The 2019 work program describes the GLOBE proposal as an IIR and a base-

[4] G.W.J. Bruins et al., "Report on Double Taxation Submitted to the Financial Committee — Economic and Financial Commission Report by the Experts on Double Taxation," E.F.S.73.F.19 (Apr. 5, 1923).

[5] The UTPR can be viewed as a supplement to the IIR or an enforcement mechanism. It applies only if there is a top-up tax that is not picked up through the IIR. For further discussion, see Brian Arnold, "The Arnold Report: The Model Rules for the Pillar Two Global Minimum Tax," Canadian Tax Foundation (Feb. 1, 2022).

[6] The notion of "source" is critical in international taxation, but its meaning is uncertain. *See* Hugh J. Ault and David F. Bradford, "Taxing International Income: An Analysis of the U.S. System and Its Economic Premises," in *Taxation in the Global Economy* 11 (1990); Jinyan Li and J. Scott Wilkie, "Elegance in Territorial Simplicity: An Historical Review of the Canadian Notion of Source," in *Income Tax at 100 Years: Essays and Reflections on the Income War Tax Act* 11:1-53 (2017).

eroding tax payments rule that "would operate by way of a denial of a deduction or imposition of source-based taxation . . . for certain payments unless that payment was subject to tax at or above a minimum rate."

- The January 2020 statement says the UTPR operates "by denying a deduction or making an equivalent adjustment in respect of intra-group payments."
- According to the 2020 pillar 2 blueprint, the rule requires a UTPR taxpayer that is a member of a multinational enterprise to make an adjustment for any top-up tax allocated to it from a low-tax constituent entity in the same group. The top-up tax is allocated to a UTPR taxpayer in two steps. First, if the UTPR taxpayer makes any deductible payments to the low-tax constituent entity during the relevant period, that entity's top-up tax is allocated to the taxpayer in proportion to the total deductible payments made to that entity by all UTPR taxpayers. Second, if the UTPR taxpayer has net intragroup expenditures, the remaining top-up tax is allocated in proportion to the total amount of those expenditures incurred by all UTPR taxpayers.

A reasonable interpretation of the above history is that the UTPR applies only when there are intragroup payments by a constituent entity to a low-taxed entity. The underlying rationale for the UTPR country to tax the paying entity is that the low-taxed profit is shifted from or originated in its jurisdiction. That is similar to the rationale of the BEAT. There seemed to be no suggestions that the original UTPR would be triggered in the absence of any intragroup base-eroding payments. It is reasonable to presume that the meaning of the term "undertaxed payments rule" in the agreement was based on the earlier OECD articulation of the UTPR in terms of the basic nature and design.

B. The Model's Profits-Based Rule

The model UTPR does not explicitly refer to "undertaxed payments." It does not require a UTPR taxpayer to have any intragroup base-eroding payments to low-taxed entities. The word "payments" is not used in specifying a condition for charging a UTPR tax, but in describing a method of collecting the tax.[7]

According to model article 2.4.1, constituent entities of an MNE located in the implementing jurisdiction will be denied a corporate tax deduction on payments made by constituent entities (or required to make an equivalent adjustment under domestic law) in an amount resulting in their having an additional cash tax expense equal to the UTPR top-up tax for the fiscal year allocated to that jurisdiction. There are no requirements that the payments subject to the deduction limitations are made to any constituent entities of the corporate group. Thus, payments to high-taxed constituent entities or third parties can be subject to the limitation or, in effect, disregarded in computing ordinary corporate income tax.

The undertaxed profit does not have to arise in or have any nexus with the UTPR jurisdiction. Any constituent entity of an in-scope multinational group is a UTPR taxpayer if it has employees and tangible assets. Subject to articles 2.6.2 and 2.6.3, article 2.6.1 says the top-up tax allocated to the implementing jurisdiction is determined by multiplying the total UTPR top-up tax by the jurisdiction's UTPR percentage. That percentage is determined each fiscal year for each MNE using the following formula:

$$50\% * \frac{\textit{number of employees in the jurisdiction}}{\textit{number of employees in all UTPR jurisdictions}} + 50\% * \frac{\textit{total value of tangible assets in the jurisdiction}}{\textit{total value of tangible assets in all UTPR jurisdictions}}$$

The U.K. consultation paper, which aims to translate the above rules into U.K. law, says that the above rules do not prescribe how the top-up tax is brought into charge and offers two possible approaches:

[7] Article 2.5.1 defines the total UTPR top-up tax for a fiscal year as the sum of the top-up tax for each low-taxed constituent entity of an MNE for that fiscal year.

- One is to deny a deduction on payments made by constituent entities in the United Kingdom. The top-up tax would be converted into payments by dividing the tax by the U.K. statutory corporate tax rate. This would cap the charge to the lower of the top-up tax allocated to the United Kingdom and the amount of payments made by U.K. constituent entities. "So, the denial [of deduction] could apply to any payment made from an entity, not just in respect of related party payments to the relevant low-taxed jurisdiction," and "there does not need to be any link between the type of expense which is denied and the nature of the low-taxed income."[8]
- The second approach is not in the model rules but can be designed to meet the equivalent adjustment requirements in the model rules: a new charge on a U.K. constituent entity based on the top-up tax allocated to the United Kingdom that is capped by reference to the payments made by constituent entities.

There may be circumstances in which there are insufficient payments in the UTPR jurisdiction to charge the top-up tax. The model rules require the uncollected portion of the top-up tax to be carried forward and collected in the next year. If there are insufficient deductions to collect the tax, there will be a further adjustment in the second year to collect the remaining top-up tax. The model rules also prevent future top-up tax from being allocated to a UTPR jurisdiction that has carried forward some of its top-up tax from an earlier year. In that case, the allocation key for that jurisdiction would be zero, according to articles 2.6.3 and 2.6.4 of the model rules. The UTPR tax base would be allocated to other jurisdictions where constituent entities have sufficient profits.

C. Transformative Change: An Illustration

The effective change of the meaning of the letter "P" in the model rules is not just semantics. It has the effect of transforming the UTPR from an anti-base-erosion rule to a tax-base-sharing or anti-tax-competition rule. To trigger the tax, there is no need for the taxpayer's profit (or the UTPR jurisdiction's tax base) to be reduced by any outgoing payments to a low-tax constituent entity of the group. The UTPR jurisdiction can gain a tax base by grabbing the tax that is not charged by the country where the low-tax entity is located and profit is generated.[9] The operation of the model UTPR is illustrated in the following hypothetical case study.

Multinational XYZ is within the scope of pillar 2. Its ultimate parent,[10] USParent, is in the United States. It has four wholly owned subsidiaries: UKSub in the United Kingdom, FrenchSub in France, CanSub in Canada, and ChinaSub in China.

We assume that the global intangible low-taxed income regime is not a qualified IIR. China does not implement pillar 2.[11] The United Kingdom, France, and Canada adopt the model UTPR.

Both China and the United States have tax incentives for research and development that reduce the ETR for USParent and ChinaSub to below 15 percent. ChinaSub's ETR is 6 percent on its adjusted GLOBE income of 100, and USParent's ETR is 12 percent on its adjusted GLOBE income of 100. The top-up tax is 9 for ChinaSub and 3 for USParent. Neither USParent nor ChinaSub receives any tax-deductible payments from any of UKSub, FrenchSub, or CanSub.

We also assume that the number of employees and total value of tangible assets in CanSub, FrenchSub, and UKSub are the same. The UTPR tax liability for each of UKSub, FrenchSub, and CanSub is thus 3 (in regard to ChinaSub) plus 1 (in regard to USParent) — that is, 1/3 of the total top-up tax in each jurisdiction. In effect, the 9 Chinese tax and 3 U.S. tax are picked up by the United Kingdom, France, and Canada. This top-up tax could be collected through denying deductions in

[8] U.K. consultation paper, *supra* note 1, at sections 7.52-7.53.

[9] The UTPR is a supplement for the minimum tax, but there are no rules prohibiting a country from imposing a UTPR tax as long as there is a top-up tax that is not picked up by an IIR in another jurisdiction.

[10] For definitions of the terms "ultimate parent entity," "intermediary parent entity," "ETR," and "GLOBE income," see chapter 10 of the model rules.

[11] If every country adopts pillar 2 or even introduces a QDMTT, none of the problems discussed in this article would arise. It is beyond the scope of this article to examine the chance of that happening.

computing corporate tax on payments made by UKSub, FrenchSub, and CanSub to anyone.

If the top-up tax charged to CanSub cannot be collected because of insufficient payments, CanSub's future percentage would be zero, and Canada would no longer be able to share the top-up tax.

In contrast, because there are no base-eroding payments from UKSub, FrenchSub, or CanSub to ChinaSub or USParent, the UTPR was not triggered under the agreement. In addition to neutralizing the effect of tax incentives in China and the United States, the model UTPR can effectively shift the Chinese and U.S. tax bases to the United Kingdom, France, and Canada.

II. Model UTPR Deviates From Consensus

Given the absence of any explicit authorization in the October agreement to replace payments with profits, the model UTPR may be viewed as going beyond the international consensus. The model rules are expected to give effect to, not replace, the GLOBE rules. The annex to the October agreement says the "model rules will define the scope and set out the mechanics of the GLOBE rules" and "include the rules for determining the ETR on a jurisdictional basis and the relevant exclusions, such as the formulaic substance-based carve-out" and "cover administrative provisions." Nowhere does the October agreement refer to introducing a fundamental change through model rules. It can be argued, though, that the modified UTPR is consistent with the overall purpose of the GLOBE rules — all income of in-scope corporate groups is taxed at the 15 percent ETR.

The model UTPR is a fundamental departure from the economic allegiance doctrine that is the bedrock of the century-old international tax consensus. According to the economic allegiance doctrine, a country's competence in taxing a person's income depends on the person's economic allegiance with that country.[12] In other words, when it comes to distributing taxing rights, the correct question is: "In what ways and to what extent can a man be served by two or more governments that he should owe them any duty?" A country of production, possession, and disposition of wealth renders services to a taxpayer by ensuring stable government, laws, and a "proper environment." The outcome of applying the model UTPR in the case study would be inconsistent with the economic allegiance doctrine as the United Kingdom, France, and Canada could collect taxes on the Chinese or U.S. income without any role in its generation.[13]

The model UTPR also departs from the guiding principle in the original base erosion and profit-shifting project: Profits should be taxed in the jurisdiction where they are derived. That value creation principle is most relevant in the actions 8-10 report on transfer pricing, which was incorporated into the OECD transfer pricing guidelines. Value creation can be evidenced by production and other economic activities; ownership of financial capital and intangible property; and the development, enhancement, maintenance, protection, and exploitation of intangibles. By allocating the top-up tax according to a formula that is not connected to the generation of the undertaxed profits, the model UTPR ignores the value creation principle and is indifferent toward the alignment of the location of taxation with the location of value creation.[14]

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[12] *Id*. The economic allegiance doctrine reflects the benefit principle. The idea behind the benefit principle is that fiscal jurisdictions charge a price proportionate to the public services rendered to the taxpayer. Even though it is impossible to attribute a specific value of public services rendered to a taxpayer, this principle is helpful to explaining the importance of linking a country's tax jurisdiction and the activities of a taxpayer in that jurisdiction. For further discussion, see Wolfgang Schön, "Value Creation, the Benefit Principle and Efficiency-Related Allocation of Taxing Rights," Working Paper of the Max Planck Institute for Tax Law and Public Finance No. 2021-06 (2021).

[13] It is unclear if this outcome was intended by inclusive framework members who joined the October agreement. For example, the EU draft directive, *supra* note 1, at 1, explains that the GLOBE rules were designed "to ensure that all corporations pay their fair share of tax on profits generated by their activities in the EU." If France adopts the model UTPR, it would be taxing profits generated by activities outside the EU.

[14] *See* Angelo Nikolakakis, "Aligning the Location of Taxation With the Location of Value Creation: Are We There Yet!?!" 75(11/12) *Bull. Int'l Tax'n* 549 (Nov./Dec. 2021) (arguing that the dislocation between location of taxation and location of value creation applies equally under the original version of UTPR, which was the version analyzed in this article).

III. Incompatibility With Tax Treaties

A. OECD View Is Problematic

The OECD pillar 2 blueprint states that the IIR and UTPR are compatible with tax treaties:

> 10.4.1 General principles.
>
> 679. The common starting point for an analysis of the compatibility of the IIR and UTPR with existing tax treaty obligations is the general principle that, with limited exceptions, tax treaties are not intended to restrict a jurisdiction's right to tax its own residents. This longstanding principle is now codified in Article 1(3) of the OECD model (often referred to as the "saving clause"), and reads as follows:
>
> > This Convention shall not affect the taxation, by a Contracting State, of its residents except with respect to the benefits granted under paragraph 3 of Article 7, paragraph 2 of Article 9 and Articles 19, 20, 23 [A] [B], 24, 25 and 28.
>
> 680. As a general matter, then, tax treaties should not present any obstacle to jurisdictions implementing an IIR and UTPR along the lines envisaged under the GloBE.
>
> 10.4.3. Undertaxed payments rule (UTPR).
>
> 684. The UTPR serves as a backstop to the IIR. It operates when the IIR does not apply by providing jurisdictions with a tool to protect themselves from the effect of base eroding transactions. In order to do so, the UTPR takes the form of a limitation (or denial) of the deduction of intra-group payments, or an equivalent adjustment. The extent to which the deduction of an intra-group payment is affected by the UTPR depends on the amount of top-up tax that is allocated to a UTPR Taxpayer. As described in Chapter 7, the UTPR uses the same mechanics as the IIR for determining the MNE's jurisdictional ETR and the amount of top-up tax allocable under the rule. The UTPR, however, operates through an allocation key that is based on deductible intra-group payments.

The above view on the UTPR's compatibility does not apply to the model UTPR because the model rule removes the link to intragroup payments and is no longer an anti-base-erosion rule. It is, in effect, a kind of modified formulary apportionment. As mentioned earlier, the UTPR does not require the income to have any connection with the erosion of the UTPR-implementing jurisdiction's tax base.

More generally, the saving clause in article 1(3) of the 2017 OECD model convention may not be in all tax treaties of a UTPR jurisdiction. Even if it were, the saving clause arguably does not cover the profits-based UTPR for three main reasons:

- What is being taxed is not its resident's income, but a nonresident's. As the case study shows, the United Kingdom, France, or Canada would be taxing Chinese or U.S. income earned by ChinaSub or USParent who is a nonresident in the United Kingdom, France, or Canada under existing domestic law and tax treaties.
- The model UTPR is no longer an antiabuse rule by delinking with any intragroup base-erosion payments. The intention of the saving clause is to allow a country to prevent tax avoidance through domestic antiabuse rules such as a controlled foreign corporation, interest deduction limitation under BEPS action 4, or even BEAT.[15] As shown in the case study, the tax base (as defined under existing laws) of the United Kingdom, France, or Canada is not eroded.
- The saving clause does not apply to anti-tax-competition rules, such as the model UTPR. One can even say that the object and

[15] For commentary on the saving clause, see OECD, "Commentaries on the Articles of the Model Tax Convention" (2017). For discussion of whether the BEAT constitutes a treaty override, see H. David Rosenbloom and Fadi Shaheen, "The BEAT and the Treaties," *Tax Notes Int'l*, Oct. 1, 2018, p. 53; and Reuven S. Avi-Yonah and Bret Wells, "The BEAT and Treaty Overrides: A Brief Response to Rosenbloom and Shaheen," *Tax Notes Int'l*, Oct. 22, 2018, p. 383.

purpose of existing tax treaties do not include preventing tax competition.[16]

B. Extraterritorial Taxation of Profit

By delinking the UTPR from intragroup base-eroding payments, the model UTPR effectively becomes a pure tax-base-sharing or extraterritorial taxation rule. It is true that the original UTPR has an element of tax-base sharing by allowing the paying jurisdiction to, in effect, tax payments (such as interest or royalties) that are reasonable and otherwise deductible under its normal rules while the receiving jurisdiction has the ultimate right to tax income arising from the interest or royalty payments. The modified UTPR would allow any UTPR jurisdiction to tax the income of any other jurisdiction. This is a qualitative shift in terms of distributing taxing rights among countries. This type of extraterritorial taxation of business profit is difficult to justify under existing tax treaties, especially article 7 and article 9, which are based on the OECD model convention.

Article 7 distributes taxing rights between the contracting states based on a corporation's residence and the source of profits — that is, profits attributable to a permanent establishment in the other contracting state. The profit of a resident in one contracting state is taxable only in that state in the absence of a PE in the other contracting state. Having a sister corporation in the other state alone does not bring its profits within the taxing jurisdiction of the other state. In the case study, article 7 in the relevant applicable tax treaties does not authorize the United Kingdom, France, or Canada to tax business profits of ChinaSub or USParent.

Article 9 reflects the arm's-length principle and allows the contracting states to adjust the profits of associated enterprises arising from transfer pricing transactions. It applies only to transactions between an enterprise in a contracting state and another enterprise in the other contracting state. It is not applicable in the absence of any transactions. The OECD transfer pricing guidelines have consistently stated that formulary apportionment is inconsistent with the arm's-length principle. That is likely the reason pillar 1 requires a multilateral tax convention to override existing tax treaties. The two-factor formula in the model UTPR rules (number of employees and value of tangible assets) is thus inconsistent with article 9 in applicable tax treaties. This formula is a worse offender of the arm's-length principle than the formula in pillar 1 because the number of employees (as opposed to the payroll value) is arguably less correlated to value creation.

Because the UTPR jurisdiction is not taxing its resident's foreign income but the income of a treaty country's resident, the saving clause in article 1(3) cannot save the UTPR tax.

C. Tax Discrimination

Article 24(5) forbids a contracting state from giving less favorable treatment to an enterprise whose capital is owned or controlled (wholly or partly, directly or indirectly) by at least one resident of the other contracting state. The model UTPR applies only to entities owned by foreign-based parent companies.[17]

In the case study, UKSub, FrenchSub, and CanSub were wholly owned by USParent. The imposition of the UTPR tax is arguably forbidden by the U.K.-U.S. tax treaty, France-U.S. tax treaty, and Canada-U.S. tax treaty.

D. Double Taxation

Tax treaties are intended to prevent double taxation of income through distribution of taxing rights and requirement of the residence country to provide relief from double taxation (article 23a or 23b of the OECD model convention). Double taxation of income could arise under the model UTPR. For example, in the case study, the Chinese income of 100 is taxed in China, then in the United Kingdom/France/Canada under the UTPR, and possibly in the United States under GILTI.

[16] For further discussion, see Vikram Chand, Alessandro Turina, and Kinga Romanovska, "Tax Treaty Obstacles in Implementing the Pillar Two Global Minimum Tax Rules and a Possible Solution for Eliminating the Various Challenges," 14(1) *World Tax J.* 1-31 (2022); and Maarten de Wilde, "Why Pillar Two Top-Up Taxation Requires Tax Treaty Modification," Kluwer International Tax Blog, Jan. 12, 2022.

[17] The U.K. consultation paper, *supra* note 1, is clear that the United Kingdom will not apply the UTPR on domestically owned corporations.

Because the UTPR tax is unlikely creditable against GILTI tax,[18] there would be double taxation of the undertaxed Chinese income and no relief mechanism seems to exist.

IV. General Legal Challenges

A. *Pacta Sunt Servanda*

Given the model UTPR's nature as an anti-tax-competition or tax-base-sharing rule (as opposed to an antiabuse rule) and its incompatibility with existing tax treaties, it is questionable whether a country that implements it can be viewed as acting in good faith under article 26 of the Vienna Convention.

Under the principle of *pacta sunt servanda*, parties to a treaty must keep their sides of the bargain and perform their obligations in good faith. Domestic tax laws, even those based on global model rules, should not have the effect of redefining the scope of taxing rights in a way that is clearly contradictory to the treaty.

In the case study, the UTPR tax in the United Kingdom, France, and Canada is arguably not permitted by the applicable tax treaty. Therefore, it is difficult to maintain that these countries act in good faith in implementing their tax treaties if they change their domestic law to levy the UTPR tax.

B. Existing National Laws

The model UTPR must be translated into domestic law. The domesticated UTPR should operate both in parallel with and in conjunction with existing corporate tax rules. Even though the computation of the UTPR tax is based on consolidated accounting income (with some adjustments) and a formula for allocating the top-up tax to each jurisdiction, the collection of the tax requires identifying constituent entities whose deductions will be denied. Because the UTPR applies after the application of existing antiabuse rules, such as thin capitalization and interest expense limitation rules, it is inevitable to integrate the UTPR and existing rules. The U.K. consultation paper notes that the government anticipates possible challenges in identifying entities with the most profit capacity to absorb the top up and creating ordering rules when there are different tax rates on some types of income, deductions are already subject to limitation under other tax rules, or the group has losses.[19]

National corporate tax rules are not harmonized. For example, some countries allow consolidated taxation of corporate groups (for example, the United Kingdom and the United States in the case study) and others do not (for example, Canada and China in the case study). There may be further challenges in implementing UTPR in the latter type of countries as they need to integrate group taxation with the existing entity-by-entity system of taxation. These challenges may be more serious in federalist jurisdictions (for example, Canada) where sub-national level corporate tax issues are involved.

It would also be interesting to see how the UTPR is given effect in existing income tax legislation that typically contains charging rules based on residence of a taxpayer or domestic source of income. For example, section 2 of the Canadian Income Tax Act stipulates that an income tax shall be paid on the taxable income of every person resident in Canada or a nonresident person but only to the extent that the nonresident person carried on business in Canada or disposed of a taxable Canadian property. The UTPR tax is payable by a resident corporation on income that is not owned by it or is imputed to it. Unlike the existing CFC rule, there is no imputation of foreign low-taxed profit under the UTPR. So the Canadian Parliament needs to give itself the power to tax income that is earned by a foreign person in a foreign country. There seems to be no precedent for claiming that kind of taxing power in Canada.

C. Treaty Overrides

Adopting the model UTPR into domestic law arguably gives rise to a treaty override. In some countries, a treaty override may be lawful because treaties are equal to domestic law, and the principle of *lex posterior*[20] or parliamentary

[18] For further discussion of the U.S. foreign tax rules in the context of GILTI, see Mindy Herzfeld, "The Problematic New FTC Regs," *Tax Notes Federal*, Feb. 28, 2022, p. 1195.

[19] U.K. consultation paper, *supra* note 1, at section 7.59.

[20] Avi-Yonah and Wells, *supra* note 15.

supremacy prevails. In Canada, some provisions of the Income Tax Conventions Interpretation Act may be considered to constitute treaty overrides but are mostly in the nature of ambulatory interpretation or antiabuse under the saving clause.

In other countries (for example, France and China), it might be impossible for a state to override a treaty if the constitution places treaties on a higher pedestal than domestic law.[21] EU members might overcome that hurdle by adopting the model UTPR into EU law, which prevails over all law, including tax treaties.[22] In other countries, a constitutional amendment may be required.[23]

D. Country-by-Country Judicial Interpretation

Corporations that are charged a top-up tax under the domesticated UTPR may challenge the tax in courts. Judges might find the rule to be overruled by an applicable tax treaty. Tax planning arrangements to minimize the top-up tax might be found acceptable, given the uncertainty in the legislation.[24]

Nothing in the model rules or October agreement can make judges of participating countries adopt a common approach to interpretation and adjudication. In Canada, for example, the OECD model convention, OECD commentaries on the convention or OECD transfer pricing guidelines do not have the force of law, even though they may be considered by courts to have some persuasive value in interpretation.[25] The same approach is expected to apply to the model rules and OECD commentaries on the model rules. As a result, the global rules on paper could turn out differently in legal reality.

V. Implications for the Fate of Pillar 2

Effectively replacing the term "payments" with "profits" in the model UTPR could have serious implications for the fate of pillar 2. It renders the OECD's view on treaty compatibility less persuasive — or even incorrect — by removing the link to intragroup base-eroding payments. It arguably changes the nature of the rule from an anti-base-erosion rule to a tax-base-sharing rule that is outside the saving clause. Countries that adopt the model UTPR could face significant legal uncertainties. Those problems are difficult to address without a multilateral tax convention.[26]

Thus, changing the meaning of "P" in the model rules might spell legal problems for pillar 2. ■

[21] Chand, Turina, and Romanovska, *supra* note 16.

[22] *Id.*

[23] KPMG US LLP, "Switzerland: Implementation of Pillar Two Global Minimum Tax" (Jan. 18, 2022).

[24] In Canada, a taxpayer's right to arrange its affairs to save tax is a bedrock of the system. The Supreme Court of Canada recently reiterated that in *Canada v. Alta Energy Luxembourg SARL*, 2021 SCC 49, *aff'g* 2020 FCA 43, *aff'g* 2018 TCC 152. For analysis, see Li, "Finding the Purpose of Tax Treaty Provisions Under GAAR: Lessons From *Alta Energy*," *Tax Notes Int'l*, Jan. 10, 2022, p. 147.

[25] *See* Li, Arthur Cockfield, and Wilkie, *International Taxation in Canada* 50-58, 128-131 (2018).

[26] *See* Mary C. Bennett, "Contemplating a Multilateral Convention to Implement OECD Pillars 1 and 2," *Tax Notes Federal*, June 14, 2021, p. 1729.