EDITORIAL

The Rule of Law and Rule of Reason in the Aftermath of BEPS

There are many reasons to be concerned about the rule of law in today's world. Its state within the international tax regime should perhaps not be at the top of the agenda for most in this context, yet it should be worrisome to everyone, especially tax people, when the rule of reason seems to be violated even more clearly in the aftermath of the Base Erosion and Profit Shifting (BEPS) Project. It is unprincipled and has been threatening the stability of the international tax regime for a decade, and what is commonly referred to as BEPS 2.0 is no different.

Much (virtual) ink has already been spilled over the insincerity of the Two Pillar program, and certainly much more is left to be said. This editorial wishes to discuss just one angle of the distressing trend of *post factum* justification of a legally questionable program. Pillar Two was born in sin, dictated by Organization for Economic Co-operation and Development (OECD) officials that had only considered the preservation of the dominance of their organization, and adopted opportunistically by a few other dominant economies. It was then sold behind the thinly veiled fig leaf of Pillar One as a *global* agreement to reform the international tax regime. No one has, at this time, any illusion about Pillar One, and many are now willing to explicitly express their disillusionment with the entire Two Pillars program, as did the United Nations in a recent statement.[1] Nonetheless, the EU is pushing the program forward with a few other richest states in the world.

The United States positioned itself awkwardly in this scenario. It could be viewed as the instigator of what is known as the global agreement.[2] Technically, much of Pillar Two is modelled after the United States' Global Intangible Low Tax Income (GILTI) and Base Erosion and Anti-Abuse Tax (BEAT) regimes. The United States further adopted a new corporate minimum tax in summer 2022 that appears to be fashioned after the 'agreed' Pillar Two solution, itself fashioned after the GILTI that had not been repealed in that occasion. None of these regimes are compatible with the global agreement instigated by the United States, yet they all have common features. Alas, the design of Pillar Two is such that it does not tolerate *similar*; it is designed to police everyone into a payment of 15% minimum taxation calculated in precisely the same way. Otherwise, it would be difficult to explain the willingness to tolerate the tremendous complexity that the newly introduced calculations based on financial accounting bring to the regime. The United States is unlikely to replace the said rules with a Pillar Two compatible regime, thus tax experts are urging the world to simply accept the exceptional United States' rules as sufficiently similar.[3] The EU likewise made special agreements with several of its Member States to ensure the unanimous passage of its directive. Such concessions are not available to financially disadvantaged source countries that will be policed into the Pillar Two regime with little input into its design and no power over its implementation regardless of domestic tax policy or political constraints on the path to adopting a Qualified Domestic Minimum Top-up Tax (QDMTT). EU and United States politics matter while those of other countries do not. In this author's view, the entire Two Pillars agreement is tainted and hence morally invalid and practically wasteful. The consequences will be borne in the long run not only by the weaker states but also by the rich states since the current plan is simply unsustainable without genuine global agreement, but perhaps that is simply the world in which we live.

Of particular concern is the casual disregard for international law, including international tax law, even among some of the world's most prestigious tax experts, in the service of a short-term political agenda. A convincing example of this is the recent debate over the compatibility of the Under Taxed Payments Rule (UTPR) with international law and tax treaties. Proponents of the Two

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1 United Nations, Promotion of inclusive and effective international tax cooperation at the United Nations, A/C.2/77/L.11/Rev.1, https://documents-dds-ny.un.org/doc/UNDOC/LTD/N22/697/88/PDF/N2269788.pdf?OpenElement (accessed 3 Feb. 2023).

2 *See* e.g., https://home.treasury.gov/news/press-releases/jy0189 (accessed 3 Feb. 2023).

3 *See* e.g., Reuven S. Avi-Yonah, *Is the United States Already Compliant With Pillar 2?*, 108 Tax Notes Int'l 825 (14 Nov. 2022).

Pillars program have been uniquely offhand with international law norms and particularly with the obligation to negotiate and apply treaties in good faith. Doing so is not only required by the law but also the proper and wise thing to do.[4] As should be evident by now, this author views Pillar Two as an undesirable development that threatens the stability of the international tax regime, yet there is no quarrel with the policy or political perspective of its supporters; it is only with their legal analysis.

The first issue that the UTPR raises is its compatibility with the norms of public international law. The tax is clearly extraterritorial, and it is inherently imposed regardless of a connection between the taxing state and the income it taxes.[5] Recent research has made clear that, limited as it may be, international law requires a *genuine link* between the taxing jurisdiction and the taxed income.[6] This association may be minimal, but one must exist. By definition, there is none in the case of the UTPR. Now, it could be argued that universal anti-tax abuse rules may be adopted and effectively override the genuine link requirement, implying that every jurisdiction has an interest in taxing the income in abusive cases. Such an argument become invalid under serious scrutiny. First, it may perhaps be made when obvious abuse is ascertained which is not the case in the UTPR context. Second, the UTPR may be applied regardless of even a remote connection between the taxing jurisdiction and the taxed income (unlike the case of the Controlled Foreign Corporations (CFC) rules that is often mentioned in support of this argument that are themselves questionable in this circumstance). Reuven Avi-Yonah implicitly attempted to overcome this difficulty by first relying on the link between the UTPR imposing state and the residence state of the ultimate parent and comparing this link to the CFC rules that are prevalent in international taxation.[7] Now, many, including this author, have serious issues with the questionable acceptance of CFC rules as being compatible with tax treaties, yet the case of the UTPR is not comparable to the CFC rules. The state imposing the UTPR has no fundamental connection with the state in which the income arose while, in the case of the CFC rules, as explained by Avi-Yonah himself, there are control relationships that permit a deemed dividend fiction not available for the UTPR. He may argue that the UTPR is a top up tax with respect to the Income Inclusion Rule (IIR) but not the source tax or the QDMTT and hence the link to the residence jurisdiction of the ultimate parent is relevant. This would be an unacceptable stretch of reality, however, since the UTPR is measured by the income of the not sufficiently taxed entity and is alternative to the IIR. Avi-Yonah's second argument in his attempt to overcome the genuine link requirement is that the global agreement somehow grants legitimacy to an extraterritorial tax such as the UTPR. His rhetoric involves a separate debate in which he is involved regarding the status of some parts of the international tax regime as customary.[8] He accuses UTPR critics that they rely on the genuine link doctrine (although not referring to it as such) as if it was customary law, which it is not, and hence the agreement to adopt the UTPR remains valid. Again, focusing only on the UTPR, it is important to realize that the genuine link doctrine is not unique to international tax law and hence cannot be examined as part of the maybe existing customary international tax law; it is a general doctrine of public international law which indeed could be conceded in an explicit and specific agreement among the relevant states (i.e., by treaty). This author's main argument in this editorial is that substantive reforms (especially fundamental reforms such as Pillar Two[9]) require a transparent and clear reform of the law, i.e., a treaty in this case. This is the right thing to do and the only way to ensure the future stability of the regime.

Similar but much more vociferous arguments were made against the claim that the UTPR is incompatible with tax treaties.[10] The automatic response of some United States scholars involved a transparent political stance in support of the Two Pillars program and the Biden Administration that promotes it and in opposition

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[4] *See* e.g., David G. Noren, *Modifying Bilateral Income Tax Treaties to Accommodate Pillar Two UTPR Rules*, 63 Tax Mgmt. Memo. No. 25 348 (5 Dec. 2022) ('Policy makers would be wise to provide for explicit coordination of the UTPR with bilateral income tax treaties, in order to protect the intended operation of both the UTPR and tax treaties, and to avoid the protracted controversies that undoubtedly will arise without better coordination of the UTPR with the existing treaty framework, especially in a world with only mixed uptake of Pillar Two by key jurisdictions'.).

[5] For a more comprehensive analysis, *see* e.g., Jinyan Li, *The Pillar 2 Undertaxed Payments Rule Departs from International Consensus and Tax Treaties*, 105 Tax Notes Int'l 1401 (21 Mar. 2022).

[6] *See* e.g., Stjepan Gadžo, *Acknowledgements in Nexus Requirements for Taxation of Non-residents' Business Income: A Normative Evaluation in the Context of the Global Economy* (IBFD 2018); Peter Hongler, *Justice in International Tax Law* (IBFD 2019); and Philip Baker, *Ch. 11: Some Thoughts on Jurisdiction and Nexus*, in *Current Tax Treaty Issues: 50th. Anniversary of the International Tax Group* 441 (Guglielmo Maisto ed., IBFD 2020).

[7] *See* Reuven S. Avi-Yonah, *The UTPR and the Treaties*, 109 Tax Notes Int'l 45 (2 Jan. 2023).

[8] A debate that, like any reference to custom, is beyond the scope of this editorial.

[9] Again, *see* Li, *supra* n. 5 for a more detailed argument.

[10] For the argument that the UTPR violates tax treaty obligations, *see* e.g., Jefferson VanderWolk, *Much Ado About Pillar 2*, 108 Tax Notes Int'l 821 (14 Nov. 2022); and Noren, *supra* n. 2.

to an unimpressive and similarly politically transparent opposition to the program among some Republican members of Congress. This author opines that the arguments in support of the UTPR demonstrate a worrying disregard to tax treaty law within the tax community.[11] The focus here is on two arguments that are distinctly lawyerly and smart but similarly involve legal gymnastics that may admittedly work in front of politicians, some courts, or the OECD yet should not be acceptable since they could not remedy the harm that Pillar Two would cause to the legitimacy and stability of the international tax regime. The first argument of this type was made by Allison Christians and Steve Shay who stated that the UTPR is not subject to tax treaties basically because it is not an income tax.[12] The authors admit that they think Pillar Two is in the interest of the United States which is a matter that this editorial does not dispute (or discuss) as it focuses only on the technical argument. Ironically, a key part of Christians' and Shay's argument is based on the fact that '(T)he UTPR's relationship to the income of a low-taxed constituent entity that gives rise to the top-up tax consists solely of its affiliation through the MNE group'.[13] This nicely articulates why the UTPR violates the *genuine link* requirement mentioned above. In any event, they explain that it is imposed when a member of an Multinational Enterprises (MNE) group pays less than a 15% tax in a jurisdiction as calculated under the rules of Pillar Two and no IIR is imposed by the residence jurisdiction of the group's parent (UPE). The UTPR is a top-up tax that complements the tax imposed by the source/residence jurisdictions of the relevant (undertaxed) entity. Christians and Shay contend that the UTPR should not be covered by treaty Articles 2 and, in the United States context, should not be creditable[14] because: (1) It is imposed on a resident (subsidiary) or a Permanent Establishment (PE) and therefore is external to tax treaty application. This argument disregards the reality that the UTPR is not imposed on the domestic entity or PE but rather it is collected through them. The calculation of the tax and its mere existence relate to the income of another entity in another jurisdiction and hence could not avoid the application of tax treaties. (2) their second argument is that the UTPR base is not related to the relevant income but is rather imposed on the book income of an entity without a connection to the taxing jurisdiction. They augment this argument by stating that the UTPR will unlikely be creditable in the United States. They attempt to fend a counterargument that the UTPR may be viewed as a tax 'in lieu' of an income tax that is creditable in the United States pursuant to 26 U.S.C. §903. This is a disingenuous argument since the UTPR complements the QMDTT that they themselves admit should be creditable in the United States.[15] How could a top-up tax based on the same basis and calculation be different in nature from the tax it tops up? (3) The third argument is that the rules do not prescribe how the UTPR should be collected. Christians and Shay indeed state that, whatever manner of collection is chosen, the impact would be the same.[16] They argue that this feature makes the tax more akin to excise taxes but, of course, any income tax could be designed as an excise. That was indeed the design of the original (1909) United States corporate income tax. This feature does not make the UTPR not a tax in lieu of an income tax. The brief version of Christians and Shay's argument is that the UTPR is so different from our income tax that it should be viewed as external to the application of tax treaties, but this is equivalently true for the entire Pillar Two. One cannot have her cake and eat it too. Christians and Shay proceed to describe the indeed difficult journey that Pillar Two is likely to face for creditability in the United States. The best analogy in this context would be other minimum taxes. These presented serious difficulties to United States jurisprudence since they do not perfectly fit into the group of creditable taxes, yet, the United States itself has been using minimum taxes for a long time and, in the case of 'friendly' jurisdictions, had to recognize these taxes as creditable.[17] Once these arguments are rejected, it must be concluded that, unless Pillar Two becomes the new Digital Services Tax (DST) and no global agreement supports it, the

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11 This editorial covers only two such arguments due to their technical nature. At least two more notable arguments were made along the same lines. Sol Picciotto expressed support of Pillar Two basically because it introduced formulary taxation that he supports (as does this author) as desirable reform direction for the international tax regime. Alas, this argument is somewhat similar to Avi-Yonah's customary law argument and is not an argument that justifies the UTPR's violations of international law. *See* Sol Picciotto, *Rebutting the Logic of UTPR Skeptics*, 108 Tax Notes Int'l 1371 (12 Dec. 2022). Another argument is similar to the analogy to the CFC rules argument with an extension that Pillar Two is imposed coherently on groups of corporations and is based on a 'use-it-or-lose-it' principle when taxing rights are divided among jurisdictions based on a priorities list in which the UTPR is last. This is a normative policy argument rather than a justification of the UTPR. First, the analogy to CFC rules is problematic as elaborated on above. Second, it may be desired that states disregard the separate corporate personality fiction, yet the reality is that taxation universally adheres to this convention. Third, despite the catchy name, there is no 'use-it-or-lose-it' principle of international law and, to the extent that the genuine link doctrine applies, there could not be one. Yes, again, states could agree to tax MNEs in many ways, but a treaty is required for that. *See* Allison Christians & Tarcisio Diniz Magalhaez, *Undertaxed Profits and the Use-It-or-Lose-It Principle*, 108 Tax Notes Int'l 705 (7 Nov. 2022).

12 Allison Christians & Stephen E. Shay, *The Consistency of Pillar 2 UTPR With U.S. Bilateral Tax Treaties*, 109 Tax Notes Int'l 445 (23 Jan. 2023).

13 *Ibid.*, at 447.

14 A parallel that is common in United States international taxation.

15 *Ibid.*, at 449 (a specific analysis of this determination is beyond the scope of this editorial).

16 *Ibid.*, at 448.

17 The case of the Italian IRAP is notable which presented a case more difficult than the UTPR since it replaced the regular income tax yet was eventually legitimized via a renegotiation of the tax treaty with Italy.

UTPR should be viewed as a tax on income or a tax substantially similar to such a tax and therefore subject to the scrutiny of tax treaties. The consequence is that tax treaties will have to be negotiated which is the obvious, correct, and proper thing to do in cases of dramatic changes of the international tax rules. This author does not dispute the political and policy arguments made by Christians and Shay, however, is worried about the attempt to subject fundamental norms of international law to temporal political interests or wishes. It should be added that renegotiating tax treaties directly or in the form of an Multilateral Instrument (MLI), Multilateral Convention (MTC), or whatever other legitimate format should benefit all and would have the added advantage of giving voice to jurisdictions that had been effectively excluded from the BEPS process. Doing so may delay matters, yet it is the only way to ensure the sustainability of the reformed international tax regime.

A different argument with a transparently similar motivation was made by Reuven Avi-Yonah[18] based on the similarity between the CFC and Pillar Two rules and on a smart analogy to the United States anti soak-up taxes rules (that deny foreign tax credits in the case of foreign taxes designed to maximize such credits). He stated that the UTPR is a legitimate equivalent to rules that are common in the international tax regime. The argument is almost uniquely based on United States law, but its main flaw is different: Avi-Yonah himself admits that his is a formal argument as he clearly understands and explicitly states that he engages in legal gymnastics. He justifies it by necessity, adding that it would be better if everyone followed the core agreement of imposing 15% either as a QMDTT or an IIR. For this author, herein lies the problem. Pillar Two proponents of all sorts pretend that there is an agreement when one does not exist. Framework agreements such as that of 8 October 2022 are beneficial at times, but they must be followed up with (yes, sometimes lengthy) negotiations of an actual treaty or treaties. It is as simple as that. States should return to the negotiation table and attempt to achieve consensus on the reform of the international tax rules whether along the lines of Pillar Two or not. The current state of affairs gnaws into the achievements of the existing regime and its legitimacy as has been proven by the multiple unilateral DSTs and other *google taxes* adopted by various countries. Thus, doing nothing is also not an option. The attempts to ignore or bend international law to avoid genuine negotiation of a global agreement over taxation are therefore harmful rather than helpful, in this author's view.

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18 *See* Avi-Yonah, *supra* n. 7.