

**Via email**

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**Comments to Public Consultation Document: *Global Anti-Base Erosion Proposal ("GloBE") - Pillar Two***

Dear Achim,

On behalf of the Institute for Tax Law of the Katholieke Universiteit Leuven (Belgium) and the Tax Policy Center ([www.unil.ch/taxpolicy](http://www.unil.ch/taxpolicy)) of the University of Lausanne (Switzerland), we are pleased to attach herewith our comments relating to the *Global Anti-Base Erosion Proposal ("GloBE") - Pillar Two*.

We appreciate the opportunity to provide these comments. As a matter of principle, we fully and strongly support the efforts of the Inclusive Framework on BEPS to arrive at a multilateral consensus in this area.

We would be glad to attend the public consultation and present the views expressed in the attached document.

Yours sincerely,

Prof. Dr. Luc De Broe

Prof. Dr. Robert J. Danon

Prof. Dr. Vikram Chand

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## 1. Structure of our comments<sup>1</sup>

1. The present submission is composed of seven sections. We begin with some introductory remarks and general policy considerations (2). Next, we turn to the scope of the GloBE proposal (3), the issue of blending (4) and carve-outs (5). Finally, sections 6 and 7 are dedicated to the compatibility of the proposal from a tax treaty and European law perspective (7).

## 2. Introductory remarks and general policy considerations

2. The GloBE Proposal<sup>2</sup> seeks to allocate additional fiscal revenues to the jurisdiction of the ultimate parent of the MNE Group or, as a back up measure, to market countries when the effective tax rates fall below a minimum rate.
3. Technically, the proposal would first of all be put into effect by an income inclusion rule on which the present submission primarily focuses. This rule would allow residence countries to tax the income of a foreign branch or a controlled entity if that income was subject to tax at an effective rate that is below a minimum rate.<sup>3</sup> It is obvious that this part of the GloBE proposal is inspired from the US global intangible low-taxed income rules ("GILTI")<sup>4</sup>. By mirrored policy, a so-called "switch-over-rule" would be introduced into tax treaties with a view to

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<sup>1</sup> The authors are grateful to the members of the research team of the Tax Policy Center of the University of Lausanne dedicated to Pillar One and Two, in particular to Mr. Lionel Reboh and Mr. Benjamin Malek for their help in selecting the various sources relating to the preparation of this submission and as regards the editing

<sup>2</sup> OECD, *Global Anti-Base Erosion Proposal ("GloBE") - Pillar Two*, Public consultation document, 8 November – 2 December 2019.

<sup>3</sup> OECD, *Global Anti-Base Erosion Proposal*, *supra* n. 2, at para. 5.

<sup>4</sup> See Section 951A US Internal Revenue Code. Also see Internal Revenue Service, *Guidance Related to Section 951A (Global Intangible Low-Taxed Income) and Certain Guidance Related to Foreign Tax Credits*, June 21<sup>st</sup> 2019 available on <https://www.federalregister.gov/documents/2019/06/21/2019-12437/guidance-related-to-section-951a-global-intangible-low-taxed-income-and-certain-guidance-related-to>

allow states applying the exemption method<sup>5</sup> to switch to the credit method where profits attributable to a foreign permanent establishment or derived from immovable property are insufficiently taxed by the source state.<sup>6</sup>

4. From the perspective of the source State, the proposal would entail the introduction of an under-taxed payments rule operating by way of a denial of a deduction or imposition of source-based taxation (including withholding tax) for a payment to a related party if that payment is not subject to tax at or above a minimum rate in the hands of the recipient.<sup>7</sup> Finally, the latter rule would also be complemented by a subject to tax rule allowing the source state to deny (or adjust) treaty benefits on such payments.<sup>8</sup>
5. In light of the foregoing, the order of priority of these rules arises. In our view, the income inclusion rules applying at the level of the State of residence should be given priority. Of course, in a multi tiers corporate structure, rules neutralizing possible double taxation cases should also be provided.
6. The GloBE proposal is at tension with the policy agreed and implemented so far by the OECD/G20 BEPS initiative. This policy indeed seeks to reunite income with substantial activities,<sup>9</sup> but at the same time, recognizes that each state is free to set its own tax rates. This policy has in particular been implemented by BEPS Actions 8-10 which provide detailed guidance on the concept of control over risk or

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<sup>5</sup> Art. 23(A) OECD MC.

<sup>6</sup> OECD, *Global Anti-Base Erosion Proposal*, *supra* n. 2, at para. 5.

<sup>7</sup> OECD, *Global Anti-Base Erosion Proposal*, *supra* n. 2, at para. 5.

<sup>8</sup> OECD, *Global Anti-Base Erosion Proposal*, *supra* n. 2, at para. 5.

<sup>9</sup> V. Chand, *Allocation of Taxing Rights in the Digitalized Economy: Assessment of Potential Policy Solutions and Recommendation for a Simplified Profit Split Method?* 47 (12) *Intertax*, 2019, pp. 1023-1026. Also see K. Ming Ho, C. Turley, *GloBE – Overriding the Value Creation Principle as Lodestone of International Tax Rules?*, 47 (12) *Intertax*, 2019, pp. 1070-1073.

DEMPE activities<sup>10</sup> and, of course, by BEPS Action 5 relating to harmful tax practices and *inter alia* the introduction of a so-called "*modified nexus approach*" for IP regimes.<sup>11</sup> In particular, the final report on BEPS Action 5 notes that: "*The work on harmful tax practices is not intended to promote the harmonisation of income taxes or tax structures generally within or outside the OECD, nor is it about dictating to any country what should be the appropriate level of tax rates. Rather, the work is about reducing the distortionary influence of taxation on the location of mobile financial and service activities, thereby encouraging an environment in which free and fair tax competition can take place.*"<sup>12</sup>

7. As we understand it, the GloBE proposal, if it were to be implemented strictly, would entail a departure from this initial policy in that GloBE would focus on no or low taxation of mobile income irrespective of the existence of substantial activities. It is submitted that such a new policy would alter the consistency of the BEPS initiative which has just been implemented, would be difficult to reconcile with the principle of proportionality and, as discussed in this submission<sup>13</sup>, would raise compatibility issues from a European law perspective.
  
8. Therefore, we welcome that the Programme of Work calls for the exploration of carve-outs, including for regimes compliant with the standards of BEPS Action 5 and, more generally, other substance-based carve-outs.<sup>14</sup> This issue, which is discussed below,<sup>15</sup> would in particular be relevant if, contrary to the opinion advocated in this

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<sup>10</sup> OECD, *Aligning Transfer Pricing Outcomes with Value Creation, Revised Guidelines on Action 8-10*, OECD/G20 Base Erosion and Profit Shifting Project, (OECD Publishing, Oct. 2015).

<sup>11</sup> OECD, *Countering Harmful Tax Practices More Effectively, Taking into Account Transparency and Substance, Action 5 - 2015 Final Report*, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris, 2015. For a critical discussion see among others Danon R., *Cahiers de droit fiscal international, Tax Incentives on Research and Development (R&D)*, 2015 (General Report), n°100a, p. 51 et seq

<sup>12</sup> OECD, *supra* n. 11, at para. 3

<sup>13</sup> See below section 7.

<sup>14</sup> OECD, *Global Anti-Base Erosion Proposal*, *supra* n. 2, at para. 74.

<sup>15</sup> See below section 5.

submission which favors a worldwide blending, the GloBE proposal was to be implemented by an entity or jurisdictional blending.<sup>16</sup>

9. In light of the need to coordinate the GloBE proposal with the existing measures introduced by the BEPS initiative (in particular in relation to the value creation pillar), we would also find it desirable to conduct an impact assessment of such measures before taking a final stand on the terms of the GloBE proposal.
  
10. The consultation document notes that: "*The GloBE proposal is based on the premise that, in the absence of a co-ordinated and multilateral solution, there is a risk of uncoordinated, unilateral action, both to attract more tax base and to protect existing tax base, with adverse consequences for all jurisdictions*".<sup>12</sup> We would agree but would then take it that the enactment of the GloBE proposal would be closely coordinated with or possibly switch off existing unilateral measures adopted by states in this area. Such necessary coordination would concern both residence and source countries. Let us for example bear in mind that BEPS Action 3 relating to CFC regimes which is not a minimum standard has not resulted into a unified approach in this area<sup>17</sup>. The same holds true within the European Union in which ATAD I has only resulted in a limited degree of harmonization and, therefore, has been described as potentially inducing a fragmentation of the internal market<sup>18</sup>. A similar outcome would clearly not be desirable in the context of the GloBE proposal.

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<sup>16</sup> See below thereupon section 4.

<sup>17</sup> OECD, *Designing Effective Controlled Foreign Company Rules, Action 3 - 2015 Final Report*, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris, 2015.

<sup>18</sup> See thereupon Danon R., *La règle sur les sociétés contrôlées de la directive européenne anti-évasion fiscale : analyse critique et impact pour la Suisse*, in IFF Forum für Steuerrecht, 2016, pp. 286-319.

### 3. Scope

11. We believe that the GloBE proposal would need to be as neutral as possible and should apply to all MNEs across the board.
12. This being said, it would be desirable for the new rules to apply only to MNE Groups that exceed a certain consolidated revenue threshold<sup>19</sup>. From an efficiency perspective (compliance costs) this would in particular make sense. For example, a possible threshold could be Euro 750 Million that is similar to the threshold set in the Country by Country Reporting (CBCR) standard<sup>20</sup>. This threshold, although used in a different context, was also indicated in the Pillar I proposal<sup>21</sup> and is also found in proposals with respect to digital service taxes (or DSTs) proposed either by the European Union<sup>22</sup> or some countries such as Austria<sup>23</sup>, Spain<sup>24</sup>, France<sup>25</sup>, Italy<sup>26</sup> and New Zealand<sup>27</sup>. The UK<sup>28</sup> uses a comparable threshold of GBP 500 Million.

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<sup>19</sup> OECD, *Global Anti-Base Erosion Proposal*, *supra* n. 2, at para. 75.

<sup>20</sup> OECD, *Transfer Pricing Documentation and Country-by-Country Reporting, Action 13 - 2015 Final Report*, OECD/G20 Base Erosion and Profit Shifting Project (OECD Publishing, Oct. 2015).

<sup>21</sup> OECD, *Secretariat Proposal for a "Unified Approach" under Pillar One*, OECD/G20 Base Erosion and Profit Shifting Project (OECD Publishing, October 2019), at para. 20.

<sup>22</sup> European Commission, *Proposal for a Council Directive on the Common System of a Digital Services Tax on Revenues Resulting from the Provision of Certain Digital Services*, COM(2018) 148 final, 2018/0073(CNS), (21 Mar. 2018).

<sup>23</sup> Austria: *Digitalsteuergesetz 2020 (132/ME)*, Art. 1, para 2.

<sup>24</sup> Spain: *Proyecto de Ley del Impuesto sobre Determinados Servicios Digitales*, Art. 8.

<sup>25</sup> France: *LOI n° 2019-759 du 24 juillet 2019 portant création d'une taxe sur les services numériques et modification de la trajectoire de baisse de l'impôt sur les sociétés*, *ad Art. 299, §III*.

<sup>26</sup> Italy: *Bilancio di previsione dello Stato per l'anno finanziario 2019 e bilancio pluriennale per il triennio 2019-2021*, n. 36, p. 8.

<sup>27</sup> NZ: *New Zealand Government, Options for Taxing the Digital Economy – a Government Discussion Document*, (June 2019).

<sup>28</sup> UK: *Draft Legislation on the New Digital Services Tax*, p. 4.

#### 4. Blending: World-wide vs Jurisdictional vs Entity Approach

13. In order to determine the effective tax rates, the public consultation document puts forward three approaches viz., a worldwide blending approach, a jurisdictional blending approach and an entity by entity blending approach<sup>29</sup>.
14. In our opinion, the worldwide blending approach,<sup>30</sup> at least from a conceptual standpoint, seems to be the simplest approach. Also, this approach, intuitively, seems to entail low compliance costs for tax administrations and MNE Groups.<sup>31</sup> Further, the approach seems to reduce the volatility in effective tax rates that are attributable to temporary differences.<sup>32</sup> Moreover, issues concerning income allocation between branch and head offices<sup>33</sup> as well as transparent entities<sup>34</sup> become less onerous under this approach. Furthermore, issues concerning crediting taxes<sup>35</sup> as well as treatment of intra group dividends<sup>36</sup> become less problematic under this approach. All these parameters indicate that the worldwide blending approach would reduce administrative complexity and the compliance burden in comparison to the other approaches. Thus, at this stage and for the

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<sup>29</sup> OECD, *Global Anti-Base Erosion Proposal*, *supra* n. 2, at para. 55.

<sup>30</sup> It is also our understanding the US follows a similar approach with respect to its GILTI provisions. In fact, the US Senate Committee states: “*The Committee believes that calculating GILTI on an aggregate basis, instead of on a CFC-by-CFC basis, reflects the interconnected nature of a U.S. corporation's global operations and is a more accurate way of determining a U.S. corporation's global intangible income*”. See Committee on the Budget of United States Senate, *Committee Recommendations Pursuant to H.Con. Res. 71*, available on <https://www.govinfo.gov/content/pkg/CPRT-115SPRT27718/pdf/CPRT-115SPRT27718.pdf>. Also, see M.Herzfeld, *What the OECD Can Learn From the GILTI Regime*, available on <https://www.taxnotes.com/featured-analysis/what-oecd-can-learn-gilti-regime/2019/01/11/291qz>

<sup>31</sup> OECD, *Global Anti-Base Erosion Proposal*, *supra* n. 2, at para. 56.

<sup>32</sup> OECD, *Global Anti-Base Erosion Proposal*, *supra* n. 2, at paras. 60-61.

<sup>33</sup> OECD, *Global Anti-Base Erosion Proposal*, *supra* n. 2, at para. 64.

<sup>34</sup> OECD, *Global Anti-Base Erosion Proposal*, *supra* n. 2, at para. 67.

<sup>35</sup> OECD, *Global Anti-Base Erosion Proposal*, *supra* n. 2, at para. 68.

<sup>36</sup> OECD, *Global Anti-Base Erosion Proposal*, *supra* n. 2, at para. 71.



foregoing reasons, we express a preference for this approach.

## 5. Carve-outs

15. The consultation document reiterates that the Programme of Work calls *inter alia* for the exploration of carve-outs, including for (i) a return on tangible assets (ii) regimes compliant with the standards of BEPS Action 5 on harmful tax practices, and (iii) other substance-based carve-outs.<sup>37</sup> The existence of such carve-outs would be in particular relevant if, contrary to our opinion supporting a worldwide blending, an entity or jurisdictional approach were to be favored.
16. In our opinion, a carve out for a return on tangible assets would certainly make sense from a policy perspective. The discussion on the need to carve out regimes compliant with BEPS Action 5 (in particular IP regimes compliant with the modified nexus approach) is not entirely new and arose already in relation to BEPS Action 3 and CFC regimes.
17. At the time, one of the authors of this submission,<sup>38</sup> with whom we are in agreement, had already argued that IP income falling within the scope of the modified nexus approach should not be caught by a CFC legislation. A number of reasons were put forward to justify this conclusion. First of all, the modified nexus approach, which is inspired from R&D input incentives, is a proportionate approach linking IP income to R&D activities<sup>39</sup> conducted by the taxpayer (subjective approach applying within the European Union) or locally (territorial approach).<sup>40</sup> Therefore, the decisive importance given to the substantial activity criterion for the purpose of tackling harmful tax

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<sup>37</sup> OECD, *Global Anti-Base Erosion Proposal*, *supra* n. 2, at para. 74

<sup>38</sup> Danon R., *Cahiers de droit fiscal international, Tax Incentives on Research and Development (R&D)*, 2015 (General Report), n°100a, p. 51 et seq.

<sup>39</sup> Technically to R&D expenditures used as a proxy.

<sup>40</sup> Subject to the 30% uplift.

competition has entailed an increased convergence with CFC rules in the sense that in both areas the focus is on the nexus of an item of income with a substantial activity. For this reason, therefore, the modified nexus already addresses concerns raised by CFC regimes. Secondly, from a policy perspective, if a CFC regime may pick up income falling within the scope of a modified nexus compliant IP regime, this would essentially mean that the revenues forgone by a state to promote R&D activities through a substantial activity-based incentive could simply be taxed away by another state. At the same time, however, this connection between BEPS Action 5 and 3 was not formally established (also partly because BEPS Action 3 merely introduces best practices).

18. We of course appreciate that the GloBE proposal pursues different policy objectives. However, such proposal should not alter the consistency of the existing BEPS outcome. Therefore, we submit that the foregoing argument remains fully valid in the context of the GloBE Proposal. In addition, carving out regimes compliant with BEPS Action 5 (in particular IP regimes) would ensure the consistency of the GloBE Proposal with the existing BEPS outcome. Finally, a carve out for regimes compliant with BEPS Action 5 would be easy to administer and promote tax certainty as such regimes are now well delineated and monitored.
19. This being said, as discussed below, a more general carve-out would also need to be foreseen in order to ensure the compatibility of the GloBE proposal with European law.<sup>41</sup>

## **6. Compatibility with Tax Treaty Law**

20. The income inclusion rule could trigger compatibility issues with tax treaty law, in particular, Article 7 OECD MC which deals with business

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<sup>41</sup> See section 7 below.

income, Article 9 OECD MC relating to associated enterprises, Article 10(5) OECD MC pertaining to taxation of undistributed profits as well as Article 21 which deals with other income.<sup>42</sup> This being said, since 2003, the OECD Commentary clearly states that CFC rules do not conflict with tax treaty obligations.<sup>43</sup> In several jurisdictions, courts decisions have also confirmed this position.<sup>44</sup> Therefore, it may be assumed that the same conclusion would apply to the income inclusion rule contemplated by the GloBE Proposal.

21. The base eroding payments rule that denies a deduction to the payor, if applicable only for payments made to non-residents, could also trigger compatibility issues with tax treaty law. Specifically, issues could arise with respect to compatibility with Article 9 OECD MC with deals with associated enterprises and the non discrimination provisions<sup>45</sup> viz., Article 24(4) OECD MC which deals with deduction non-discrimination<sup>46</sup> and Article 24(5) which deals with ownership non-discrimination.<sup>47</sup>
22. In order to avoid potential conflicts, we would recommend that a provision (safeguard clause) be inserted by States into their tax treaty policy (bilaterally or, preferably, through a multilateral instrument).

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<sup>42</sup> For a detailed discussion on this matter, see L. De Broe, *International Tax Planning and Prevention of Abuse*, Vol. 14 – Doctoral Series, IBFD, Amsterdam, 2008, pp. 575-652. Also see V. Chand, *The Interaction of Domestic Anti-Avoidance Rules with Tax Treaties (with special references to the BEPS project)*, Tax Policy Series, Geneva/Zurich 2018, Schulthess, Chapter 18.

<sup>43</sup> OECD Model Tax Convention (2017): Commentary on Article 1, para. 81; Article 7, para. 14; Article 10, para. 37.

<sup>44</sup> For an extensive discussion of case law on this matter, see L. De Broe, *International Tax Planning and Prevention of Abuse*, supra n. 42 and V. Chand, *The Interaction of Domestic Anti-Avoidance Rules with Tax Treaties*, supra n. 42.

<sup>45</sup> For an extensive discussion of this matter, see L. De Broe, *International Tax Planning and Prevention of Abuse*, supra n. 42, pp. 500-566 and V. Chand, *The Interaction of Domestic Anti-Avoidance Rules with Tax Treaties*, supra n. 42, pp. 314-360.

<sup>46</sup> OECD Model Tax Convention (2017): Commentary on Article 24, para. 74.

<sup>47</sup> OECD Model Tax Convention (2017): Commentary on Article 24, para. 79.

The new provision would expressly authorize the application of the income inclusion rule and the base eroding payments provision.<sup>48</sup>

## **7. Compatibility with EU Law**

### **7.1. The State of play of EU law in the area of the prevention of tax avoidance**

23. For the discussion below, we assume that the Member States of the European Union that are also members of the Inclusive Framework (“IF”), would enact under their domestic laws the rules adopted by the IF under the GloBE-project and that the EU itself would not take a coordinated action by way of a Directive.<sup>49</sup> Any actions of the Member States must be in accordance with the requirements imposed on such Member States by the rules on the fundamental freedoms under the Treaty on the Functioning of the European Union (“TFEU”). Although this question is not specifically discussed in the present submission, let us also bear in mind that compliance with primary European Union law naturally also extends to State aid rules.<sup>50</sup> Therefore, the design of the GloBE proposal – including possible carve-outs<sup>51</sup> – would need to comply with State aid rules.<sup>52</sup> Further, any actions of the Member States must also be in line with the obligations imposed on them under secondary EU law, in particular under the direct tax Directives.

<sup>48</sup> V. Chand, *The Interaction of Domestic Anti-Avoidance Rules with Tax Treaties*, *supra* n. 42, Chapter 23.

<sup>49</sup> We believe that the principle of subsidiarity may prevent the EU Council from taking action by means of a Directive in this area which in our view belongs to the exclusive competence of the Member States.

<sup>50</sup> Art. 107 et seq. TFEU.

<sup>51</sup> On the need to provide for a carve-out to ensure compliance with fundamental freedoms, see below N. 29 et seq.

<sup>52</sup> See for example thereupon and in a different context : Commission decision of 2 April 2019 on the State aid SA.44896 implemented in the United Kingdom concerning CFC Group Financing Exemption available at : [https://ec.europa.eu/competition/state\\_aid/cases1/201929/271690\\_2063757\\_139\\_2.pdf](https://ec.europa.eu/competition/state_aid/cases1/201929/271690_2063757_139_2.pdf)

24. In that regard it is to be recalled that it is settled case law of the CJEU that each Member State has the sovereign power to organize, in compliance with EU law, its system for taxing profits in so far as these profits come within the jurisdiction of the Member State concerned. Accordingly, each Member State is free to determine the chargeable event of the tax, the tax base and the tax rates on the condition that resident companies are not treated less favourably where they hold shares in companies established in other Member States compared as to where they hold shares in domestic companies, that branches of non-resident companies established in a Member State are not treated less favourably than companies resident in that State, that companies based in other Member States are not treated in a manner that is discriminatory in comparison with comparable resident companies and that cross-border transactions are not treated less favourably than similar domestic transactions.<sup>53</sup> It is equally well-established case law that the loss of tax revenues may not be relied by a Member State as a justification for applying discriminatory tax rules or tax rules that restrict the fundamental freedoms.<sup>54</sup> It has also been decided that tax measures which discriminate against resident taxpayers that have engaged in transactions with taxpayers based in another Member State that enjoy a favourable tax regime there and which aim to retaliate against such a tax regime are incompatible with the fundamental freedoms. In the terms of the CJEU "*such compensatory tax arrangements prejudice the very foundations of the single market*".<sup>55</sup> It

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<sup>53</sup> See e.g. CJEU 17 May 2017, *X v. Ministerraad (Belgium)*, C-68/15, § 41 and the case law cited there. See also Opinion of AG Léger in *Cadbury Schweppes*, C-196/04: § 81: "*The fixing of rates of corporation tax falls, as we have seen, within the unfettered competence of each Member State and Articles 43 EC and 48 EC (now Art. 49 and 54 TFEU) confer on every company in accordance with Article 48 EC the right to set up a subsidiary in the place of its choice within the Union. A Member State may not, therefore, treat differently its resident companies which establish subsidiaries in other Member States depending on the tax rate applicable in the host State*".

<sup>54</sup> CJEU, 21 September 1999, *Saint Gobain*, C- 307/97, § 51; CJEU, 16 July 1998, *ICI*, C-264/96, § 28.

<sup>55</sup> CJEU, 26 October 1999, *Eurowings*, C-294/97, § 44 – 45; CJEU, 26 June 2003, *Skandia*, C-422/01, § 52.

follows, amongst others, that any tax advantage resulting from the low taxation to which a subsidiary established in a Member State other than the one in which the parent company is incorporated cannot by itself authorise the latter Member State to turn off that advantage by a less favourable tax treatment of the parent company had it not set up a subsidiary abroad.<sup>56</sup> Likewise, a Member State cannot levy compensatory taxes against a resident taxpayer because it has used the services of a provider established in another Member State where the service payments enjoy a favourable tax treatment.

25. A Member State may only apply discriminatory or restrictive tax rules if such rules are justified by a limited number of justification grounds, in particular the need to prevent tax avoidance (sometimes in combination with the need to preserve the balanced allocation of taxing powers between Member States<sup>57</sup>). However, where a justification ground is present, anti-avoidance and anti-base erosion measures need to comply with the general EU law principle of proportionality. It follows that the measures must be suitable to achieve the objective of the prevention of tax avoidance and do not go beyond what is necessary to achieve that goal. General and irrebuttable presumptions of tax avoidance based on the fact that a subsidiary is based in a Member State where it benefits from a low rate of tax or from an advantageous tax regime (e.g. offered to activities of a passive nature) or that the recipient of the income enjoys a favourable tax regime in its State of residence or that the activities carried on abroad are of a passive nature, are therefore systematically condemned by the CJEU for failing to meet the principle of

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<sup>56</sup> CJEU, 12 September 2006, *Cadbury Schweppes*, C-196/04: § 49.

<sup>57</sup> The justification based on the preservation of the balanced allocation of taxing powers is accepted where the measure is designed to prevent conduct of a taxpayer that is capable of jeopardising the right of a Member State to exercise its taxing powers on profits realised in connection with activities carried on in its territory (CJEU, 13 December 2005, C-446/03, § 45, CJEU, 29 March 2007, *Rewe Zentralfinanz*, C-347/04, § 42). When the taxpayer carries on genuine commercial or industrial activities in Member States and such activities are remunerated by an arm's length compensation, such justification is not applicable.

proportionality.<sup>58</sup> This explains why the CJEU has held at several occasions that a national measure restricting the fundamental freedoms may only be justified by the need to prevent tax avoidance (and/or the need to ensure the balanced allocation of taxing powers between the Member States) where it specifically targets wholly artificial arrangements which do not reflect economic reality and the purpose of which is to avoid the tax normally payable on the profits generated by activities carried out in the territory of the Member State concerned.<sup>59</sup> The CJEU has held that the performance by a subsidiary of trading activities excludes the existence of a wholly artificial arrangement which has no real economic link with the host Member State. It also decided that application of controlled foreign company-legislation should be excluded where the subsidiary reflects economic reality. Such is the case where the incorporation of the subsidiary corresponds to an actual establishment which carries on genuine economic activities in the host Member State, regardless of whether the tax regime of that Member State is more beneficial than the one applicable in the Member State of the parent company.<sup>60</sup>

## **7.2. Application to the measures proposed under GloBE**

### **7.2.1. The income inclusion-rule**

26. According to the GloBE proposal, the income inclusion-rule would tax the income of a foreign branch or controlled entity in the hands of the

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<sup>58</sup> CJEU, 26 October 1999, *Eurowings*, C-294/97, § 43 – 45; CJEU, 12 September 2006, *Cadbury Schweppes*, C-196/04: § 50 and more recently CJEU, 7 September 2017, *Eqiom*, C-6/16, § 31; CJEU, 26 February 2019, *X GmbH v. Finanzamt Stuttgart*, C-135/17, § 85 – 86.

<sup>59</sup> CJEU, 12 September 2006, *Cadbury Schweppes*, C-196/04: § 51 and 55; CJEU, 13 March 2007, *Thin Cap GLO*, C-524/04, § 72 and 74; CJEU, 3 October 2013, *Itelcar*, C-282/12, § 34; CJEU, 26 February 2019, *X GmbH v. Finanzamt Stuttgart*, C-135/17, § 72 – 73.

<sup>60</sup> CJEU, 12 September 2006, *Cadbury Schweppes*, C-196/04: § 61 and 65 - 66.

parent company<sup>61</sup> if that income is subject to tax in the State where that branch or controlled entity is established at an effective tax rate that is below a minimum rate [level to be determined]. Such a rule undermines the sovereign rights of the Member State to freely develop their fiscal policy according to the economic realities and revenue needs proper to each Member State. In particular it interferes significantly with the rights of the Member States to determine the tax base of and the rate at which entities established there are to be taxed. As it aims to recoup the tax advantages enjoyed by the multinational group of companies outside the State of residence of the parent, it raises very serious concerns from an EU law perspective.

27. The rule has quite some similarities with CFC-legislation as it permits the State of residence of the company controlling the subsidiary or branch to tax on a current basis the undistributed profit of a subsidiary or branch where it has not been subject to a sufficient level of tax in the State of residence of the subsidiary or branch. Unlike a CFC-regime where the profit of the subsidiary or branch is taxed at the domestic corporate tax rate of the State of residence of the parent company (eventually with a foreign tax credit), under the GloBE proposal tax in the State of residence of the parent company on the tainted income of its subsidiaries or branches would operate as top up to achieve a minimum rate of tax.
28. However, like under CFC-legislation, the effect of the GloBE proposal is that the undertaxed undistributed profit of subsidiaries or branches based in other Member States are subject to the top up tax in the State of residence of the parent company. Therefore, the income inclusion rule would - just like the CFC-legislation at stake in the above mentioned judgments re *Cadbury Schweppes* and *X GmbH* - discriminate against parent companies that have set up subsidiaries or branches in other Member States the profit of which is subject to an

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<sup>61</sup> Where a foreign branch is involved, we assume the tax will be assessed against the head office of the company. Any further reference to "parent company" includes a reference to the head office of companies owning foreign branches.



effective tax rate which is below the set minimum rate. As explained above, such a fact cannot in all circumstances be regarded as abusive or result in a shift of taxable base from one Member State to another and therefore the income inclusion-rule will not be able to be justified on grounds of prevention of abusive tax practices or the balanced allocation of taxing powers because it violates the principle of proportionality. It follows that the rule can only be applied to companies with branches or subsidiaries within the European Union without infringing the freedom of establishment if it targets wholly artificial arrangements.<sup>62</sup>

29. Accordingly, a carve out needs to be foreseen, like is currently the case for the CFC-legislation adopted under Art. 7 (2) (a) of the EU Anti Tax Avoidance Directive, for subsidiaries and branches established in another Member State that carry out genuine commercial activities by means of staff, assets and premises. If such a carve out is provided, the possible inconsistency of the OECD's approach with regard to patent box regimes which comply with the modified nexus-approach and therefore do not engage in harmful tax competition would also be removed as the relevant companies are actually engaged in R&D-activities and carry on the necessary DEMPE-functions and assume the risks associated therewith. Such a carve out would also assure that the GloBE-proposal becomes again consistent with the basic underlying

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<sup>62</sup> We assume that only controlled entities would come into scope of the income inclusion rule (e.g. shareholding of 25% or more) so that the rule needs to be tested against the requirements imposed by the freedom of establishment. If, however, the rule would apply to shareholdings below that percentage, the rule could come within the scope free movement of capital and then also apply to profits of companies based in third countries (CJEU, 26 February 2019, *X GmbH v. Finanzamt Stuttgart*, C-135/17). The CJEU added however that in the framework of the free movement of capital, the term wholly artificial arrangement covers any scheme which has as its primary objective or one of its primary objectives the artificial transfer of profit made by way of activities carried on in the territory of a Member States to third countries with a low tax rate (§84). As regards the application of CFC rules and income inclusion rules in the context of free movement of capital, see inter alia Danon R., *Some Observations on the Carve-Out Clause of Article 7(2)(a) of the ATAD with Regard to Third Countries*, in Pistone/Weber (ed), *The Implementation of Anti-BEPS Rules in the EU: A Comprehensive Study*, chap. 17, IBFD, 2018.

principle of the BEPS Actions 1 to 15, i.e. achieving that taxes are paid where value is created, while at the same time tackling remaining BEPS issues.

30. The argument that the income inclusion-rule does not discriminate against companies that have exercised their freedom of establishment as the rule would also apply to companies owning domestic branches and subsidiaries, is not convincing.<sup>63</sup> The extension of the rule to domestic situations is quite pointless and would be an act of bad tax policy as there is only a very remote or no risk of undertaxed profit in a domestic situation.<sup>64</sup> In all likelihood, branches and subsidiaries established in the same Member State as the company owning them would not benefit from favourable tax regimes because, if they were, such regimes would constitute harmful tax practices and/or illegal state aid and be in breach of BEPS or the TFEU on such ground. Accordingly, for all practical purposes the income inclusion-rule will only or predominantly apply to cross-border investments and thus discriminate against companies that have exercised their freedom of establishment. The CJEU has held that tax rules of a Member State which in the large majority of cases reserve a different treatment to

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<sup>63</sup> That would still not prevent the rule from discriminating between domestic companies that own subsidiaries in "normal" tax jurisdictions and those that own subsidiaries in "low" tax jurisdictions. The rule would breach the freedom of establishment on that ground alone as it accelerates the payment of the tax on the profits of a low taxed subsidiary, while tax on profits of a normally taxed subsidiary would be deferred until actual distribution to the parent company (see CJEU, 12 September 2006, *Cadbury Schweppes*, C-196/04, § 44 - 45).

<sup>64</sup> AG Geelhoed already criticised in very clear terms the extension of anti-abuse measures to domestic situations where no potential risk of abuse exists: "*Nor am I of the view that, in order to conform with Article 43 EC (now Art. 49 TFEU), Member States should necessarily be obliged to extend thin cap legislation to purely domestic situations where no possible risk of abuse exists. I find it extremely regrettable that the lack of clarity as to the scope of Article 43 EC justification on abuse grounds has led to a situation where Member States, unclear of the extent to which they may enact prima facie 'discriminatory' anti-abuse laws, have felt obliged to 'play safe' by extending the scope of their rules to purely domestic situations where no possible risk of abuse exists. Such an extension of legislation situations falling wholly outwith its rationale for purely formalistic ends and causing considerable extra administrative burden for domestic companies and tax authorities is quite pointless and indeed counterproductive for economic efficiency. As such, it is the anathema to the internal market*" (Opinion of AG Geelhoed in *Thin Cap GLO*, C-524/04, § 68).

resident taxpayers according to whether or not they have exercised their fundamental freedoms and tax those that have exercised such freedom less advantageously than those that have not, are incompatible with the fundamental freedoms.<sup>65</sup> The CJEU has also held that the TFEU provisions on the freedom of establishment do not only prohibit *de jure* discrimination on the basis of criteria linked with the fact that the company has exercised its fundamental freedoms but also *de facto* discrimination based on another objective criterion which in practical terms results in the majority of cases in a less favourable tax treatment for those companies that have exercised their freedoms.<sup>66</sup> In the case at hand, such other objective criterion would be the fact that the branch or subsidiary has paid insufficient tax in the Member State where it is established and in practical terms such would only be the case where the company owning the branch or subsidiary has exercised its freedom of establishment.

31. Finally, the attention is drawn to the fact that dividends which enjoy the participation exemption under the Parent/Subsidiary Directive and/or domestic rules transposing that Directive and which have not yet been distributed up in the chain of companies cannot be subject to the income inclusion-rule in the hands of the ultimate parent as such would lead to a breach of the rules of the Parent/Subsidiary Directive.<sup>67</sup> Likewise, the attention is drawn to the fact that profits of a subsidiary or branch that have been subject to CFC-legislation in the hands of a controlling company pursuant to the Anti-Tax Avoidance Directive should be excluded from the scope of the income inclusion-rule in the hands of the ultimate parent company otherwise multiple taxation would arise. Alternatively, CFC-legislation should be aborted if the income inclusion-rule is implemented.

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<sup>65</sup> CJEU, 26 October 1999, *Eurowings*, C-294/97, § 36 – 37 and 40.

<sup>66</sup> CJEU, 5 February 2015, *Hervis Sport*, C-385/12, § 37 – 39.

<sup>67</sup> An issue that could be relevant if the income inclusion-rule would not depart from the global consolidated group accounts.

### 7.2.2. **Undertaxed payments-rule**

32. The proposed tax on base eroding payments would operate by way of a denial of the deduction in the hands of the paying entity or the imposition of a source-based taxation (including a withholding tax) for payments to related parties that are not subject to tax at or above the minimum rate in the State of the recipient. Again these rules intend to annihilate the tax advantages offered by the Member State of the recipient of the income. As explained earlier, such offsetting rules undermine the functioning of the internal market and are very problematic from an EU law point of view.
33. A rule that denies the deduction of a cost item only where the payments are made to beneficiaries resident in another Member State would discriminate between payments to domestic and non-domestic beneficiaries and infringe several of the fundamental freedoms (freedom of establishment, freedom of services, free movement of goods and free movement of capital<sup>68</sup>). In this respect it is worth mentioning that the EU has informed the US Treasury that it considered the US BEAT-rules adopted in 2017, which assess supplementary US tax but only on payments to non-US related parties, as being discriminatory and in breach of the provisions of the WTO by which the US is bound.<sup>69</sup> Under EU law, an undertaxed payment rule of the kind discussed here can be justified by the need to prevent tax avoidance and the need to preserve a balanced allocation of taxing powers between the Member States. However, as the proposed rule applies in each instance where the payment would be undertaxed in the State of residence of the recipient, it operates as a general, automatic and irrebuttable presumption of abuse or profit shifting that

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<sup>68</sup> Where the payment would come within the scope of the free movement of capital, a breach of that freedom would also be at stake where the payments are made to beneficiaries in third countries.

<sup>69</sup> Letter of 11 December 2017 from the Finance Ministers of France, Germany, the UK, Italy and Spain to the US Treasury Secretary of State; EU Council Group to Discuss OECD Review of US Tax Reform, *Tax Notes International*, 16 April 2018.

would seriously impact on genuine commercial operations of all kind. It would therefore be a disproportionate infringement of the fundamental freedoms.<sup>70</sup> Again the rule would only be compliant with these freedoms if it provides for a carve out for payments made in respect of genuine flows of goods and capital or in respect of services genuinely performed.<sup>71</sup>

34. As discussed above with respect to the income inclusion-rule, the argument that the discrimination could be removed if the rule would also be applied to payments under domestic transaction is not convincing. It is indeed very doubtful that within a domestic context a risk of tax avoidance and profit shifting of the kind contemplated here would ever be present. Accordingly, even if the rule would apply also to domestic payment made for domestic transactions, the rule would entail a *de facto* discrimination of cross-border transactions which is prohibited under EU law.
35. An undertaxed payment rule that would take the form of a withholding tax to be retained by the payor from the payment made to the non-resident payee where the latter is not sufficiently taxed on that payment, also raises concerns from an EU law perspective. It is clear from the CJEU's case law that the application of a withholding tax as a method of collecting tax from non-resident service providers and financiers, where resident service providers and financiers are not subject to such a tax may constitute a restriction to the freedom to provide services or the free movement of capital (e.g. because of the cash flow disadvantage suffered by the non-resident). However, the CJEU has also held that such a restriction may be justified by the need to ensure the effective collection of the tax from the non-resident.<sup>72</sup>

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<sup>70</sup> CJEU, 5 July 2012, *SIAT*, C-318/10, § 35 – 39.

<sup>71</sup> CJEU, 5 July 2012, *SIAT*, C-318/10, § 40, 42 and § 48. Allowing the taxpayer to prove that such is the case would comply with the judgment in *SIAT* as it would ensure taxpayers that the rule only strikes down abusive practices and would allow the tax authorities to properly exercise their enforcement powers.

<sup>72</sup> CJEU, 13 July 2016, *Brisal and KBC Finance Ireland*, C-18/15, § 21; CJEU, 18 October 2012, *X Football Club*, C-498/10, § 39.

The main discrimination issue with respect to withholding taxes lies in the fact that withholding taxes against non-residents are levied on the gross income derived by the non-resident in the State of source, while resident taxpayers receiving the same type of payments (and are not subject to withholding) pay tax in that State on their net income, i.e. after deduction of related expenses. Such a different treatment between resident and non-resident service providers and financiers could work to the detriment of non-residents (in particular in the financial industry). It is well-established case law that such a different treatment entails a discrimination that breaches the freedom to provide services or the free movement of capital.<sup>73</sup> It follows from that case law that in all instances where the State of source levies tax against non-residents by way of withholding whereas it taxes its residents on net profit-basis, the non-resident taxpayers should have the opportunity to deduct the business expenses that are directly related to the activity performed in the State of source from that State's tax base. Furthermore, the CJEU has recently held that levying withholding tax on distributions of dividends to non-resident companies (that were loss-making in the year the dividend was distributed), whereas resident loss-making companies would not pay corporate tax on the dividend in the year of distribution, infringes the TFEU rules on the free movement of capital.<sup>74</sup> Such implies that the State of source should defer the levy of withholding tax until the non-resident company becomes profitable in its State of residence. Needless to say that such makes a system of withholding tax extremely difficult to administer.

36. Withholding tax rules may also discriminate between non-resident recipients if, under the domestic law of the State of source, residents

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<sup>73</sup> CJEU, 13 July 2016, *Brisal and KBC Finance Ireland*, C-18/15, § 21; CJEU, 15 February 2007, *Centro Equestre*, C-345/04, § 23; CJEU, 3 October 2006, *Scorpio*, C-290/04, § 42, CJEU, 12 June 2003, *Gerritse*, C-234/01, § 29 and 55. Where the payment would come within the scope of the free movement of capital, a breach of that freedom would also be at stake where the payments are made to beneficiaries in third countries.

<sup>74</sup> CJEU, 22 November 2018, *Sofina*, C-575/17.

of one Member State receiving income from that State are subject to a higher withholding tax than residents of another Member State receiving the same income.<sup>75</sup> This is likely to happen in the case at hand. For practical purposes, a withholding tax can only be assessed where the recipient of the payment is subject to a nominal tax rate below the minimum threshold as the paying agent cannot determine the effective tax rate of the recipient at the time the liability for withholding arises. This would mean that the recipient does not suffer withholding tax where it is subject to a nominal tax rate in its State of residence above the minimum threshold even if it pays low corporate tax there because it has eroded its tax base. On the other hand, a recipient that is subject to a nominal tax rate in his State of residence which is lower than the minimum threshold but pays tax on a non-eroded tax base is subject to withholding. Such leads to unequal treatment of taxpayers which are in light of the objective of the undertaxed payment rule (i.e. the withholding tax in the State of source) in a comparable situation.<sup>76</sup> In that case, the relevant TFEU freedom will be infringed and no justification comes to mind to explain this infringement.

37. Finally, we would like to draw your attention to the fact that the levying of withholding taxes could be in breach of the Interest and Royalty Directive. Such would be the case where interest and royalty payments would be made between associated enterprises that are residents of the EU for tax purposes and meet the other conditions set out in the Directive to qualify for withholding tax exemption in the

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<sup>75</sup> CJEU, 24 February 2015, *Sopora*, C-512/13, § 25; CJEU, 11 June 2009, *Commission v. the Netherlands*, C-521/07, § 38 – 39.

<sup>76</sup> Assume that the minimum GloBE-rate is set at 15%. Taxpayer Aco in Member State A is subject to a nominal rate of 12,5%. Aco is subject to withholding in the State of source because the nominal rate in Member State A is below 15%. Aco receives a payment of 100 (net of withholding) which is entirely taxed in MS A. Aco pays an effective tax of 12,5 in Member State A. Taxpayer Bco in Member State B is subject to a nominal rate of 30%. Bco is not subject to withholding in the State of source because the nominal rate in Member State B exceeds 15%. Bco receives a payment of 100, but only 20 of it is taxed in Member State B. Bco pays an effective tax of 6 in Member State B.

State of source.

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