Treaty Compatibility of the IIR and the UTPR

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Abstract: This paper explores the compatibility of the Income Inclusion Rule (IIR) and the Undertaxed Profits Rule (UTPR) with existing tax treaties. The paper first assesses whether the taxes under IIR and UTPR meet the coverage criteria of Art. 2 of the OECD Model Convention (MC) and then analyses potential treaty infringements, focusing on Art. 7, 9, and 10(5), highlighting the inherent contradiction between tax treaties, which aim to limit taxing rights, and the global minimum tax, which allows taxation of global profits. Next, the paper reviews the historical development of IIR and UTPR, emphasising the OECD's initial recognition of the need for treaty amendments but noting the current lack of multilateral solutions, which poses potential dispute risks. In conclusion, the paper argues that the global minimum tax presents compliance challenges and legal uncertainties, questioning the binding effect of double taxation agreements. The article calls on the OECD to resolve these uncertainties through international agreements and advises countries to carefully consider the legal implications when implementing the IIR and the UTPR.

Keywords: Income Inclusion Rule; Undertaxed Profits Rule; OECD Model Convention; Global minimum tax

1. Introduction

We are currently in the midst of implementing the global minimum tax worldwide. Some countries have already introduced a Qualified Domestic Minimum Top-up Tax (QDMTT) and/or an Income Inclusion Rule (IIR).[1] The purpose of the former is to ensure that local profits are not taxed abroad, while the latter aims to ensure that other countries also implement a 15% minimum corporate income tax. Additionally, the Undertaxed Profits Rule (UTPR), another key element of the global minimum tax, serves as a backstop rule to the IIR in the case where undertaxed constituent entities of the MNEs are not subject to a QDMTT and/or an IIR. The UTPR has not yet been implemented in any country; however, EU countries are required to do so by 1 January 2025. Switzerland, my home country, has introduced a QDMTT as of 1

1 Some of the large accounting firms provide for overviews of the implementation stages in various jurisdictions. See e.g. https://www.pwc.com/gx/en/services/tax/pillar-two-readiness/country-tracker.html.

January 2024, but it has not yet decided whether to implement an IIR and/or a UTPR.

The purpose of this brief analysis is to assess whether both the IIR and the UTPR infringe tax treaties. There are already numerous articles on this topic[2] — particularly regarding the compatibility of the UTPR with tax treaties. In the following this article will refer to some of the existing arguments but of course we are unable to comprehensively discuss the topic and outline all facets of the existing discourse in detail.

The focus in the following is on the OECD Model Convention (MC), as usual with respect to questions of compatibility with tax treaties. However, it is necessary to look at the actual treaties signed to conclusively assess the question at hand.

2. An Example

To better illustrate the main arguments, the following example should help clarify the legal problem. Let's take a multinational enterprise with three constituent entities for example.[3]

The ultimate parent entity (UPE) is resident in Country A and subject to an effective tax rate of 20%. The UPE has one subsidiary in Country B subject to an effective tax rate of 16%. Moreover, the UPE has a permanent establishment in Country C subject to a tax rate of 10%.

If Country C does not implement a QDMTT, Country A will apply the IIR on the undertaxed profits of the permanent establishment in Country C based on the calculation in the Model Rules[4]. If Country A has not implemented an IIR (and Country C still not implemented a QDMTT), the undertaxed profits will be subject to the UTPR in Country B.

The question to be assessed below is whether both the IIR and the UTPR would infringe the obligations of tax treaties between Country A-C and Country B-C.

3. Infringement of Tax Treaties

3.1 Overview

The application of the IIR and the UTPR in a treaty context raises various questions. First, we need to assess whether the UTPR and the IIR, or to be more precise, the taxes levied through the application of these rules are covered by tax treaties. Art. 2 of the OECD MC generally provides that corporate income taxes are covered taxes and that *identical or substantially similar taxes* are also included.[5]

The tax base of the UTPR is the corporate income of a multinational enterprise, specifically the undertaxed corporate income in accordance with a jurisdictional blending approach (considering the substance-based income exclusion). It is a tax on the excess profits of undertaxed entities. Therefore, it seems persuasive to argue that the UTPR is a covered tax for tax treaty purposes.[6] The same is true for the IIR, which is also a tax on the excess profits of foreign entities whose effective tax rate is below 15%.

In the next step it needs to be reviewed whether a state infringes any of the treaty obligations (in particular any of the allocation rules in combination with the article of applicable double

2 See, for instance, Vikram Chand, Alessandro Turina & Kinga Romanovska (2022). Tax Treaty Obstacles in Implementing the Pillar Two Global Minimum Tax Rules and a Possible Solution for Eliminating the Various Challenges. 14 *World Tax Journal* 1, p.3 et seq.; Filip Debelva & Luc De Broe (2022). Pillar 2: An Analysis of the IIR and UTPR from an International Customary Law, Tax Treaty Law and European Union Law Perspective. *Intertax*, p,898 et seq.

3 The term "constituent entity" is used within the Model Rules to cover both companies and permanent establishments belonging to an multinational group subject to the global minimum tax (see Art. 1.3.1 of the Model Rules).

4 OECD (2021). *Tax Challenges Arising from Digitalisation of the Economy — Global Anti-Base Erosion Model Rules (Pillar Two): Inclusive Framework on BEPS*, https://doi.org/10.1787/782bac33-en.

5 Art. 2 para. 4 of the OECD MC.

6 This is also the majority view in literature see e.g., Angelo Nikolakakis & Jinyan Li. Unprecedented (and Unprincipled?) Tax Policy Response. *Tax Notes International*, 6 February 2023, p.743, et seq. For a minority view see Allison Christians & Stephen E. Shay. The Consistency of Pillar 2 UTPR with U.S. Bilateral Tax Treaties. *Tax Notes International*, 23 January 2023, p.445 et seq.

taxation alleviation method). Next we will focus on Art. 7, 9 and 10(5) of the OECD MC. Art. 24 of the OECD MC will not be discussed, though some argue that the application of the IIR and the UTPR may also trigger non-discrimination concerns.[7]

3.2 Allocation Rules

There is a systemic contradiction between tax treaties and the global minimum tax. The main purpose of tax treaties has been to limit taxing rights, primarily for source countries. This is the main reason why countries (still) sign tax treaties, i.e. they want to enhance cross-border trade and investment through ensuring lower or even no taxation in one or both of the contracting states.

However, the global minimum tax allows countries to tax global profits of multinationals, which seems per se to be an insurmountable contradiction. Therefore, by design it does not seem at all surprising that the global minimum tax creates friction and incompatibilities with tax treaties. If we hypothesise for a second what states would agree in tax treaties if they knew that a global minimum tax had already been introduced, it seems obvious that they would likely exclude the global minimum tax from the scope of tax treaties. In some treaties which have been signed or amended recently, countries have indeed included such a waiver.[8] The latter again demonstrates that countries are aware of the potential legal challenges triggered by the global minimum tax.

This brings us to the technical part. Several rules might prevent states from introducing the IIR and/or the UTPR. The first norm that could be infringed is Art. 7 of the OECD MC which limits the taxing rights of source countries to the profits attributable to permanent establishments in the source country. If a multinational enterprise has a permanent establishment in the source country and such a country applies the UTPR, the source country would not only tax the income attributable to the permanent establishment deemed as a separate entity but also the profits of entities resident in other jurisdictions. A similar logic applies to the IIR. In our example above the situation is as follows. Country A (through the IIR) will tax the profits of the undertaxed permanent establishment in Country C and by doing so Country A infringes its obligations according to the A-C tax treaty if Country A follows the exemption method.[9]

Another potential infringement could arise under Art. 9 of the OECD MC. The limitation that Art. 9 of the OECD MC provides for domestic tax law is not easy to grasp. Art. 9 of the OECD MC is the base for transfer pricing adjustments between related parties, but it does not contain a limiting rule on the basis of which, for instance, countries have to grant specific deductions or according to which countries can only tax certain kinds of income. For instance, Art. 9 of the OECD MC does not require from countries that interests are in general deductible or that intra-group services shall be subject to taxation if at arm's length. However, one way of looking at Art. 9 of the OECD MC is that it requires that domestic allocation rules are in line with the arm's length principle.[10] As the allocation under the UTPR and the IIR does obviously not follow the arm's length standard (and assuming both the UTPR and the IIR are considered to be allocation rules), it could be argued that they both infringe Art. 9 of the OECD MC. Similar problems

7 See on this topic Sjoerd Douma, Alexia Kardachaki, Georg Kofler, et al. The UTPR and International Law: Analysis from Three Angles. *Tax Notes International*, 15 May 2023, p.857 et seq. (p.873 et seq.).

8 See Art. 9 of the Protocol to the tax treaty between Switzerland and France as of 27 June 2023.

9 Of course, this is not the case in all treaties but, for instance, Switzerland follows the exemption method in case there is a foreign permanent establishment.

10 See a detailed overview of the various interpretations of Art. 9 of the OECD MC and its restrictive content, Vikram Chand, Alessandro Turina & Kinga Romanovska (2022). Tax Treaty Obstacles in Implementing the Pillar Two Global Minimum Tax Rules and a Possible Solution for Eliminating the Various Challenges. *World Tax Journal*, p.9 et seq.

arise in relation to CFC rules as pursuant to their design they might lead to an allocation of more profits to the parent company than allowed under the arm's length principle. Admittedly there is also a different reading according to which Art. 9 of the OECD MC does not provide for such a limitation. We will not delve into such dispute for the purpose of the present contribution.

Another dispute could arise in relation to Art. 10(5) of the OECD MC. Art. 10(5) of the OECD MC which is not as commonly used as Art. 7 and 9 of the OECD MC has the following wording:

"5. Where a company which is a resident of a Contracting State derives profits or income from the other Contracting State, that other State may not impose any tax on the dividends paid by the company […], nor subject the company's undistributed profits to a tax on the company's undistributed profits, even if the dividends paid or the undistributed profits consist wholly or partly of profits or income arising in such other State."

Such obligation does not, of course, apply if the dividends are paid to a company or a permanent establishment in the other contracting state. Again, the potential conflicts can arise with respect to both the UTPR and the IIR as both taxes are potentially levied on undistributed profits of the company.[11]

3.3 Fighting Tax Abuse as a Justification?

Once the legal position is that both the IIR and the UTPR infringe one, several or all above-mentioned provisions in a tax treaty, the question to be discussed is whether the application of both the IIR and the UTPR, nevertheless, is justified. This could be the case if a rule (such as the UTPR or the IIR) aims at fighting tax avoidance. To fight avoidance situations, countries might not be bound by treaty obligations. This is, inter alia, derived from the Preamble (at least since 2017):[12]

"Intending to conclude a Convention for the elimination of double taxation with respect to taxes on income and on capital without creating opportunities for non-taxation or reduced taxation through tax evasion or avoidance (including through treaty-shopping arrangements aimed at obtaining reliefs provided in this Convention for the indirect benefit of residents of third States),"

Therefore, one could argue that the above-mentioned conflicts will dissolve as they are justified by the purpose of the treaty. However, to sustain such a position it would need to be proven that both the IIR and the UTPR aim at fighting avoidance structures. Though, it is well known that both the IIR and the UTPR apply regardless of whether the multinational enterprise aims at tax savings or adopts tax planning schemes. Therefore, it might well be the case that both the IIR and the UTPR apply to situations in which multinational enterprises have set up their supply chain without any tax concerns but driven by business reasons only. Essentially the goal of the global minimum tax is to achieve a 15% effective tax rate regardless of how a business is structured. To sum up, it is rather challenging to argue that either the IIR or the UTPR is in line with tax treaties as these rules do not aim at fighting avoidance structures.

3.4 The Saving Clause

The saving clause has its origins in the US and has found its way into the OECD MC in 2017. Many treaties, such as the double tax treaty between Switzerland and China, however, do not yet contain such a provision. The saving clause in Art. 1(3) has the following wording:

"3. This Convention shall not affect the taxation, by a Contracting State, of its residents except with respect to the benefits granted under paragraph 3 of Article 7, paragraph 2 of Article 9 and Articles 19, 20, 23 [A] [B], 24, 25 and 28."

11 See with some examples Filip Debelva & Luc De Broe (2022). Pillar 2: An Analysis of the IIR and UTPR from an International Customary Law, Tax Treaty Law and European Union Law Perspective. *Intertax*, p.898 et seq. (p.899 et seq.).

12 We will not specifically address the question if even treaties based on the old Preamble contain an implicit norm according to which the treaty does aim at fighting tax avoidance.

It needs to be assessed whether the saving clause justifies the application of the UTPR and/or the IIR. The first obvious conclusion is that the saving clause does not permit the taxation of non-residents, which would be the case if the UTPR is applied in a permanent establishment situation, as outlined in the example above. Even though there would be a saving clause in the treaty, Country C might not be allowed to tax profits of foreign entities. Therefore, it would not help the country apply the UTPR if only a permanent establishment, and not a company resident in that country, exists. The question remains whether the saving clause mitigates potential friction between the IIR, the UTPR and tax treaties, however, in other situations.

One way of understanding the saving clause is to argue that its purpose is to allow top-down taxation in case of genuine economic activities in the resident state of the entity controlling other entities.[13] Therefore, countries are allowed to tax their residents on profits accrued at lower levels in the whole group structure as it is indeed the case with respect to the IIR. However, one could also argue that the primary goal of a saving clause is to guarantee the application of domestic anti-abuse rules in top-down situations,[14] which would again mean that the IIR is not protected by a saving clause as it is not an anti-abuse measure.

What seems persuasive is that the saving clause does not cover the UTPR, even if the entity subject to the UTPR is resident in a jurisdiction, as it will lead to taxation in any jurisdiction in the group structure rather than the parent jurisdiction and, therefore, not following a top-down approach. The latter, however, has been the main purpose of the saving clause.

4. How It Started?

To better understand the current potential friction between tax treaties and both the IIR and the UTPR, it is important to briefly look back on how these rules were developed. This is particularly interesting, as it seems quite astonishing that the current proposals stemming from the OECD do not foresee any solutions to the outlined legal problems.

Already since the beginning of the discussion about the introduction of a global minimum tax, it has been obvious that an IIR-like rule is necessary. By an IIR-like rule we mean a mechanism similar to a CFC rule. Moreover, the Blueprint published in 2020 contained a rule to enforce the implementation of an IIR in the source state. Such rule was originally called the Undertaxed Payments Rule.[15] The Undertaxed Payments Rule would have functioned similar to an interest-limitation rule, where the deduction of certain expenses is denied if another country does not sufficiently tax the operations of a multinational enterprise. It was only at a later stage when the current design of the UTPR became decisive and finally found its way into the Model Rules. The treaty problems mainly arise in relation to the new form of the UTPR as a tax on foreign profits and not just a denial of deductions. However, so far the OECD has not offered a solution.

On the other hand, at the early stage of the project the OECD was of the opinion that the implementation of the IIR indeed required a treaty amendment.[16] It was in particular highlighted that the IIR could lead to a situation in

13 On this topic, see Sjoerd Douma, Alexia Kardachaki, Georg Kofler, et al. The UTPR and International Law: Analysis from Three Angles. *Tax Notes International*, 15 May 2023, p.857 et seq. (p.870 et seq.).

14 For details see Sjoerd Douma, Alexia Kardachaki, Georg Kofler, et al. The UTPR and International Law: Analysis from Three Angles. *Tax Notes International*, 15 May 2023, p.857 et seq. (p.871).

15 OECD (2020). *Tax Challenges Arising from Digitalisation — Report on Pillar Two Blueprint: Inclusive Framework on BEPS*, https://doi.org/10.1787/abb4c3d1-en. See abbreviation "Blueprint".

16 See OECD (2020). *Tax Challenges Arising from Digitalisation — Report on Pillar Two Blueprint: Inclusive Framework on BEPS*, https://doi.org/10.1787/abb4c3d1-en, para. 9 and 455.

which the income of a foreign permanent establishment is subject to corporate income taxation in the jurisdiction of the head office although the treaty might contain the exemption method for the income of permanent establishments. This also reflects a long-standing opinion of the OECD; for instance, it was also argued in the final report on BEPS Action 3 that CFC rules — depending on the design — might require an amendment of tax treaties.[17] The OECD has not officially changed its opinion. Nevertheless, it seems that no efforts are currently being made to find a multilateral solution to facilitate the implementation of these switch-over rules into the global treaty network. Countries are left with significant risks of infringing treaty obligations triggering costly and yearlong disputes.

5. What Does That Mean for Countries?

Countries follow different approaches regarding the applicability of treaty-based rules in case there is an infringement through national law. In some countries treaty overrides are possible, meaning that the domestic law is applicable even if it infringes tax treaties. Therefore, the IIR and the UTPR would apply even if a treaty infringement is observed. In my own country Switzerland, however, treaties in general prevail. Therefore, Switzerland — although it might indeed implement the IIR and the UTPR — will not be able to apply either of them. Respectively, it might apply the IIR or the UTPR but it seems likely that some companies will appeal against both the IIR and the UTPR. This creates a lot of uncertainty in the next couple of years.

The situation is even more complex in the EU as the EU requires the implementation of the global minimum tax through an EU Directive.[18] Therefore, a conflict arises between an EU Directive (so-called secondary law) and tax treaties signed among EU member states or with third countries outside the EU. Such conflict is difficult to solve and depends on various parameters.[19]

6. Conclusion

The global minimum tax is not only a major compliance challenge for multinational enterprises, but also leads to legal uncertainty and calls into question the binding effect of double taxation agreements in general. We should not underestimate the latter effect.

The current Model Rules undermine the common and years-old understanding of tax treaties as an instrument limiting taxing rights mainly for the source state but in some instances also for the resident state. By implementing these rules, a Pandora's box has been opened and it will be difficult to argue in the future that double taxation agreements actually restrict some taxing rights. In the meantime, however, it seems very likely that several courts around the world will have to deal with the questions raised in the present contribution. The OECD on the other side would do well to eliminate this legal uncertainty by means of an international treaty enabling countries to apply both the IIR and the UTPR.

States on the other hand would do well not to sacrifice their rule of law through the narrow-minded introduction of both the IIR and the UTPR without solving the tax treaty concerns. Switzerland, a country with a long tradition of legislating in accordance with international obligations, is well-advised to carefully assess the benefits of introducing both the IIR and the UTPR, given the significant disadvantages that may arise from the resulting legal uncertainties.

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17 See OECD (2015). *Designing Effective Controlled Foreign Company Rules, Action 3: 2015 Final Report*, https://doi.org/10.1787/9789264241152-en, para. 137.

18 See *Council Directive (EU) 2022/2523 of 14 December 2022 on Ensuring a Global Minimum Level of Taxation for Multinational Enterprise Groups and Large-Scale Domestic Groups in the Union*, https://eur-lex.europa.eu/eli/dir/2022/2523/oj.

19 For a detailed assessment both of the legal problem and the potential solution Mees Vergouwen (2024). Conflicts Between Directives and Tax Treaties: Which Obligation Takes Precedence? Three Perspectives. 33 *EC Tax Review* 4, p.1 et seq.