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# World Tax Journal

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# World Tax Journal

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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*

**This article addresses the interaction between the global anti-base erosion rules (GloBE rules, namely, the income inclusion rule, IIR, and the undertaxed payments rule, UTPR) with tax treaties. In particular, the article analyses potential limitations to the application of the IIR by the provisions of article 9 of tax treaties. Further, the article investigates possible obstacles to the application of the IIR to tax treaties that contain tax sparing clauses. The article then conducts a similar analysis with respect to the UTPR, which is assessed from the perspective of article 9 and the non-discrimination provisions of article 24. Furthermore, the article explores whether importing article 9(1) into the list of exceptions to the saving clause would be appropriate, and the related consequences. Thereafter, the article gives an insight into the problem of tax treaty overrides which may arise if the Pillar Two rules are implemented in national legislation without making relevant changes to tax treaties. Moreover, this contribution also explores the dispute resolution instruments available to solve potential tax disputes that could arise when "taxation not in accordance with the convention" is detected, as well as other tax disputes that could arise from inconsistent application of the GloBE rules. The authors also highlight possible ramifications under non-tax agreements for such situations. In light of the strong arguments made in this article which indicate that conflicts could indeed arise and treaty overrides could occur, the authors put forth a solution in the form of a *safeguard clause – as opposed to a saving clause or interpretative MAPs* – that policymakers can incorporate in their treaty network to ensure that the GloBE rules can be applied without triggering frictions with tax treaty law. On the other hand, if such a clause is not inserted into tax treaties, then there is a concrete risk that an unforeseen obstacle of considerable magnitude could arise on the path of the Pillar Two initiative. Of course, the Pillar Two rules should be applied within the boundaries of the safeguard clause and if a state goes beyond its authorization, a conflict with the provisions of the treaty could once again arise. This could then possibly give the taxpayers access to MAPs for misapplication or inconsistent application of the Pillar Two rules. Needless to say, such a clause needs to be implemented through a Multilateral Agreement, which the authors discuss in this contribution. Finally, the authors also analyse selected treaty law-related discrimination issues linked to domestic minimum taxes that are being contemplated by several jurisdictions.**

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## 1. Introduction

This article enumerates and assesses the possible points of friction between the Pillar Two global anti-base erosion (GloBE) rules and the existing tax treaty framework.

To elaborate, section 2. analyses whether existing tax treaty rules could preclude the application of the income inclusion rule (IIR). In particular, the analysis focuses on whether article 9 of tax treaties as well as treaties that contain tax sparing clauses (typically, found in article 23) could restrict the application of the IIR. Of course, references will be made time and again to controlled foreign company (CFC) rules or transfer pricing rules as the effect of applying these allocation/attribution rules is similar to that of the IIR even though their respective policy rationale are quite different.

A similar line of analysis is then conducted with regard to the proposed "undertaxed payments" (or "undertaxed profits", to use the more suitable formulation, in light of the most recent version of this mechanism resulting from the December 2021 Model Rules, as also reflected in the 2022 Public Consultation on the Implementation of Pillar Two launched by the British Treasury on 11 January 2022) rule (hereinafter, also UTPR) which is assessed from the perspective of article 9 and the non-discrimination provisions contained in article 24. As a background and to serve as a lead into the analysis the authors will also analyse the tax treaty compatibility of interest limitation rules, in particular, specific rules which target associated enterprises exclusively as well as general rules such as comprehensive interest barriers (*see* section 3.).

While undertaking the analysis, the authors realize that potential frictions between such national rules and article 9 could be diffused through the saving clause. The authors, however, ponder the question of whether it is appropriate to import article 9(1) into the list of exceptions to the saving clause? This matter is discussed in section 4.

The next section (section 5.) deals with the issue of whether the national implementation of the GloBE rules, without changing tax treaties, could amount to tax treaty overrides. Indeed, if potential frictions could arise between these rules and treaties, then the possibility of a treaty override occurring is quite high.

Next, as tax disputes could arise (e.g. treaty override issues), the authors address the question of whether these issues could be solved through article 25 of the OECD Model. The authors also comment on the relevance of article 25 in relation to issues arising from inconsistent application of the Pillar Two rules by states (*see* section 6.).



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The authors conclude by providing one simple answer to the question of how potential conflicts between GloBE rules and tax treaties could be regulated by policymakers. One possibility is the saving clause. However, this clause is insufficient due to its exceptions. Another option is the introduction of multilateral interpretative MAPs pursuant to treaties which contain an article similar to article 25(3) of the OECD Model; however, such an administrative agreement, likely to be expressed in the form of a mere Memorandum of Understanding would not be suitable per se for overriding treaty provisions. Accordingly, a safeguard clause could be introduced which would authorize the application of the IIR or the UTPR. Such a clause, which is found in the treaty policy of some states with respect to national anti-abuse rules (CFC/thin capitalization rules), even though, as will be further illustrated, GloBE rules may not constitute anti-abuse rules *stricto sensu*, could be inserted into the treaty network, possibly through the Multilateral Instrument that is being considered for implementing the Global Tax Agreement (*see* section 7.).

Finally, the authors also analyse selected treaty law-related discrimination issues linked to domestic minimum taxes that are being contemplated by several jurisdictions (*see* section 8.).

## 2. Transfer Pricing Rules, CFC Rules, Relief Rules, IIR and Tax Treaties

The issue of the interaction of CFC rules with tax treaties has already received considerable attention. In general, CFC rules can trigger compatibility issues with article 7 of the OECD Model, which deals with business income, and article 10(5) of the OECD Model pertaining to the taxation of undistributed profits.[1]

To summarize, many countries are of the opinion that CFC rules do not conflict with tax treaty obligations. This position has been expressed in the 1986 Base Companies Report (majority view),[2] the 1992 OECD Commentary (majority view),[3] the 2003 OECD Commentary[4] (with a few states recording observations), the 2017 OECD Commentary[5] and the 2017 UN Commentary.[6] Many courts have also held that CFC rules are compatible

1. For a detailed analysis and a list of references on this issue, *see* L. De Broe, *International Tax Planning and Prevention of Abuse* pp. 575-643 (IBFD 2008), Books IBFD; V. Chand, *The Interaction of Domestic Anti-Avoidance Rules with Tax Treaties (with special references to the BEPS project)* ch. 18 (Schulthess 2018). For an overview of the policy rationale of controlled foreign company (CFC) rules, *see* R. Krever, *Controlled Foreign Company Legislation: General Report*, in *Controlled Foreign Company Legislation* (G. Kofler et al. eds., IBFD 2020), Books IBFD.
2. OECD, *Double Taxation Conventions and the Use of Base Companies*, paras. 39-51 (25 Nov. 1986).
3. *OECD Model Tax Convention on Income and on Capital: Commentary on Article 1*, paras. 22-26 (1 Sept. 1992), Treaties & Models IBFD [hereinafter *OECD Model: Commentary on Article 1* (1992)].
4. *OECD Model Tax Convention on Income and on Capital: Commentary on Article 1*, para. 22.1 (28 Jan. 2003), Treaties & Models IBFD [hereinafter *OECD Model: Commentary on Article 1* (2003)]; *OECD Model Tax Convention on Income and on Capital: Commentary on Article 10*, paras. 37-39 (28 Jan. 2003), Treaties & Models IBFD [hereinafter *OECD Model: Commentary on Article 10* (2003)]; and *OECD Model Tax Convention on Income and on Capital: Commentary on Article 7*, para. 10.1 (28 Jan. 2003), Treaties & Models IBFD [hereinafter *OECD Model: Commentary on Article 7* (2003)].
5. *OECD Model Tax Convention on Income and on Capital: Commentary on Article 1*, para. 81 (21 Nov. 2017), Treaties & Models IBFD [hereinafter *OECD Model: Commentary on Article 1* (2017)]; *OECD Model Tax Convention on Income and on Capital: Commentary on Article 7*, para. 14 (21 Nov. 2017), Treaties & Models IBFD [hereinafter *OECD Model: Commentary on Article 7* (2017)]; and *OECD Model Tax Convention on Income and on Capital: Commentary on Article 10*, para. 37 (21 Nov. 2017), Treaties & Models IBFD [hereinafter *OECD Model: Commentary on Article 10* (2017)].
6. *United Nations Model Double Taxation Convention between Developed and Developing Countries: Commentary on Article 1*, para. 40 (1 Jan. 2017), Treaties & Models IBFD [hereinafter *UN Model:*

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with treaties. For example, *see* the decisions in the cases of *UK Bricom Holding* (1997),[7] *Finnish Re A Oyj Abp* (2002),[8] *Swedish X AB* (2008)[9] and *Japanese Glaxo Kabushiki* (2009).[10] Furthermore, it should be noted that the latest version of the OECD Model contains a saving clause in article 1(3). The clause, which can be found in US tax treaties as well as some other tax treaties which have been modified as a result of article 11 of the Multilateral Instrument to Implement Tax Treaty Related Measures to Prevent BEPS (MLI),[11] states:

> 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, 24 and 25 and 28.

It is obvious that if this clause exists in tax treaties it would not be possible to argue that a state is restricted from applying its CFC rule.[12] This is because the said clause reserves a state's right to tax its residents under the rules provided in the domestic laws, notwithstanding any provisions of the tax treaty.[13] This said, the OECD[14] and UN[15] Commentaries make it clear that even if a treaty does not have a saving clause then this does not mean that a state is restricted from applying its CFC rule.[16]

The question whether the IIR conflicts with treaty provisions when applied by the state of the ultimate parent entity (UPE) now arises. In this respect, it should preliminarily be observed that even though CFC rules and the IIR share similar mechanisms, they cannot be conflated in that there is a fundamental difference when it comes to their policy rationale namely, unlike CFC rules, the IIR (and GloBE rules in general) do not aim to counter (specific) abusive practices but, rather, to steer international tax coordination in a direction that reduces the potential for MNEs to become engaged in profit shifting. In light of the discussion made in the context of CFCs while taking into due account the underlying differences in policy rationale between the IIR and CFC rules, one could simply argue that the IIR will

*Commentary on Article* 1 (2017)]; *United Nations Model Double Taxation Convention between Developed and Developing Countries: Commentary on Article 7*, para. 8 (1 Jan. 2017), Treaties & Models IBFD [hereinafter *UN Model: Commentary on Article 7* (2017)]; and *United Nations Model Double Taxation Convention between Developed and Developing Countries: Commentary on Article 10*, para. 16 (1 Jan. 2017), Treaties & Models IBFD [hereinafter *UN Model: Commentary on Article 10* (2017)].

7. UK: 3 Apr. 1996, *Bricom Holdings Ltd v. Inland Revenue Commissioners*, [1996] STC (SCD) 228. Followed by UK: COA, 25 July 1997, Appeal no. OOTRF 96/1522/B, *Bricom Holdings Limited v. Inland Revenue Commissioners*, 1 oflr ITLR 365, pp. 366-379. The *Bricom* case appears particularly relevant for the purpose of the present analysis since, above all, the proposed income inclusion rule (IIR) as it currently stands in light of the Blueprint (*see*, in particular, sec. 6.2 et seq. of the October 2020 Pillar Two Blueprint) would seem to have a lot in common with the mechanics of the British CFC rules that were at stake in the Bricom case. Essentially, it seems that notional income would be added to the income of the ultimate parent entity (UPE).
8. FI: KHO, 20 Mar. 2002, *Re A Oyj Abp*, KHO:2002.26, 4 ITLR 1009, pp. 1009-1076.
9. SE: RR, 3 Apr. 2008, Case no. 2695-05, *X AB v. Swedish Tax Agency*, 12 ITLR 311, pp. 311-342.
10. JP: SC, 29 Oct. 2009, Case no. 2008 (Gyou Hi), *Glaxo Kabushiki Kaisha v. Director of Kojimachi Tax Office*, 12 ITLR 644, pp. 644-657, Case Law IBFD.
11. For a detailed analysis of this clause, *see* V. Chand, *Should States Opt for the Saving Clause in the Multilateral Instrument?*, 86 Tax Notes International 8, p. 689 (22 May 2017).
12. G. Kofler, *Some Reflections on the 'Saving Clause'*, 44 Intertax 8/9, pp. 582-584 (2016).
13. *United States Model Technical Explanation Accompanying the United States Model Income Tax Convention of November*, art. 1(4), available at https://home.treasury.gov/system/files/131/Treaty-US-Model-TE-2006.pdf.
14. *OECD Model: Commentary on Article 1* (2017), *supra* n. 5, at paras. 17-18.
15. *UN Model: Commentary on Article 1* (2017), *supra* n. 6, at para. 8.
16. *OECD Model: Commentary on Article 1* (2017), *supra* n. 5, at para. 15.


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not conflict with tax treaties, in particular, article 7(1) and article 10(5). In fact, this position is expressed explicitly by the OECD in the Pillar Two Report.[17]

However, the OECD's (as well as the UN's) position with respect to CFCs does not seem to represent the universal view. For example, Switzerland, in the past as well as currently, is of the view that CFC rules "may, depending on the relevant concept, be contrary to the spirit of Article 7".[18] Moreover, a few courts in the past have held that CFC rules (or similar national attribution provisions) are contrary to tax treaties, for instance, in France,[19] Brazil[20] and Canada.[21] Also, some states such as Germany and France as well as Ireland and Luxembourg (the latter previously recorded observations on CFC rules) have reserved the right not to include the saving clause in their tax treaties.[22] Furthermore, some commentators in the post-BEPS era continue to argue that conflicts arise, in particular, with the treaty text contained in article 7(1).[23] At a more fundamental level, CFC rules seem to signal an implicit departure from the fundamental principle that non-resident corporations should be treated as taxable entities separate from their resident controlling shareholders. The departure from the separate entity concept carries significant implications for the allocation of taxing rights between source and residence countries; that is, by disregarding separate entities, a state which enforces the CFC legislation is reallocating taxing rights or a taxable base that has been allocated to another state. Consequently, on the purely legal plane, leaving aside possible convergences on the political and policy plane, arguing that the IIR is compatible with tax treaties may not be easily substantiated bearing in mind tax treaty case law devel-

17. OECD/G20, *Tax Challenges Arising from Digitalisation – Report on Pillar Two Blueprint: Inclusive Framework on BEPS*, paras. 681-683 (OECD 2020) [hereinafter *Report on Pillar Two Blueprint*]. *Also see* J. Englisch & J. Becker, *International effective minimum taxation – the GLOBE proposal*, sec. V (11 Apr. 2019), available at: https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3370532. With regard to fundamental difference in policy rationale between CFC rules and the IIR, *see* P. Pistone et al., *The OECD Public Consultation Document "Global Anti-Base Erosion (GloBE) Proposal – Pillar Two": An Assessment*, 74 Bull. Intl. Taxn. 2, sec. 1.3. (2020), Journal Articles & Papers IBFD; and P. Pistone & A. Turina, *The Way Ahead: Policy Consistency and Sustainability of the GLoBE Proposal*, in *Global Minimum Taxation? An Analysis of the Global Anti-Base Erosion Initiative* p. 419 (A. Perdelwitz & A. Turina, eds., IBFD 2021), Books IBFD. The Blueprint needs to be read in conjunction with the recently released Model Rules. *See* OECD/G20, *Tax Challenges Arising from the Digitalisation of the Economy Global Anti-Base Erosion Model Rules (Pillar Two)* (OECD 2022) [hereinafter *Model Rules*] available at https://www.oecd.org/tax/beps/tax-challenges-arising-from-the-digitalisation-of-the-economy-global-anti-base-erosion-model-rules-pillar-two.pdf.
18. *OECD Model: Commentary on Article 1* (2017), *supra* n. 5, at para. 110. Also, *see OECD Model: Commentary on Article 1* (2003), *supra* n. 4, at para. 27.9.
19. FR: CE, 28 June 2002, Appeal no. 232276, *Re Societe Schneider Electric*, 4 ITLR 1077, pp. 1106-1129, Case Law IBFD. *See also* FR: CA, 30 Jan. 2001, Appeal no. 96-1408, *Re Societe Schneider Electric*, 3 ITLR 529. *See also*, for a contextualization, D. Gutmann, R. Danon & H. Salomé, *The Personal Attribution of Income Requirements in International Tax Law, French-Swiss Point of View on the Société Schneider Electric Case*, 8 IBLJ, 911 (2002); and C. Garcia, *Controlled Foreign Company Legislation in France*, in *Controlled Foreign Company Legislation* pp. 287-288 (G. Kofler et al. eds., IBFD 2020), Books IBFD.
20. L. Schoueri & G. Galdino, *Controlled Foreign Company Legislation in Brazil*, in *Controlled Foreign Company Legislation* pp. 123-124 (G. Kofler et al. eds., IBFD 2020), Books IBFD.
21. CA: TC, 10 Sept. 2009, Case 2006-1405(IT)G, *Garron and another v. R; Re Garron Family Trust; Garron v. R; St Michael Trust Corp v. R; Re Fundy Settlement; Dunin v. R; St Michael Trust Corp v. R; Re Summersby Settlement*, 12 ITLR 79, pp. 79-148 (*see* paras. 322-326 and 337-338), Case Law IBFD. The case discusses the interaction of a Canadian deemed attribution rule with a provision similar to that of art. 13(5) OECD Model. The case was decided in favour of the taxpayer. A similar conclusion was reached in the *Sommerer* case. *See* CA: FCA, 13 July 2012, Docket A-188-11, *Canada v. Sommerer*, 2012 DTC 5126 [at 7219], 2012 FCA 207, paras. 62-68, Case Law IBFD.
22. *OECD Model: Commentary on Article 1* (2017), *supra* n. 5, at para. 117.
23. L. Schoueri, *Some Considerations on the Limitation of Substance-Based Carve-Out in the Income Inclusion Rule of Pillar Two*, 75 Bull. Intl. Taxn. 11 (2021), Journal Articles & Opinion Pieces IBFD. For a contrary view, *see* Chand, *supra* n. 1, at pp. 108-116.

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opments from across the globe which sometimes support a broad "purposive" interpretation of the treaty provisions.

One new argument which could support the incompatibility of the IIR with existing tax treaties is based on the developments to the OECD Commentary. As a start, it should be noted that the role of the OECD Commentary (or reports such as the Blueprint) in the interpretation process is highly debated. In the authors' view, the attempt to classify the Commentary on the OECD Model under one provision or another of the Vienna Convention on the Law of Treaties (1969) (VCLT) is not a profitable exercise. This is because the interpretation of provisions contained in the VCLT are not exhaustive. The draft Commentary on the VCLT makes this clear, and states that the drafters, in drafting the interpretation rules of the VCLT, never intended articles 31 and 32 of the VCLT to be a complete codification of all principles and maxims to be adopted in interpreting treaties. Therefore, even if the Commentary on the OECD Model cannot be fitted into articles 31 and 32 of the VCLT, it is submitted that it should be considered relevant in the tax treaty interpretation process. Therefore, the position adopted in this article is that the Commentary on the OECD Model, as it exists at the time of conclusion of a tax treaty, is not a legally binding instrument but nevertheless plays an important role in the tax treaty interpretation process. Having established that the OECD Commentary plays an important role in the interpretation process, even though not legally binding, the issue arises as to which version of the OECD Commentary should be used to interpret a tax treaty – i.e. is it the OECD Commentary that existed at the time a treaty was concluded (static approach), or are subsequent commentaries and guidelines also relevant (ambulatory/dynamic approach)? In the authors' view, a dynamic approach should be used. That said, subsequent versions can be considered if, and only if, they are clarificatory in nature. Consequently, if the updated or revised commentaries *represent a fundamental change, or if they reverse or contradict previous versions,* then the updated Commentary should be disregarded and should not be considered for the tax treaty interpretation process.[24]

In this regard, the 1992 OECD Commentary (as a result of the 1986 Base Companies report) contained strong language that CFC rules should not apply when the CFC carries out genuine business activities (business activity test) or the CFC is located in a jurisdiction whose tax rate is similar to that of the state applying the CFC (comparable tax rate test).[25] The commentary on the business activity test was deleted in the 2003 update to the OECD Commentary[26] and the comparable tax rate test was deleted in the 2017 update to the OECD Commentary.[27] The latter is an important development because the deletion now indicates that CFC rules (and this would be relevant also for the IIR) can also apply to CFCs (or constituent entities – CEs) established in countries where the tax rate is comparable to that of the state enforcing the CFC rule/IIR. This would, for example, even be the case under the IIR when the CE, which is normally subject to high corporate taxes, has access to a preferential tax regime in its state of establishment and thus has a low effective tax rate (ETR). This is indeed a *fundamental/substantial change* to the OECD Commentary. One could thus argue that such a change can only be applied to existing tax treaties on a prospective basis (that is, only to tax treaties concluded after the 2017 update) with respect to interpreting the relevant

24. Chand, *supra* n. 1, at pp. 108-116 (as well as all the references therein).
25. *OECD Model: Commentary on Article 1* (1992), *supra* n. 3, at para. 26.
26. *OECD Model: Commentary on Article 1* (2003), *supra* n. 4, at para. 26.
27. *OECD Model: Commentary on Article 1* (2017), *supra* n. 5, at para. 81.



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treaty provisions. In other words, if the CFC rules/IIR apply to countries where the tax rate is comparable to that of the parent, then the statements contained in the commentary do not hold good. If the IIR applies to countries where the tax rate is comparable then these changes cannot be applied to pre-existing treaties.[28]

The above discussion represents situations wherein CFC rules were tested with article 7(1) and article 10(5). To take the discussion further, the authors hereby explore new areas of potential conflicts.

One area which has not been extensively explored in the literature is whether CFC rules (or possibly the IIR) conflict with article 9, especially when the rules apply to genuine operating entities in which the CFC or the CE *controls* keys risks (including development, enhancement, maintenance, protection and exploitation (DEMPE) related risks). In other words, this is the case when the CFC or the CE is a genuine operating entity and profits have been allocated to it on an arm's length basis. To give an example, Company R (a State R resident and the UPE of the Group) owns Company T, an IP Company (a resident of State T, a low-tax country). Company T licenses out all its IP to related parties around the world and receives royalty income. From a transfer pricing perspective, the authors assume that Company T is entitled to all the royalty income in light of its functional profile, i.e. it performs DEMPE functions and assumes associated risks. Now the question is: if State R taxes the royalty income pursuant to its national CFC rule, does this conflict with article 9 of the R-T tax treaty? The question is relevant because State R increases the tax base of Company R by including in its income the profits which have not been derived by Company R but by Company T. Clearly, if the treaty has a saving clause, then there is no issue of a conflict as article 9(1) is not listed as an exception in that clause.[29] Accordingly, it could be argued that the tax treaty shall not restrict State R from applying the CFC rule (or possibly the IIR) to its own resident; it should be noted in any case that this circumstance does not exclude that the outcome may result in double taxation. And what if the treaty does not include such a clause (which is probably the case for a majority of tax treaties around the world)?[30]

To reiterate, article 9 deals with adjustments to profits that may be made for tax purposes where transactions between associated enterprises are made on non-arm's length conditions. Article 9(1) of the OECD Model, in its various versions, allows the tax authorities of a state to adjust the profits of the enterprises resident in that state if, as a result of the special relations between that enterprise and other *associated enterprises* resident in another State, the profits of the first enterprise have been diverted to the other associated enterprises, due to the fact that they operate with each other on a non-arm's length basis. Where the tax authorities have adjusted the profits, article 9(2) of the OECD Model is aimed at eliminating

28. As will be addressed further in this section, it is worth remarking that even if the compatibility of CFC legislation with art. 7 were to be justified based on the fact that the residence country would be taxing its own taxpayer, such an argument would ultimately be based on an anti-profit shifting and "value creation" understanding of CFC rules so that these rules would function as a complement to transfer pricing rules, with both sets of rules pursuing taxation where the value is created. However, this line of argumentation would simply not apply to the IIR, as such rule would apply even if value is actually created in the source country unless carve-outs apply. *See also*, in this sense, Schoueri, *supra* n. 23.
29. *See* M.G. Beemer, *Revenue Act of 1962 and United States Treaty Obligations*, 20 Tax Law Review 125 (1964).
30. On the other hand, it may also be observed that under best practices, it is the duty of the parent company to give credit; compare for instance, in this sense, Recital 5 of Council Directive (EU) 2016/1164 of 12 July 2016 (ATAD I), as well as the optional CFC rule thereby included.

the economic double taxation that may arise pursuant to article 9(1). Clearly, several commentators are of the opinion that article 9(1) is restrictive in nature,[31,32] that is, it restricts national law rules whereas others (a minority) support an "illustrative" view.[33] But what does article 9(1) exactly restrict?

It is clear that national rules, which serve as allocation norms (profit allocation norms), need to be tested with article 9(1).[34] Article 9 restricts national allocation norms if they apply beyond the boundaries of the arm's length principle (ALP) (for example, a national formulary norm).[35] To illustrate, assume Company R (resident of State R) has licensed a patent to Company S (a resident of State S). The arm's length royalty is determined to be 4% on sales in Country S. However, Country R applies a national formulary rule and deems the royalty to be 8%. In this case, article 9(1) would restrict Country R from applying its deemed formula. In other words, Country R is permitted to tax up to an arm's length royalty. In this case, the provision restricts the State R tax administration from making arbitrary income/profit allocation adjustments. On the other hand, it is less clear as to whether article 9(1) would restrict State R from allocating/attributing the additional 4% royalty income pursuant to its national anti-avoidance rules (such as CFC rules). Put differently, should CFC rules be tested with article 9[36] and, if yes, what is the consequence? Arguments for and against are discussed hereafter.

First, arguably, the historical development of article 9 indicates that it has an anti-avoidance flavour in the sense of combating tax avoidance among associated enterprises.[37,38,39,40] In light of this, specific national anti-abuse rules targeting related parties and applicable in *residence–residence situations*, need to be tested with article 9. As CFC rules[41] apply mainly to related parties/associated enterprises, article 9 becomes relevant. This argument could

31. A. Bullen, *Arm's Length Transaction Structures: Recognizing and Restructuring Controlled Transactions in Transfer Pricing* pp. 68-74 (IBFD 2011), Books IBFD. *See also* V. Chand & G. Lembo, *Intangible-Related Profit Allocation within MNEs based on Key DEMPE Functions: Selected Issues and Interaction with Pillar One and Pillar Two of the Digital Debate*, 3 ITAXS 6, p. 14 (2020), Journal Articles & Opinion Pieces IBFD; and G. Kofler & I. Verlinden, *Unlimited Adjustments: Some Reflections on Transfer Pricing, General Anti-Avoidance and Controlled Foreign Company Rules, and the "Saving Clause"*, 74 Bull. Intl. Taxn. 4/5, sec. 3.2. (and all references therein) (2020), Journal Articles & Opinion Pieces IBFD.
32. J. Wittendorff, *The Transactional Ghost of Article 9(1) of the OECD Model*, 63 Bull. Intl. Taxn. 3, sec. 5.2.1. (2009), Journal Articles & Opinion Pieces IBFD.
33. For recent support of this view, *see* B. Arnold, *The Relationship Between Restrictions on the Deduction of Interest Under Canadian Law and Canadian Tax Treaties*, 67 Canadian Tax Journal/Revue fiscale canadienne 4, p.1074 (2019), available at https://www.ctf.ca/CTFWEB/Documents/CTJ%202019/Issue%20 4/1051_2019CTJ4-Sym-Arnold.pdf.
34. *See also* Chand & Lembo, *supra* n. 31, at pp. 14-23.
35. Wittendorff, *supra* n. 32, at sec. 5.2.1.
36. A commentator, when analysing the interaction of art. 344(2) Belgian Income Tax Code – a sort of CFC rule – raises this issue and states that the answer to the question is rather uncertain. *See* De Broe, *supra* n. 1, at pp. 639-641. On this point, *also see* Chand & Lembo, *supra* n. 34, at p. 23; *also see* G. Kofler, *Commentary on Article 9*, in *Klaus Vogel on Double Taxation Conventions*, paras. 88-90 (4th ed., E. Reimer & A. Rust eds., Wolters Kluwer 2015), (the issue at stake here is not discussed in the commentary).
37. L. Schoueri, *Arm' s Length: Beyond the Guidelines of the OECD*, 69 Bull. Intl. Taxn. 12, pp. 690 et seq. (2015), Journal Articles & Opinion Pieces IBFD. *See also* Kofler, *supra* n. 36, at paras. 7-10.
38. R. Collier & J. Andrus, *Transfer Pricing and the Arm's Length Principle* chs. 1 and 2 (Oxford University Press 2017).
39. Kofler & Verlinden, *supra* n. 31, at secs. 2.1 and 2.6.
40. L. Pogorelova, *Transfer Pricing and Anti-abuse Rules*, 37 Intertax 13, pp. 688-691 (2018).
41. CFC rules apply to enterprises that are controlled by the shareholder. For a definition of control, *see* OECD/G20, *Designing Effective Controlled Foreign Company Rules – Action 3: 2015 Final Report* paras. 34-49 (2015), Primary Sources IBFD [hereinafter *Action 3 Final Report*].


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also be supported by the fact that the OECD Commentary on Article 9 (1992, 2003, 2014 and 2017 versions) as well as the US Technical Explanation (2006)[42] analyse the interaction of national thin capitalization rules (which apply to related parties and are based on fixed debt-to-equity ratios) with article 9 (*see* section 3.). As a result, it is surely not appropriate to say that specific paying state rules, which unduly or arbitrarily inflate the profits of the payor, need to be tested with article 9 whereas CFC rules need not.

Second, it is clear that article 9(2) aims at avoiding economic double taxation.[43] Economic double taxation, in the classical sense, arises when two different persons are taxable in respect of the same income or capital.[44] CFC rules similar to transfer pricing rules could possibly lead to economic double taxation among related parties. Consequently, specific rules which trigger economic double taxation among associated enterprises need to be tested with article 9.

Third, there seems to be a significant overlap between transfer pricing rules and CFC rules. Both rules could target the same income and the difference between these sets of rules becomes blurred after the BEPS changes to the OECD Transfer Pricing Guidelines.[45] This is recognized in the BEPS Action 3 Report.[46] If national income/profit allocation norms need to be tested with article 9 so do CFC-type rules which are deemed attribution norms.

Fourth, some have even argued that the ALP is customary international law which applies for all transactions between related parties. Thus, states need to adhere to the principle whenever they deal with associated enterprises.[47]

The consequence of the above arguments is that if the national CFC rule makes income/profit allocations beyond the ALP, then it is prohibited by article 9(1) as the tax administration of the state enforcing the CFC legislation is including in the hands of the shareholder the profits of the CFC even though the "conditions … imposed between the two enterprises in their commercial or financial relations" *do not* "differ from those which would be made

42. *See* art. 9(1) *US Technical Explanation* (2006).
43. *OECD Model Tax Convention on Income and on Capital: Commentary on Article 9*, paras. 5, 6.1 and 10 (21 Nov. 2017), Treaties & Models IBFD [hereinafter *OECD Model: Commentary on Article 9* (2017)]; *OECD Model Tax Convention on Income and on Capital: Commentary on Article 25*, paras. 10-12 (21 Nov. 2017), Treaties & Models IBFD [hereinafter *OECD Model: Commentary on Article 25* (2017)]; and De Broe, *supra* n. 1, at sec. 6.2.1.1.
44. *OECD Model Tax Convention on Income and on Capital: Commentary on Article 23*, para. 2 (21 Nov. 2017), Treaties & Models IBFD [hereinafter *OECD Model: Commentary on Article 23* (2017)].
45. *See* F. Majdowski & K. Bronzewska, *Revolutionary Changes to the Arm's Length Principle under the OECD BEPS Project: Have CFC Rules Become Redundant?*, 46 Intertax 3 (2018).
46. OECD/G20, *Action 3 Final Report*, *supra* n. 41, at para. 8. The report states "transfer pricing rules are intended to adjust the taxable profits of associated enterprises to eliminate distortions arising whenever the prices or other conditions of transactions between those enterprises differ from what they would have been if the enterprises had been unrelated. Because controlled foreign company rules by definition address related parties (as the companies that are captured by such rules are controlled by another party), jurisdictions often also use these rules to combat the adjusted prices charged between related parties. *In other words, CFC rules are seen as a way for a parent jurisdiction to capture income earned by a foreign subsidiary that may not have been earned had the original pricing of the income-creating asset been set correctly. CFC rules are thus often referred to as 'backstops' to transfer pricing rules*" [emphasis added].
47. *See* R. Avi-Yonah, *Altera, the Arm's Length Standard, and Customary International Tax Law*, 38 MJIL Opinio Juris (2018), available at https://repository.law.umich.edu/cgi/viewcontent.cgi?article=1000&context=mjil_opiniojuris. One could argue that this development is to some extent reflected in the recent decision of the General Court in the *Apple* case with respect to the OECD Transfer Pricing Guidelines and the Authorized OECD Approach; *see* IE: EGC, 15 July 2020, Cases T-778/16 and T-892/16, *Ireland and Others v. Commission*.

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between independent enterprises". In other words, by applying the CFC rule, the state of the shareholder is unilaterally "re-writing … the accounts of associated enterprises" even though the "transactions between such enterprises have taken place on normal open market commercial terms".[48] Coming back to the authors' example, this would mean that article 9 of the R-T tax treaty prohibits Country R from applying its CFC rule as Country R recaptures the profits of Company T in the hands of Company R. Put differently, article 9(1) deals with computing/quantifying arm's length taxable profits of associated enterprises and allocation of those profits among states.[49] Once profits are allocated to a state then that state is free to determine the tax treatment of those profits (e.g. to exempt them or to tax them). However, national CFC rules reallocate the profits of the CFC to the shareholder. By doing so they are taxing the taxable base which has been allocated to another country on an arm's length basis. Thus, as they go beyond the boundaries of article 9 they are restricted.[50] Purposive interpretation, done on a reasonable basis, of this provision would support such an outcome. Additionally, support for this proposition can also be found in the CFC rule contained in the Anti-Tax Avoidance Directive which provides a carve-out for appropriate profit allocations pursuant to transfer pricing rules. That rule, as a result of the *Cadbury Schweppes*[51] judgment, does not apply when the CFC has the appropriate functional profile to generate its underlying income.[52] This may actually be seen as consistent with the Model B CFC rule to be found in ATAD 1, where only the profit which is not derived from key functions, assets and risks of the CFC may be allocated to the parent (e.g. when the CFC is a pure letter box company). In fact, analogous conclusions may be reached under Model A as that model provides for a carve-out for "substantive economic activity supported by staff, equipment, assets and premises, as evidenced by relevant facts and circumstances".[53]

A similar line of reasoning could then be applied to the IIR which applies on a jurisdictional blending basis and which seeks to tax the profits of the low taxed offshore entities in the state of the UPE. It is debatable whether the IIR serves as a mere extension of an anti-avoidance norm (CFC rule) or is simply a deemed attribution/formulary norm, granted that there are good reasons to hold that the underlying policy rationale of CFC rules and GloBE rules would be different, as earlier mentioned in this section. In any case, arguably, it would still need to be tested with article 9. This is because (i) it applies among related parties;[54] (ii) the

48. *OECD Model: Commentary on Article 9* (2017), *supra* n. 43, at para. 2.
49. V. Chand, A. Turina & L. Ballivet, *Profit Allocation within MNEs in Light of the Ongoing Digital Debate on Pillar I – A "2020 Compromise"? From Using a Facts and Circumstances Analysis or Allocation Keys to Predetermined Allocation Approaches*, 12 World Tax J. 3 (2020), Journal Articles & Opinion Pieces IBFD.
50. Another commentator argues that a conflict arises. *See* S. Buriak, *Controlled Foreign Company Legislation in Ukraine*, in *Controlled Foreign Company Legislation* p. 792 (G. Kofler et al. eds., IBFD 2020), Books IBFD.
51. UK: ECJ, 12 Sept. 2006, Case C-196/04, *Cadbury Schweppes plc and Cadbury Schweppes Overseas Ltd v. Commissioners of Inland Revenue*, Case Law IBFD.
52. *See further* V. Chand & B. Malek, *The Relevant Economic Activity Test and its Impact on the International Corporate Tax Policy Framework*, British Tax Review 3 (2019), available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3435134.
53. *See further* on this point Chand & Malek, *supra* n. 52, in particular p. 408.
54. IIR applies to CEs that are a part of the MNE group. For a definition of CE, *see* OECD/G20, *Report on Pillar Two Blueprint*, *supra* n. 17, at paras. 48-61 and OECD/G20, *Model Rules*, *supra* n. 17, at article 1.3. On a separate note, an issue that goes somewhat beyond the scope of this article is the one addressing the prospective interaction of the IIR with CFC regimes. In this respect, different positions have been set forth in literature, ranging from the integration of the IIR measure in an enhanced CFC regime to those that propose the abolition of the CFC regime when the IIR measure enters into force. Compare, inter alia, J. Hey, *The 2020 Pillar Two Blueprint: What can the GloBE income inclusion do that CFC Can't Do?*, 49 Intertax 1, p.7 et seq. (2021); D. Noren, *What Role for Subpart F in a GILTI 2.0 World?*, Tax Management


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UTPR – which is a sort of a reverse/formulary attribution rule as discussed in section 3. – is analysed by the OECD with article 9, so why should not the IIR; (iii) the rules could possibly lead to economic double taxation which article 9(2) seeks to avoid; (iv) there is an overlap with respect to the imputation effect of transfer pricing rules, CFC rules and the IIR; and (v) specific rules which apply to associated enterprises need to adhere to the ALP, in particular, from a proportionality standpoint (which is a general principle of law). As a result, if the IIR makes income/profit reallocations beyond arm's length allocations then a conflict arises.

In light of the above discussion, one may even remark that, prior to testing CFC rules or, for the purpose at hand, the IIR with article 7(1) or 10(5), it would be necessary to analyse whether profits have been allocated among the associated enterprises on an arm's length basis. This is because the "profits" which fall within the scope of those distributive rules need to be arm's length profits. If profits have been allocated on an arm's length basis, then article 9(1) would restrict national rules, that is, CFC rules or the IIR (if they make beyond arm's length allocations) and it would not really be necessary to get into an article 7 or 10(5) analysis vis-à-vis CFC rules or the IIR (or use these latter distributive rules as a back-up to argue that conflicts arise). If this line of reasoning is correct, then the majority of states who have argued that CFC rules do not conflict with tax treaties have simply overlooked the importance of article 9 and its restrictive force.

On the other hand, even under a restrictive interpretation of article 9(1), it could be argued that CFC rules or the IIR should not be tested with article 9. First, this is because the target/objective of CFC rules or the IIR is different from the scope of national transfer pricing rules.[55] For instance, CFC rules, which are applicable on a broad basis and are mechanical in nature, target tax deferral/profit shifting with the ultimate objective of ensuring capital export neutrality (CEN). These rules, which are "now internationally recognised as a legitimate instrument to protect the domestic tax base",[56] are not intended to establish arm's length profit allocations. A similar argument can be made for the IIR as its objective is to ensure minimum taxation and given the fact that almost 137 members of the OECD/Inclusive Framework have accepted these rules they become a legitimate instrument in international tax law.[57]

International Journal (11 May 2021); R. Goulder, *Thinking Heretical Thoughts: Should GILTI Replace Subpart F?*, 104 Tax Notes International, p. 97 et seq. (4 Oct. 2021); B. Ferreira Liotti, *What does the OECD's Minimum tax Proposal mean for Brazil's CFC Regime*, 104 Tax Notes International, p. 307 et seq. (18 Oct. 2021); and S. Wu & B. Anthony Billings, *Differences in the Consequences of GILTI and Subpart F Inclusions*, 103 Tax Notes International, p. 1433 et seq. (13 Sept. 2021).

55. For detailed differences between CFC rules and TP rules, *see* M. Kane, *Milking versus Parking: Transfer Pricing and CFC Rules under the Internal Revenue Code*, 55 Tax Law Review 487 (2013), available at https://www.law.nyu.edu/sites/default/files/ECM_PRO_073859.pdf; and Majdowski & Bronzewska, *supra* n. 45, at pp. 213-214. *See also* J. Fleming, R. Peroni & S. Shay, *Worse Than Exemption*, 59 Emory Law Journal 1, pp. 119-132 (2009), available at https://scholarlycommons.law.emory.edu/cgi/viewcontent.cgi?article=1357&context=elj.

56. *UN Model: Commentary on Article 1* (2017), *supra* n. 6, at para. 40.

57. *See* OECD/G20, *Statement on a Two-Pillar Solution to Address the Tax Challenges Arising From the Digitalisation of the Economy* (1 July 2021), available at https://www.oecd.org/tax/beps/statement-on-a-two-pillar-solution-to-address-the-tax-challenges-arising-from-the-digitalisation-of-the-economy-july-2021.pdf; and OECD/G20, *Statement on a Two-Pillar Solution to Address the Tax Challenges Arising from the Digitalisation of the Economy* (8 Oct. 2021), available at https://www.oecd.org/tax/beps/statement-on-a-two-pillar-solution-to-address-the-tax-challenges-arising-from-the-digitalisation-of-the-economy-october-2021.pdf.

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Second, article 9 has a narrow scope. The only rules that need to be tested with article 9 are national transfer pricing rules (or formulary allocation norms) and these rules are restricted by article 9 if they make profit adjustments among related parties which go beyond arm's length allocations. This line of reasoning is also supported by a literal reading of article 9(1) which applies only when "conditions are made or imposed between the two enterprises in their commercial or financial relations" and they "differ from those which would be made between independent enterprises".[58] What happens after an arm's length allocation of profit among States (after applying article 9) is beyond the scope of article 9(1).[59,60] Thus, any upward adjustment made to the taxable base of a resident enterprise under a national rule such as a CFC rule or the IIR, which goes beyond the ALP, is outside the scope of article 9,[61,62] hence, possibly leading to double taxation (which could be contrary to the treaties' object and purpose to eliminate double taxation) and probably disputes.

In this regard, BEPS Action 3 indicates

> Transfer pricing rules focus primarily on payments between related parties, do not remove the need for CFC rules many CFC rules automatically attribute certain categories of income that is more likely to be geographically mobile and therefore easy to shift into a low-tax foreign jurisdiction, regardless of whether the income was earned from a related party. CFC rules therefore play a unique role in the international tax system. Transfer pricing rules should generally apply before CFC rules, but even after the completion of the BEPS work on transfer pricing under the BEPS Action Plan, there will still be situations where income allocated to a CFC could be subject to CFC rules. For example, current work on transfer pricing may allow a funding return to be allocated to a low-function cash box that just provided financing. If that cash box were a low-tax foreign subsidiary and a country were to choose to subject that return to CFC taxation, this choice would be consistent with the BEPS Action Plan.[63]

These statements clearly indicate that CFC rules could coexist with transfer pricing rules even though there could be overlaps between these two legislations.

Support for this line of reasoning can also be found in the French *Schneider* case. In this case, the French Supreme Court as well as the Administrative Court of Appeals in Paris held that CFC rules are incompatible with article 7(1).[64] It should be noted that the government representative, before the Paris Court, also analysed the interaction of French CFC rules with a provision similar to article 9(1). The representative concluded that there was no incompatibility by mainly stating that the objectives of both CFC rules and Transfer Pricing rules are different.[65]

Third, with respect to CFC legislation, the issue of economic double taxation is probably taken care of as many states unilaterally provide relief for taxes paid by CFCs.[66] With respect to the IIR, one may also raise the question as to whether these rules lead to economic

58. *See* Englisch & Becker, *supra* n. 17, at sec. V.
59. Arnold, *supra* n. 33, at p. 1073.
60. On this point, in the context of business restructurings, *see OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* para. 9.34 (2017), Primary Sources IBFD [hereinafter *OECD Guidelines*].
61. In the context of GAARs, *see* Bullen, *supra* n. 31, at pp. 171-179.
62. Wittendorf, *supra* n. 32, at secs. 6.2. and 6.3.
63. OECD/G20, *Action 3 Final Report*, *supra* n. 41, at paras. 8-9.
64. *Re Societe Schneider Electric* (28 June 2002), at pp. 1106-1129. *See also Re Societe Schneider Electric* (30 Jan. 2001).
65. *See Re Societe Schneider Electric* (30 Jan. 2001), at pp. 551-552.
66. M. Dahlberg & B. Wiman, *General Report*, in *Taxation of foreign passive income for groups of companies* p. 40 (IFA Cahiers vol. 98a, 2013), Books IBFD.


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double taxation. Under the classical definition, this may be the case. However, a closer look indicates that there is only single taxation of the undertaxed profits as opposed to double taxation in the sense that the state of the UPE taxes the low-taxed income only up to the top-up rate. For example, if the minimum rate is set at 15% and the ETR of a CE is 10%, then the UPE state can levy a top-up tax of 5% and not up to its domestic rate (e.g. 30%). In contrast, under a CFC rule, the shareholder state taxes the CFC income up to its normal corporate tax rate and then provides a relief for the taxes paid by the CFC on those profits. Incidentally, this illustration also suggests that it would be reasonable to assume that the top-up tax under GloBE rules would fall within the taxes covered by tax treaties as exemplified by article 2 of the OECD Model as they would be functionally connected to the application of income taxes and could thus arguably be said to be levied in lieu of an income tax, even though their rationale may arguably be driven by regulatory considerations.

The above discussion showcases that the scope of article 9 in relation to its restrictive force is unclear[67] and arguments for potential conflicts can be made under a reasonable purposive interpretation of that provision.

Another area of a potential conflict is with respect to tax treaties that include tax sparing clauses. In general, tax sparing clauses oblige the state of residence to provide relief for the taxes spared by the source state. The clauses are typically found in the relief provisions similar to article 23A or 23B of the OECD Model.[68] The question now is whether the state of residence, when applying its CFC rule or the IIR, shall provide relief to its own resident for taxes that have been spared by the other state (in the hands of a separate resident taxpayer)? As a start, it should be noted that the saving clause contains an exception for article 23. This would mean that the state enforcing the CFC rule or the IIR would have to provide treaty benefits to its own residents for cases falling within the elimination of double taxation provisions.

In its 1997 report on tax sparing,[69] the OECD explicitly discussed the interaction of CFC rules and tax sparing clauses. In paragraph 93, it is stated that:

> controlled foreign company (CFC) legislation has been enacted by fifteen OECD countries in response to regulatory reform and the growing use of tax havens and preferential tax regimes to defer or avoid taxation. While foreign investment that is targeted by CFC legislation generally is excluded from the scope of applicable tax sparing provisions, CFC and tax sparing rules may in certain instances apply concurrently. *The rules of the CFC legislation may then conflict with those of the tax sparing provisions. To remove any doubt, an interpretative provision could be included in the treaty providing that CFC legislation will prevail in these situations.* [Emphasis added.]

Thus, based on the treaty text to article 23 (at least the versions before 2017) and the statement emphasized above, one may indeed argue that CFC rules or the IIR could conflict with

67. R. Collier & J. Andrus, *Transfer Pricing and the Arm's Length Principle* pp. 146-148 (Oxford University Press 2017).
68. *See OECD Model: Commentary on Article 23* (2017), *supra* n. 44, at paras. 72-78.
69. For a detailed discussion on tax sparing, *see* OECD, *Tax Sparing: A Reconsideration*, in *Model Tax Convention on Income and on Capital 2017 (Full Version)* (OECD 2019), available at https://www.oecd-ilibrary.org/docserver/54682700-en.pdf?expires=1631867313&id=id&accname=ocid195770&checksum=B7D066491293724A1CA7D5A96EE8B334. With regard to the literature, compare L. Schoueri, *A Reconsideration of the Reconsideration*, in *Tax, Law and Development* p. 106 (Y. Brauner & M. Stewart eds., Elgar 2013); and B. Andrade, *A Look at Tax Sparing Clauses in the 21st Century as Tools for the Implementation of Tax Incentives from the Perspective of Developing Countries*, 3 ITAXS 7 (2020), Journal Articles & Opinion Pieces IBFD.

tax treaties that contain such clauses unless there is a clear statement that the national rules take precedence. In the context of CFC rules, this could be the case when the shareholder is taxed on the CFC income without being entitled to, for example, a deemed tax credit for its spared taxes. In the context of the IIR, this is the case when the UPE is taxed on the CE income and, for example, the spared tax is not considered as covered taxes for calculating the ETR of the CE. With respect to CFC rules, the UK HMRC seems to have taken the position that:

> Where the terms of a double taxation agreement provide for credit to be given against UK tax in respect of tax "spared" in an overseas territory, any tax 'spared' by the overseas territory in relation to a CFC should be included in the company's creditable tax up to the limit specified in the double taxation agreement.[70]

Although a similar position has not yet been put forward with respect to the IIR, the UK position seems to be that tax sparing relief is available to its resident taxpayer in a CFC context.

On the other hand, one may argue that article 23 deals only with juridical double taxation. The text of article 23 has been modified (as a result of the BEPS Project) to explicitly reflect this. Both article 23A and 23B oblige the residence state to provide relief "except to the extent that these provisions allow taxation by that other State solely because the income is also income derived by a resident of that State ...".[71] The Commentary on the provision in paragraph 11.1 states that the foregoing addition "clarifies that in such cases, both States are not reciprocally obliged to provide relief for each other's tax levied exclusively on the basis of the residence of the taxpayer".[72] As a result of this addition, the commentary in paragraph 69.2 vis-à-vis fiscally transparent partnerships has also been updated. It is clearly stated that the state of the partner shall provide a credit for the taxes paid in the state of the partnership only "to the extent that the income may be taxed by the State of the partnership in accordance with the provisions of the Convention that allow taxation of the *relevant income as the State of source or as a State where there is a permanent establishment to which that income is attributable*" [emphasis added]. This would imply that the state of the partner is not obligated to provide relief for taxes paid in the state of the partnership if it considers that the income is, for example, derived by a separate tax resident and is not attributable to a permanent establishment of the partner in the state of source. In comparison, the Commentary prior to this update (2010 and 2014 Commentaries) only mentioned that to "the extent that the State of residence flows through the income of the partnership to the partner for the purpose of taxing him, it must adopt a coherent approach and flow through to the partner the tax paid by the partnership for the purposes of eliminating double taxation arising from its taxation of the partner". This indicated that taxes paid at the level of the partnership could be relieved at the level of the state of the partner, irrespective of whether or not they were, for example, attributable to a permanent establishment (PE).

70. *See* HM Revenue & Customs, *HMRC internal manual International Manual* (9 Apr. 2016), available at https://www.gov.uk/hmrc-internal-manuals/international-manual/intm230300.
71. For instance, this new wording can be found in the *Austl.-Ir. Income Tax Treaty* (2019), Treaties & Models IBFD, available at https://www.revenue.ie/en/tax-professionals/documents/double-taxation-treaties/a/australia.pdf. *See* the synthetized text in light of the MLI at this link: https://www.ato.gov.au/law/view/document?docid=MLI/MLI-Ireland-agreement (accessed 3 Oct. 2021).
72. *See OECD Model: Commentary on Article 23* (2017), *supra* n. 44, at para. 11.1.



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Based on these latest changes, one may argue that CFC rules or the IIR take precedence over treaties that contain tax sparing provisions.[73] In other words, as such national rules tax the income of the CFC or CE (separate tax residents) in the hands of the shareholder or UPE (separate tax residents), article 23 does not require the latter state to provide relief for taxes paid in the former state (or not paid and which are subject to a tax sparing provision). This is because it is not the shareholder or UPE which pays taxes in the source state but rather the CFC or CE. Nonetheless, this finding may not be conclusive when determining how to overcome frictions between the IIR and tax treaties including a tax sparing clause.

The above tension is reflected in the New Zealand *Lin* case. The facts are quite straightforward. Ms Lin, a New Zealand tax resident, had ownership interests in Chinese companies (CFCs). The CFCs paid taxes in China and at the same time were entitled to certain Chinese tax concessions. The question was whether these concessions represented spared taxes for the purpose of the New Zealand-China Tax Treaty? If yes, a credit for the spared taxes had to be provided. Pursuant to the CFC rules, the tax administration added additional income in the hands of Ms Lin and determined her New Zealand tax liability. The actual taxes paid by the CFC were credited against the New Zealand tax liability (under national law) but not the spared taxes. The taxpayer challenged this position and won before the High Court of New Zealand[74] but lost before the Court of Appeal.[75]

The High Court of New Zealand detected three major issues that needed resolution. First, the Court had to determine if "Chinese tax paid … in respect of [CFC] income derived by a resident of New Zealand" includes Chinese tax paid by the CFC itself, as opposed to tax which is paid directly by the New Zealand resident?. Second, if the answer is yes, then the question was if the "New Zealand resident was also entitled to a credit for tax spared to the CFC under Article 23(3)". Third, if the answer to this question is also affirmative, the Court had to find out "what is the effect of Article 23 upon the assessment of CFC income under New Zealand's domestic income tax legislation?".[76]

With respect to the first issue, the Court held that article 23(2)(a) of the treaty does not require the tax to have been paid by the same person, but it requires the following conditions to be met: (i) Chinese tax paid; (ii) "in respect of" income derived by a New Zealand tax resident; and (iii) from sources in China.[77] Based on all fact and circumstances of the case, the subject of the dispute was as to the meaning of the phrase "in respect of".[78]

73. The circumstance that rules such as the CFC or the IIR may take precedence based on the above line of argumentation does not detract from the fact that a conflict between such rules and tax-sparing clauses would still be there. Compare B. Andrade & L. Nouel, *Interaction of Pillar Two with Tax Treaties*, in *Global Minimum Taxation? An Analysis of the Global Anti-Base Erosion Initiative* p. 256 (A. Perdelwitz & A. Turina eds., IBFD 2021), Books IBFD, according to whom tax treaties already containing a tax-spar ing provision could be incompatible with the Pillar Two proposal, as the deemed tax according to the tax-sparing provision will not be considered for the calculation of the covered taxes.
74. NZ: HC, 12 May 2017, CIV-2015-404-2267; NZHC 969, *Lin v. Commissioner of Inland Revenue*, Case Law IBFD, available at https://forms.justice.govt.nz/search/Documents/pdf/jdo/48/alfresco/service/api/node/content/workspace/SpacesStore/47970e01-e7d8-4cb6-a407-f40d4ce077c9/47970e01-e7d8-4cb6-a407-f40d4ce077c9.pdf.
75. NZ: CA, 8 Mar. 2018, CA308/2017; NZCA 38, *Lin v. Commissioner of Inland Revenu*e, 28 NZTC 23-052, Case Law IBFD, available at https://forms.justice.govt.nz/search/Documents/pdf/jdo/3b/alfresco/service/api/node/content/workspace/SpacesStore/ae028be3-23bc-462a-a35f-9e82eedcb0f5/ae028be3-23bc-462a-a35f-9e82eedcb0f5.pdf.
76. NZHC 969 (2017), at para. 15.
77. Id., at para. 58.
78. Id., at para. 59.

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According to Ms Lin's line of reasoning, tax which is paid by a CFC is "Chinese tax paid … in respect of [CFC] income derived by a resident of New Zealand". The Commissioner, on the other hand, submitted that "Chinese tax paid … in respect of [CFC] income derived by a resident of New Zealand" must mean tax which has been paid by the New Zealand resident herself, therefore excluding tax paid by the CFC.[79] The Court supported a "purposive" interpretation, such as presented by Ms Lin, and noted that domestic legislation used the term "in respect of" to allow a foreign tax credit in respect of the attributed CFC income under domestic law.[80] Thus, the Chinese tax that "has been paid by the CFC in China is 'in respect of' income treated as having been derived by Ms Lin as a New Zealand resident. Tax paid in respect of income is not necessarily only tax paid on income".[81]

Further, the Court also made reference to the context, object and purposes of the tax treaty. In particular, the Court referred to the interpretation of article 23 in two aspects. The first one was a question of whether article 23 is applicable to relieve both juridical and economic double taxation or only the former. The second aspect was the relevance of the partnership's discussion made in paragraph 69 of the prior OECD Commentary (before the BEPS Project) on article 23.[82] The Court held, based on the OECD Commentary on articles 23A and 23B, which described three cases of juridical double taxation, that "taxation of CFC attributed income can be considered to fall within the definition of or be deemed to be juridical double taxation and covered by Article 23". To support this line of thinking, the Court referred to the discussion on partnerships and remarked that, "the OECD Commentary extends Article 23 to partnerships and entities which, like partnerships, are treated in different ways by contracting states, and this can properly include CFCs".[83]

As regards the second issue, i.e. the applicability of the tax sparing provision to CFC income, the Court noted that article 23(3) must be read in light of article 23(2)(a). Pursuant to the CFC rules, "the income of the CFC is deemed to have been earned by the owner, and so the tax paid by the CFC is deemed to have been paid by the owner (the New Zealand resident)".[84] Applying the same logic to article 23(3), the only "conclusion is that tax paid or payable by a New Zealand resident includes tax which is deemed to have been paid or to be payable by the New Zealand resident for the purpose of Article 23(2)(a)".[85]

Finally, to address the third issue, the Court held that a New Zealand resident is entitled to a credit for the tax spared in China to the CFC and pursuant to the New Zealand-China tax treaty, Ms Lin was entitled to a credit for tax paid by and tax spared vis-à-vis the CFCs.[86]

One the other hand, the Court of Appeal disagreed with the High Court. The former court seems have made a "close textual analysis"[87] and, in paragraph 33, held that:

> In our judgment art 23(2)(a) relieves solely against juridical double taxation. Mr Clews's argument requires us to disregard the legal nature of the relationship between Ms Lin and the

79. Id., at para. 55.
80. Id., at para. 62. *See also* C. Elliffe, *Interpreting International Tax Agreements: Alsatia in New Zealand*, 28 New Zealand Universities Law Review 1 (2018), available at https://ssrn.com/abstract=3279665.
81. NZHC 969 (2017), at para. 64.
82. Id., at para. 65.
83. Id., at para. 85.
84. Id., at para. 97.
85. Id., at para. 97.
86. Id., at para. 103.
87. NZCA 38 (2018), at para. 23.


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> Chinese CFCs to focus instead on the substantive source of "the income derived". The fact that the ultimate source is income attributed to Ms Lin from the Chinese CFCs does not justify treating the two income streams, earned separately by the CFCs and Ms Lin, as one for revenue purposes, and ignoring the plain foundation of art 23(2)(a) on the source of "the income derived by a resident of New Zealand", Ms Lin. Mr Clews's reliance on the CFC attribution regime to circumvent the plain meaning of art 23 must fail.

The view seems to support that article 23 only resolves juridical double taxation. The case has been debated by scholars from New Zealand[88] and one scholar has been quite critical of the judgment of the higher Court.[89]

In light of the above discussion, if one follows a "purposive" interpretation of tax treaty provisions (broad approach) as opposed to a pure literal reading one can surely argue that conflicts could arise, especially in the presence of tax sparing clauses.

To summarize, it could be argued that CFC rules and the IIR disregard the separate entity concept and by doing so they disturb the allocation of taxing rights balance as agreed by countries in tax treaties.[90] Given the fact that the allocation of taxing rights issue is a sensitive one and a result of the aforementioned divergent views with respect to article 9 and article 23, it is worthwhile to explore the possibility to insert a safeguard clause[91] in tax treaties which would authorize the application of the IIR (*see* section 7.). The authors would favour the insertion of a safeguard clause as opposed to a mere updating of the Commentary[92] as "such a change might not be sufficient to ensure that national courts would not interpret the provisions of the tax treaties that a country has concluded to prevent it from imposing a minimum tax".[93]

88. For example, *see* A. Smith & A. Sawyer, *Controlled Foreign Company Legislation in New Zealand*, in *Controlled Foreign Company Legislation* pp. 476-479 (G. Kofler et al. eds., IBFD 2020), Books IBFD.
89. Elliffe, *supra* n. 80.
90. Arnold states: the "remarkable journey of CFC rules, i.e. from unacceptable, to acceptable only if the scope of the rules was restricted, to unquestionably acceptable irrespective of the scope of the rules, reflects the rejection of the fundamental principle that non-resident corporations should be treated as taxable entities separate from their resident controlling shareholders. This shift also alters the allocation of taxing rights between source and residence countries". *See* B. Arnold, *The Evolution of Controlled Foreign Corporation Rules and Beyond*, 73 Bull. Intl. Taxn. 12, p. 641 (2019), Journal Articles & Opinion Pieces IBFD. A further issue, which somewhat exceeds the scope of this article, pertains to the need of establishing a sort of rule pecking order governing the application of transfer pricing rules, CFC rules and GloBE rules. In the view of the authors, it would be desirable that the OECD comes out with clear rules that would prioritize the application of transfer pricing and CFC rules over the application of GloBE rules. In the absence of coordination measures between the transfer pricing and CFC regimes on the one hand and the GloBE rules on the other, international tax controversies of a certain magnitude may be expected to arise, which would jeopardize the functioning and sustainability of the entire post-BEPS international tax regime. Further considerations on the importance of an ex ante rule pecking order are further developed in sec. 6. With regard to the need of a pecking order (proposed as a second best to integration) of CFC rules and GloBE rules, *see also* G. Gallo & A. Perdelwitz, *Coordination and Rule Order*, in *Global Minimum Taxation? An Analysis of the Global Anti-Base Erosion Initiative* sec. 7.4.1. (A. Perdelwitz & A. Turina, eds., IBFD 2021), Books IBFD; and Pistone et al., *supra* n. 17, at p. 72.
91. *See* Chand, *supra* n. 1, at pp. 207-215 (as well as all the references therein). *See also* De Broe, *supra* n. 1, at pp. 461-466. On the one hand, safeguard clauses could ultimately be seen to belong to the broader spectrum of "compatibility clauses" foreseen under public international law when it comes to treaties. However, while compatibility clauses *stricto sensu* are meant to govern potential conflicts between treaties, safeguard clauses are primarily understood to target conflicts between treaties and other legal spheres, typically, but not exclusively, domestic law.
92. Some commentators have argued for this. *See* J. Englisch & J. Becker, *Implementing an International Effective Minimum Tax in the EU*, Materialien zu Wirtschaft und Gesellschaft 224, Working Paper-Reihe der AK Wien, sec. 4.3. (July 2021).
93. Arnold, *supra* n. 90, at p. 645.

## 3. Transfer Pricing Rules, Interest Limitation Rules, the UTPR, Non-Discrimination Provisions and Tax Treaties

The UTPR is designed as a backstop. It could well be possible that the rule is inapplicable if all countries in the world introduce qualified domestic minimum top-up taxes or the IIR. However, at this stage the authors cannot predict whether all countries will introduce such rules. If countries do not introduce such rules (especially, the IIR), it could well be possible that the UTPR applies. Thus, the authors believe that it is important to discuss the treaty compatibility of this rule in an extensive manner. We will start with the manner in which the rules are designed in the Blueprint and then move towards the Model Rules.

As the rule is linked to undertaxed payments in the Blueprint, as a background and a lead into the analysis, the authors will discuss the treaty compatibility of selected interest limitation rules. This is because the developments in these areas have a direct impact on understanding the UTPR and its treaty compatibility.

To start, it is worthwhile to note that thin capitalization rules trigger compatibility issues with tax treaty law. These compatibility-related issues have been discussed extensively in the literature.[94,95] For example, as implicitly provided in the Commentary on Article 1,[96] thin capitalization rules that are based on fixed debt/equity ratios[97] and which apply only to related parties could trigger a conflict with tax treaty provisions.[98] In particular, conflicts could arise with article 9(1),[99] and the non-discrimination provisions viz., article 24(4) which deals with deduction non-discrimination[100] and article 24(5) which deals with ownership non-discrimination.[101] In fact, Courts in several countries have also confirmed that conflicts could arise with these treaty provisions. For example, refer to the *Hero Espana*[102] case (Spain, 2011) and *Société Andritz*[103] case (France, 2003) where these treaty provisions have been discussed and disputed. On the other hand, if a thin capitalization rule is based on a pure arm's length approach, then it would be difficult to argue that treaty conflicts arise (as discussed subsequently).[104]

94. *See* Chand, *supra* n. 1, at pp. 314-360 (as well as all the references therein); and De Broe, *supra* n. 1, at pp. 500-574.
95. *See also* C. Elliffe, *Thin Capitalisation Rules and Treaties: Does the Ratio in the New Zealand Thin Capitalisation Rules Contravene New Zealand's Tax Treaty Obligations?*, 18 New Zealand Business Law Quarterly 4, pp. 307-332 (2012), available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2120839; and C. Elliffe, *Trans-Tasman Thin Capitalisation Rules and Treaties: Implications for New Zealand and Australia on Tighter Thin Capitalisation Ratios*, 28 Australian Tax Forum 3 (2013), available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2337191.
96. *OECD Model: Commentary on Article 1* (2017), *supra* n. 5, at paras. 72 and 74.
97. The 1987 report on Thin Capitalization describes this approach as: "if the debtor company's total debt exceeds a certain proportion of its equity capital, then the interest on the loan or the interest on the excess of the loan over the approved proportion is automatically disallowed or treated as a dividend".
98. For a discussion of this matter, *see* Chand, *supra* n. 1, at pp. 352-354.
99. *OECD Model: Commentary on Article 9* (2017), *supra* n. 5, at para. 3.
100. *OECD Model Tax Convention on Income and on Capital: Commentary on Article 24*, para. 74 (21 Nov. 2017), Treaties & Models IBFD [hereinafter *OECD Model: Commentary on Article 24* (2017)].
101. Id., at para. 79.
102. ES: TS, 17 Mar. 2011, Case 5871/2006, *Hero Espana SA v. Direccion General de Tributos*, Case Law IBFD.
103. FR: CE, 30 Dec. 2003, Case 233894, *Re Société Andritz Sprout Bauer*, 6 ITLR 604, pp. 605-641, Case Law IBFD.
104. *See* Chand, *supra* n. 1, at pp. 348-352 (as well as all the references therein).


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Interestingly, BEPS Action 4[105] provides recommendations in designing domestic law rules to prevent base erosion through the use of (excess) interest expenses.[106] Essentially, a fixed ratio rule is recommended to restrict interest deductions. In particular, the rule restricts the interest payment of an entity of an MNE group to a percentage of that entity's EBITDA[107] as opposed to debt/equity rules[108] which recharacterize equity into debt. The recommendation leaves open the possibility for states to choose a percentage between 10%-30% based on certain parameters. Furthermore, the report recommends countries to incorporate a group ratio rule alongside the fixed ratio rule. This approach would enable entities with net interest expense above a country's fixed ratio rule to deduct interest up to the level of the net interest/EBITDA ratio of its worldwide group[109] (subject to certain conditions). The question now arises of how these rules interact with the arm's length provisions and the non-discrimination provisions.

With respect to interaction of such domestic rules with article 9(1), it should be noted that quite recently the OECD launched a paper which proposed changes to the Commentary.[110] The changes reflect the work of the OECD on financial transactions[111] as well as BEPS Action 4. Paragraph 3 of the Commentary, which dealt with the interaction of national thin capitalization rules with tax treaties, is going to be replaced with new wording. The old wording, in paragraphs 3a and 3c explicitly provided that article 9, in some situations, could prevent the application of national thin capitalization rules whereas paragraph 3b stated that article 9 permits reclassification of debt. Proposed new paragraph 3 now deals with the issue of whether or not article 9 allows debt to be converted into equity. Additionally, the proposed new paragraph 3.1 states that:

> Once the profits of the two enterprises have been allocated in accordance with the arm's length principle, *it is for the domestic law of each Contracting State to determine whether and how such profits should be taxed, as long as there is conformity with the requirements of other provisions of the Convention. Article 9 does not deal with the issue of whether expenses are deductible when computing the taxable income of either enterprise. The conditions for the deductibility of expenses are a matter to be determined by domestic law, subject to the provisions of the Convention and, in particular, paragraph 4 of Article 24. Paragraph 30 of the Commentary on Article 7 makes an equivalent statement for the application of Article 7.*[112] *Examples of domestic rules that can deny*

105. OECD/G20, *Limiting Base Erosion Involving Interest Deductions and Other Financial Payments – Action 4: 2015 Final Report* (OECD 2015), Primary Sources IBFD [hereinafter *Action 4 Final Report*].
106. For a discussion on these rules, *see* C. Elliffe, *Interest Deductibility: Evaluating the Advantage of Earnings Stripping Regimes in Preventing Thin Capitalisation*, New Zealand Law Review, Vol. II (2017), available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3059176.
107. OECD/G20, *Action 4 Final Report*, *supra* n. 105, at paras.18-20.
108. Id., at para. 17 and Annex D, Example 1.
109. Id., at paras. 22-32.
110. *See* OECD, *Proposed Changes to Commentaries in the OECD Model Tax Convention on Article 9 and on related Articles*, p. 6 (OECD, 28-29 May 2021), available at https://www.oecd.org/tax/treaties/public-consultation-document-proposed-changes-to-commentaries-in-oecd-mtc-on-article-9.pdf.
111. *See* OECD, *Transfer Pricing Guidance on Financial Transactions: Inclusive Framework on BEPS Actions 4, 8-10* (OECD 2020), available at https://www.oecd.org/tax/beps/transfer-pricing-guidance-on-financial-transactions-inclusive-framework-on-beps-actions-4-8-10.pdf.
112. *OECD Model: Commentary on Article 7* (2017), *supra* n. 5, at para. 30. The commentary states: "Paragraph 2 determines the profits that are attributable to a permanent establishment for the purposes of the rule in paragraph 1 that allocates taxing rights on these profits. Once the profits that are attributable to a permanent establishment have been determined in accordance with paragraph 2 of Article 7, it is for the domestic law of each Contracting State to determine whether and how such profits should be taxed as long as there is conformity with the requirements of paragraph 2 and the other provisions of the Convention. *Paragraph 2 does not deal with the issue of whether expenses are deductible when computing the taxable income of the enterprise in either Contracting State. The conditions for the deductibility of expenses are a*

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> *a deduction for expenses include certain rules on entertainment expenses and on interest such as those recommended in the final report on Action 4 of the OECD/G20 Base Erosion and Profit Shifting (BEPS) Project.* [Emphasis added.]

Is this position appropriate?

In this regard, it should be noted that some commentators have argued that BEPS Action 4 rules (comprehensive interest barriers) conflict with the ALP contained in article 9(1) when applied to payments between separate related companies (also article 7(2) when applied to PEs). Similar to the arguments raised in the context of CFCs, this is mainly because the rules lead to an unequitable inter-nation tax base allocation (as payor countries can deny a deduction for arm's length expenses) and also lead to economic double taxation.[113] In this regard, some have argued that the German interest barrier rule conflicts with article 9 as they disallow deductions only to entities (payors) that belong to an MNE group,[114] even though, the denial applies to all interest payments made by these entities including third-party interest.

On the other hand, first, it could be argued that the statements made in the OECD Commentary on Article 9 (2017 Commentary and its previous version) on potential conflicts apply only to rules that were discussed in the 1987 report on thin capitalization, viz., fixed debt equity rules which applied among related parties and had the effect of recharacterizing debt into equity (the recharacterization issue is also covered by the recent OECD paper on financial transactions).[115] Comprehensive interest barriers were not within the scope of these statements.[116]

Second, if the interest limitation rule acts as a restriction to all interest payments made by the payor (separate entity or PE) for related and unrelated-party debt in domestic and cross-border situations, then it could be argued that such a rule should not fall within the scope of article 9[117] (or article 7) as it also applies to transactions with unrelated parties. In other words, the rules apply broadly and are not targeted only towards funding from associated enterprises.

Third, it is true that interest limitation rule could lead to economic double taxation. However, they are general rules which lead to such double taxation as opposed to specific rules targeting associated enterprises. Hence, they do not need to be tested with article 9. Moreover, as these rules provide for carry-forward/carry-back mechanisms for the disallowed interest, depending on the rules' implementation in national law, the issue of the economic double taxation may become a non-issue.[118]

Fourth, one may argue that national transfer pricing rules and article 9 only deal with ensuring an arm's length allocation of income and expenses (and, as a consequence, profits) among associated enterprises. Once these items are allocated to a state, then that state is

*matter to be determined by domestic law, subject to the provisions of the Convention and, in particular, paragraph 3 of Article 24 (see paragraphs 33 and 34 below)*" [emphasis added].

113. S. Fernandes, *International Double Taxation of Interest* sec. 4.4.2.2. (IBFD 2019), Books IBFD.
114. A. Fross, *Earnings Stripping and Thin Cap Rules: Maintaining an Arm's Length Distance*, 53 Eur. Taxn. 10, pp. 514-515 (2013), Journal Articles & Opinion Pieces IBFD (*also see* the sources mentioned therein).
115. OECD, *Transfer Pricing Guidance on Financial Transactions*, *supra* n. 111, at paras. 10.4-10.8.
116. For instance, *see* N. Martinez, *BEPS Action 4 and Its Compatibility with the Principle of Non-Discrimination Under Article 24(4) of the OECD Model Convention*, 47 Intertax 1, p. 59 (2019).
117. OECD/G20, *Action 4 Final Report*, *supra* n. 105, at para. 25.
118. Id., at paras. 159-167.



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free to determine, under its general tax rules, the tax treatment of those items (e.g. restrict a deduction). Indeed, a state may apply a general interest limitation rule, which targets base erosion and profit shifting, to an arm's length interest expense that has been allocated to it.

On this point, a slight differentiation needs to be made between CFC rules or the IIR and general interest limitation rules vis-à-vis article 9. As explained previously, national CFC rules (or the IIR) could tax the taxable base which has been allocated to another country on an arm's length basis. As a result, arguably, they conflict with article 9. However, by applying an interest limitation rule, a state seeks to deny a deduction of an arm's length interest expense that has been allocated to it. Thus, interest limitation rules do not *per se* seek to recapture profits that have been allocated to another state but rather seek to govern the tax treatment of an expense which has been allocated to the state under transfer pricing rules.

As a result of the above, such rules do not seem to conflict with article 9 as they are a general rule for the determination of the taxable profit of the payor.[119] The fact that the rule applies only to a payor (who is a part of the MNE group) does not change this conclusion as it applies to all interest payments made by such a payor.[120,121]

This said, the incompatibility argument with regard to article 9(1) becomes appealing if the interest limitation rule targets only funding transactions among associated enterprises in cross-border situations. If the rule only denies a deduction for foreign related-party financing i.e. restricts foreign related-party interest up to, for example, 30 percent of the payors EBIDTA whereas all other interest is allowed as a deduction then such a rule could possibly conflict with article 9 as it falls within its scope and hence its restrictive effect. To illustrate, assume Co S is a company in an MNE group. Co S has a foreign related-party interest expense of USD 100 million and total unrelated-party interest expense of USD 200 million. Its EBITDA is USD 100 million. Country S, as a result of its fixed ratio rule linked to EBITDA which targets only funding from associated enterprises, allows a deduction of USD 30 million on the related-party interest in addition to USD 200 million unrelated-party interest. USD 70 million of related-party interest is disallowed as a deduction. In this case, one could indeed possibly argue that article 9 becomes relevant (as the transactions apply only to related-party relations) and the rule conflicts with this provision as it increases the taxable profit of the payor to more than the arm's length profit. As an example, this seems to be the case for the interest limitation rule that has been implemented in section 94B of the Indian Income Tax Act, 1961[122] (for interaction with the non-discrimination provisions, *see* further below).

In any event, the question arises as to whether such a conflict be neutralized if the treaty has a saving clause? In this regard, it should be noted that as article 9(1) is not listed as an exception in the saving clause, it could be argued that the tax treaty shall not affect the taxation by State S (the State applying the interest limitation rule) of its own resident. Accordingly, the rule could apply notwithstanding a possible conflict with article 9(1).[123] Nevertheless, if

119. Arnold, *supra* n. 33, at p. 1074.
120. O. Marres, *Interest Deduction Limitations: When to Apply Articles 9 and 24(4) of the OECD Model*, 56 Eur. Taxn. 1, p. 3 (2016), Journal Articles & Opinion Pieces IBFD.
121. For instance, *see* Martinez, *supra* n. 116, at pp. 62-64.
122. A. Karundia & K.R. Phatarphekar, *India*, in *Interest deductibility: the implementation of BEPS Action 4* pp. 361-362 (IFA Cahiers vol. 104a, 2019), Books IBFD.
123. J. Sasseville, *A Tax Treaties Perspective: Special Issues*, in *Tax Treaties and Domestic Law* pp. 53-54 (G. Maisto ed., IBFD 2006), Books IBFD.

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the treaty contains article 24 then the national rule needs to be tested with the non-discrimination provisions. This is because that clause lists article 24 as an exception.[124]

The EBITDA linked interest limitation rule (implemented as a general rule) should not raise any discrimination concerns if it is applicable equally in domestic and cross-border situations.[125] What happens if the rule (or another similar rule like the one implemented by India) applies only to cross-border situations and targets payments made only to non-residents?[126]

As a start, it should be noted that if a profit adjustment (denial of interest deduction) is made pursuant to a national transfer pricing rule based on the ALP (which could apply only for transactions with non-residents) then article 24(4) does not prohibit such adjustments as the rules are in conformity with article 9(1). One interesting question that arises is whether it is correct to import the ALP contained in article 9(1), in article 24(5) as well as article 24(3) because unlike article 24(4), the texts of article 24(5) and article 24(3) do not refer to article 9? The issue can be illustrated with the help of an example. Assume Co R, a tax resident of State R, advances an interest-bearing loan to its wholly owned subsidiary Co S and its PE, both in State S. The interest paid by both taxpayers is USD 100. The State S tax administration applies its transfer pricing rules (which apply only in cross-border situations), makes a transfer pricing adjustment and disallows USD 20 as a deduction to both taxpayers as it considers a part of the interest to be not at arm's length. The question that now arises is whether article 24(5), which applies to parent-subsidiary relations, or article 24(3), which applies to head office and PE relations, restricts State S from applying national transfer pricing rules, as these rules do not apply in purely domestic situations (in many countries, transfer pricing rules do not apply locally). In line with the OECD view,[127,128] the authors would tend to argue that under a reasonable purposive interpretation approach it is correct to import the arm's length principle even to the provisions of article 24(5)[129,130,131]/ article 24(3). This is because article 24 must be read in the context of the other articles of the Convention in such a manner that measures that are authorized by the provisions of other articles cannot be considered to violate the provisions of article 24. Accordingly, article 24(5)/article 24(3) cannot prohibit an arm's length adjustment even if it applies only to loans provided by non-resident creditors who are also shareholders, i.e. creditors who at the same time own or control capital of the payer or in head office/PE relations.

124. *Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting*, art. 11(1)(e) (7 June 2017), Treaties & Models IBFD [hereinafter *MLI*].
125. For instance, *see* Martinez *supra* n. 116, at pp. 62-64. This seems to be the case within the European Union with respect to the interaction of these rules with the EU fundamental freedoms as they apply in domestic and cross-border situations. *See* A.P. Dourado, *The Interest Limitation Rule in the Anti-Tax Avoidance Directive (ATAD) and the Net Taxation Principle*, 26 EC Tax Review 3, pp. 118-119 (2017). However, some commentators have argued that these rules are non-proportional as they make profit adjustments to the borrower beyond the arm's length standard. *See* P. Van Os, *Interest Limitation under the Adopted Anti-Tax Avoidance Directive and Proportionality*, 25 EC Tax Review 4, (2016).
126. For instance, *see* Martinez *supra* n. 116, at pp. 63-64.
127. *OECD Model: Commentary on Article 24* (2017), *supra* n. 100, at para. 79, 3rd sentence.
128. Id.
129. For instance, *see* H.J. Ault & J. Sasseville, *Taxation and Non-Discrimination: A Reconsideration*, 2 World Tax J. 2, p. 117 (2010), Journal Articles & Opinion Pieces IBFD.
130. Arnold, *supra* n. 33, at p. 1067.
131. C. Elliffe, *Unfinished Business: Domestic Thin Capitalization Rules and the Non-Discrimination Article in the OECD Model*, 67 Bull. Intl. Taxn. 1, pp. 29-32 (2013), Journal Articles & Opinion Pieces IBFD.



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The authors now turn to the issue of the general interest limitation rule. As stated in the Commentary on Article 24(4):

> paragraph 4 does not prohibit the country of the borrower from applying its domestic rules on thin capitalisation insofar as *these are compatible with paragraph 1 of Article 9 or paragraph 6 of Article 11. However, if such treatment results from rules which are not compatible with the said Articles and which only apply to non-resident creditors (to the exclusion of resident creditors), then such treatment is prohibited by paragraph 4*.[132] [Emphasis added.]

As confirmed by a draft report of the OECD on non-discrimination, the thin capitalization rules mentioned in the Commentary here also include earning stripping rules in addition to fixed debt equity ratios.[133]

The question that arises now is whether BEPS Action 4 rules, assuming that they are applicable for interest payments made only in cross-border scenarios, are compatible with article 9. As discussed previously, the authors would tend to argue that the general rule would fall outside the scope of article 9. This said, even if they fall outside the scope of article 9 (as article 9 does not "apply"), they still need to be tested with the deduction non-discrimination provision which has also been confirmed by the proposed new Commentary on Article 9. Thus, if the rule applies only in cross-border situations a conflict could arise with article 24(4).[134]

With respect to article 24(5), as a start, it should be noted that the 1992 OECD Commentary stated that this provision is relevant to thin capitalization but as it is general in scope, article 24(4) which is more specific, will take precedence.[135] Moreover, in the 2007 draft non-discrimination Report (ND Report), the Working Group concluded that article 24(5) would not be relevant for most thin capitalization rules because article 24(5) deals with resolving discrimination issues for company-shareholder relationships (discrimination based on foreign ownership of the capital of the enterprise) and not debtor-creditor relationships (discrimination based on the residence of the lender). This was explained by the fact that the thin capitalization rules of most countries would apply to a local subsidiary with a local parent and this local subsidiary is making interest payments to foreign related companies. According to the 2007 ND Report, on this view thin capitalization rules would be outside the scope of article 24(5) as they would not constitute discrimination based on foreign ownership of the capital of a domestic enterprise but on the fact that the domestic enterprise has foreign related creditors.[136] The conclusion of the Working Group was obviously logical and is reflected in the current Commentary since 2008.[137]

The Commentary also contains some statements as to when a national thin capitalization rule could/could not conflict with article 24(5) and this can be explained with the help of two examples. Assume Co R, a tax resident of State R, provides a loan to its wholly owned subsidiary, Co S, a tax resident of State S. At the same time, Co S receives a loan from a related sister company, Company T resident in Country T. In this case, if Country S has a

132. *OECD Model: Commentary on Article 24* (2017), *supra* n. 100, at para. 74.
133. *See* OECD, *Application and Interpretation of Article 24 (Non-Discrimination)*, Public discussion draft, paras. 79-81 (3 May 2007), available at https://www.oecd.org/ctp/treaties/38516170.pdf.
134. Marres, *supra* n. 120, at pp. 8-9.
135. *OECD Model Tax Convention on Income and on Capital: Commentary on Article 24*, para. 58 (1 Sept. 1992), Treaties & Models IBFD [hereinafter *OECD Model: Commentary on Article 24* (1992)].
136. OECD, *Application and Interpretation of Article 24 (Non-Discrimination)*, *supra* n. 133, at para. 82.
137. *OECD Model: Commentary on Article 24* (2017), *supra* n. 100, at para. 79.

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thin capitalization rule which targets all foreign related-party financing and pursuant to these rules it denies a deduction for the interest payments made both to Co R and Co T then such a rule may not conflict with article 24(5). Indeed, in this case the denial of deduction is based on the fact that a domestic enterprise (Co S) has foreign related creditors (Co R and Co T) as opposed to targeting only company-shareholder relationships.[138] This said, clearly a conflict could arise with article 24(4) as the rule applies only to payments made to foreign related parties.[139] Furthermore, now assume that Country S has a thin capitalization rule which targets only foreign shareholder related-party financing and pursuant to these rules it denies a deduction for the interest payments made only to Company R. In this case, a conflict with article 24(5) arises. Indeed, in this case the denial of deduction is based on the fact that Co S is owned by Co R.[140] In this sense, article 24(5) prevents discrimination against rules that target company-shareholder relationships (parent-subsidiary relationships).

Against this backdrop, the UTPR will now be considered. The rule applies when the IIR does not apply.[141] Once the top-up tax is calculated,[142] according to the Blueprint, it is allocated to a particular UTPR taxpayer on the basis of base eroding payments made by that UTPR taxpayer.[143] A two-step approach is provided.[144] It should be noted that the allocation mechanism has changed in the Model Rules, and the authors will discuss them too.

First, if the UTRP taxpayer makes tax-deductible payments directly to the low-taxed recipient then the top-up tax that applies to the income of the low-taxed recipient is allocated in proportion to the total of deductible payments made directly to the low-tax recipient by all UTPR taxpayers. For example, assume Co R, a tax resident of State R and the MNE group's UPE, owns Co T, a tax resident of State T which is a low-tax jurisdiction (a low-ETR state). Co X, a resident of State X and Company Y, a resident of State Y (owned by Co R), make an interest payment to Co T. In this case, if Country R does not apply the IIR to collect the top-up tax vis-à-vis Country T then Country X and Y would be entitled to it.[145]

Second, if there is "remaining top-up tax" (or if no top-up tax has been allocated pursuant to the first key) then that tax is allocated in proportion to the total amount of net intra-group expenditure incurred by all UTPR taxpayers. Continuing with the previous example, assume Co X and Co Y make interest payments to Co R as opposed to Co T. In this case, if Country R does not apply the IIR to collect the top-up tax vis-à-vis Country T's low-taxed business income, then Country X and Y would be entitled to the tax under the second allocation key.[146]

Interestingly, a UTPR taxpayer which is classified as a low-taxed entity will not be allocated the top-up tax under both allocation keys. A low-taxed entity is an entity whose tax rate is below the minimum rate, subject to a few exceptions.[147] Continuing with the previous examples, assume Co X is a low-taxed entity. Co X and Co Y make interest payments to

138. Id., at para. 79, 3rd sentence.
139. Id., at para. 79, 4th sentence.
140. Id., at para. 79, 5th sentence.
141. OECD/G20, *Report on Pillar Two Blueprint*, *supra* n. 17, at paras. 459-466. Also, *see* OECD/G20, *Model Rules*, *supra* n. 17, at article 2.4.
142. Id., at paras. 467-470. Also, *see* OECD/G20, *Model Rules*, *supra* n. 17, at article 2.5.
143. Id., at paras. 461-472.
144. Id., at paras. 473-491.
145. Id., at paras. 480-482.
146. Id., at paras. 483-487.
147. Id., at paras. 488-491.


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Co T. In this case, if Country R does not apply the IIR to collect the top-up tax vis-à-vis Country T's low-taxed income, then only Country Y would be entitled to the tax under the allocation keys.

The top-up tax could be collected from the UTPR taxpayer in different forms. The Blueprint's inclination is to introduce a rule in the form of a provision which denies the deduction to the UTPR taxpayer, which could be a separate legal entity or a PE, for payments made to related parties.[148] At the same time, it should be noted that other design mechanisms for its implementation are being considered such as an additional tax. While details of this additional tax are not clear, the Blueprint does state: "the form in which the adjustment is made will depend on the existing design of the domestic tax system and should be co-ordinated with other domestic law provisions and a jurisdiction's international obligations including those under tax treaties". As examples, additional income could be allocated to the UTPR taxpayer (as opposed to denial of a deduction) or if the local country provides for a notional interest deduction then such deduction could be reduced.[149]

The issue of treaty compatibility will now be considered. With respect to compatibility with article 9(1) or 7(2), the Blueprint argues that there is no conflict. Similar to the wording in the proposed new Commentary on Article 9, it states

> It is generally recognised, *however, that once the profits have been allocated in accordance with the arm's length principle, how they are taxed is a matter determined by the domestic law of each country.* A frequently quoted illustration of this point, found in the domestic law of many countries, are rules denying a deduction for entertainment expenses. [Emphasis added.]

It also argues, by referring to the saving clause, that residence state taxation is not prohibited by tax treaties.[150] It is clear that if there is a saving clause in the treaty then there should not be any conflicts with article 9(1). However, what if the clause is not present?

As expressed previously in the context of CFC rules and the IIR as well as interest limitation rules, a key argument that can be made against the conflict is that article 9(1) has a narrow scope. It only allows states to make profit adjustments when associated enterprises operate on a non-arm's length basis. What happens after an arm's length allocation among states is beyond the scope of article 9(1) (similar analogy can be drawn for article 7(2)).

On the other hand, one could indeed argue that the UTPR conflicts with article 9(1). First, the rules apply only for payments made among related parties. Second, these specific rules could lead to economic double taxation for transactions among associated enterprises. A consequence of the above is that, similar to national thin capitalization rules which use fixed debt/equity ratios, they need to be tested with article 9 as they would fall within its scope. Thus, they would be prohibited if they make profit adjustments to the payor beyond the ALP.[151]

On this matter, a differentiation needs to be made between general interest limitation rules (such as a BEPS Action 4 rule) and the UTPR. As already explained, the former rules, which deny a deduction for all interest payments made by the payor, do not seek to recapture arm's length profits that have been allocated to another state. They rather seek to govern

148. Id., at paras. 521-522. Also, *see* OECD/G20, *Model Rules*, *supra* n. 17, at art. 2.4.
149. Id., at para. 519.
150. Id., at para. 689.
151. For contrary arguments, *see* Englisch & Becker, *supra* n. 17, at sec. V.

the tax treatment of an arm's length interest expense which has been allocated to the state of the payor. This state is indeed free to decide whether this interest expense can be further restricted under a general rule pursuant to national law.

However, the latter rules, which apply only to related-party payments, recapture arm's length profits that have been allocated to another state. The mechanism used to recapture the profits, although unique, consists of the following key steps. First, the taxable base and taxes paid in the low tax jurisdiction is determined to compute the jurisdictional ETR. Second, if the jurisdiction ETR is lower than the minimum rate then the top-up tax is determined. Third, the top-up tax is allocated to the UTPR taxpayer pursuant to the two allocation keys (if the IIR does not apply) which are, arguably, based on formulas linked to payments. Fourth, the top-up tax is collected by the UTPR jurisdiction, for example, by denying the deduction from the local tax base or adding additional income to the local tax base. It is clear that the adjustments in step 4 to the local tax base are linked to profits (taxable base) of an enterprise in a low-taxed state. If an OECD or UN Model type tax treaty exists between the two states then one could indeed strongly argue that article 9(1) could indeed restrict the application of these rules.

A similar conclusion could also be drawn with respect to the manner in which the UTPR is designed in the Model Rules. According to article 2.6, the top-up tax is allocated to the UTPR jurisdiction pursuant to a formula linked to the number of employees and the value of tangible assets in that UTPR jurisdiction. It is clear that these rules represent a sort of formulary apportionment, and one could strongly argue that article 9(1) could indeed restrict the application of these rules. To illustrate, assume Co R, a tax resident of State R and the MNE group's UPE, owns Co T, a tax resident of State T, which is a low-tax jurisdiction (a low-ETR state). Co X, a resident of State X and Company Y, a resident of State Y, are also owned by Co R. State X and State Y are UTPR jurisdictions. In this case, if Country R does not apply the IIR to collect the top-up tax vis-à-vis Country T, then Country X and Y would be entitled to it pursuant to the UTPR based on a predetermined formula. If Country T has tax treaties with Country X and Y, then article 9(1) could prohibit the application of the UTPR (in addition to other provisions discussed in this and the previous section).

The non-discrimination issue will now be addressed based on the manner in which the rule is reflected in the Blueprint (the Model Rules will be analysed subsequently). If the UTPR is structured as a rule which denies a deduction to the taxpayer, in addition to article 9, it needs to be tested with article 24(4), in the case of separate legal entities, and article 24(3), in the case of PEs. As initial comments, the authors would like to highlight that the issue seems less relevant for the second allocation key as:

> deniability can arise in respect of any net related party expenditure, whether the payment is made to a domestic or foreign member of the group. The net related party expenditure is determined on an entity-by-entity basis. Under this step, therefore, the UTPR will apply in the same way to intra-group payments made to domestic and non-resident group entities without any distinction.[152]

In case of companies, under the first allocation key, the rule denies a deduction for a payment made by a taxpayer in a high-tax country to a recipient in a low-tax country. The rule does not apply when the same taxpayer in a high-tax country makes a payment to the

152. OECD/G20, *Report on Pillar Two Blueprint*, *supra* n. 17, at para. 692.



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recipient in the same state. The OECD's view is that discrimination does not arise.[153] It is argued that:

> the denial of a deduction under the first step of the UTPR *is not determined by the residence of the recipient of the payment but by the jurisdiction's classification as high or low tax on the basis of the local group's effective tax rate profile in the relevant period.* [Emphasis added.]

It is true that this provision only seeks to regulate discrimination based on residence of the recipient and not discrimination caused by other reasons.[154] This is why the OECD has argued that the denial is linked to the jurisdiction's tax classification as opposed to the residence of the recipient. However, it is obvious that the UTPR is triggered when the payment is made to a resident in a low-tax country. Thus, disguised discrimination[155] under the first allocation key arises (as opposed to indirect discrimination).[156,157] This is because the local taxpayer in a high-tax state is not allowed to deduct a payment (or a part of it) when it is paid to a resident in low-tax state[158] in comparison to the situation when it is paid domestically, that is, to a resident in the same high-tax state.[159,160] The fact that the UTPR does not apply when a payment is made by the taxpayer in a high-tax state to another recipient in a high-tax state or it does not apply when a taxpayer in low-tax state makes a payment to another recipient in another low-tax state cannot be used to justify that the rule applies in other situations. To support this, one may argue that tax treaties are bilateral in nature and a treaty-by-treaty analysis needs to be made to determine whether or not issues arise with respect to the non-discrimination standards.

The first allocation key also denies a deduction for tax-deductible payments made by a PE in a high-tax country. These tax-deductible payments could be paid to the head office in a low-tax state or to other associated enterprises that are situated in low-tax jurisdictions.[161] The

153. Id., at para. 691.
154. On this point, *also see* A. Rust, *Commentary on Article 24*, in *Klaus Vogel on Double Taxation Conventions*, para. 98 (E. Reimer & A Rust eds., Wolters Kluwer 2015). Rust, however, does not examine the issue at stake here.
155. In fact, indirect discrimination must be distinguished from "disguised" discrimination. In the latter case, the measure at issue is aimed at the protected persons, but a seemingly innocent distinguishing criterion is used in order to disguise the discrimination. That is to say, instead of distinguishing on the basis of the prohibited criterion, the distinction is made on the basis of a criterion that is inextricably linked to the prohibited criterion. Disguised discrimination obviously falls foul of art. 24 OECD Model. *See*, in this respect, N. Bammens, *The Principle of Non-Discrimination in International and European Tax Law* sec. 4.5. (IBFD 2012), Books IBFD.
156. *OECD Model: Commentary on Article 24* (2017), *supra* n. 100, at para. 1. Indirect discrimination seems permissible in the OECD Model in certain situations.
157. On the topic of direct versus indirect discrimination, *also see* N. Bammens & F. Vanistendael, *Article 24: Non-Discrimination – Global Tax Treaty Commentaries,* Global Topics IBFD (accessed 2 Feb. 2022).
158. *OECD Model: Commentary on Article 24* (2017), *supra* n. 100, at para. 73. The friction is also highlighted by B. Da Silva, *Taxing Digital Economy: A Critical View Around The Globe (Pillar Two)*, 15 Frontiers of Law in China 2, pp. 128 et seq. (2020).
159. In another context, *also see* De Broe, *supra* n. 1, at pp. 550-551.
160. *See* Englisch & Becker, *supra* n. 17, at sec. V. In the context of the US BEAT, Rosenbloom, and Shaheen express a similar position, *see* H.D. Rosenbloom & F. Shaheen, *The BEAT and the Treaties*, 92 Tax Notes International 1 (2018), available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3229532. On the other hand, Avi-Yonah expresses a contrary opinion, *see* R.S. Avi-Yonah, *BEAT It – Tax Reform and Tax Treaties*, Michigan Law, Public Law and Legal Theory Research Papers, No. 587, p. 3 (2018), available at https://repository.law.umich.edu/cgi/viewcontent.cgi?article=1260&context=law_econ_current.
161. OECD, *Report on the Attribution of Profits to Permanent Establishments* (22 July 2010), available at https://www.oecd.org/ctp/transfer-pricing/45689524.pdf.

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OECD seems to analyse only the former type of payment[162] (deemed or notional payments) and states that discrimination does not arise.[163] It is argued that:

> *the UTPR applies to a PE that is a UTPR Taxpayer, in the same way as to a UTPR Taxpayer that is a group entity, as a mechanism to allocate top-up tax resulting from a low-tax outcome within an MNE*. The mechanism takes the form of a limitation (or denial) of the deduction of intra-group payments, or an equivalent adjustment, based on deductible payments to a low-tax entity or net related party expenditures in the relevant period. It is a rule designed to serve as a backstop to the IIR by allocating top-up tax among the Constituent Entities in an MNE Group when the IIR does not apply. *The UTPR, therefore, does not discriminate against a PE situated in a state compared with a resident entity of that state which carries on the same activities merely because it is the PE of a non-resident entity.* [Emphasis added.]

These statements are indeed questionable.

As a start, article 24(3) states that when a resident (of State R) has a PE in the other State (State S) then the taxation of a PE shall not be less favourable than "the taxation levied on enterprises" of State S which carry "same activities" as those of the PE. The object of comparison is an enterprise of the other state but what exactly? Should the PE in State S be compared to a subsidiary (which is subject to the UTPR) that a foreign corporation (resident in a low-tax state) has in State S? The authors would tend to answer this question in the negative and argue that objective of comparison is a purely domestic enterprise.[164,165] This would imply that object of comparison is a State S tax resident (e.g. a local company) which carries out activities similar to those of the PE. If the local company would normally be allowed a deduction for payments made to a low-tax jurisdiction then equal treatment warrants that the same is extended to the PE.[166] To strengthen this conclusion, an analogy can also be drawn with the comments made in paragraph 60 of the Commentary on branch taxes.[167] The Commentary clearly states that such additional taxes on the profits of the PE are contrary to article 24(3). Thus, it could also be argued that a minimum tax, which is also a tax on the profits of the PE could contravene the non-discrimination provisions.

With respect to article 24(5), as a start, it should be noted that this provision deals with taxation of the entities and not that of the shareholders or even of the combined taxation borne by the entities and their shareholders; namely, the objective of article 24(5) is not to protect the (non-resident) shareholders or partners of the resident company from discrimination as compared to resident shareholders or partners.[168] Consequently, the provision does not prohibit the contracting state in question from taxing the income accruing to the shareholders or partners from their shareholdings differently from such income accruing to residents.[169] With respect to the object of comparison, it is disputed whether the comparison should be made with either domestically owned companies or with companies owned by third-state residents, also considering that the Commentary does not address this point directly. Nonetheless, it seems unlikely that the provision is merely intended to prevent discrimina-

162. OECD/G20, *Report on Pillar Two Blueprint*, *supra* n. 17, para. 694.
163. Id., at paras. 694-696. On the other hand, under the latter type of payment, the scope of art. 9 may be activated; however, it would involve a state different from the PE state.
164. On this point, *also see* Rust, *supra* n. 154, at para. 63.
165. Bammens & Vanistendael, *supra* n. 157, at pp. 21-22.
166. *OECD Model: Commentary on Article 24* (2017), *supra* n. 100, at para. 40.
167. Id., at para. 60.
168. Compare id., at para. 76.
169. *See* Bammens, *supra* n. 155, at sec. 9.4. For an application of this perspective in tax treaty case law, *see* LU: Tribunal Administratif de Luxembourg,5 Apr. 2000, Case 10473.



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tion between different categories of foreign owned companies, as that would significantly reduce its importance.[170] In this respect, it is also debatable whether the condition of foreign ownership should constitute the only ground for the discrimination[171] or whether this may also be coupled with other factors in order for the prohibition under article 24(5) to apply.

In light of the above, it could be argued that the UTPR applies only to domestic companies (which are in high-tax states) that are owned and controlled by UPEs in other states. Thus, there is a conflict. Put differently, it is accepted that the object of comparison for this provision is a domestic company with domestic shareholders (both in the high-tax state). As the latter are not subject to the UTPR, the non-applicability needs to be extended to a domestic company with foreign shareholders. On the other hand, one could argue against this proposition as the UTPR applies to payments made to all associated enterprises situated in low-tax jurisdictions as opposed to being applicable to associated enterprises who only own/control the capital of the payor. The different treatment does not seem to be based directly on ownership per se.

The above analysis indicates that potential conflicts could arise with selected provisions of article 24.

In order to avoid such conflicts, the Model Rules now indicate that, once a top-up tax is allocated to a UTPR jurisdiction, then that country can collect the tax, for example, by denying the deduction from the local tax base. According to article 2.4, an entity "shall be denied a deduction … in an amount resulting in those Constituent Entities having an additional cash tax expense equal to the UTPR Top-up Tax Amount for the Fiscal Year allocated to that jurisdiction". It seems that denial of deduction applies to all payments made by the UTPR taxpayer (domestic or cross border to low-tax or high-tax entities). If the denial is linked to all payments, then discrimination issues may not arise. Another manner in which such taxes could be collected is by introducing a new charge on a CE located in the UTPR jurisdiction. Such an approach could indeed trigger compatibility issues with article 9(1) as well as other provisions (already discussed in section 2.). Thus, it is worthwhile to explore the possibility to insert a safeguard clause[172] in tax treaties which would authorize the application of the UTPR (*see* section 7.) as opposed to merely changing the Commentary.

## 4. Is It Correct to Import Article 9(1) into the Exceptions List of the Saving Clause?

In the previous sections, the authors highlighted that article 9(1) of the OECD Model is not listed as an exception to the saving clause. Thus, the "restrictive" effect of article 9(1) is taken away not only in relation to allocation norms[173] but also with respect to national

170. Id.
171. This interpretative line has been upheld in tax treaty case law. Compare SE: Administrative Supreme Court, RÅ 1993 ref 91 II, discussed in K. Ståhl, *The Application of the Treaty Non-discrimination Principle in Sweden*, 28 Intertax 5, pp. 198-199 (2000). This line of interpretation would seem to resonate also in the *OECD Model: Commentary on Article 24*, compare in particular para. 79, according to which "the paragraph prevents the discrimination of a resident enterprise that is solely based on who owns or controls the capital of that enterprise".
172. *See* Chand, *supra* n. 1, at pp. 207-215 (as well as all the references therein). *See also* De Broe, *supra* n. 1, at pp. 461-466.
173. For example, suppose a company in State R (Corp R) sells goods to its related party (Corp S) in State S for EUR 1,000. However, the arm's length price for this transaction is determined to be EUR 1,500. Nevertheless, under its domestic rules for pricing transactions among related parties, State R considers the sale price for the transaction to be EUR 2,000 (for example, by using a formulary mechanism). If art.

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anti-avoidance norms[174] or other deemed attribution norms. The question analysed here is whether it makes sense to import article 9(1) into the exceptions list even though it is not expressly listed as an exception. On may argue that this should be the case under a reasonable "purposive" interpretation for the following reasons.

First, as discussed in this article, the OECD Commentary has already imported article 9(1) into article 24(5) vis-à-vis thin capitalization situations. By doing so, national thin capitalization rules which are compliant with the arm's length standard cannot be considered to infringe the ownership non-discrimination provision. The Commentary states:

> since the provisions of paragraph 1 of Article 9 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.

One may thus argue that article 9(1) should be imported into the exceptions list of the saving clause as adjustments which are only compatible with the arm's length standard should be permitted and thus all other non-arm's length adjustments should be considered incompatible with the provisions of the treaty. In other words, article 9(1) is an "authoritative statement" on the arm's length principle and this principle shall be respected for all the provisions of the treaty.

Second, it should be noted that article 9(2) is listed as an exception to the saving clause. Article 9(2), for example, requires State S to provide a corresponding adjustment only when State R makes primary adjustments on an arm's length basis. If article 9(1) is not excepted and State R makes non-arm's length adjustments, then State S would not be obliged to provide a corresponding adjustment (for the non-arm's length amount). Thus, it could be argued that not excepting article 9(1) could possibly lead to unresolved economic double taxation which clearly article 9(2) seeks to avoid.

Third, there is also no guarantee that the issue of economic double taxation would be resolved by the mutual agreement procedure (MAP) contained in article 25 (even though this provision is listed as an exception to the saving clause). For example, if Country R makes an upward adjustment to its resident taxpayer beyond the ALP then this country could argue that such taxation "is in accordance" with the saving clause. This taxpayer then

9(1) is read as restrictive, it would permit State R to rewrite the accounts of Corp R only up to the arm's length standard price of EUR 1,500. However, because art. 9(1) is not excepted from the saving clause, State R may not need to apply the arm's length standard when making primary adjustments, since State R can tax its residents in accordance with its internal laws. Consequently, the accounts of Corp R could be rewritten to EUR 2,000. A similar example was already discussed in a previous contribution of one of the authors to this paper. *See* Chand, *supra* n. 11.

174. For example, suppose a company in State R (Corp R) provides a loan to its related party (Corp S) in State S for EUR 1,000 at 10% interest rate. Both the funding and the interest are at arm's length. However, the State S tax administration apply a national thin capitalization rule, based on an arbitrary fixed debt equity ratio approach, and recharacterize a part of the loan into equity. As a result, the interest on the recharacterized part is not allowed as a deduction. If the national rule needs to be tested with art. 9(1) then this rule would conflict with the treaty provision. However, the restrictive force of art. 9 (1) is taken away because it could be argued that the tax treaty should not affect State S's taxation of its own resident (Corp S). Therefore, the saving clause opens the door for states to apply non-arm's length thin capitalization rules to associated enterprises. A similar example was already discussed in a previous contribution of one of the authors to this article. *See* Chand, *supra* n. 11.



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will not be able to access the MAP as that dispute resolution mechanism is only available when taxation is "not in accordance with the provisions of this Convention".[175]

In light of the above one may argue to import article 9(1) into the list of exceptions because double taxation would arise. One possible consequence then, as already discussed in sections 2. and 3., would be to possibly argue that article 9(1) restricts the application of CFC rules or the IIR as well as the UTPR.

Of course, the above reasons do not square correctly with a literal reading of the saving clause which does not list article 9(1) as an exception. Support for this proposition can also be found in the *Xilinx* case, wherein the US Court of Appeals for the Ninth Circuit clearly stated that US domestic law – section 1.482-7(d)(1) – does not violate the United States-Ireland tax treaty as that treaty contains a saving clause. Thus, adjustments which could possibly go beyond the arm's length standard could be applied to US residents.

## 5. Tax Treaty Overrides

In the 1989 Tax Treaty Override report (1989 TTO report), the OECD refers to a treaty override as "a situation where the domestic legislation of a State overrules provisions of either a single treaty or all treaties hitherto having had effect in that State".[176] Such domestic legislation may be implemented explicitly by stating that treaty provisions are to be disregarded in certain circumstances (such as in case of treaty shopping or other forms of abuse).[177] The question now arises, also having in due regard that these rules cannot really be conflated with anti-abuse rules, is whether the GloBE rules (IIR or UTPR), if implemented in national law with changing treaties, amount to treaty overrides.

Arguably, after the widespread adoption of the new preamble pursuant to the MLI, the main "object and purpose" of tax treaties are (i) allocating taxing rights and eliminating double taxation with a view to promoting cross-border investment; (ii) the prevention of tax evasion; and (iii) the prevention of tax avoidance. Additionally, a tax treaty has several other supplementary purposes. As indicated in the OECD Commentary, these include, amongst others, the elimination of tax discrimination as provided in article 24 and the establishment of a MAP as per article 25.[178] If all these objects and purposes have to be taken into consideration, it is reasonable to conclude that the objectives and purposes of the OECD Model are multifold.[179]

While the policy objectives of the Pillar Two rules may be open to discussion, it is clear that these rules (IIR and UTPR) are not designed to exclusively target tax evasion. It is arguable whether or not their objective is to prevent tax avoidance but it seems that, for the reasons outlined earlier in section 2., the answer should rather be in the negative as these rules are designed to ensure minimum taxation and restrict tax competition. As a result, the prevention of evasion or avoidance[180] cannot be used to justify the application of

175. *See also*, on this point, Kofler, *supra* n. 12, at pp. 582-584.
176. OECD, *Recommendation of the Council concerning Tax Treaty Override*, para. 2 (2 Oct. 1989).
177. Id., at para. 2.
178. Para. 26, Introduction *OECD Model* (2017).
179. V. Chand, *The Principal Purpose Test in the Multilateral Convention: An in-depth Analysis*, 46 Intertax 1, pp. 23-26 (2018).
180. Some scholars have argued that if a domestic rule is designed to prevent tax avoidance, then it does not amount to a treaty override. *See*, for example, C. Elliffe, *The Lesser of Two Evils: Double Tax Treaty Override or Treaty Abuse?*, British Tax Review 1, pp. 78-85 (2016).

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these rules if introduced after the conclusion of a tax treaty. As a result, the interaction of GloBE's objectives with these two objectives will not be discussed further. This brings us back to the first main objective (i). Clearly, it can be argued that a "material breach"[181] arises when one state (through its legislature) disturbs the treaty's object and purpose, namely, the "allocation of taxing rights". Similarly, a "material breach" arises when one state (through the legislature), introduces a rule that leads to unresolved double taxation. Likewise, a "material breach" arises when one state (through the legislature), creates a rule that leads to tax discrimination.

The previous sections, sections 2. and 3., highlighted that the GloBE rules could, arguably, trigger conflicts with the provisions of a tax treaty. To reiterate, article 9 is the only provision which is placed within the distributive rules (articles 6-22) that governs determination of taxing rights in residence-residence situations (as opposed to residence-source situations). Also, it was previously established that article 9 is restrictive in nature and could possibly prohibit the adjustment of profits to an amount exceeding the arm's length amount. Accordingly, if the IIR or UTPR, make adjustment of profits to an amount exceeding the arm's length amount among associated enterprises, then an argument can be made that a conflict arises. Also, to the extent these rules lead to economic double taxation (which is within the scope of article 9) a conflict arises. Additionally, if the IIR applies to low-taxed PEs even if a treaty exempts such income, then a clear conflict arises.

If one accepts the fact that conflicts could arise, logically, when the GloBE rules are introduced after the conclusion of a tax treaty, these rules should not be applicable as the provisions of the tax treaty take precedence. Accordingly, if the legislator introduces posterior GloBE rules, that notwithstanding the conflict, reallocate income, lead to double taxation, or trigger tax discrimination, then an argument can be made that a treaty override occurs.

In this regard, it should be noted that it might not be possible for a state to override a treaty if the constitution of a state places treaties on a higher pedestal than domestic law.[182] This is typically the case in states such as the Netherlands, France,[183] Belgium[184] and Switzerland.[185]

Treaty override may, nevertheless, be possible in states where treaties rank at an equal footing with domestic law and are subject to the rule of *lex posterior derogat legi priori* or where the principle of parliamentary sovereignty applies (the legislature passes legislation

181. Vienna Convention on the Law of Treaties, UN, Treaty Series, vol. 1155 (1969) [hereinafter VCLT], Art. 60(1) VCLT provides "a material breach of a bilateral treaty by one of the parties entitles the other to invoke the breach as a ground for terminating the treaty or suspending its operation in whole or in part". This implies that the injured State (the State that is impacted by the breach) can, as a remedy for non-compliance, terminate the treaty or suspend it completely or partially. The provision provides that this is possible only in situations of a "material breach". Art. 60(3)(b) VCLT provides that "material breach" arises when a "provision essential to the accomplishment of the object or purpose of the treaty" is violated.
182. *See* Elliffe, *supra* n. 180, at sec. 2.2.
183. OECD, *Recommendation of the Council concerning Tax Treaty Override*, supra n. 176, at para. 7.
184. *See* De Broe, *supra* n. 1, at pp. 231-233.
185. In Switzerland, where there is a conflict between current/subsequent domestic law and treaty law and if that conflict cannot be solved by interpretation, the treaty prevails. The principle of superiority of international law over domestic law is reflected in art. 5(4) Swiss Federal Constitution. *See* Chand, *supra* n. 1, at p. 84 (as well as all the references therein). This said, it should be noted that the GloBE rules will be implemented in Switzerland through a constitutional amendment. Such an amendment may reduce the incompatibility argument at the domestic law level if the legislation states there is an override (although this position is debateable). *See* C. Martin, V. Chand, N. Burkhalter, *Arm's Length Principle from a Swiss Perspective: Profit Allocation to Inbound and Outbound Permanent Establishments*, 50 Intertax 1, p. 66 (2022).


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that clearly intends to override treaties). This is typically the case in states such as the United States[186] and other dualist countries,[187] such as the United Kingdom and Germany; however, also in this case scholarship often indicates that treaty override would still not be possible or at least (depending on the country) be challenged before courts (in particular, constitutional courts).[188] An interesting perspective is then offered by the relationship between EU law and international treaty law, as, in the relations among Member States, EU law prevails over all law, including international treaties. This implies that if all Member States implement the Pillar Two Directive[189] and make the necessary changes to their domestic tax laws, they will all have agreed at Union level to amend their treaties through an EU law instrument.[190]

It is generally accepted that domestic and international law are two spheres that exist independently of each other.[191] While, treaty overrides may be possible at domestic law level, such override conflicts with international law provisions, in particular, the provisions of the VCLT that govern the law of treaties.[192] Article 26 of the VCLT, which contains the *pacta sunt servanda*[193] principle, provides that "every treaty in force is binding upon the parties to it and must be performed by them in good faith". This implies that once a treaty comes into force it is binding on the parties (the contracting states) to the agreement, and the provisions of the treaty have to be performed in good faith.[194] The principle of "good faith"[195] requires contracting states to mutually respect and apply treaty provisions in a reasonable way and in such a manner that their purpose is realized.[196] Thus, passing a domestic legislation (even if the local constitution permits domestic level overrides)[197] such that it

186. K. Vogel, *Klaus Vogel on Double Taxation Conventions* p. 68 (3rd ed., Kluwer Law International 1999). *See also* Elliffe, *supra* n. 180.
187. *See* Elliffe, *supra* n. 180. *See also* C. Elliffe, *International Tax Avoidance – The Tension between Protecting the Tax Base and Certainty of Law*, Journal of Business Law 7, p. 11 (2011), available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=1787843.
188. *See* Chand, *supra* n. 1, at pp. 88-89 (as well as all the references therein).
189. In fact, the Proposal for a Council Directive on ensuring a global minimum level of taxation for multinational groups in Europe COM(2021) 823 final has been released on 22 December 2021 and can be accessed at https://ec.europa.eu/taxation_customs/system/files/2021-12/COM_2021_823_1_EN_ACT_part1_v11.pdf (accessed 7 Feb. 2022). On the background of the initiative, *see* the Statement by Commissioner Gentiloni on the G20's endorsement of the agreement on international taxation reform of 13 October 2021, available at https://ec.europa.eu/commission/presscorner/detail/en/STATEMENT_21_5247.
190. If the case for an incompatibility of CFC rules with art. 7, as the authors believe, can ultimately be upheld, this implies that when CFC was implemented under ATAD where there was a clear conflict between art. 7 of all Member State treaties and the CFC rule requiring the profit of a low-taxed PE of an EU-based company to be taxed in the state of residence. Art. 7 of Member State treaties prevents this, but the Directive unanimously accepted overrides this.
191. K. Vogel, *The Domestic Law Perspective*, in *Tax Treaties and Domestic Law* p. 3 (G. Maisto ed., IBFD 2006), Books IBFD.
192. J. Wouters & M. Vidal, *The International Law Perspective*, in *Tax Treaties and Domestic Law* p. 19 (G. Maisto ed., IBFD 2006), Books IBFD.
193. C. De Pietro, *Tax Treaty Override* pp. 225-227 (Wolf Legal Publishers 2012).
194. Wouters & Vidal, *supra* n. 192, at p. 21.
195. R. Danon, *The PPT in Post-BEPS Tax Treaty Law: It Is a GAAR but Just a GAAR*, 74 Bull. Intl. Taxn. 4/5 (2020), Journal Articles & Opinion Pieces IBFD. *See further also* F. Engelen, *Interpretation of Tax Treaties under International Law* pp. 122-125 (IBFD 2004), Books IBFD.
196. B. Michel, *Anti-Avoidance and Tax Treaty Override: Pacta Sunt Servata?*, 53 Eur. Taxn. 9, p. 418 (2013), Journal Articles & Opinion Pieces IBFD.
197. Analogous considerations can be derived also in connection between bilateral investment treaties and the domestic legal order: to quote the recent award in the *Cairn* case (*Cairn Energy PLC and Cairn UK Holdings Limited v. The Republic of India*, PCA Case no. 2016-07), a bilateral investment treaty "does […] not simply replicate the existing level of protection under domestic law. It offers independent, although not wholly unrelated, international standards of protection in order to stimulate the growth of the cross-border investment". One of the practical implications was that the retrospective application of tax

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contravenes a state's treaty obligations, conflicts with the *pacta sunt servanda* principle as that state gives preference to domestic and not international law. This conclusion is overtly reflected in article 27 of the VCLT which, under the heading of "internal law and observances of tax treaties", provides that a "party may not invoke the provisions of its internal law as justification for its failure to perform a treaty". While this provision of the VCLT precludes a state from disrupting its treaty obligations at the international law level, it does not solve the situation at the domestic law level. Thus, more often than not, states contravene their treaty obligations even though a conflict can arise with the provisions of international law.[198] This outcome could be expected with the GloBE rules, in particular, for countries where overrides are possible. Implementing the GloBE rules in countries where overrides are not possible will be a challenging task.

At the same time, the above "conventional wisdom" about tax treaty override may, in the view of the authors, fail to appreciate a further fundamental dimension of this phenomenon; namely, the difficulty in qualifying tax treaty override as a substantively unlawful attempt to extend taxation beyond the limits agreed with treaty partners is anchored in the earlier outlined view which perhaps overplays the independence of the municipal and international legal spheres, so that it would not seem to possible to set forth more comprehensive approaches to this problem besides the comparative assessment of the persuasion of each state when it comes to the relationship between the two spheres and ultimately their hierarchy. By contrast, as it has been set forth in recent scholarly contributions to this matter, the authors wonder whether (tax) treaty override would not perhaps benefit to be addressed as an issue of jurisdiction, instead of a matter of hierarchy. This shift of perspective would be of broader systemic import but would in particular display its merits in the tax domain, provided that it would appear more consistent with the actual purpose of double tax conventions and with the need to preserve the jurisdictional limitations agreed under such agreements.[199] In other words, from this perspective, tax treaty override would constitute an attempt to extend taxation beyond the jurisdictional limits a state agreed with its treaty partners, so that, by means of a tax treaty override, a state would end up legislating beyond its own jurisdiction. Such consideration and perspective appear particularly topical in connection with rules such as the IIR.

This perspective would then allow to raise the issue of state responsibility in tax treaty override matters. While an in-depth assessment of a matter with such broad ramifications is beyond the scope of this article, what would matter for the purposes at hand would be "objective responsibility" and would be found even in the absence of fault entailing strict responsibility: in other words, once an unlawful act that has caused injury has been committed by an agent of the state, the acting state is, under international law, responsible for the state suffering the damage, irrespective of good or bad faith.[200] Indeed, applying such

legislation at the core of the case would run counter to the applicable bilateral investment treaty regardless of its compatibility with the domestic Indian constitutional order.

198. Wouters & Vidal, *supra* n. 192, at p. 21.

199. For an introduction to this alternative perspective, compare L. Schoueri, *Tax Treaty Override: A Jurisdictional Approach*, 42 Intertax 11, p. 682 (2014).

200. *See* further on this point V. Arruda Ferreira, *The Improper Use of Tax Treaties by Contracting States*, ch. 5 (IBFD 2021), Books IBFD. A further set of issues arises in connection with the possibility for states to bring claims of state responsibility against other states on behalf of their nationals within the framework of diplomatic protection. In fact, art. 33(2) of the ILC Draft Articles determines that the rules on state responsibility owed to another state are "without prejudice to any right, arising from the international responsibility of a State, which may accrue directly to any person or entity other than a state", this



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categories to the realm of taxation may not be so straightforward. This difficulty may be exacerbated by the circumstance that the type of situations that would be most relevant for the purpose of this article (namely, situations where the state bearing the damage would be the "low-tax source state") have typically been far less frequent than situations where, by means of a treaty override, the source state claims taxing rights which the treaty conferred upon the residence state.

### 6. The GloBE Rules and Dispute Prevention and Resolution

Two issues need to be addressed here. The first pertains to the role of article 25 (and beyond) vis-à-vis treaty conflicts that have been discussed in foregoing sections (sections 2. to 5.). The second pertains to issues that arise from inappropriate or inconsistent application of Pillar Two rules by states.

With respect to addressing conflicts, the first question deals with relations between states. The issue is whether countries can agree through an interpretative MAP that the provisions of a treaty do not restrict the application of the IIR and the UTPR. In other words, in connection with reliance on the MAP as a tool to administer GloBE rules within the framework of tax treaties, one may wonder whether, at the structural level, the so-called "interpretative MAP" as exemplified by article 25(3) of the OECD Model would provide for a suitable legal basis to regulate the conflicts (which may then render superfluous a safeguard clause such as the one discussed in section 7.). In particular, in itself issues concerning compatibility between the IIR and the UTPR and certain key provisions within tax treaties may perhaps be addressed interpretatively through a shared mutual agreement which could be multilateralized. The potential of multilateral MAPs has already been envisaged by the work of the Forum on Tax Administration despite certain hurdles concerning the applicable legal basis and procedural rules.[201]

However, many of these complexities would seem to be connected with the ex post nature of dispute resolution MAPs (i.e. those based on provisions modelled after paragraphs 1 and 2 of article 25 of the OECD Model) while the same concerns may not hold true for the interpretative MAPs based on paragraph 3, which typically take place ex ante. States that are party to the envisaged new Multilateral Instrument may then agree to pre-emptively address the issue of frictions through reconciliatory interpretation in an ad hoc interpre-

would however appear to carry limited practical import given that the legal standing of private persons before international tribunals is unheard of as international law currently stands. On the other hand, states may be entitled to bring a claim on behalf of individuals and legal entities before the International Court of Justice, provided that the represented parties suffered damage as a consequence of a breach of an international obligation of a state. *See* ILC Commentary on Article 36, para. 5 of the Draft Articles on Responsibility of States for International Wrongful Acts, according to which: "Financially assessable damage encompasses both damage suffered by the State itself (to its property or personnel or in respect of expenditures reasonably incurred to remedy or mitigate damage flowing from an internationally wrongful act) as well as damage suffered by nationals, whether persons or companies, on whose behalf the State is claiming within the framework of diplomatic protection". With regard to the applicability of such framework to instances of tax treaty override and tax treaty dodging, *see further* Arruda Ferreira, id., at sec. 5.3.2.

201. Ongoing work in this area was presented at the 2020 Tax Certainty Day (of which the agenda and materials are available at https://www.oecd.org/tax/dispute/agenda-tax-certainty-day-2020.pdf). Indeed, in that context it was recognized that for the time being no directly applicable legal basis had been foreseen so that, of the instances of multilateral MAPs or APAs, most had to be initiated separately and multilateralized as parallel procedures. Designing a streamlined process for such procedures currently appears to feature on the agenda of the Forum.

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tative MAP. At the same time, it appears clear that such an interpretative MAP would only lead to the adoption of a Memorandum of Understanding,[202] of mere administrative nature, which, per se, may not override the terms of the relevant treaty provisions.[203] At the same time, it does not appear entirely clear which legal remedy would be available to a taxpayer affected by a Memorandum of Understanding whose terms run counter to some treaty provision. On the domestic plane, nonetheless, some recent Belgian tax treaty case law appears to have addressed the issue,[204] where the Belgian judges found that an interpretative MAP concluded between the Belgian and French competent authorities had to be disregarded in that it had effectively departed from the wording of the applicable Convention. With regard to the broader question of the relevance of Memoranda of Understanding for tax treaty interpretation purposes, in principle, article 31(3)(a) of the VCLT leaves the question open, providing that "[t]here shall be taken into account, together with the context … any subsequent agreement between the parties regarding the interpretation of the treaty or the application of its provisions …".

While it is generally agreed, as it is also reflected in paragraph 54 of the 2017 OECD Model Commentary on Article 25, that interpretative MAPs shall be binding upon administrations as long as the competent authorities do not agree to modify or rescind the mutual agreement.[205] in many countries, interpretative MAPs are typically not considered to bind Courts, as is reflected by tax treaty case law of high courts of countries such as Germany.[206] As has been observed, this outcome appears difficult to question where the courts reject the interpretation provided through a MAP concluded under article 25(3) if that interpretation goes beyond a possible interpretation of the tax treaty, an example of which can be illustrated by the earlier recalled Belgian case, while it appears quite problematic in situations where a Court could reject an interpretation adopted in the MAP that accords with the wording of the tax treaty only because the court considers that better arguments support a different interpretation.[207] This being said, while this avenue would nonetheless remain granted its relevance for treaty interpretation purposes,[208] it could not constitute a suitable alternative to a safeguard clause where it shall be found that the GloBE rules concerned conflict with and override tax treaties.

202. On the legal nature of Memoranda of Understanding, *see further* J. Hattingh, *Legal Considerations Arising from the Use of Memoranda of Understanding in Bilateral Tax Treaty Relations*, in *Current Tax Treaty Issues* (G. Maisto ed., IBFD 2019), Books IBFD.
203. In this sense, compare also M. Lang, *Introduction to the Law of Double Taxation Conventions* m.nos. 505-507 (Linde 2021).
204. Compare, in particular, BE: Court of Cassation, 17 Sept. 2020, *Belgium v. PDV and another*, Case F.19.0021.F/1. It should, however, also be noted that earlier tax treaty case law of other Countries took an opposite orientation, compare, in particular, UK: Court of Appeal, 23 May 2013, Case [2013] EWCA Civ 578*Ben Nevis (Holdings) Ltd v. Revenue and Customs Comrs*, Case Law IBFD, both decisions having been published on the International Tax Law Reports.
205. *See also*, in this sense, CA: TCC, 10 Mar. 2017, Case 2017 TCC 37, *Sifto Canada Corp. v. The Queen*, Case Law IBFD; and, for broader comments, S. Wilkie, *Article 25 – Global Tax Treaty Commentaries*, Global Topics IBFD (accessed 2 Feb. 2022).
206. *See*, for instance, DE: BFH, 10 June 2015, Case I R 79/13, Case Law IBFD; or the Netherlands (NL: HR, 6 Jan. 2017, Case 15/05836, Case Law IBFD).
207. Compare, in this sense, J. Sasseville, *The 2017 Change to Article 3(2) of the OECD Model: Comments on Professor Alexander Rust's Presentation*, 74 Bull. Int. Taxn. 4/5, p. 283 (2020), IBFD Journal Articles and Opinion Pieces.
208. In particular in light of art. 31.3.(a) VCLT, foreseeing that together with the context the interpreter should take into account, inter alia, "any subsequent agreement between the parties regarding the interpretation of the treaty or the application of its provisions".


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The second question pertains to the vertical relations between states and taxpayers. The issue is whether contracting states may block access to the MAP for the taxpayer based on the consideration that the issues at the heart of the dispute would revolve around abusive situations. In this regard, Spanish case law indicates that access to the MAP was denied by the tax administrations on grounds of tax avoidance, an orientation which appears to have recently been upheld by the Spanish Supreme Court.[209] On the other hand, while the 2017 version of the Commentary on Article 25 recognizes that:

> Some States may deny the taxpayer the ability to initiate the mutual agreement procedure under paragraph 1 of Article 25 in cases where the transactions to which the request relates are regarded as abusive,

it nevertheless provides:

> […] In the absence of a special provision, there is no general rule denying perceived abusive situations going to the mutual agreement procedure, however. The simple fact that a charge of tax is made under an avoidance provision of domestic law should not be a reason to deny access to mutual agreement.[210]

A preclusion to the access to the MAP could reasonably not be envisaged then even in the unlikely scenario that the IIR or the UTPR were to be considered rules aimed to target artificiality, which would arguably not be the case based on the policy rationale of the whole initiative.[211]

Another issue revolves around whether the notion of "taxation not in accordance with the provisions of this Convention" which constitutes the precondition for activating a MAP under terms based on article 25(1) of the OECD Model would also encompass situations where the origin of the friction lies in perceived instances of discrimination based on treaty rules modelled after article 24 of the OECD Model, a scenario which, in light of the foregoing analysis, would appear sufficiently concrete with respect to the UTPR (as designed in the Blueprint). While there appears to be scarce evidence (even on a purely anecdotal level) of MAPs which had instances of prohibited discrimination as their triggering cause, nothing in the literal wording of article 25(1) would seem to prevent such an occurrence, considering that what is at stake would indeed constitute an instance of "taxation not in accordance with the provisions of the convention", as all the forms of discrimination barred by the terms of article 24 of the OECD Model entail in one way or another a form of taxation precisely not in accordance with the convention.

The same considerations apply to situations where "taxation not in accordance with the convention" would be the result of a treaty override. Treaty override is typically understood

209. *See* ES: Tribunal Supremo, decision of 22 Sept. 2021, *SGL Carbon Holding*, ECLI:ES:TS:2021:3572; for a critical assessment of the decision, *see* A. Navarro, *Spanish Supreme Court denies Access to MAP in domestic GAAR Cases*, MNE Tax (2 Nov. 2021), available at https://mnetax.com/spanish-supreme-court-denies-access-to-map-in-domestic-gaar-tax-case-46099. Lower courts on the other hand had set forth different arguments and raised different conclusions on analogous issues, *see* ES: Audiencia Nacional, 28 Mar. 2017, Case 171/2017, Case Law IBFD and ES: Spanish National Court, 17 Apr. 2017, Case 232/2015. The Spanish Courts, however, determined that in the event of economic double taxation, domestic law cannot be invoked in rejecting an application to initiate a MAP, even when domestic GAAR legislation has been used to question the transactions undertaken by the taxpayer.

210. *See OECD Model: Commentary on Article 25* (2017), *supra* n. 43, at para. 26.

211. For further considerations on this point, *see* P. Pistone et al., *The OECD Public Consultation Document "Global Anti-Base Erosion (GloBE) Proposal – Pillar Two": An Assessment*, 74 Bull. Intl. Taxn. 2, sec. 1.2. (2020), Journal Articles & Opinion Pieces IBFD.

as a purely horizontal issue between states; however, its most immediate and concrete reverberation is typically felt by the concerned taxpayers. The circumstance that access to MAP would be open does not necessarily imply that a substantive remedy may be provided: in fact, either of the contracting states may simply not agree to bring the matter further so that, ultimately, the only available protection would be an indirect sui generis[212] form of diplomatic protection (assuming that the state responsible for the breach of the treaty is not the same residence state) which would culminate in denunciation, termination or withdrawal from the treaty.[213] At the same time, some interesting developments may be observed with regard to the administrative practice of states that, despite having introduced measures that may arguably be considered to entail a form of treaty override, admit the concerned measures within the potential objective scope of MAP. In particular, as of late, HMRC has announced that legislation will be introduced in Finance Bill 2021-22 in order to make the diverted profits tax one of the taxes in respect of which, subject to the terms of the relevant treaty, a MAP outcome can potentially be implemented.[214] At the same time, there is clearly no evidence about the potential impact of this broadening for taxpayers, since the same state implementing the potentially overriding measure may deny that an override has effectively taken place.

In light of the foregoing, it seems that the existing bilateral tax treaty framework would already contain suitable tools to address the key sources of possible disputes which could be initiated by one of the affected taxpayers when it comes to instances of potential incompatibility between the GloBE rules and existing tax treaty rules. It is also to be noted that it seems rather unlikely that states would be willing to submit such disputes to binding mandatory arbitration, so that if a MAP is initiated upon the taxpayer's request, it may be expected that the matter would be dealt with within the prescribed time limits before the requests for submitting the matter to arbitration becomes actionable for the taxpayer.[215]

212. As, of course, qualifying as a resident would not imply nationality, which diplomatic protection in the proper sense presupposes. Moreover, diplomatic protection also typically presupposes the exhaustion of local remedies. On the other hand, this conceptual framework would not apply at all if the breach of the treaty is brought about by the residence state.
213. Governed by arts. 42-45, 54-56, 65-68 and 70-71 respectively of the VCLT, unless specific rules apply. On the formal plane, thus, tax treaty override and the more anodyne tax treaty dodging typically warrant the same type of reactions. On the responses to tax treaty dodging, *see* Arruda Ferreira, *supra* n. 200.
214. *See* HMRC, *Mutual Agreement Procedure (MAP) decisions relating to the Diverted Profits Tax. Policy Paper* (27 Oct. 2021), available at https://www.gov.uk/government/publications/mutual-agreement-procedure-map-decisions-relating-to-the-diverted-profits-tax/mutual-agreement-procedure-map-decisions-relating-to-the-diverted-profits-tax.
215. On the impact of time frames on delimitating the scope of disputes that may effectively subjected to arbitration, *see also* H. Ault, *Tax Treaty Arbitration: A Reassessment*, in *Thinker, Teacher, Traveler: Reimagining International Tax (Essays in honor of H. David Rosenbloom)*, in particular at secs. 3.1. and 3.5.5. (G. Kofler, R. Mason & A. Rust eds., IBFD 2021), Books IBFD.



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Additionally, bilateral investment treaties (BITs)[216] could possibly be invoked to counter treaty overrides.[217] It should be clarified that an in-depth analysis of such an avenue goes beyond the scope of this article,[218] also in light of the greater fragmentation in the area of investment law, due in part to the plurality of treaty models on whose basis negotiations are conducted resulting in investment treaty clauses being formulated in comparatively less homogeneous and consistent ways than what can arguably be observed in connection with tax treaties.

In this respect, issues concerning the conduct of states in the implementation of the UTPR could be open to discussion[219] on the assumption that there is no tax carve-out in the applicable bilateral investment treaty.

Also, of particular importance for investment dispute ramifications is the *Cairn* award.[220,221] In this award, the tribunal highlighted the different perspective that is taken by investment tribunals in light of their mandate: a tax dispute is one concerned with "whether and how

216. Under BITs, non-discrimination standards would typically encompass "national treatment" and "most favoured nation" clauses (often along the following typical formulation: "Neither Contracting Party shall in its territory subject investments or returns of nationals or companies of the other Contracting Party to treatment less favourable than that which it accords to investments or returns of its own nationals or companies or to investments or returns of nationals or companies of any third State". In addition, the fair and equitable standard (typically formulated along these terms: "All investments made by investors of one Contracting Party shall enjoy a fair and equitable treatment in the territory of the other Contracting Party"). Such standards can also be (and typically are) complemented by other types of clauses for the promotion and protection of investments, e.g., so-called umbrella clauses (typically formulated along these terms: "Each Contracting Party shall observe any other obligation it may have with regard to a specific investment of an investor of the other Contracting Party"), "stabilization clauses" (typically included in contracts for the exploitation of natural resources and of which a rather standard formulation could be the following: "Modification to the tax system: In the event of a modification to the tax system or the creation or elimination of new taxes not foreseen in this Contract, which have an impact on the economics of this Contract, a correction factor will be included in the production sharing percentages to absorb the impact of the increase or decrease in the tax"). BITs then typically contain clauses prohibiting expropriation, which would typically involve both direct and indirect expropriation and regulating compensation. It seems that the fair and equitable standard constitutes the most commonly found standard in bilateral investment treaties, as well as the one on which most investment treaty disputes appear to rely. Among these, stabilization clauses in direct investor-state contracts could constitute the most sensitive area; in fact, whereas even under the FET standard a host state would generally be free to change its domestic legal system, including tax laws, up until the point where this would not amount to an arbitrary/discriminatory conduct, a violation of such a stabilization commitment may entail a violation of the contract and, as such, possibly lead to dispute settlement under the contract or a BIT claim under an umbrella clause.
217. With regard to the possibility of submitting treaty dodging or treaty override disputes to international investor-state arbitration on the basis of bilateral investment treaties, *see* Arruda Ferreira, *supra* n. 200. In broader terms, an investment arbitration may be initiated independently, concurrently or alternatively to a MAP under a tax treaty concluded by the host state; *see*, in this sense, R.J. Danon & S. Wuschka, *International Investment Agreements and the International Tax System: The Potential of Complementarity and Harmonious Interpretation*, 75 Bull. Int. Taxn. 11/12, sec. 3.6 (2021), Journal Articles & Opinion Pieces IBFD.
218. For an updated analysis of the key points of contact between the international tax and investment regimes, *see* S. van Weeghel, *Tax and Investment Treaties: A Few Observations*, in *Thinker, Teacher, Traveler* (G. Kofler & R. Mason eds., IBFD 2021), Books IBFD.
219. The compatibility of the UTPR with fair and equitable treatment standard *may be* subject to debate. One further issue in this regard would concern whether the circumstance that the UTPR would be triggered as a backstop in case the IIR is not applied may somewhat mitigate the responsibility of the host state in applying the clause. It is also not clear which entity within the Group may hypothetically bring about the claim. Additionally, as already indicated previously, a separate issue is whether the implementation of the of Pillar Two rules by States may conflict with stabilization commitments.
220. *See Cairn Energy Plc and Cairn UK Holdings Limited v. Republic of India*, PCA Case no. 2016-7.
221. With regard to the relevance of the *Cairn* award in connection with taxation, *see* Danon & Wuschka, *supra* n. 217, at sec. 3.3.

a particular transaction is taxable under the applicable (municipal) law or, possibly laws of several countries if the transaction is international";[222] while a "tax-related investment dispute" is one where the Tribunal is tasked "with determining whether the respondent State has breached substantive standards of treatment under the investment treaty through the exercise of its authority in the field of taxation, and whether liability arises as a result".[223,224]

This being said, leaving aside for a moment the income tax carve-out applicable to many BITs, a phenomenon which appears to be less and less monolithic as greater scrutiny is awarded to the matter,[225] a more straightforward preliminary answer in the negative can be set forth with regard to issues surrounding the IIR (assuming it is only the UPE which applies this rule and the agreement concluded by the UPE State are sought to be invoked). As is well known and addressed earlier, this rule would operate under the prerogative of the residence state, which, in investment law terms, can be qualified as the home state. However, the structure of international investment law is unambiguous in foreseeing that investment protection extends to investors who are nationals of a contracting state other than the host state (in colloquial tax treaty terms, the "source state") in which the investment is made,[226] so that such protection would not be devised to operate against the home state (in colloquial tax treaty terms, the "residence state").

222. *See Cairn* Award, *supra* n. 220, at para. 793.
223. Id.
224. In another prominent award concerned with tax carve-outs, the Tribunal found, also in light of the concern of countering possible abuses of such tax carve-outs, that the tax carve-out could only apply to "bona fide taxation actions", "[…] i.e. actions that are motivated only by the purpose of raising general revenue for the State". Compare RU: PCA, 18 July 2014, Case no. 2005-04/AA227, *Yukos Universal Ltd. v. the Russian Federation*, at para. 1407. One may raise the question of whether the UTPR would constitute a "bona fide taxation action" in light of the above criterion, also considering its back-up function. Nonetheless, bearing in mind that, to date, the award has not consistently been followed and such criterion applied, the question may indeed hold relative little/negligible relevance, also considering that the UTPR would not be enacted to take advantage of a tax carve-out contained in an investment treaty but within the framework of a series of measures on which a global agreement among policy makers has been reached.
225. In fact, different approaches to tax carve-outs under bilateral investment treaties can be categorized: from general carve-outs excluding tax matters from the treaty scope of application without any reservation (such as Hong Kong-New Zealand Promotion and Protection of Investments of 1995) to carve-outs that give priority to double taxation conventions in case of overlap (such as, for instance, the South Korea-Mexico Promotion and Reciprocal Protection of Investments Agreement of 2000). Often the carve-out distinguishes between direct and indirect taxes, with the investment treaty encompassing only the latter. The carve-out may not be absolute but only concern some of the protection clauses: from specific exclusion of the application of the fair and equitable treatment with regard to taxation measures to the specific exclusion of certain non-discrimination standards, such as the most favoured nation clause with regard to tax measures. Without pretension of exhaustiveness, based on a desktop review of the EDIT database by the World Trade Institute (https://edit.wti.org), it would appear that a very frequently encountered type of carve-out concerns precisely the "fair and equitable treatment" standard. At the same time, many Model BITs of European countries do not foresee such a carve-out but rather restrict the application of non-discrimination standards such as the national treatment and the most favoured nation clauses (compare, for instance, the current French and British Model Bilateral Investment Treaties. On the other hand, the 2012 US Model BIT provides for a carve-out of tax measures, but then gives the expropriation provisions an overriding force, foreseeing however the need for competent authorities to agree there is no expropriation.
226. This is consistent with the essential character of investment treaty law as a series of bilateral promises made between states in respect of each other's nationals. The nationality of the claimant thus determines, as a preliminary matter, whether it is entitled to take the benefit of treaty protections; this, in turn, determines the jurisdiction rationale personae of the investor-state arbitral tribunal. *See* C. MacLachlan, L. Shore & M. Weiniger, *International Investment Law - Substantive Principles* m.no. 5.01 (2nd ed., Oxford University Press 2017).


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It goes without saying that taxpayers can always resort to domestic litigation channels, which, as it will be illustrated further in this section, under certain situations may constitute the only available avenue.

With respect to inappropriate or inconsistent application of the Pillar Two rules by states, one fundamental source of disputes susceptible of arising from the prospective implementation of Pillar Two lies in the circumstance that the taxing right of one state depends on the taxing rights of several other states, so that situations of double, if not multiple taxation may arise. The most typical scenario to be envisaged in this regard would encompass situations where several states fail to apply Pillar Two rules correctly (or initiate reassessments based on their own understanding of the rules).

Despite the above concerns, the Pillar Two Blueprint does not dwell at length on dispute resolution in these situations. This applies in particular with regard to the IIR and the UTPR, based on the assumption that such rules will be transposed into the domestic law of the adhering states so that any potential conflict would be prevented by design, as the rules "have been designed in a way to minimise the scope for disputes concerning their application across multiple jurisdictions primarily because of the rule order and the binary way in which they operate".[227]

Even assuming this may be the case when it comes to pure matters of "rule pecking order",[228] which, as acknowledged by the same Blueprint in connection with reassessment cases, states may still have the chance to resolve issues through interpretative MAPs based on provisions modelled after article 25(3) (second sentence, concerned with the "the elimination of double taxation in cases not provided for in the Convention") of the OECD Model.[229] This channel, however, can only be activated upon initiative by the contracting states.

On the other hand, it may be wondered whether a MAP based on article 25(1) of the OECD Model, to be activated upon request by the taxpayer, may provide a suitable tool for addressing situations where double taxation may still occur because of inconsistent application of the rules by the states involved (e.g. about the identification and localization of the UPE for applying the IIR or recalculation of top-up taxes based on each state's own interpretation of the rules). As mentioned, while such procedure may in principle lend itself to address instances of taxation "not in accordance with the convention" arising from the override of treaty provisions brought by the application of GloBE rules, it seems dubious that it may also address instances of double taxation resulting from misalignments among states with regard to the implementation of the same rules. Thus, most likely, in the absence of the creation of a dispute prevention mechanism, it could be possible that the only available avenue for addressing disputes potentially arising from misalignments among States in the application of the rules would remain domestic litigation.

This said, one may once again raise the question of whether possible instances of incorrect application of the rules by states may effectively constitute a breach of the agreed international framework to which states have committed within the "common approach". Assume that a host state (UTPR jurisdiction) goes beyond the Pillar Two agreed framework in its

227. *See* OECD/G20, *Report on Pillar Two Blueprint*, *supra* n. 17, at para. 711.
228. Something that, as it has been pointed out, may not actually prevent, as earlier mentioned, situations where states simply fail to apply the rules correctly.
229. *See* OECD/G20, *Report on Pillar Two Blueprint*, *supra* n. 17, at para. 714.

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conduct and allocates additional taxes to the UTPR taxpayer in an arbitrary manner. If this is the case, and if the investor can access the investment treaty (assuming also that no tax carve-out would apply), then one may raise the question of whether this action could be challenged under the terms of the investment treaty. In other words, the question would be whether the UTPR state has breached standards of treatment under the investment treaty, such as the FET standard. The answer to such a question would go beyond the scope of this article and would be subject to a number of assumptions, which makes addressing such hypothetical queries rather arduous.

In light of the above, as acknowledged in the Blueprint, it would be of the utmost importance to ensure that a robust dispute prevention and resolution mechanism is available for Pillar Two.[230]

## 7. Overcoming Treaty Hurdles: One Simple Answer to Ensure that a Conflict Does Not Arise

The article so far has shown that the OECD's position in the Blueprint is not bulletproof. Clearly, from a legal perspective, several potential frictions could arise with tax treaties, in particular, when treaties are interpreted not in a literal manner but rather in a reasonable, "purposive"[231] manner. Moreover, tax treaty overrides could be triggered if these rules are implemented without changing tax treaties.

Widespread adoption of the saving clause can do the trick for conflicts linked to article 9(1) – to the extent that article 9(1) is not imported into the exceptions list – but not for conflicts linked to the other provisions of the tax treaties, such as the relief provisions or the non-discrimination provisions. Moreover, a multilateral interpretative MAP (or multilateral competent authority agreements) may not work for regulating conflicts for the reasons already discussed before, namely that a Memorandum of Understanding, as a mere administrative agreement, may simply not override treaty provisions.

If policymakers (or the OECD's Inclusive Framework) wish to end the debate on potential conflicts and ensure that national courts of their countries do not rule against the IIR or the UTPR, the authors propose that a safeguard clause, which authorizes the application of the IIR and the UTPR, is implemented in tax treaties.[232] Several states have introduced such a

230. Id., at para. 715.
231. In this regard, the authors would like to highlight that when they use the term "purposive" interpretation, they do not mean teleological interpretation. In the authors' view, the treaty text is controlling, and the treaty text needs to be read in (i) good faith; (ii) in light of its context; and (iii) the object and purpose of the relevant provisions at stake (in particular, the reasons for its introduction and the intended outcome of that specific provision), as well as the object and purpose of the overall treaty. This, for the authors, is the reasonable purposive approach. On the other hand, under a broad purposive approach, a similar mechanism is employed but the treaty text is sometimes read in an unintended manner. Broad purposive interpretation of some treaty provisions, in certain circumstances, could lead to the outcome that a conflict arises with treaty provisions whereas a more reasonable approach could indicate that a conflict does not arise. The borderline between these two approaches is difficult to determine and entails a high degree of subjectivity. For a general discussion on purposive interpretation, *see* R. Smith, *Tax Treaty Interpretation by the Judiciary*, 49 The Tax Lawyer 4, pp. 845-891 (1996).
232. *See* Chand, *supra* n. 1, at pp. 108-116. Also, *see* V. Chand & C. Elliffe, *The Interaction of Domestic Anti-Avoidance Rules with Tax Treaties in the Post-BEPS and Digitalized World*, 74 Bull. Intl. Taxn. 4/5, pp. 319-320 (2020), Journal Articles & Opinion Pieces IBFD. For a similar conclusion, *see* M. Bennet, *Contemplating a Multilateral Convention to Implement OECD Pillars 1 and 2*, 102 Tax Notes International, pp.1453 et seq. (14 June 2021). It is important to underline how the exact wording used in the safeguard clause, which would be a possible configuration of the broader category of "compatibility


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safeguard clause in their treaty network with respect to specific anti-avoidance rules.[233] For example, France,[234] in many of its tax treaties, includes a provision that preserves the application of its thin capitalization rules.[235] A typical clause would provide that "[t]he provisions of this Convention shall not prevent … France from applying the provisions of Articles … 212" or any other similar provisions of the French tax legislation. Article 212 here deals with the French thin capitalization rules.[236] Another example is that of Canada. It has been reported that Canada in almost all of its tax treaties (barring four) has inserted a clause that preserves the application of the Canadian deemed income attribution rules, such as CFC rules.[237] A typical clause would provide that "[n]othing in the Convention shall be construed as preventing a Contracting State from imposing a tax on amounts included in the income of a resident of that State with respect to a partnership, trust, or controlled foreign affiliate, in which the resident has an interest".[238] Moreover, the OECD itself was contemplating introducing a switch-over rule (SOR) in tax treaties as opposed to proposing that in national law, as national implementation of the SOR clause could trigger conflicts with treaties and also result in treaty overrides for states which follow the exemption method with respect to permanent establishments.[239]

With respect to its content, to give an example, the safeguard clause could simply say that "[t]he provisions of the existing Conventions or future Conventions shall in no case prevent a Contracting Jurisdiction from applying the GloBE rules, that is, the Income Inclusion Rule and the Undertaxed Payment Rule as agreed within the Pillar Two framework". This would imply that if contracting states apply the IIR and UTPR in a manner which exceeds the authorization of the safeguard clause (i.e. countries apply Pillar Two rules in a manner which is inconsistent and at odds with the model rules developed by the OECD), then a treaty conflict would be detected. In this case, taxpayers shall have the possibility to invoke a MAP (under bilateral treaties) to resolve the issues as taxation is not in accordance with the safeguard clause and hence with the convention. Thus, inconsistent application of the Pillar

clauses" contemplated by public international law when it comes to regulating treaty conflict, should be as exact as possible in order to effectively help in interpreting and overcoming the conflict. *See also*, in this sense, S. Govind & P. Pistone, *The Relationship Between Tax Treaties and the Multilateral Instrument: Compatibility Clauses in the Multilateral Instrument*, in *The OECD Multilateral Instrument for Tax Treaties: Analysis and Effects* (Lang et. al. eds, Wolters Kluwer 2018).

233. S. Van Weeghel, *General Report*, in *Tax treaties and Tax Avoidance: Application of anti-avoidance provisions* p. 44 (IFA Cahiers vol. 95a, 2010), Books IBFD.
234. *See* the French reservation: *OECD Model: Commentary on Article 24* (2017), *supra* n. 100, at para. 91.
235. S. Austry & M. Collet, *France*, in *Tax treaties and Tax Avoidance: Application of anti-avoidance provisions* pp. 326-327 (IFA Cahiers vol. 95a, 2010), Books IBFD.
236. For instance, *see* para. 8, Protocol, *Austria-Fr. Income and Capital Tax Treaty* (1993), Treaties & Models IBFD.
237. N. Goyette & P. Halvorson, *Canada*, in *Tax treaties and Tax Avoidance: Application of anti-avoidance provisions* p. 189 (IFA Cahiers vol. 95a, 2010), Books IBFD.
238. For instance, *see* art. 26(2) *Can.-Mex. Income Tax Treaty* (2006). Arguably, if this type of provision is not introduced in the Canadian tax treaty network, then the national rules (CFC rules or the IIR) could conflict with tax treaties. In this regard, for example, *see* CA: FCA, 13 July 2012, Docket A-188-11, *Canada v. Sommerer*, 2012 DTC 5126 [at 7219], 2012 FCA 207, paras. 64-65. In that case, the Austria and Canada tax treaty had a safeguard provision for Canadian CFC rules. The Court held that only the Canadian CFC rules could be covered by the safeguard clause and the attribution norm at stake was outside the scope of that provision. This implied that Canada was restricted from applying its deemed attribution norm to its own resident as a conflict with treaty provisions was detected.
239. *See* OECD/G20, *Report on Pillar Two Blueprint*, *supra* n. 17, at para. 9, as well as paras. 453-456. *See also* Chand, *supra* n. 1, at pp. 456-462.

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Two rules by states could arguably be brought within the article 25(1) framework, provided that the relevant safeguard clause is formulated along the lines of the one reported above.

Within the European Union, the safeguard clause when implemented in tax treaties will have to comply with EU law. To elaborate, treaty-based rules should not lead to any restriction or discrimination on the exercise of treaty freedoms, such as that of establishment or capital. Even if such restriction or discrimination arises, these rules need to be justified and have to be proportional. For instance, it has been contended that the limitation on benefits clause (because of presumptions of abuse) or the principal purpose test rule (because of its unbalanced burden of proof and the lack of legal certainty) could be contrary to EU law. Accordingly, if EU Member States adopt such safeguard clauses in their treaty network, then such rules will have to be applied taking into consideration the proportionality requirement.[240] However, if the Pillar Two rules (especially the IIR) apply in cross-border as well as domestic situations then, arguably, one may not need to get into the proportionality discussion vis-à-vis the fundamental freedoms due to the absence of discriminations or restrictions.[241] Moreover, if the rules are implemented through a directive,[242] then the chances of possible conflicts with EU law may be reduced, also with regard to State aid. At the same time, overall, the adoption of a safeguard clause may ensure greater consistency and certainty and, indirectly, a broader set of possible remedies for taxpayers since, inter alia, it would provide broader access to Directive 2017/1852 (Dispute Resolution Directive), as any dispute potentially arising from misalignments in the application of the rules would fall under its scope of application as disputes arising "from the interpretation and application of agreements and conventions that provide for the elimination of double taxation of income", which would not otherwise be the case when it comes to disputes surrounding the misalignments in the application of the rules. The authors note that this interim conclusion on EU law merits further investigation.

In light of the relevance of the issue of compatibility of the proposed changes to the applicable tax treaty framework with other international non-tax obligations, primarily in the field of investment law, one question that may be raised is whether the inclusion of a safeguard clause may prevent possible claims of a breach of investment law obligations.[243] If relevant tax treaties were to be amended, for example, in order to provide for the applicability of the

240. *See* Chand, *supra* n. 1, at pp. 499-500 (as well as all the references therein).
241. For example, this seems to be the case within the European Union with respect to general interest limitation rules as they apply in domestic and cross-border situations, even though, they may be considered to be non-proportional as they go beyond the ALP. *See* Dourado, *supra* n. 125, at pp. 118-119.
242. Certain issues may still nevertheless exist, in particular, issues concerning proportionality. *See* L. De Broe & M. Massant, *Are the OECD/G20 Pillar Two GloBE-Rules Compliant with the Fundamental Freedoms?*, 30 EC Tax Review 3, pp. 94-98 (2021).
243. In this respect, it should be premised that it would be difficult to generalize as different outcomes may be envisaged depending on the type of investment protection standard invoked: for instance, the same conclusions may not necessarily be reached depending on whether one considers the FET ("fair and equitable treatment" standard), avoidance of "arbitrary, discriminatory or unreasonable measures" clauses, umbrella clauses and so on. Among such clauses, umbrella clauses arguably represent one of the most sensitive sources of potential friction. In fact, while stabilization clauses are typically contractual in nature and fall under the protection of domestic law, umbrella clauses impose a treaty obligation on host countries requiring them to respect contractual obligations entered into with respect to investment protected by the treaty. On the distinction between stabilization clauses and umbrella clauses, *see* Committee of Experts on International Cooperation in Tax Matters, *Relationship of tax treaties with trade and investment treaties*, 8 April 2019, Eighteenth session New York, E/C.18/2019/CRP.14, 23-26 April 2019, p. 11.


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UTPR by the host state,[244] for instance by means of a safeguard clause,[245] it may be wondered whether a "conflict of treaties" may arise, granted that such a broader issue of public international law somewhat transcends the boundaries and scope of this article and the authors have no pretension of addressing it exhaustively.

In this regard, it should be noted that in the *Cairn* award, the Arbitral Tribunal held that "[t]he UK-India DTAA and the BIT govern different subject-matters: the former provides rules for 'the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income and capital gains' applicable to residents of each contracting State, while in the latter, each Contracting Party agrees to treat the investments in its territory made by nationals of the other Contracting Party in accordance with certain standards of treatment".[246,247] Accordingly, it is clear that the subject matter addressed by BITs is different from that of tax conventions.

A following question, which also goes beyond the scope of this article, would lie in determining under which circumstances the conduct of states implementing the GloBE rules may breach the fair and equitable (FET) standard and whether the presence of a safeguard clause in the tax treaty would hold any bearing in this regard. Preliminarily, it should generally be observed that the existence of a safeguard clause may not have any bearing on the possibility of an investment tribunal to scrutinize the application of the GloBE rules. Assuming that the investor has treaty access and no tax carve out would apply, it should be reminded, as discussed in the *Cairn* award, that the FET standard, among others, is built on principles such as "good faith" and "legitimate expectations".[248] It may be argued that if there is a global agreement on the implementation of the "common approach" in domestic law and a tax treaty expressly allows the application of the GloBE rules by means of a safeguard clause removing compatibility issues between such rules and tax treaties insofar as the implementation of the concerned rules is compliant with such international framework,

244. In sec. 7. it has, on the other hand, been addressed how investment law considerations would likely not extend to the IIR as this clause would not have a bearing, if not indirectly (i.e., where the UTPR were to be triggered), on the conduct of the host state.

245. Potentially relevant to the question at hand appears the final award rendered in connection with the *Mikula* case (ICSID Case no. ARB/05/20), where an ICSID tribunal considered whether Romania was in breach of the Sweden-Romania bilateral investment treaty, as, within the framework of its EU accession process, it repealed incentives offered regarding investments made in some of the country's deprived regions. The case then had further ramifications with regard to the interaction between EU law and BITs, but for the purposes of the question at hand, the concerned final award is most notable in that it concluded that unilateral declarations made by a state would fall within the scope of an umbrella clause and that the latter would only extend to contractual obligations as the common wording in which they are formulated "obligation entered into with an investor" would seem to suggest (incidentally, prior to the *Mikula* case, confining umbrella clauses to contractual obligations had been the most common outcome; compare for instance within the ICSID system *Continental Casualty Company v. Argentine Republic* (ICSID Case ARB/03/9), Award, 5 Sept. 2008.

246. For the objective of tax treaties, *see* para. 15.2 Introduction *OECD Model* (2017) and the discussion in sec. 5.

247. *See*, in particular, para. 803 of the *Cairn* award, *supra* n. 186. For further analysis and assessment, *see* Danon & Wuschka, *supra* n. 217, at sec. 3.4 and the further references thereby included.

248. For example, in the recent *Cairn Energy* case, *supra* n. 186, in para. 1722, it is stated that investment tribunals have identified the following core principles of the FET standard: "(1) the requirement of stability, predictability and consistency of the legal framework, (2) the principle of legality, (3) the protection of investor confidence or legitimate expectations, (4) procedural due process and denial of justice, (5) substantive due process or protection against discrimination and arbitrariness, (6) the requirement of transparency and (7) the requirement of reasonableness and proportionality". *Also see* the discussion in paras. 1723-1823.

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then it would be challenging, at least on a substantive plane, to argue that under the FET standard the contracting state is breaching a pact or acting in an illegitimate arbitrary manner or creating an uncertain legal environment. In other words, under this scenario, bringing tax treaty override claims arguing them to be in breach of the FET standard would prove challenging. As such, the incorporation of a safeguard clause would not in itself offer any additional assurance about the possible prevention of breaches of the applicable investment law regime but, if formulated in such a way to presuppose with the international framework laid down by the "common approach", it may provide a proxy to assess the conduct of the state in the application of the GloBE rules. In fact, if a state goes beyond the Pillar Two framework, even if a safeguard clause exists, and acts in an arbitrary manner, one may once again raise the question of whether there would be a breach of an investment protection standard such as the FET, a question whose answer goes beyond the scope of this article.

Obviously, bilateral implementation of such safeguard clauses will take a long time. Thus, the authors propose that this issue is tackled through a multilateral instrument (MLC). One possibility would be to design this clause in the instrument which is being considered for implementation of the subject-to-tax rule (STTR). However, it is our understanding that the STTR will be implemented only in treaties between developing countries and Inclusive Framework member countries where the nominal corporate tax rate is less than 9% on selected payments. Accordingly, the STTR MLC may not represent the best implementation outlet.

The Pillar Two report in paragraph 707 states "[i]t may also be possible to include the GloBE provisions in the new multilateral instrument considered under Pillar One, which could also have the benefit of setting out the interaction between Pillar One and Pillar Two". As a result, one may look into the Multilateral Instrument that is being considered in a Pillar One context.[249] It is a well-known fact that if countries implement the Amount A regime in national law, then tax treaties will prohibit their application (in particular, articles 9, 7 and 5).[250] Accordingly, a first of its kind Pillar One MLC is being considered, which is expected to contain provisions (supersede clauses) to regulate the relationship between existing tax treaties and the Amount A formulary regime. Perhaps the safeguard clause could be included in this MLC (in an addendum) or within an independent Pillar Two MLC[251] (which would deal with rule order) to regulate the relations between national Pillar Two rules and tax treaties.

If such a safeguard clause is not developed within the treaty network, then there is a huge risk that the entire Pillar Two project may fail as tax treaties could restrict the application of these rules.

## 8. Domestic Minimum Taxes and Non-Discrimination

To take the discussion a step further, it should be noted that many states are currently contemplating a two-rate corporate tax system. To elaborate, that would entail one tax rate for local entities which belong to in-scope foreign or inbound MNEs – MNEs which cross the

249. OECD/G20, *Tax Challenges Arising from Digitalisation – Report on Pillar One Blueprint: Inclusive Framework on BEPS*, paras. 822-842 (OECD 2020).
250. *See* further on this point, Chand, Turina & Ballivet, *supra* n. 49.
251. For reasons why a Pillar Two MLC is needed, *see* M. Bennet, *Contemplating a Multilateral Convention to Implement OECD Pillars 1 and 2*, 102 Tax Notes International, pp. 1453 et seq. (14 June 2021).



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global revenue threshold, e.g. EUR 750 million – (for instance, 15% so that there is no top-up tax in the state of the UPE through the IIR) and another tax rate (for instance, 12.5%) for:
- local entities which are standalone entities;
- local entities which belong to domestic or foreign MNEs whose global turnover is less than EUR 750 million; or
- *local entities which belong to a domestic or local headquartered MNE whose revenue is more than EUR 750 million*.

Consider the following example. Company S (or PE S) is in State S and subject to a corporate tax rate of 15% as it belongs to an in-scope offshore MNE group, headquartered in Country R. On the other hand, Company S 1 in State S is subject to a corporate tax rate of 12.5% as it is (i) a standalone entity; or (ii) it belongs to an MNE whose revenues is less than EUR 750 million; or (iii) *they are a part of domestic headquartered MNEs whose turnover is more than EUR 750 million*. In this scenario, one could indeed argue that there is a violation of article 24(3), as State S is applying a higher tax rate to PE S which is less favourable. Similarly, it could be argued that a potential conflict arises with article 24(5) as Company S is subject to more burdensome taxation as the higher rate applies to it due to the fact that it is owned or controlled by non-residents. In other words, the discrimination is linked to foreign ownership of Company S. Moreover, such a rule could then possibly conflict with the non-discrimination provisions found in investment treaties such as national treatment (to the extent that the provision applies).

The reality of the situation is that many countries, going forward, would want to be in a position to apply such different tax rates for either tax competition reasons or to retain their attractiveness as a location or for simply political reasons to protect domestic headquartered MNEs. If a state wishes to do so, then it may contemplate the incorporation of treaty safeguard clauses to overcome non-discrimination concerns. To illustrate, India, in a completely different context to the one being discussed here, usually discriminates between PEs and subsidiaries respectively, as the tax rate for the former is usually higher than for the latter.[252] India has recognized that this is discrimination but preserves its right to discriminate in tax treaties. For example, article 26(2) of the India-United Kingdom Income Tax Treaty (1993) states that the PE non-discrimination provision "shall not be construed as preventing a Contracting State from charging the profits of a permanent establishment which an enterprise of the other Contracting State has in the first mentioned State at a rate of tax which is higher than that imposed on the profits of a similar enterprise of the first mentioned Contracting State, nor as being in conflict with the provisions of paragraph (4) of Article 7 of this Convention". If some states want a different treatment, they may wish to simply agree that the non-discrimination provisions, for example, "shall not be construed as preventing a Contracting State from applying an effective tax rate of 15% to local enterprises/entities who belong to a foreign MNE Group which is subject to the Pillar Two rules".

On the other hand, granted that this matter transcends the scope of this article and leaving aside for a moment issues concerning carve-outs from BITs as well as the jurisdiction of arbitration tribunals, agreeing to incorporate such a clause in tax treaties may reasonably be conducive also to reduce claims under at least some standards of protection in investment treaties, namely those linked with the legitimate expectations of the investor. Of course, this area merits further investigation, in particular, its interaction with stabilization clauses.

252. *See* the Indian position to the *Commentary on Article 24*.

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Moreover, adoption of a two-rate corporate tax system could be challenging within the European Union. While analysing this question is beyond the scope of this contribution, particular attention needs to be paid to potential conflicts with fundamental freedoms (e.g. if an EU Member State applies a higher tax rate for local entities of foreign in-scope MNE groups but applies a lower rate for entities that belong to an in-scope domestic controlled MNE or purely large domestic groups). Additionally, depending on the jurisdiction, constitutional law concerns could arise from an equality and neutrality perspective.[253]

Thus, to avoid such concerns and ensure equality of treatment, the authors would argue against the insertion of a clause which would permit discriminatory taxation and the authors would actually suggest that Country S, at a minimum, also applies the 15% tax rate to local entities that belong to a domestic MNE which is subject to Pillar Two rules.[254] In other words, the 15% rate shall be applicable to local entities of both foreign headquartered MNEs and domestic headquartered MNEs (including purely domestic groups with domestic operations only) whose revenue is more than EUR 750 million. The chances of potential frictions with tax treaties,[255] investment treaties[256] (to some extent and granted that the issue may be extremely treaty specific) and the EU law framework[257] could then possibly be reduced.[258] Of course, to give an affirmative answer on conflicts with the non-discrimination standards, it would be necessary to see the manner in which the rules are implemented in domestic tax law to determine the exact object of comparison.

253. While these considerations would be jurisdiction-specific, with frameworks where these principles may be overridden in light of other prevailing consideration, these appear as general principles inspiring most tax systems. *See*, in this sense, R. Musgrave, *In Defense of an Income Concept*, 81 Harvard Law Review 44, p. 45 (1967).
254. This basically mirrors the equalization between cross-border and domestic situations that has been indicated as a viable alternative to reconcile the IIR with EU primary law. *See*, in this sense, P. Koerver Schmidt, *A General Income Inclusion Rule as a Tool for Improving the International Tax Regime – Challenges Arising from EU Primary Law*, 48 Intertax 11, p. 983 (2020); and J. Nogueira & A. Turina, *Pillar Two and EU Law*, in *Global Minimum Taxation? An Analysis of the Global Anti-Base Erosion Initiative* p. 287 et seq. (A. Perdelwitz & A. Turina, eds., IBFD 2021), Books IBFD.
255. If a strict reading of art. 24(5) is given as prohibiting discrimination solely on the grounds of foreign ownership, an orientation that would seem to be confirmed, as mentioned earlier by the OECD Commentary and by domestic tax treaty case law, it may also be argued that coupling the requirement of foreign ownership with the exceeding of certain internationally agreed turnover thresholds may in turn support the overcoming of frictions with art. 24(5) – to the extent that it does not constitute disguised discrimination. This may in turn appear to resonate with broader trends in the international tax regime; compare P. Pistone, *Digital Service Taxes and Tax Treaties*, in *Thinker, Teacher Traveler* p. 412 (G. Kofler, R. Mason, A. Rust, eds., IBFD 2021), Books IBFD.
256. As already indicated previously, one important issue is whether the introduction of domestic minimum taxes by states (such as those, for example, that did not have any corporate income taxes) may raise issues of compatibility with stabilization commitments.
257. This may also likely prove to overcome potential frictions with EU law in light of recent streams of case law, such as, in particular in light of recent Court of Justice of the European Union (ECJ) case law, such as, in particular ECJ, 3 Mar. 2020, Case C-75/18, *Vodafone Magyarország*. In such stream of case law, the ECJ appears to having become more reluctant to qualify a national tax measure as a covert de facto restriction where it does not display any protectionist tendencies; *see*, in this sense, J. Englisch, *Designing a harmonized EU-GloBE in compliance with fundamental Freedoms*, 30 EC Tax Review 3, p. 139 (2021).
258. This seems to be the direction adopted in the EU Directive Proposal COM(2021) 823 final, *see supra* n. 189, where the proposed art. 2 foresees that the Directive shall apply "to constituent entities located in the Union that are members of an MNE group *or a large-scale domestic group* (emphasis added by the authors) which has an annual revenue of EUR 750 000 000 or more in its consolidated financial statements in at least two of the last four consecutive fiscal years".


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