EDITORIAL

Pillar Two and the Principles of Ability-to-Pay, Legality, and Symmetry*

Pillar Two[1] can be examined from the viewpoint of its compatibility with the principles of ability-to-pay, legality, and symmetry. Ability-to-pay is a constitutional principle in rule-of-law states that is used as the measure to allocate the tax burden in a jurisdiction.[2] It means that the amount of tax to which an individual or organization is liable should be commensurate to the amount it earns and may include those earned by the entities that it owns.

Ability-to-pay is inherent to each taxpayer with the latter being defined by law. In a domestic situation, the marital status of an individual is not supposed to interfere with their ability to pay; companies and branches may be taxed autonomously or as a group, and the latter solution is justified because the ability to pay is inherent to the group from an economic point of view.[3]

There is no international or EU tax law concept of ability-to-pay. However, its meaning changes in a cross-border situation due to the principle of territoriality and the benefits principle (which lead to the allocation of taxing rights between jurisdictions).[4] Ability-to-pay is related to individuals or companies[5] residing or with income accrued in a territory. Multinationals, as such, do not have an ability to pay as it is allocated to a group member (or an option to group taxation or consolidation regime) by each territorial jurisdiction. Controlled foreign company (CFC) rules, switch-over rules, or anti-hybrid rules combine the ability-to-pay principle with an international single tax principle (bringing back taxing rights to the state that applies those rules). [6] CFC rules and some anti-avoidance rules provide that an entity in Country A may be liable to additional tax because a subsidiary or an entity with which it transacts is not taxed (or is low taxed) in Country B.

Pillar two[7] has a different impact in respect of the taxpayer's ability to pay and is capable of challenging the existing ability-to-pay principle in the constitutions of rule-of-law states. The two Global Anti-Base Erosion Model (GloBE) rules – the income inclusion rule (IIR) and the undertaxed payments rule (UTPR) [8] – are top-up taxes to be paid by a constituent entity (CE) because the effective tax rate (ETR) on the income of a non-resident entity accrued abroad[9] is below the minimum ETR of 15%.[10]

In applying Pillar Two, a multinational group's parent entity or subsidiary may be found liable for taxes relating to profits derived by another group entity in another territory if the latter has not been 'sufficiently' taxed in its jurisdiction. Such a situation already exists in the

Notes

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1 OECD, *Tax Challenges Arising from the Digitalisation of the Economy – Global Anti-base Erosion Model Rules (Pillar Two): Inclusive Framework on BEPS* (Paris: OECD Publishing Ltd 2021), https://www.oecd.org/tax/beps/tax-challenges-arising-from-the-digitalisation-of-the-economy-global-anti-base-erosion-model-rules-pillar-two.pdf (accessed 2 Apr. 2023).

2 *See* e.g., Johanna Hey, *Das Leistungsfähigkeitsprinzip als allgemein anerkanntes Fundamentalprinzip gerechter Besteuerung, § 3, B,* in Tipke/Lang, Seer, Hey, Montag, Englisch, Hennrichs, 24. Auflage, Otto Schmidt, Köln, espec. 3.40, 3.50-3.51 et seq.

3 *See* about group regimes or some form of fiscal consolidation within one jurisdiction in contrast to cross-border situations: Ana Paula Dourado (update), *Cross-Border Tax Relief*, 1 Terra/Wattel, Eur. Tax L., General Topics and Direct Taxation 757–758 (7th ed., Wolters Kluwer 2018).

4 On the benefits principle (Nutzenprinzip) *see* Hey, *supra* n. 2, at 3.45.

5 On the disputed ability-to-pay of companies, *ibid.,* at 3.51 et seq.

6 CFC rules are often designed as an exception to a deferral and generally apply to income that is not genuine business income and income derived by the CFC subject to low tax rates in the foreign jurisdiction. The GloBE rules' top-up taxes are based on a coordinated system of calculating the effective tax rate (relying on international accounting standards) and applied to the income of the in-scope entity located in a foreign low taxed jurisdiction. In contrast, the CFC and the other existing switchover rules are calculated and implemented on the basis of domestic tax bases and rates. *See* Ana Paula Dourado, *The Pillar Two Top-Up Taxes: Interplay, Characterization, and Tax Treaties*, 50 (5) Intertax 392–393 (2022), https://kluwerlawonline.com/journalarticle/Intertax/50.5/TAXI2022045, doi: 10.54648/TAXI2022045 .

7 The OECD/G20 Base Erosion and Profit Shifting Project, *Statement on a Two-Pillar Solution to Address the Tax Challenges Arising from the Digitalisation of the Economy*, (Statement on a Two-Pillar Solution) 3 (8 Oct. 2021), https://www.oecd.org/tax/beps/statement-on-a-two-pillar-solution-to-address-the-tax-challenges-arising-from-the-digitalisation-of-the-economy-october-2021.pdf (accessed 2 Apr. 2023).

8 OECD/G20, *supra* n. 7, at 3. States are using the term undertaxed profits rule taking into account the changes in the application of the rule.

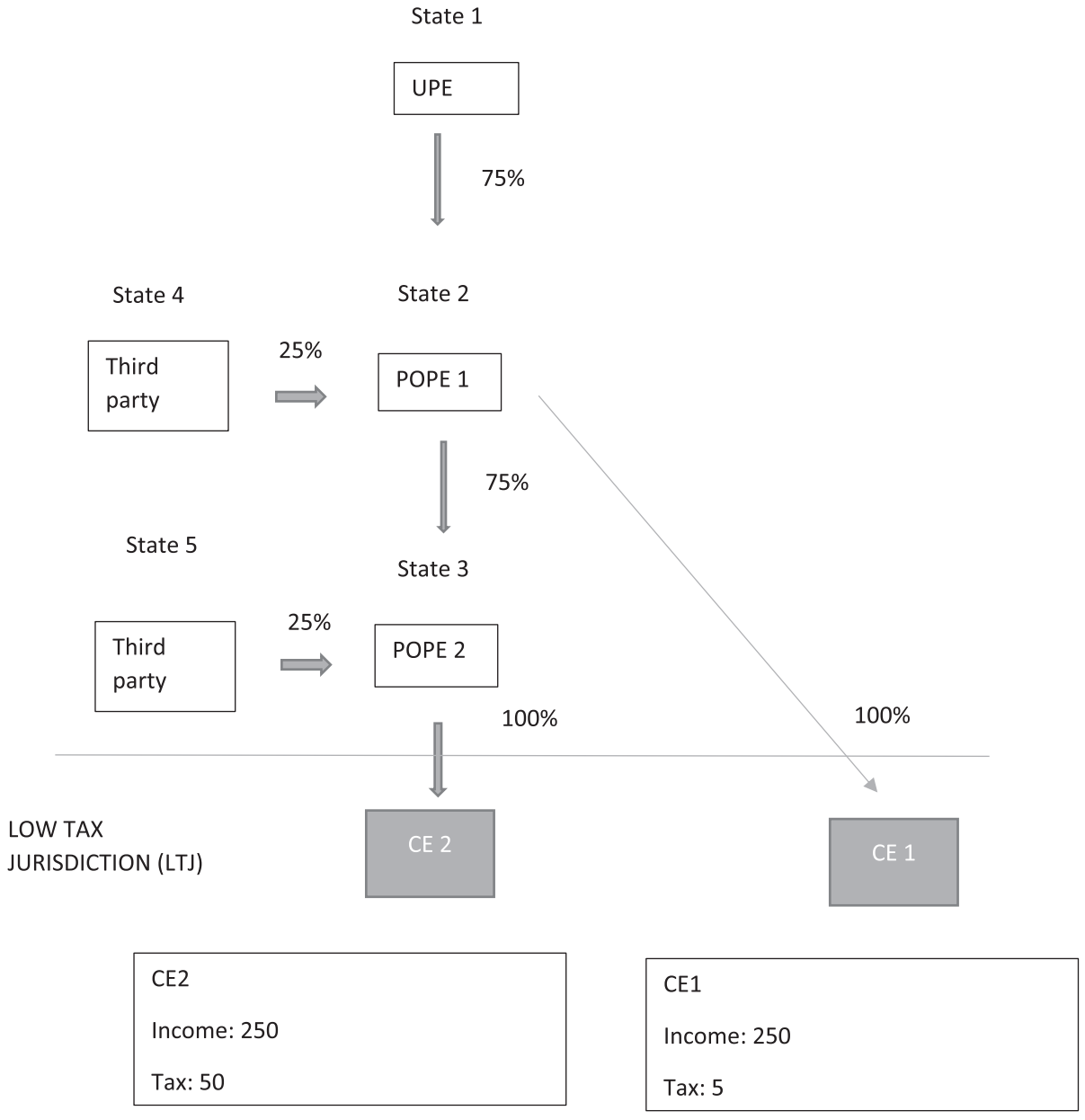
9 Subsidiaries, parent entities, sister entities, or on the income of a permanent establishment accrued abroad.

10 OECD/G20, *supra* n. 7, at 4; OECD, *Tax Challenges Arising from the Digitalisation of the Economy – Commentary to the Global Anti-base Erosion Model Rules (Pillar Two)*' 8 (Paris 2022), https://www.oecd.org/tax/beps/tax-challenges-arising-from-the-digitalisation-of-the-economy-global-anti-base-erosion-model-rules-pillar-two.htm (accessed 2 Apr. 2023).

context of CFC rules, but the latter typically create additional taxation for a shareholder of the low taxed entity. As mentioned, there are also anti-avoidance rules that create an additional tax burden for a taxpayer that transacts with a low taxed entity. Under Pillar Two, the novel situation is that the top-up tax may be due by a group entity that has neither direct nor indirect participation in the low taxed entity or transactions with the latter.

An example is the case of two partially owned parent entities (POPEs) with each of them in different jurisdictions. POPE 2 is not fully owned by POPE 1. POPE 1 holds 100% of one constituent entity (CE 1) in a low tax jurisdiction (LTJ), and POPE 2 holds 100% of another constituent entity (CE 2) in the same LTJ. POPE 2 does not hold any shares in CE 1 and engages in no transactions with CE 1.No Qualified Domestic Top-Up Tax (QDMTT) will be applied by the LTJ. The applicable top-up tax is calculated on a jurisdictional approach and therefore takes into account the joint ETR of CE1 and CE2.

CE 1 is subjected to an ETR below the minimum ETR of 15%, and an ETR of at least 15% is levied on CE 2. Because the top-up tax is calculated on a jurisdictional basis and attributed on a pro rata basis to the CE of that jurisdiction, POPE 2 will pay a top-up tax related to profits of a CE that is not its subsidiary (combined application of Articles 5.2.4, 2.1.4 & 2.1.5 GloBE Model Rules), and POPE 1 will apply the IIR offset mechanism in relation to CE1 (Article 2.3. GloBE Model Rules). CE



Jurisdiction Income: 500; Tax: 55; ETR 11%; Top-Up Tax: 20; CE1: 10; CE2: 10; POPE 2: 10; POPE 1: 10

1 is POPE 2´s sister company in which POPE 2 has no interest and with which it engages in no transactions.

If POPE 2 was 100% held by POPE 1, only POPE 1 would apply the top-up tax (Article 2.1.5, Model Rules) - the UPE would also be entitled to apply its IIR (after POPE 1) subject to the IIR offset mechanism (example 2.3.2 – 1 of the OECD Illustrative Examples).

Thus, even if two taxpayers are considered constituent entities of a group (POPE 2 and CE 1), they may be only sister companies, and one of them (POPE 2) may be responsible to pay a top-up tax (compensating the LTJ to which CE 1 was submitted). It is difficult to claim that this outcome is in conformity with the constitutional ability-to-pay principle.

The Irish department of finance released a feedback statement on 31 March 2023, asking, among other questions, whether it would be possible for one Constituent Entity within a group (a 'group payer') to pay top-up tax liabilities on behalf of other Constituent Entities within the group (4.8.4). Being the answer affirmative, it further asked how should this operate.[11] If POPE 2 above could reallocate the top-up tax expense to the entity that generated it (CE 1), the issue on ability-to-pay would be solved. However, if LTJ did not want to introduce a QDMTT, it will also not agree that CE 1 bears any top-up taxes; moreover, under Pillar 2, POPE 2 jurisdiction is legally liable to collect the top up tax.

The principle of legality and foreseeability of taxes are also menaced by Pillar Two. Some concepts, such as deferred taxes, are vague and may lead to frequent cases of indeterminacy (Articles 4.1., 4.4., and 4.5. GloBE Model Rules). Other provisions are not fully understandable without the OECD Commentary from March 2022 (such as Article 4.1.5. GloBE Model Rules).[12,13]

Moreover, from the perspective of international and European Union tax law, the GloBE rules also raise issues connected to symmetry. This is related to the principle of territoriality and broadly means that a state may allow deductions of a CE of the same group located in a different jurisdiction if it taxes its profits accrued in that different jurisdiction. Symmetry has been acknowledged as a EU tax law principle in cross-border loss cases.[14]

According to the UTPR, the payment of the top-up tax may take the form of either a denial of a deduction against the taxable income of that entity or an equivalent adjustment under domestic law (Article 2.4. GloBE Model Rules). While the UTPR may apply in cases when a profit is low-taxed, there is no additional deduction or recapture of it for constituent entities that are taxed at a high rate. A deduction or recapture would of course be very difficult to implement in practice, taking into account that the UTPR calculation results from a pool of top-up taxes not connected to one particular jurisdiction or CE.

An international agreement aimed at introducing minimum ETRs is a major achievement in the European and international tax systems. However, there are several challenges raised by it that threaten states' constitutional principles as well as international and European tax principles.

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Editor-in-chief

Notes

[11] Department of Finance, Pillar Two Implementation, Feedback Statement, at 26: https://www.gov.ie/pdf/?file=https://assets.gov.ie/251777/588e3b10-231f-411e-8990-e0c42c895c11.pdf#page=null (accessed 2 Apr. 2023).

[12] The Court of Justice of the European Union recently acknowledged that the rule of law (the principle of legality) is inherent to the European Union (to its Member States): 'It is only the national provisions that are relevant for the purposes of analysing whether particular transactions must be examined in the light of the arm's length principle and, if so, whether or not transfer prices, which form the basis of a taxpayer's taxable income and its allocation among the States concerned, deviate from an arm's length outcome'. Court of Justice of the European Union (CJEU): Joined cases C-885/19 P and C898/19 P, Fiat Chrysler Finance Europe, Ireland, *v.* European Commission, ECLI:EU:C:2022:859, at 18, 96, https://curia.europa.eu/juris/document/document.jsf?text=&docid=268045&pageIndex=0&doclang=EN&mode=req&dir=&occ=first&part=1&cid=183838.

[13] Questioning whether the reference to IFRS rules in Pillar Two is compatible with the principle of legality: Gauthier Blanluet, *Le Pilier 2 à l'Épreuve de la Constitution: Premières Réflexions*, 2 Fiscalité Internationale 141–142 (2022): Determination of tax rates is based on IFRS rules. They are not enacted by parliaments but instead by the International Accounting Standard Board which is a private technical committee at the International Financial Reporting Standards Foundation. They do not represent a state and have no democratic legitimacy.

[14] For example, Case C-322/11, K. EU:C:2013:716; Case C-48/13, Nordea Bank Danmark A/S, EU:C:2014:2087;Case C-388/14, Timac Agro Deutschland GmbH, EU:C:2015:829; Case C-538/20, W AG, ECLI:EU:C:2022:717.