EDITORIAL

The Costs of Pillar 2: Legitimacy, Legality, and Lock-in

Global minimum taxation as designed under Pillar 2 rules is soon to become reality. The adoption of a European Union Directive[1] mirroring the rules set forth by the OECD/IF all but guarantees the realization of the initiative even though the United States has not (yet?) fully aligned their tax regime to the 'agreed' standard.[2] The expected (almost)[3] global adoption of common standards on the taxation of multinational corporate groups is certainly a remarkable achievement in its own right and on par with the progress made under the original BEPS 1.0 Project. The leading champions of the initiative are not hesitant to claim that it is a historic success.[4]

Yet, it is difficult to find any enthusiasm for the project – tax academics, professionals, tax administrators, and international organizations seem rather unanimously critical, if for different reasons. The latest addition to those voicing reservations on the project in the form of Tsilly Dagan's insightful paper published in this Issue of Intertax[5] has inspired the writer of this editorial to consider some additional reflections on this state of affairs. Why is it that a project of such seemingly groundbreaking progress is coming under so much fire long before it has had the chance to be tested in practice? Additionally, how can the world move beyond it if the fears and concerns expressed in various quarters prove prescient?

1 Legitimacy

The criticism of the Pillar 2 regime is based on various arguments. One primary concern from a policy perspective relates to its legitimacy. Interestingly, no one seems to question the wisdom of its overall objective insofar as it is intended to improve the fiscal situation of all participating jurisdictions,[6] although the assumption that it will do so must be – and has been – questioned.[7] It indeed seems unrealistic to think that any reform could truly benefit all countries. While a Pareto-improvement from adopting a coordinated approach to fix minimum taxation can be modelled under certain assumptions,[8] it is difficult to imagine how low-tax jurisdictions that rely to a large extent on tax incentive effects to attract international investment and crucially depend on foreign capital as a revenue source could truly benefit from adopting a higher tax rate. Even optimists in this respect need to contend with the inevitably costly behavioural responses of that crucial mobile capital.

Attempts at calculating revenue effects similarly suggest that a pareto-improvement is unlikely to result from

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1 *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*, OJ L 328 (22 Dec. 2022), at 1–58.

2 Yariv Brauner, *The Rule of Law and Rule of Reason in the Aftermath of BEPS*, 51 Intertax 268 (2023); *see also* Reuven S. Avi-Yonah, *Is the United States Already Compliant With Pillar 2?*, 108 Tax Notes Int'l 825 (14 Nov. 2022), doi: 10.2139/ssrn.4270995; and the detailed analysis by Kimberley S. Blanchard, *Can U.S. Worldwide Taxation and Pillar 2's Minimum Tax Peacefully Coexist?*, 111 Tax Notes Int'l 639 (7 Aug. 2023), who answers the question raised in the title of her contribution thus: 'Yes, they can peacefully coexist, but only if the OECD and all countries that adopt pillar 2 agree that the U.S. worldwide system is equivalent to (or better than) pillar 2 and agree to excuse the United States (and other worldwide countries, if there are any) from the application of other countries' IIR and UTPR.' (*ibid.,* at 668).

3 Although the Pillar 2 rules do not require jurisdictions that have expressed their general agreement with the framework to actually adopt any minimum tax provisions (a feature of their design as a 'common approach'), it would appear to leave 'money on the street' not to do so once a sufficient number of other jurisdictions have implemented a version of the model rules so as to effectively 'soak up' any revenue within the scope of the framework that has not been elsewhere collected.

4 *See* e.g., Pascal Saint-Amans, *Paradis fiscaux. Comment on a changé le cours de l'histoire*, Seuil 2023. Rumours that the author of that book has begun talks with Georg Clooney to play him as the main character of the movie based on it could not be substantiated by the writer of this editorial.

5 Tsilly Dagan, *GLoBE: The Potential Costs of Cooperation*, 51 Intertax 1 (2023).

6 As the OECD contends, albeit without proof; *ibid.*, at 6.

7 *Ibid.*

8 *See* e.g., Shafik Hebous & Michael Keen, *Pareto Improving Corporate Minimum Taxation*, IMF Working Paper WP/21/250 (2021) via, https://www.elibrary.imf.org/view/journals/001/2021/250/article-A000-en.xml (accessed 9 Aug. 2023).

the Pillar 2 regime as presented.[9] While clearly in favour of the project itself, Barake et al.[10] reveal that the outcome in terms of revenue reallocation following the application of the model rules would hardly align with the thrust of the project itself. Unless uncertain behavioural responses by businesses and governments lead to a significant shift of allocation of activities compared to the status quo, the main beneficiaries of the regime would appear to be not merely primarily rich countries such as the United States. Various countries that may be seen as beneficiaries of tax competition that the project apparently aimed to address including especially Ireland, Luxembourg, and Switzerland would also reap significant benefits. At the same time and by comparison, emerging economies such as Brazil, China, India, Indonesia, and South Africa are estimated to gain only minimal revenue, and the share of additional revenue accruing to the least developed nations would be a mere 0.065% of the total generated by the Pillar 2 regime.[11]

Dagan's and others'[12] concerns about the lack of benefit to the less and least developed countries from participation in the regime – and, as she also shows, indeed its very existence since non-participation would not carry any obvious benefits – are clearly warranted. As discussed in an editorial by Baker one year ago,[13] the quite possibly negative impact on developing countries' resources from the project has even led experts of human rights law to express concerns that the regime would 'reduce the ability of low and middle-income countries to mobilise sufficient resources to invest in essential public services and to ensure the realisation of human rights'.[14] Dagan at least gives the benefit of the doubt to the view that the Pillar 2 regime reflects a consensus (or at least genuine cooperation) of all countries represented in the Inclusive Framework. Her argument is that cooperation or 'agreement' should not be considered as an indicator that everyone who is 'in' actually benefits from cooperating in that way.[15] Without saying so herself (at least not directly), Dagan's meticulous dissection of the situation in which many countries found themselves when confronted with the detailed proposals developed by a few powerful and rich countries further chips away at any claim of legitimacy for the Pillar 2 'agreement'.

Even the point Dagan concedes for the sake of her argument – specifically, that participants in the Inclusive Framework have actually 'agreed' to the model rules – is undermined by the UN Secretary General's report on international tax cooperation prepared in response to the UN General Assembly's Resolution of 30 December 2022[16]: The report points to 'procedural issues that prevent developing countries from full participation in the agenda-setting and decision-making process'.[17] In noting that it can be particularly difficult for countries with a small international tax staff to fully participate, the UN Secretary General exposes the merely apparent consensual governance structure, thus, 'In the IF, a country is considered to agree to a proposal unless it raises an objection; it is not required to affirmatively "opt in" to be included in the "consensus". Therefore, a country that cannot keep up with the pace of work, and never expresses a view on a proposal, is viewed as agreeing to it'.[18] In the absence of a substantive agreement, Dagan's reflection on the lack of benefit and possible harm done to many countries formally participating in the IF process highlights the lack of the project's legitimacy previously decried in stark terms be others.[19]

A further limit to the project's legitimacy derives from the simple insight that taxation is not an island disconnected from other – especially fiscal – policies that a country would pursue. Any benefit to global welfare from reducing outright tax competition (if such an elusive

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[9] 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 9 Aug. 2023).

[10] Mona Baraké, Paul-Emmanuel Chouc, Theresa Neef & Gabriel Zucman, *Revenue Effects of the Global Minimum Tax Under Pillar Two*, 50 Intertax 689 (2022), doi: 10.54648/TAXI2022074.

[11] *See ibid.*, at 701 (Table 3 giving the additional revenue estimate for the least developed countries as 0.1bn out of a total 154.5bn).

[12] *See* e.g., Annet Wanyana Oguttu, *Preventing International Tax Competition and the Race to the Bottom: A Critique of the OECD Pillar Two Model Rules for Taxing the Digital Economy – A Developing Country Perspective*, 76 Bull. Int'l Tax'n 547 (2022).

[13] Philip Baker, *Human Rights and the Two-Pillar Solution*, 50 Intertax 574 (2022), doi: 10.54648/TAXI2022066.

[14] *Ibid.*, at 576 (quotation from a letter sent by four human rights experts to the OECD).

[15] Dagan, *supra* n. 5, fn. 15: 'cooperation in itself is no assurance for serving the interests of the cooperating parties'.

[16] *General Assembly Resolution on 'Promotion of Inclusive and Effective Tax Cooperation at the United Nations' (A/RES/77/244)* adopted on (30 Dec. 2022) , https://documents-dds-ny.un.org/doc/UNDOC/GEN/N23/004/48/PDF/N2300448.pdf?OpenElement (accessed 9 Aug. 2023).

[17] UN Secretary General Report, *Promotion of inclusive and effective international tax Cooperation at the United Nations*, Advance unedited version published (8 Aug. 2023), https://financing.desa.un.org/sites/default/files/2023-08/A-78-235_advance%20unedited%20version_0.pdf (accessed 9 Aug. 2023), para. 42.

[18] *Ibid.*, para. 44.

[19] *See* e.g., Brauner, *supra* n. 2, at 268: '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'.

benefit is indeed achievable[20]) may be lost by pushing governments towards adopting no less harmful alternatives such as direct subsidies or regulatory competition.[21] Similarly, Wilkie[22] has expressed criticism based on the realization that the regime's impact is inevitably going to extend well beyond the purview of the technical tax experts who created it. 'Fundamentally', he notes, 'pillar 2 seeks to marginalize tax expenditures for public purposes, like influencing the course of trade and foreign investment'.[23] He argues that any attempt at establishing a global tax order with such potentially profound effects on countries' freedom to set their fiscal policies should have involved not only more open and serious discussion but also the inclusion of expert perspectives on trade and foreign relations. The failure to do so and its adoption with 'imprudent haste and insufficient attention to scope and detail'[24] has led to serious risks for countries' fiscal independence.

2 LEGALITY

Despite those powerful and regularly expressed concerns relating to the legitimacy of the Pillar 2 regime, questions relating its compatibility with various legal rules have been debated even more frequently – and, given the highly technical nature of the questions, perhaps unsurprisingly – given rise to more controversy. As contributions to these debates are far too numerous to attempt and list them comprehensively in this short editorial, and it is not the author's aim to answer any of the complex legal questions they raise, a very truncated overview of the diversity of claims shall suffice.

Even prior to considering any particular constitutional, European, or international rules, the difficulties with the Pillar 2 regime begin with the realization that its actual purpose has not been well defined and is thus not clear: As recounted in detail by Englisch,[25] the now widely assumed purpose of the project to curb tax competition at large[26] appears not to have been generally shared by jurisdictions represented in the Inclusive Framework. Many would instead regard it as nothing more than an additional measure to prevent base erosion whereby the limitation to offer below minimum tax rates would be merely the method to reduce profit shifting incentives for multinational businesses. Consequently – and maybe unsurprisingly – the model rules[27] do not unambiguously work towards reducing incentives for tax competition.[28] This lack of a clearly formulated and consistently implemented objective matters since, as any lawyer knows, the purpose of legal rules is instrumental for their proper interpretation. This is especially important for those of a highly technical and complex nature that will inevitably result in many uncertainties and likely litigation. It is even more so given the interactive nature of the regime under which the collection of a tax in any jurisdiction may depend on the application of tax norms in many others.

Serious and varied doubts have been raised in respect of its compliance with principles of international tax law,[29] tax treaties,[30] investment treaties,[31] European Union law,[32] and national constitutional (tax) principles.[33] Given the highly innovative nature of the complex interlocking rules making up the Pillar 2 regime combined with the notorious uncertainty within which international tax law already operated prior to its BEPS reforms, it comes as no surprise that hardly any agreement can be

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[20] This editorial is not the place to relitigate a decades-long debate among scholars as to whether tax competition is, and if so, in what form, harmful or beneficial to either global or individual countries' welfare. For a discussion of various viewpoints, *see* Lilian V. Faulhaber, *The Trouble With Tax Competition: From Practice to Theory*, 71 Tax L. Rev. 311 (2018), doi: 10.2139/ssrn.2912477.

[21] Joachim Englisch, *GloBE Rules and Tax Competition*, 50 Intertax 859, 872 (2022), doi: 10.54648/TAXI2022086.

[22] Scott Wilkie, *Pillar 2 – What's It All About?* 110 Tax Notes Int'l 499 (2023).

[23] *Ibid.*, at 503.

[24] *Ibid.*, at 504.

[25] Englisch, *supra* n. 21.

[26] In contrast to earlier consistent and exclusive focus by the OECD as well as the EU on *harmful* tax competition.

[27] OECD, *supra* n. 9.

[28] For a detailed analysis of the impact on tax competition relating to routine and residual profits, *see* Englisch, *supra* n. 21; an even more in-depth analysis has been made by Michael Devereux & John Vella, *The Impact of the Global Minimum Tax on Tax Competition*, 15 World Tax J. 3 (2023).

[29] *See* e.g., Brauner, *supra* n. 2, at 270, who points to the incompatibility of UTPR – in certain circumstances – with the genuine-link nexus requirement arguably established in international (tax) law.

[30] Among many, *see* e.g., Ana Paula Dourado, *The Pillar Two Top-Up Taxes: Interplay, Characterization, and Tax Treaties*, 50 Intertax 395 (2022), doi: 10.54648/TAXI2022045; Brauner, *supra* n. 2, at 268; Vikram Chand, Alessandro Turino & Kinga Romanovska, *Tax Treaty Obstacles in Implementing the Pillar Two Global Minimum Tax Rules and a Possible Solution for Eliminating the Various Challenges*, 14 World Tax J. 3 (2022), doi: 10.2139/ssrn.3967198.

[31] *See* Catherine Brown & Elizabeth Whitsitt, *Implementing Pillar Two: Potential Conflicts with Investment Treaties*, 71 Can. Tax J. 189 (2023), doi: 10.32721/ctj.2023.71.1.sym.brown.

[32] Prior to the adoption of the Pillar 2 Directive, *see* e.g., Joachim Englisch, *Non-harmonized Implementation of a GloBE Minimum Tax: How EU Member States Could Proceed*, 30 EC Tax Rev. 207 (2021), doi: 10.54648/ECTA2021022. After its adoption, *see* e.g., Georg Kofler & Arne Schnitger, *Does 'Initial Phase Relief' Make the EU Minimum Taxation Directive (2022/2523) Invalid?*, 63 Eur. Tax'n 186 (2023), doi: 10.2139/ssrn.4392892.

[33] Ana-Paula Dourado, *Pillar Two and the Principles of Ability-to-Pay, Legality, and Symmetry*, 51 Intertax 448 (2023), doi: 10.54648/TAXI2023049. With respect to such challenges, it is worth noting the need for a constitutional reform in Switzerland, including a popular referendum, in order to implement the Pillar 2 minimum tax.

discerned on many of these questions in academic circles. While it is highly unlikely that the debates will subside any time soon, inevitable disputes on many of these issues will, in due course, end up in courts and arbitration bodies.

3 Lock-in

In her article, Dagan points towards the lock-in effect as one of the big risks for those countries that do not, in fact, benefit from the Pillar 2 regime. The mere fact that a major reform has been put in place makes it highly unlikely that an alternative agreement could emerge with the support of a critical mass of jurisdictions to replace the OECD/IF solution. The attempted challenge by the UN to the OECD's international tax hegemony indeed appears to be too late to reverse a process that has already seen significant investment by governments, legislatures, and taxpayers. For this, the OECD Model is an instructive example of the process of monopolization of the international tax field where the UN model has not been able to develop a serious alternative. Instead, it has been locked into a path-dependent development following changes of the OECD Model and its commentary for many years despite the significantly divergent interests of most countries not represented in the OECD.

Indeed, the further the implementation process progresses – and the OECD/IF will reportedly begin to peer-review the implementation process, keeping pressure on jurisdictions that may be minded to defy the 'agreed' rules – the less easily the system can be opposed. At this point, a full reversal is already unrealistic; even significant adjustments may be difficult to achieve, not least because of the adoption of the EU Directive. After having reached (true) unanimity among EU Member States to pass legislation, it could only be abolished with the same level of agreement. As long as the EU collectively follows the rules and, in accordance with the directive's design, imposes their effect on third countries within which EU-based corporate groups operate – even irrespective of potential conflicts with existing tax treaties – a significant change in the rules would have to pass that (almost) impossible threshold. The primacy of EU law over bilateral agreements is also the main reason why even an emerging consensus regarding the incompatibility of the UTPR with tax treaties would be unlikely to threaten the Pillar 2 Regime in a meaningful way.

Perhaps paradoxically, the best chance to escape the lock-in could be presented by further integration of EU corporate tax systems. If Member States agreed to a more comprehensive harmonization of corporate taxation across the European Union, the incentive of those of them that have been particularly active in driving the agenda at the OECD level – fuelled at least in large part by the wish to curb intra-EU tax competition – would automatically fall away, potentially paving the way for an alternative, simpler, and more flexible regime also at international level. This would also require the relevant tax policy makers to recognize that the Pillar 2 framework imposes unnecessarily high administrative and compliance burdens on many countries while leaving them minimal, if any, additional revenue as a reward. Unfortunately, this is not a likely scenario.

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