Pillar Two and EU Law

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10.1 Introduction

In the public consultation document of November 2019, the OECD secretariat emphasised that Pillar Two rules had to be:

> "compatible with existing international obligations, including where appropriate the EU fundamental freedoms. Therefore, the design of the GloBE proposal rules will need to take into account their interactions with such international obligations".[3]

Later on, the Programme of Work mentioned that GloBE would ensure "compatibility with international obligations (and, where appropriate, the EU fundamental freedoms)".[4]

More recently, the Pillar Two Blueprint[5] included a chapter on coordination, covering compatibility of GloBE with tax treaties. However, "it does not include an analysis on the compatibility of the GloBE rules with other international obligations, such as the EU fundamental freedoms."[6]

At the time of writing, all contributions addressing the EU law implications of the Pillar Two proposal predate the publication of the Blueprint so that some of the important developments introduced by the latter policy document have to date not been addressed systematically[7].

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[3] OECD *Secretariat, Public Consultation Document "Global Anti-Base Erosion Proposal ("GloBE") – Pillar Two"*, Paris, 8 Nov. 2019, Para. 77 [hereinafter GloBE Proposal].
[4] OECD, OECD/G20 Inclusive Framework on BEPS – *Programme of Work to Develop a Consensus Solution to the Tax Challenges Arising from the Digitalisation of the Economy* (OECD 2019), available at http://www.oecd.org/tax/beps/programme-of-work-to-develop-a-consensus-solution-to-the-tax-challenges-arising-from-the-digitalisation-of-the-economy.pdf (accessed 15 December 2020), Para. 30 [hereinafter Programme of Work].
[5] OECD (2020), *Tax Challenges Arising from Digitalisation – Report on Pillar Two Blueprint*: Inclusive Framework on BEPS, OECD/G20 Base Erosion and Profit Shifting Project (OECD 2019) [hereinafter *Pillar Two Blueprint*].
[6] Pillar Two Blueprint, *supra* n. 5, Para. 668.
[7] Among the most recent contributions, see, in particular, J. Pinto Nogueira, *GloBE and EU Law: Assessing the Compatibility of the OECD's Pillar II Initiative on a Minimum Effective Tax Rate with EU Law and Implementing It within the Internal Market*, 12 World Tax J. (2020), Journal Articles & Papers IBFD, J. Englisch & J. (Johannes) Becker, *International Effective Minimum Taxation – The GLOBE Proposal*, 11 World Tax J. (2019), Journal Articles & Papers IBFD and . M. Devereux et Al., *The OECD Global Anti-Base Erosion*, Oxford CBT Report, January 2020, retrievable at the following link: https://www.sbs.ox.ac.uk/sites/default/files/2020-02/OECD_GloBE_proposal_report.pdf (last accessed 15 December 2020).

In light of the foregoing, the goal of the present contribution is to present an overview of the relations between the GloBE project proposals and EU Law, focusing in particular, as mentioned in the caveat under section 10.2, on the interaction with fundamental freedoms. Such an analysis entails issues of compatibility, issues of coordination of rules and some policy issues.

The compatibility analysis will be made following the four traditional steps of the Court's reasoning when assessing the compatibility of domestic rules with fundamental freedoms: i) scope of protection; ii) restriction/discrimination; iii) justifications, and; iv) proportionality.[8] Given the heterogeneity, each one of the rules will be assessed separately.

All these different steps will be addressed in conjunction to each of the individual Pillar Two rules (section 10.3 will be devoted to the Income Inclusion Rule, section 10.4 will cover the Switchover Rule, section 10.5 will address the Undertaxed Payments Rule and Section 10.6 will analyse the implications of the Subject-to-Tax Rule). Besides, some common overarching issues to the four rules will also be examined (Section 10.7). Finally, a possible approach that, although not devoid of pitfalls, may promote greater compatibility between the proposed rules and the existing framework of EU fundamental freedoms will be explored under Section 10.8.

10.2. Relevance and scope of the analysis: An introductory caveat

Direct taxation remains outside the realm of EU harmonised areas. Member States (hereinafter MSs) are still free to define how to structure their tax system (and how it interplays with the social security system), how to design each one of the taxes (namely subjective scope, objective scope, taxable event, rate, credits) and to freely define the limits of their tax sovereignty (and the nexus used).

Nevertheless, the Court of Justice of the European Union (hereinafter CJEU) has, for over three decades, been clearly stating that:

> "Although, as Community law stands at present, direct taxation does not as such fall within the purview of the Community, the powers retained by the Member States must nevertheless be exercised consistently with Community law".[9]

Accordingly, EU law creates a limitation on the exercise of an MS sovereignty in direct taxation. This also applies when MSs decide to enter into international arrangements aimed at further defining or limiting the exercise of their sovereign rights in direct taxation and applies regardless of whether those arrangements are bilateral or[10] multilateral.

Compliance with EU law is, therefore, a pre-condition of any tax discussion by MSs. This also covers any talks at the OECD level, and namely for measures leading to

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[8] For a detailed analysis, see J.F.P. Nogueira, Direito Fiscal Europeu – O paradigma da proporcionalidade; A proprocionalidade como critério central da compatibilidade de normas tributárias internas com as liberdades fundamentais, Wolter Kluwer / Coimbra Editora, 2010, p. 205 et seq..

[9] See DE: ECJ, 14 February 1995, Case C-279/93, *Finanzamt Köln-Altstadt v Roland Schumacker*, Case Law IBFD, Para. 21.

[10] For instance, see the infringement procedure against The Netherlands, for the introduction of an eventually discriminatory condition on the limitation of benefits clause of its tax treaty with Japan. This infringement procedure (infringement number 20144233) was closed on 30 October 2020 without any explanation on the reasons for the closure. See: https://ec.europa.eu/atwork/applying-eu-law/infringements-proceedings/infringement_decisions/index.cfm?lang_code=EN&typeOfSearch=false&active_only=0&noncom=0&r_dossier=20144233&decision_date_from=&decision_date_to=&title=&submit=Search (last accessed 15 December 2020).

the introduction of a global minimum rate for corporate taxation. Of course, despite the significant coincidence between the OECD and the EU membership, the former is not bound by EU law. And nothing prevents the OECD to adopt any instrument that is not EU-compliant.

Compliance with EU law is, however, necessary to ensure the effectiveness of any tax measure that covers the territory of the Union. First, because MSs cannot approve or implement non-EU compliant measures. Second, because even if they do, both the EU Commission[11] or any EU citizen[12] could react against them, with a final (adverse) decision on its compatibility being taken by the CJEU.

This being said, it should be underlined that the present analysis takes into account the rules as are formulated in the October 2020 Pillar Two Blueprint. This means that this assessment is a preliminary one since the Blueprint is still silent on many design options. Furthermore, nothing prevents the Inclusive Framework or individual countries from agreeing on rules that would substantially deviate from those put forward in the Blueprint. A final assessment of the rules still needs to be made on the basis of their final wording.

The present assessment builds further on the review that one of the co-authors of this study has already presented.[13] In some instances, the authors will simply remit to that study, insofar as still topical. This appears to be in particular the case for the analysis of the possible points of friction between the proposed Pillar Two rules and EU secondary law, most notably Directives adopted in the area of direct taxation. In this regard, the Authors uphold the general finding that any friction perceived to be arising between the proposed rules and the existing secondary law framework would need to be targeted by means of explicit amendments. Said amendments would have to be formulated in a way that would not allow any room for the Member States, in the implementation stage, to introduce rules capable of jeopardizing the application of the EU directives beyond what is needed for the achievement of the Pillar Two goals.

Another sensitive point concerns the interaction between the proposed rules and general antiavoidance rules [14], provided the two would be premised on different policy rationale. In this respect, a clear rule order should be envisaged according to which the application of the Pillar Two rules themselves would continue to be subject to the general anti-avoidance rules. This would also imply that said antiavoidance rules would not allow taxpayers to adopt abusive practices aimed at circumventing the application of the Pillar Two rules[15]. All these considerations, however, belong more properly to the sphere of implementation rather than compatibility and as such should be addressed by means of dedicated secondary law, a hypothesis that is further explored in other contributions within this Volume[16].

10.3 Income Inclusion Rule

10.3.1 Fundamental Freedoms

The first step of any exam consists of identifying the fundamental freedom that may be at stake. The income inclusion rule applies to companies that are part of an "MNE

[11] In the framework of an infringement procedure – see Art. 258 TFEU.
[12] In the framework of any domestic procedure regarding the application of such rules, which could trigger a request for a preliminary ruling by the domestic judge to the CJEU – see Art. 267 TFEU.
[13] See Nogueira, *GloBE and EU Law*, *supra* n. 7.
[14] As contained, in particular, in the ATAD but also in the Parent Subsidiary Directive.
[15] See Nogueira, *GloBE and EU Law*, supra n. 7, in particular Para. 6.1.
[16] See in particular Chapter 13 in this Volume.

group" or, in the wording of the Blueprint, a "constituent entity". This notion is defined very broadly and basically covers any company that can be included in the consolidated financial statement of an MNE group.[17]

The final definition of the entities that might be covered by this rule is left for accounting standards. Moreover, the Blueprints have not specified which accounting standard would apply, indicating that each parent should take into account the accounting standard that applies to it[18].

In the impossibility of assessing each one of the standards, the authors have decided to adopt as a reference framework the International Financial Reporting Standards (hereinafter IFRS) which, at the present moment, are those applicable by most jurisdictions in the world.[19]

The matter under scrutiny is, in particular, currently regulated by IFRS 10 on "Consolidated Financial Statements". Based on this standard, the inclusion of a company on the financial consolidated accounts depends on the fact that the parent exercises control over the that company. According to this standard:

> "An investor controls an investee when it is exposed, or has rights, to variable returns from its involvement with the investee and has the ability to affect those returns through its power over the investee".[20]

Accordingly, there is control in the following three circumstances: i) "power over the investee"; ii) "exposure, or rights, to variable returns from its involvement with the investee"; iii) "ability to use its power over the investee to affect the amount of the investor's returns".[21]

This notion of "control" may not be wholly aligned with the notion of "definite influence" as put forward by Baars[22] which remits to situations where the parent has a "holding in the capital of a company established in another Member State which gives him definite influence over the company's decisions and allows him to determine its activities".[23] In fact, control in IFRS terms includes power-situations that go well beyond the control that is provided by one's-shareholding.

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[17] This short definition is provided by the *Pillar Two Blueprint*, *supra* n. 5, at Para 48. This is further expanded later, and the Blueprint clarifies that it covers three situations: "(a) any separate business unit of an MNE Group that is included in the consolidated financial statements of the MNE Group for financial reporting purposes, or would be so included if equity interests of the Ultimate Parent Entity of the MNE Group were traded on a public securities exchange; (b) any such business unit that is, or would be, excluded from the MNE Group's consolidated financial statements solely on size or materiality grounds; and (c) any permanent establishment of any separate business unit of the MNE Group included in (a) or (b) above provided the business unit prepares a separate financial statement for such permanent establishment for financial reporting, regulatory, tax reporting, or internal management control purposes – See *Pillar Two Blueprint*, *supra* n. 5, page. 24. On the other hand, according to Para. 46 of the Blueprint, "[a] group is defined as a collection of enterprises that are consolidated for financial accounting purposes. This consolidation test is, in turn, based on a control test used for accounting. *In general* (emphasis by the authors), the effect of this test is that two entities will be treated as part of the same Group where one entity controls the other or both entities are controlled by another entity." At will be discussed further in this section, this does not exclude that there may be instance of financial accounting consolidation that do not integrate a control relationship.

[18] See the *Pillar Two Blueprint*, supra n.5, Para. 24.

[19] According to the IFRS website, the standards are currently applicable by 144 jurisdictions in the world. See https://www.ifrs.org/use-around-the-world/use-of-ifrs-standards-by-jurisdiction/#:~:text=Adoption%20of%20IFRS%20Standards%3A,institutions)%20in%20their%20capital%20markets (last accessed on 15 Dec. 2020).

[20] IFRS 10, para.6.

[21] IFRS 10, para. 7.

[22] NL: ECJ, 13 April 2000, case C-251/98, C. Baars v Inspecteur der Belastingen Particulieren/Ondernemingen Gorinchem , Case Law IBFD.

[23] See Baars, C-251/98, supra n. 22, Para. 22.

Besides, according to the IFRS, there are clear cases where income is included in financial statements without any (complete) definite influence by the parent that does such consolidation. These are the cases where two ore more investors act together to direct the relevant activities of a company. In these cases:

> "because no investor can direct the activities without the co-operation of the others (…) each investor would account for its interest in the investee in accordance with the relevant IFRSs such as IFRS 11 *Joint Arrangements*, IAS 28 *Investments in Associates and Joint Ventures* or IFRS 9 *Financial Instruments*"[24].

According to the Court, a case falls within the purview of the free movement of the capital and payments if the scrutinized rule goes beyond the strict regulation of cases of definite influence[25]. This seems to be the case, as both partners or associates have to include, in their consolidate statements (or in the consolidated statements of the respective parents) their interest on the joint venture or joint arrangement – despite the fact that neither of them, individually considered, being able to exercise definitive influence. Therefore, the CJEU will likely to examine the IIR in the framework of the free movement of capital.

This conclusion leads to significant consequences. Free movement of capital and payments applies not only within the Union but also in the relations from and to third countries. A discriminatory rule falling under the scope of the freedom of establishment could be considered compliant with EU law in case a real substance-based carve-out is introduced for intra-EU situations[26]. However, if the rule falls under the free movement of capital and payments, this carve-out would only solve the compatibility issue if also extended to third countries. Which may decrease the effectiveness of the measure.

The CJEU may also follow another approach and further develop the earlier outlined Baars criteria taking into account the concept of control laid down in the IFRS. This would bridge the gap between the IFRS and the Court's legal notion and would allow all situations to be covered by the freedom of establishment.

10.3.2 Discrimination and restriction

If not extended to domestic situations,[27] the income inclusion rule may discriminate parent companies (regardless of whether they are Ultimate Parent Enterprises – hereinafter UPEs or Partially Owned Intermediate Parents - hereinafter POIPs) that include, in their consolidated statements, entities with residence in a different State.

This conclusion is not affected by the jurisdictional blending put forward by the Blueprint[28]. In this case, comparison can always be made with a parent company, controlling a specific set of companies which are resident in the same country, whose effective tax rate, in a specific year, falls below the defined minimum rate. According to the Blueprint, these domestic groups would never be covered by the IIR[29]. However, if the same group of controlled companies is located in a different jurisdiction, the rule would already apply. The mere fact that a parent company (UPE or POIP) decided to exercise its freedom of establishment and setting subsidiaries abroad may place it in a

[24] See IFRS 10, Para. 9.
[25] See, for example. ECJ, 15 July 2004, Case C-315/02, Anneliese Lenz v. Finanzlandesdirektion für Tirol [2004] ECR I-7063 and ECJ, 7 September 2004, Case C-319/02, Petri Manninen [2004] ECR I-7477.
[26] Similar to the one introduced by Art. 7 of the ATAD directive.
[27] See Nogueira, *GloBE and EU Law*, *supra* n. 7, in particular section 4.3.4.
[28] See *Pillar Two Blueprint*, *supra* n. 5, section 3.4.
[29] See *Pillar Two Blueprint*, *supra* n. 5.

worse tax situation from the one it would be facing in case the subsidiaries would be set up in the same MS where it is a resident.

The modus operandi of the IIR is similar to controlled foreign company rules, which aim to:

> "treat the situation of residence companies which have invested capital in a company established in a third country with a "low" tax rate in the same way as that of resident companies which have invested their capital in another company resident in [the same country], with a view, inter alia, to offset any tax advantages which the former might obtain from investing their capital in a third country".[30]

This similarity requires one to provide particular attention to the Court's case-law regarding CFC's and particularly of Cadbury Schweppes[31] which, without any reservation, considered not admissible a less favourable treatment of domestic companies on the basis of the location of its subsidiaries and PEs, treating differently (and worse of) those with subsidiaries or PEs in different states.[32]

One could argue that CFC and IIR feature some fundamental differences in that: i) the first requires fulfilment of an abuse test whereas the latter does not; ii) CFC rules lead to a full neutralization of the advantage gained at the level of the subsidiary, whereas the IIR only requires a (quite limited) tax top-up.

However, such differences do not prevent the application of the Court's reasoning in CFC cases to the IRR as what matters is the fact that the Member State applying the rule has taken into account elements of the non-resident subsidiary for the purposes of determining the tax liability of the resident company. And that occurs both in CFC as in IIR cases. As stated by the Court

> "[a]s soon as a Member State unilaterally taxes a resident company on the income obtained by a company established in a third country, in which that resident company holds shares, the situation of that resident company becomes comparable to that of a resident company which holds shares in another resident company".[33]

The same applies to PEs. Insofar as the State where the head office is situated takes into account the tax situation of the PE (namely its effective tax rate) and uses it to trigger a tax consequence at the level of the head office (whereas the same does not happen internally)[34], that State is engaging in discrimination.[35]

If the CJEU decides to assess the IIR under the free movement of capital, the discrimination would still be ascertained if jurisdiction of the subsidiary is not an EU MS (or an EEA MS), which may dramatically inflate the occurrence of challenges to EU MS applying such rules.

Before moving to the next section, it seems necessary to stress the impact of jurisdictional blending on the EU internal market[36]. Until now, the differences in

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[30] DE: ECJ, 26 February 2019, Case C-135/17, X-GmbH v Finanzamt Stuttgart – Körperschaften, Case Law IBFD, para. 67.

[31] UK: ECJ, 12 Sept. 2006, Case C-196/04, Cadbury Schweppes plc, Cadbury Schweppes Overseas Ltd v. Commissioners of Inland Revenue, Case Law IBFD.

[32] See Cadbury Schweppes, C-196/04, supra n. 31, Para. 36.

[33] See X (C-135/17), para. 67.

[34] Even if, in this situations the comparability is more complex, since there is no such thing as a "domestic PE".

[35] In Argenta Spaarbank, the Court has clearly concluded that an "advantageous treatment of that kind is liable to deter a Belgian company from carrying on its business through a permanent establishment situated in a Member State other than the Kingdom of Belgium and therefore constitutes a restriction prohibited in principle by the Treaty provisions relating to freedom of establishment" – See BE: ECJ, 26 October 2017, Case C-39/16, Argenta Spaarbank NV v. Belgische Staat, Case Law IBFD, para. 22.

[36] See also in this regard, Nogueira, *GloBE and EU Law*, supra n. 7, in particular, para. 4.1.

corporate income tax rates were considered as an unavoidable consequence of the lack of harmonisation in direct taxation. And that taxpayers could exploit the differences between tax systems (and namely between the corporate income tax rates) insofar as they did it genuinely (through genuine arrangements and transactions), and the sole limit to the exploitation of (CIT) disparities was the combat against abusive practices[37].

It may thus be argued that jurisdictional blending fragments the EU internal market beyond what one is able to anticipate. For the purposes of allowing a better illustration, let it be assumed that the final agreed rate is in line with some of the examples put forward by the OECD in the Blueprint: 10%[38]. This rate is precisely the top marginal rate in Bulgaria (10%), and quite close to the top marginal rate in Hungary (10,8%), Ireland (12,5%) and Cyprus (12,5%).[39] Any company operating in these jurisdictions will easily fall below the minimum agreed rate. This raises several concerns. If no safeguards are adopted, this would mean that any EU company establishing any subsidiary or any branch in one of the above-mentioned EU jurisdictions, would be targeted by the IIR and would be subject to a top-up taxation. In an oversimplification, it could be held that, in substance, the IIR implies that you have to pay taxes to effectively exercise your freedom of establishments which, put in those terms, seem fundamentally wrong: in the absence of abusive practices, no EU citizen should pay a fee to exercise their core EU fundamental freedoms.

10.3.3. Justifications and proportionality

10.3.3.1 Introductory considerations

Despite the differences between these two levels of analysis (justifications and proportionality), the authors have deemed it appropriate to combine its assessment since the proportionality argument needs to be assessed by reference to each possible argument that may be presented as a justification.

10.3.3.2 Fight against abusive practices – in general

Like many other tax rules, GloBE rules in general, and IIR in particular, also have in view reducing the scope for abusive practices. The CJEU does not require a strict connection between the measure and the domestic goal it may pursue: insofar as the measure can be considered as a step towards the obtention of a domestic goal, said measure could already be assessed against the background of that goal[40].

Some authors even argue that GloBE rules are anti-avoidance measures and, accordingly, they would need to abide by the requirements laid down by the CJEU regarding the fight against abusive practices. Relevance is given to the name of the proposal ("global anti-base erosion proposal") and to its explanation which clarifies that "GloBE-proposals are defined as a set of measures aimed at curbing down profit shifting to jurisdictions where they are subject to no or to very low taxation". As a conclusion "they are measures against abusive tax practices consisting of base erosion and profit

[37] See also in this regard, Nogueira, *GloBE and EU Law*, supra n. 7, in particular, para. 4.4.3.
[38] See the numerical examples throughout the *Pillar 2 Blueprint*, *supra* n. 5.
[39] Data retrieved from the study EU (DG Taxation and Customs Union), Taxation Trends in the European Union – Data for the EU Member States, Iceland and Norway – 2020 edition, 1st edition, 2020, page 42, table 9: "Top statutory corporate income tax rates (including surcharges 2004 – 2020).
[40] See further Nogueira, *GloBE and EU Law*, *supra* n. 7, Para. 4.4.1.

shifting".[41] In our view, and despite the capacity of targeting abusive practices, the IIR and, more generally Pillar Two rules, are not (solely) driven towards abusive practices[42], targeting any companies whose subsidiaries and PEs in a given jurisdiction are taxed below the minimum rate, yet to be defined. It is clear that GloBE rules are general measures, which would apply equally to genuine and non-genuine situations. Such an automatism in the application would put them outside of the realm of this specific justification.[43]

In fact, even if the fight against abusive practices is an accepted justification, the Court considers that any domestic measure seeking that goal is only admissible insofar as it is limited to "wholly artificial arrangements",[44] i.e. to situations devoid of economic reality put forward to obtain a specific (tax) benefit. If the measure under scrutiny targets even if just one situation beyond that scope, it will be considered disproportionate and, as a consequence, incompatible with EU law. Even if the situation under scrutiny refers to a purely artificial construction.

While it is true that the IIR will not be supported by this justification, failure to meet the justification does not imply necessarily that the measure is incompatible with EU law. Domestic measures can pursue a plurality of objectives, each of them amounting to a different justification.[45] A measure will be considered as compatible with EU law in cases where it pursues (at least) one valid justification and is proportionate in that doing so.

10.3.3.3 Fight against abusive practices – with the introduction of the formulaic substance-based carve-out

One of the novelties introduced by the October 2020 Blueprint with regard to the IIR is the introduction of a formulaic substance-based carve-out by which income falling within the formula will no longer be considered for the purposes of determining the minimum effective tax rate.

The formula is built on two components: i) the payroll component; ii) the tangible asset component.

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[41] L. de Broe, OECD's Global Anti-Base Erosion Proposal ("GloBE") – Pillar Two Raises Fundamental Concerns of Compatibility with EU Law, KU Leuven, 3 dec. 2019, retrievable at the following link: https://www.law.kuleuven.be/fisc/globe-ldb.pdf (last accessed 15 December 2020), in particular at para. 2.1.

[42] On the policy rationale of the Pillar Two package vis-à-vis abuse, see the further considerations in Chapter 14 in this Volume.

[43] This automatism differentiates CFC rules from GloBE's income inclusion rules. Whereas in the first there is normally an abuse test (which, depending on its wording, may allow narrowing the scope to "wholly artificial arrangements"), the latter does not have that test. This is the reason why all GloBE's income inclusion rule, despite its similarities with CFC rules, cannot be considered within this justification. In what concerns the admissibility of CFC rules, see X (C-135/17), supra n. 30.

[44] Already in ICI the Court clarified that "As regards the justification based on the risk of tax avoidance, suffice it to note that the legislation at issue in the main proceedings does not have the specific purpose of preventing wholly artificial arrangements, set up to circumvent United Kingdom tax legislation, from attracting tax benefits, but applies generally to all situations in which the majority of a group's subsidiaries are established, for whatever reason, outside the United Kingdom. However, the establishment of a company outside the United Kingdom does not, of itself, necessarily entail tax avoidance, since that company will in any event be subject to the tax legislation of the state of establishment". See UK: ECJ, 16 July 1998, Case C-264/96, Imperial Chemical Industries (ICI) v. Kenneth Hall Colmer, Case Law IBFD, Para. 26.

[45] For an analysis of this issue see J.F.P. Nogueira, *Direito Fiscal Europeu – O paradigma da proporcionalidade; A proprocionalidade como critério central da compatibilidade de normas tributárias internas com as liberdades fundamentais*, Wolter Kluwer / Coimbra Editora, 2010, p. 296 et seq.

When examining the formula, one finds some familiar elements such as staff, equipment and buildings (besides other elements). The formula resonates a lot with the wording of the Court in Cadbury Schweppes[46]: On that occasion, the Court held that, the assessment of whether there was an establishment, intended to carry on genuine economic activities in the host Member State

> "must be based on objective factors which are ascertainable by third parties with regard, in particular, to the extent to which the CFC physically exists in terms of premises, staff and equipment".[47]

One could be tempted to conclude that this carve-out would be the adjustment needed to narrow down the IIR to situations of artificiality and, as a consequence, to ensure its compatibility with EU law.

However, in the view of the authors, this is not the case. In fact, this carve-out is not able to exclude from the scope of the rule all genuine situations but merely the income that would result from the formula, an outcome that would arguably still not be compliant with the Court's case-law in this field. In fact, nothing prevents a genuine company from having profits that are above or below the "fixed return" determined by the formula. Therefore, in those situations, genuine companies would still be targeted by the discriminatory rule.

This seems to be recognised by the OECD in the Blueprint when addressing the issue of "low margin businesses", which by having "more expenses as a percentage of their income (…) would secure a relatively larger carve-out".[48] Although not mentioned, a contrario, "high margin businesses" would still be significantly impacted, despite the application of the formulaic carve-out, as they would most likely be required to attest, for every fiscal year, that the income it produces would fall within the target of the formula, which may constitute an inadmissible procedural burden.

A safe-harbour based on a formula that merely exempts the income that is considered the "normal" remuneration based on the objective indicators of a company seems difficult to reconcile with the Court's case-law on abuse. In fact, in the Court's case-law it is possible to see a clear concern for restricting the reach of a domestic law discriminatory tax measure to situations of abuse, "devoid of economic and commercial justification", shams that were put in place to secure a benefit[49]. Instead, the IIR would also target genuine establishments, and the carve-out only limits the impact to a part of the real remuneration of this genuine establishment.

10.3.3.4 Need to ensure a balanced allocation of taxing rights

The need to ensure a balanced allocation of taxing rights is traditionally accepted by the Court as a valid justification. However, it is difficult to understand how this justification could be invoked in the context of the IIR.

The measure does not seek to protect tax sovereignty of either the Residence or Source State. First, no consideration is given to a possible correspondence between the activities of the parent and of the subsidiary. Second, the rule does not take into account the existence of an effective distribution of profit from the subsidiary to the parent. And thirdly, it does not take at all into account the level of taxation at the parent level.

The lack of consistency between the domestic and cross-border situations is also meaningful (i.e. the fact that the compensatory tax applies only to cross-border

[46] Cadbury Schweppes, *supra*. n. 31.
[47] Cadbury Schweppes, *supra*. n. 31, para 67.
[48] Pillar Two Blueprint, *supra* n. 5, § 370.
[49] Cadbury Schweppes, *supra*. n. 31,

situations).[50] A State cannot sustain a discriminatory measure on the need to ensure a balanced allocation of taxing rights when it does not protect its taxing rights in a comparable domestic situation.[51]

As a consequence, this justification cannot be invoked for ensuring compatibility of the IIR with EU Law.

10.3.3.5 Need to ensure the effectiveness of fiscal supervision

Despite being an accepted justification, it is difficult to understand how this one could be invoked in this context. There is no measure whose application requires a verification of a fact or element located outside of the State of origin/residence. As a consequence, any claims based on this justification would be considered disproportionate due to a lack of adequacy between the measure and the objective underlying this justification. If invoked, the Court may simply discard this justification since it does not match with the measure's rationale.

Admitting that the conditions to invoke this justification were met, and taking into account the available instruments for mutual assistance in exchange of information, both within the European Union[52] and in the relations with third countries[53], we believe that the restriction created by the IIR would be considered disproportionate[54]. This reduces the scope of the justification to cases with third countries in which there is no mutual assistance instrument between the European Union Member State in question and the third country.

10.4 Switch-over Rule

One should start by recalling that this rule had been inserted in the original proposal of the ATAD directive, where it had a gatekeeping function since it aimed to shield the internal market from "situations whereby untaxed or low-taxed income enters the internal market and then, circulates — in many cases, untaxed — within the Union".[55] The introduction of a switch-over clause would have allowed exempted income to be taxed in the Union "if it ha[d] been taxed below a certain level in the third country" and Member State "should give a credit for the tax paid abroad, to avoid double taxation".[56] The European Parliament proposed amending this clause to other-than-active income and

[50] As the Court stated in Skandia, "any tax advantage resulting for providers of services from the low taxation to which they are subject in the Member State in which they are established cannot be used by another Member State to justify less favourable treatment in tax matters given to recipients of services established in the latter State. Such compensatory tax arrangements prejudice the very foundations of the single market" - SE: ECJ, 8 Mar. 2001, Case C-240/99, Försäkringsaktiebolaget Skandia (publ), Case Law IBFD (accessed 23 Dec. 2020), Para 44 and 45.

[51] The same lack of consistency was highlighted by the Court in DE: ECJ, 13 Nov. 2019, Case C-641/17, College Pension Plan of British Columbia v. Finanzamt München III, Case Law IBFD, Para 84.

[52] As based on Directive 2011/16/EU of 15 February 2011 and subsequent amendments.

[53] Based on exchange of information provisions incorporated in tax treaties or in the Multilateral Convention on Mutual Administrative Assistance.

[54] See in this regard the implications of LUX: ECJ, 11 October 2007, Case C-451/05, ELISA vs Directeur général des impôts, Case Law IBFD.

[55] European Commission, Proposal for a Council Directive laying down rules against tax avoidance practices that directly affect the functioning of the internal market, Brussels, COM(2016) 26 final, 2016/0011(CNS), 28.1.2016, recital 8 of the preamble.

[56] European Commission, Proposal for a Council Directive laying down rules against tax avoidance practices that directly affect the functioning of the internal market, supra n. 55, recital 8 of the preamble.

to cases where the statutory rate would be lower than 15%.[57] This last proposal would have arguably made the rule closer to the one envisaged by the Pillar 2 Blueprint. However, this clause was not introduced in the final proposal of the ATAD, and the European Commission has never explained its removal.

In a nutshell, the switch-over rule as proposed in the Pillar 2 Blueprint will allow the State of residence to switch from exemption to credit in case the other state does not tax (or does not tax sufficiently) the prima facie exempted income. The Blueprint seems to limit the realm of this clause to specific categories of income that, according to a tax treaty, are exempt[58].

This clause seems not to trigger major issues in what concerns its compatibility with EU Law. In practice, what it does is reclaiming tax sovereignty over tax base that had been excluded from it on the basis of a treaty and, in doing so, granting cross-border situations the default tax treatment applicable to domestic situations[59]. Thus, it is a step forward in equalizing the treatment between domestic and cross-border situations, from the perspective of the residence state.

One could argue that this clause risks creating instances of unrelieved double taxation. Due to its application, both residence and other contracting (source) state could tax. First, this does not seem to be an issue: since the other contracting state is taxing at an insufficient level, all taxation borne in that jurisdiction could be credited at residence. Second, and even if juridical double taxation could emerge, it should be observed that the Court does not consider it, per se –and when resulting from the parallel exercise by two or more MSs of their tax sovereignty – as incompatible with the fundamental freedoms.[60]

In what concerns compatibility of such a clause with EU law, it seems that Court's case-law has provided sufficient guidance in Columbus Container[61], regarding a clause that appears to be similar to the one proposed by GloBE. The German foreign tax act determined that the credit method should be applied whenever foreign exempted PEs would be targeted by the German CFC rules in case they were subsidiaries. This rule aimed at preventing abuse of CFC rules in case the taxpayer decided to do business through a PE instead of a subsidiary. The Court considered that such rule was fully compatible with EU law as, for the Court, the concern is not with the method, but with the taxation that results from the application of different methods. For the Court:

> "Member States are at liberty to determine the conditions and the level of taxation for different types of establishments chosen by national companies or partnerships operating abroad, on condition that those companies or partnerships are not treated in a manner that is discriminatory in comparison with comparable national establishments."[62]

Moreover:

> "the freedom of companies and partnerships to choose, for the purposes of establishment, between different Member States in no way means that the latter

[57] EP, Amendment 102 of Article 6 of the European Parliament legislative resolution of 8 June 2016 on the proposal for a Council directive laying down rules against tax avoidance practices that directly affect the functioning of the internal market (COM(2016)0026 — C8-0031/2016 — 2016/0011(CNS)) : https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52016AP0265&from=EN.

[58] For further considerations, see Chapter 4 in this Volume.

[59] See Nogueira, *GloBE and EU Law*, *supra* n. 7.

[60] See in this regard, BE: ECJ, 14 November 2006, case C-513/04, Mark Kerckhaert and Bernadette Morres v Belgische Staat, Case Law IBFD and BE: ECJ, 16 July 2009, case C-128/08, Jacques Damseaux v Belgian State , Case Law IBFD.

[61] DE: ECJ, 6 Dec. 2007, Case C-298/05, Columbus Container Services B.V.B.A. & Co. v. Finanzamt Bielefeld-Innenstadt, Case Law IBFD.

[62] See Columbus Container Services, C-298/05, *supra* n. 58, Para. 53.

are obliged to adapt their own tax systems to the different systems of tax of the other Member States in order to guarantee that a company or partnership that has chosen to establish itself in a given Member State is taxed, at national level, in the same way as a company or partnership that has chosen to establish itself in another Member State."[63]

In conclusion, in *Columbus Container*, as the rule did not lead to discrimination, but rather to applying the same tax treatment to domestic and cross-border situations, it was considered admissible. In view of the authors, such reasoning may also be extended to the switch-over rule as envisaged by the Pillar Two Blueprint[64].

10.5 Undertaxed payments rule

For the purposes of this assessment, the version of the undertaxed payments rule (UTPR) envisaged by the Pillar Two Blueprint will be adopted as a benchmark. For such UPTR what matters is that this is a rule to be applied by the source state in case of intra-group payments to companies subject to an amount of tax below a certain minimum. That being the case, and in case the IRR is not triggered at the level at the parent (UPE or POIP), then a top-up tax applies in the source State.

In terms of fundamental freedoms, it is possible to refer to the discussion held in the context of the IIR since the subjective scope appears to be the same.[65] Accordingly, either the freedom of establishment or the free movement of capital may be at stake, with the latter scenario having the noteworthy consequence of putting within the Court's jurisdiction situations with third countries.

The Pillar Two Blueprint clarifies that this rule is expected to be applied discriminatorily and merely to cross-border situations, which facilitates the conclusion that the rule introduces a discriminatory treatment. Whereas payments to low-taxed companies in the same jurisdiction do not trigger any tax, similar payments to comparable foreign low-taxed companies will require payment of a top-up tax.

The reasoning mentioned above in the assessment of the IIR seems to be entirely applicable for the UTPR. The rule would virtually end-up creating a link between the exercise of a fundamental freedom and the imposition of a top-up tax. And, as the Court has repeatedly mentioning, the exercise of a treaty's freedom cannot be associated with a discriminatory and less favourable treatment of the taxpayer exercising said freedom[66].

On the other hand, the same considerations formulated *supra* in section 10.3.3 *supra* in what concerns the analysis of the justifications and proportionality of the IIR could also be extended to the UTPR so that there is hardly any justification that an MS could put forward in order to uphold the concerned measure.

10.6 Subject to tax rule

10.6.1 Introduction

[63] Columbus Container Services, C-298/05, *supra* n. 58, Para. 51.
[64] Nogueira, GloBE and EU Law, *supra* n. 7, Section 4.3.3.
[65] The Pillar Two Blueprint, see *supra* n. 5, refers that it is applicable to "low-tax constituent entities" which was defined in section 2.2. of the same document as entities included in the consolidated financial statements of a group.
[66] For an overview, see N. Bammens, *The Principle of Non-Discrimination in International and European Tax Law*, 2012, online books IBFD, in particular Chapter 13.

For the purposes of this assessment, it is essential to retain that this rule, to be introduced in tax treaties, is designed to be applied by the other contracting state (source jurisdiction) in what concerns specified intra-group payments whenever the recipient of said payments is taxed at a nominal rate below the minimum rate yet to be agreed.[67]

In particular, the subject to tax rule (STTR)[68] is designed as an independent (standalone) measure[69]. As such, it is no longer applicable to companies included in the same consolidated financial statement but to companies that are considered as closely related. This circumstance requires an autonomous assessment of the rule, which will follow the step-by-step approach outlined in the introduction.

10.6.2 Fundamental Freedom

The subjective scope is limited to "closely related" persons, following the definitions of Art. 5(8) of the OECD Model Convention.

Examining the provision, this would cover solely instances where a person owns, directly or indirectly "more than 50% of the beneficial interest in the other (or, in the case of a company, more than 50 percent of the aggregate vote and value of the company's shares or of the beneficial equity interest in the company)"[70]. The OECD Commentary clarifies that this applies when "based on all the relevant facts and circumstances, one has control of the other or both are under the control of the same persons or enterprises (…)"[71] including cases where "by virtue of a special arrangement that allows that person or enterprise to exercise rights that are similar to those that it would hold if it possessed directly or indirectly more than 50 percent of the beneficial interests in the enterprise".[72] This narrow definition of "closely related" ensures that all situations covered by the rule are covered in the concept of definitive influence of Baars.[73] As a consequence, in view of the authors, this rule should be assessed under the freedom of establishment, and the assessment will be limited to intra-EU situations.

The definition of "closely related" also includes a second prong, covering companies controlled by the same parent. According to the OECD Commentary, "this condition is met where a person holds directly or indirectly more than 50% of the aggregate vote and value of the company's shares or of the beneficial equity interest in the company".[74] The condition is met even if there is no definitive influence of the payor over the payee (or the other way around) as it is always possible to find a person (namely, the common parent) having definitive influence over both the payor and the payee so that such person would be the one exercising its freedom of establishment. In this case, the discrimination factor (the condition of "closely related") would not be referred to the relationship between the payor and payee but to the common parentship of that third company. As a consequence, the person indirectly discriminated would be that third company (common parent), despite the fact that it is not the addressee of the tax measure. Accordingly, the measure would need to be assessed under the freedom of establishment.

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[67] Therefore, there is no need to make any (jurisdictional) blending or assessing the effective tax rate of the company receiving the payments.
[68] For an in depth analysis see Chapter 6 in this Volume.
[69] See Pillar Two Blueprint, *supra* n. 5, Para. 566.
[70] See OECD, Model Tax Convention on Income and on Capital (2017), Art. 5, Para. 8, Models IBFD.
[71] See OECD, *Model Tax Convention on Income and on Capital: Commentary on Article 5*, para 120, Models IBFD.
[72] Ibid.
[73] See ECJ, Baars, *supra* n. 22.
[74] See OECD, *Model Tax Convention on Income and on Capital: Commentary on Article 5*, para 121, Models IBFD.

10.6.3 Discrimination and Restriction

10.6.3.1 In general

Unlike other subject-to-tax rules, this rule would not be aimed at conditioning the granting of benefits from the source state in cases where the income was not effectively subject to tax in the source state. Instead, this rule aims "to allow the payer jurisdiction to apply a top-up tax to bring the tax on the payment up to an agreed minimum rate."[75] Thus, the rule will be triggered "where a covered payment is subject to a nominal tax rate in the payee jurisdiction that is below an agreed minimum rate (…)".[76] Unlike what is foreseen for the GloBE rules stricto sensu, the latter rate is the nominal tax rate of the payee in what concerns that specific payment.[77]

Despite the differences, and for the purposes of this assessment, the mechanics of this rule are partly similar to other subject-to-tax rules: the source state would regain its tax jurisdiction (previously restricted by virtue of a tax treaty) whenever this payment is not taxed (or not sufficiently taxed) in the jurisdiction where the payment is received (i.e., the residence state). However, and besides that, a top-up tax is imposed.

The Court has already had the opportunity to assess a similar clause in *Bosal*.[78] However, the clause was applied by the residence Member State and in the framework of the Parent-subsidiary directive. Thus, in view of the authors, that decision is not of relevance in the situation hereby under scrutiny.

In the authors' view it is necessary to break down the analysis into two different issues: i) the provision allowing for the source state to regain its taxing rights in certain situations; ii) the provision requiring a top-up of tax.

10.6.3.2 Source state regaining taxing rights

This clause appears to simply be an extra condition for the application of the benefits of a treaty, which the Member States are still free to determine autonomously.[79] The new provision allows for the source state to regain taxing rights in certain circumstances. In a nutshell, and in the end, the situation would be the same as the source state keeping its taxing rights on a broader number of cases.

Insofar as the rule applies automatically (and does not require meeting an abusive test – which is the case), it becomes an (additional) element of the allocation rule (such as, for instance, the time limits or the minimum holding requirements). However, such an additional element would indeed constitute a special element since it would effectively be based on a linking-rule-reasoning, as it would depend on the nominal tax rate applicable to that payment at the level of the counterpart. At the same time, it would remain a condition and an integral part of the connecting factors.

At present, allocation of taxing powers within the Union is not harmonized. According to the Court, "Member States are free to determine the connecting factors for the allocation of fiscal sovereignty in bilateral conventions for the avoidance of double

[75] See Pillar Two Blueprint, *supra* n. 5, para 573 g).
[76] Blueprints, *supra* n. 5, para 637.
[77] See the illustrative examples in connection with Chapter 9 in the Pillar Two Blueprint, *supra*. n. 5.
[78] NL: ECJ, 18 Sept. 2003, Case C-168/01, Bosal Holding BV v. Staatssecretaris van Financiën, Case Law IBFD.
[79] Judgment of 5 July 2005, D. (C-376/03, ECR 2005 p. I-5821) ECLI:EU:C:2005:424, Para. 52.

taxation."[80] To that end, "it is not unreasonable for Member States to use the criteria followed in international tax practice" and particularly in the OECD MC.[81]

As such, the criterion used "in a provision which is intended to allocate fiscal sovereignty, there is no justification for considering such differentiation (…) as constituting prohibited discrimination".[82]

Furthermore, the "objective of a bilateral convention for the avoidance of double taxation (…) is to prevent the same income from being taxed in each of the two parties to that convention; it is not to ensure that the tax to which the taxpayer is subject in one State is no higher than that to which he or she would be subject in the other contracting State".[83] Thus, even if the end result of applying the STTR is a higher level of taxation for an entity or its counterpart, that fact alone is not enough to consider that the rule, itself, is contrary to EU law since the differences would arise from "disparities existing between the respective tax systems of those contracting parties."[84] In fact, "[t]he choice of various connecting factors, made by those parties to allocate powers of taxation between them (…) must not be regarded, as such, as constituting discrimination".

In conclusion, the prong of the rule consisting of the source state regaining taxing rights should likely be considered as not incompatible with EU Law.

10.6.3.3 Application of a top-up tax

The next prong of the rule refers to the application of a top-up tax, which is to be borne by the company making a payment. For the purposes of this assessment, the way how the top-up is calculated would ultimately not be relevant.

The expected outcome of an STTR is to put the cross-border situation back under the tax jurisdiction of the other contracting state (source state) and, as a consequence, the cross-border situation would be taxed just like a comparable purely domestic situation.

However, this would not be the case with the Pillar Two STTR. First, because the rule would only be triggered in a cross-border scenario, as it would not apply domestically, even if the same conditions are met. Second, because the rule would require the payment of a top-up amount of tax, which is related to the tax burden of the counterparty located in the other territory: namely, such a top-up tax would not be required if the company were to make payments to entities located in its territory, even if the same exact circumstances were to be met.

In light of the above, the main issue refers to the asymmetrical application (i.e., application restricted to cross-border situations) of the rule, which places companies making intra-group cross-border payments in a different and worse tax situation than that of comparable companies making intra-group payments to domestic counterparts.

To illustrate this more clearly, it is possible to consider the same company, making royalty payments to two "closely related" companies: a) company A, located in the same territory, and company B, located in a different jurisdiction covered by a tax treaty including the proposed Pillar Two STTR. A and B are comparable, and in both cases, the states where these companies are located apply a preferential tax rate to that royalty

[80] IT: ECJ, 30 Apr. 2020, Case C-168/19, HB v. Istituto Nazionale della Previdenza Sociale, Case Law IBFD, Para. 16.
[81] Istituto nazionale della previdenza sociale (C-168/19 and C-169/19), supra n. 80, Para. 17. Even though they have to exercise that power and freedom consistently with EU law. See DE: ECJ, 21 Sept. 1999, Case C-307/97, Compagnie de Saint-Gobain, Zweigniederlassung Deutschland v. Finanzamt Aachen-Innenstadt, Case Law IBFD, Para. 56-58.
[82] Istituto nazionale della previdenza sociale (C-168/19 and C-169/19), supra n. 80, Para. 18.
[83] Istituto nazionale della previdenza sociale (C-168/19 and C-169/19), supra n. 80, Para. 17.
[84] Istituto nazionale della previdenza sociale (C-168/19 and C-169/19), supra n. 78, Para. 20.

payment or exclude a certain percentage of the royalties received from taxation. The end result is that, in both A and B, the received royalties are subject to tax below the agreed minimum (nominal) tax rate. A would only have to compute and apply the top-up tax in the second situation.

This asymmetrical burden would amount to a discrimination. The reasoning, as explained above, in the framework of the IIR rule is here fully applicable[85]. The fact that the rule is now applied by the source state now does change the outcome of the analysis.

10.6.4 Indirect discrimination and the use of thresholds

The Blueprints indicate that "to minimise (…) compliance burdens"[86] a materiality threshold will be introduced. Although not completely defined yet, this materiality threshold will likely be based on one of the following thresholds: i) threshold based on the size of the MNE[87]; ii) threshold based on a tiered value of covered payments made to connected persons in other contracting states[88]; iii) threshold based on a ratio, taking into account the payments made to connected persons versus the total expenditures.[89]

All of the proposed thresholds are based on objective criteria that do not take into account nationality or an element that is inherent to nationality. According to the Court's case-law, the introduction of these limitations would not amount to indirect discrimination.[90]

10.7 Common issues to all the rules

10.7.1 Introductory remarks

This section aims to address issues that are common to all the proposed Pillar 2 rules and that relate to their design. The exception appears to be the subject to tax rule, which was conceived as a standalone rule to be included in treaties and that does not share many design elements of the other rules, apart from the thresholds, which have already been addressed in that specific respect in section 10.6.4 supra and will be addressed in connection to the other proposed rules in section 10.7.3 hereinbelow.

10.7.2 Exclusion of certain entities

The envisaged Pillar 2 rules would exclude certain entities from its scope, and namely investment funds, pension funds, sovereign wealth funds, government bodies, international organizations, and non-profit organizations.[91]

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[85] See Section 10.3.2 *supra*.
[86] Pillar Two Blueprint, *supra* n. 5, para. 623.
[87] See Pillar Two Blueprint, *supra* n. 5, para. 627.
[88] See Pillar Two Blueprint, *supra* n. 5, para. 630.
[89] See Pillar Two Blueprint, *supra* n. 5, para. 632.
[90] In this respect, see HU: ECJ, 3 March 2020, Case C-75/18, *Vodafone Magyarország Mobil Távközlési Zrt.*, Case Law IBFD and also CFE ECJ Task Force, *Opinion Statement ECJ-TF 2/2020 on the ECJ Decision of 3 March 2020 in Vodafone Magyarország Mobil Távközlési Zrt. (Case C-75/18) on Progressive Turnover Taxes*, 60 Eur. Taxn. 12 (2020), IBFD Journals and Papers.
[91] See Pillar Two Blueprint, *supra* n. 5, para. 71.

Such exclusion is justified on the basis of two key guidelines and namely: i) the fact that the low or no taxation of these entities does not affect the prosecution of the GloBE goals; ii) simplification reasons.[92]

The exclusion, insofar as done across the board, would appear to be admissible in the view of the authors. However, the implementation would need to be done carefully, ensuring that there are no comparable entities are caught by the Pillar 2 rules.

Exempting some entities whereas subjecting others will not be an issue insofar as done consistently (i.e., whereas there is adequacy between the goal and the implementation measure), and that the concrete application of the rules does not amount to State Aid[93], i.e., do not lead to granting a selective advantage to an excluded company, which is competing with one of the entities within the scope of application of the rules.

10.7.3 Use of thresholds

The Pillar Two proposed rules would only apply to MNE groups whose consolidated group revenue is at least 750 Million EUR.[94] This calculation is done taking into account the financial accounting standards applicable to the ultimate parent company of the group.[95] In this regard, the Blueprint presents a series of policy reasons in favour of that design option.[96]

This limitation is similar to the limitation proposed by the EU commission in its proposal for a Digital Services Tax (DST).[97] One of the authors of this study has already had the opportunity of examining the compatibility of such a threshold with EU law.[98] In that context, the claim that had to be assessed was whether the threshold would limit the application of the DST to companies outside of the European Union, thus shielding this measure to non-European Union cases. Within the purview of Pillar Two, such shielding effect appears much more difficult to uphold: i) being an Inclusive Framework initiative, it cannot be assumed that the design option aims at protecting the EU or a specific part of the globe; ii) whereas in the digitalised economy the number of EU players is comparatively quite limited, such a finding would be hard to extend to the Pillar Two rules, which would apply to the whole economy.

Even if it were possible to conclude that the threshold leads to a certain shielding effect, with the EU companies being – for that reason – exempt from the proposed Pillar Two rules, one would still conclude that the measure would not amount to indirect discrimination.

The Court has had the opportunity of revisiting the concept of indirect discrimination in the framework of a series of decisions regarding turnover taxes, in which thresholds were used. The Court considered a criterion, such as the amount of turnover, as a neutral criterion that would not amount to indirect discrimination. The latter

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[92] The Blueprints, supra n. 5, para 73 refer to three "key principles" but, in fact, the first and the third can be reconduced to the same idea: exclusion of entities whose low or no taxation does not affect the GloBE goals.

[93] As prohibited by Art. 107 et seq. of the TFEU.

[94] See Pillar Two Blueprint, supra n. 5, para. 113.

[95] See Pillar Two Blueprint, supra n. 5, para. 121.

[96] See Pillar Two Blueprint, supra n. 5, para. 114 to 188.

[97] Art. 4 of the Council of the European Union, 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 (21 Mar. 2018), EU Law IBFD.

[98] J.F. Pinto Nogueira, *The Compatibility of the EU Digital Services Tax with EU and WTO Law: Requiem Aeternam Donate Nascenti Tributo*, Intl. Tax Stud. 1 (2019), Journal Articles & Papers IBFD, section 4.3.2.2.

would only occur when the tax measure at staked relied on a criterion that inherently amounted to discrimination.[99]

The Court followed this criterion strictly in *Hervis*.[100] In *Vodafone*,[101] the Court went further and clarified this matter definitely. At stake was a turnover tax that operated with a system of bands and with steep progressivity, which had the effect of exempting from the higher-band all domestic companies. In fact, almost all of the tax was borne by foreign-owned companies.[102]

Despite this statistical correspondence between the tax and foreign ownership, the Court considered that there was no indirect discrimination. Said correspondence was considered as "fortuitous" and was "due to the fact that the Hungarian telecommunications market is dominated by such [foreign] taxable persons, who achieve the highest turnover in the market."[103] For the Court, "the amount of turnover constitutes a criterion of differentiation that is neutral and, on the other, turnover constitutes a relevant indicator of a taxable person's ability to pay."[104]

In conclusion, the Court appears to limit indirect discrimination to cases where the used criterion "inherently" amounts to discrimination. Leaving behind previous assessments focused on how the domestic-used criterion lead, in the large majority of cases,[105] or systematically,[106] to treat non-nationals or non-residents less favourably.

In the authors' view, it is correct to move from a quantitative-based approach to a qualitative-based approach. The fact that a tax is levied, in the majority of cases, by or even exclusively on non-nationals (or non-residents) cannot be seen, in itself, as indirect discrimination. In the context of the internal market and highly integrated economies, it is expected that States specialize in the production of goods and services in which they have a comparative advantage. Therefore, a normal (and intended) potential consequence of the internal market is that, at a certain point, national economic operators of one State could decide to stop offering a certain good or service, which starts to be offered by economic operators of another Member State. The fact that goods and services are (vastly or exclusively) provided by non-residents cannot mean that a State cannot levy a tax on those products or services, or even on the economic operator offering them. On the contrary, that would trigger issues both at a domestic (namely in terms of compliance with domestic constitutional law) and at a European level (namely in what concerns fundamental freedoms or State Aid).

In conclusion, the authors are of the view that the introduction of thresholds would not, per se, lead to indirect discrimination or any added concerns in terms of EU law. Nonetheless, and although not related to the European Union, it is the authors' view that high thresholds do not add anything to the fairness of the measure and may lead to some

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[99] This is based on the conclusions of AG Kokott in ANGED. In the words of the AG ""affect foreign undertakings in particularly intrinsic or in the vast majority of the cases" - see Opinion of Advocate General Kokott, 9 Nov. 2017, Case C-233/16, Asociación Nacional de Grandes Empresas de Distribución (ANGED) v. Generalitat de Catalunya, para. 38, ECJ Case Law IBFD.

[100] HU: ECJ, 5 Feb. 2014, Case C-385/12, Hervis Sport- és Divatkereskedelmi Kft. v. Nemzeti Adó- és Vámhivatal Közép-dunántúli Regionális Adó Főigazgatósága, Case Law IBFD.

[101] HU: ECJ, 3 Mar. 2020, Case C-75/18, Vodafone Magyarország Mobil Távközlési Zrt. v. Nemzeti Adó- és Vámhivatal Fellebbviteli Igazgatósága, Case Law IBFD.

[102] Vodafone (C-75/18), supra n. 87, Para. 45-48.

[103] Vodafone (C-75/18), supra n. 87, Para. 52.

[104] Vodafone (C-75/18), supra n. 87, Para. 50.

[105] DE: ECJ, 12 Dec. 2002, Case C-324/00, Lankhorst-Hohorst GmbH v. Finanzamt Steinfurt, Case Law IBFD, Para. 28.

[106] NL: ECJ, 24 Feb. 2015, Case C-512/13, Sopora v. Staatssecretaris van Financiën, Case Law IBFD, Para. 35-36.

abusive fragmentation practices, especially if not accompanied by strong anti-splitting measures.

10.8 In search of a solution: extension to domestic cases

In the previous sections, the authors provided evidence that limiting the application of the proposed Pillar 2 rules to cross-border cases may lead to cases of restriction or discrimination that find hurdles in their quest to be considered as justified or proportional in an EU law context.

In this respect, the past offers possible lessons that could act as good predictors of future policy developments.

In the wake of unfavourable decisions by the Court, many Member States have decided that, instead of merely abolishing the rule, they should extend it to domestic situations. Such a solution has been stably accepted by the Court whenever these (extended) measures have again appeared before the Court. In the context of CFC rules, this solution was also proposed by the OECD's BEPS final report on action 3.[107] The domestic extension means that Pillar 2 rules would have to be applied indiscriminately, regardless of the residency of the parties.

Of course, cne should start by acknowledging the shortcomings of such a proposal. Firstly, a domestic extension would not correspond to the implementation of a policy decision but merely to an issue of legality. Secondly, such extension would almost amount to a circumvention strategy since, in most cases, the domestic situations will not be impacted by the rule.[108] Thirdly, this approach would hamper domestic operators even in cases where there is no real reason for that obstacle, and that would be a collateral damage of a decision that merely aims to avoid issues of compatibility of rules targeting cross-borders operators.

In the words of Advocate General Geelhoed, on the extension of thin-cap rules to domestic scenarios

> "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 the 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 to situations falling wholly outwith its rationale, for purely formalistic ends and causing considerable extra administrative burden for domestic

[107] The OECD stated that "Applying CFC rules equally to both domestic subsidiaries and cross-border subsidiaries. A CFC rule will only be found inconsistent with the freedom of establishment if the rule itself discriminates against non-residents. (…) Therefore, if a CFC rule treats domestic subsidiaries the same as cross-border subsidiaries, it arguably should not be treated as discriminatory under the case law of the ECJ, and no justification is needed.". See OECD/G-20, *Designing Effective Controlled Foreign Company Rules - ACTION 3: 2015 Final Report*, Paris, 2015, p. 17-18.

[108] In the same vein, see Englisch & Becker, *International Effective Minimum*, *supra* n. 7, p. 524. Anyhow, it would not amount to an artificial circumvention or an abusive practice of the State insofar as the rule would effectively apply to all domestic scenarios. Therefore, whenever the domestic situation meets the conditions of the rule, it is also hit by the rule.

companies and tax authorities, is quite pointless and indeed counterproductive for economic efficiency. As such, it is anathema to the internal market."[109]

It is true that this extension does not fall within the original rationale of the Pillar Two package, which is related to profit shifting to low tax jurisdictions. However, it is also not prohibited by it.

Pillar Two rules are triggered by effective tax rates below a certain amount. One may also find such cases in the domestic scenario. This could be the consequence of several factors, namely low nominal tax rates, subjective exemptions, objective exemptions covering all or a great extent of the entities' income, incentives (such as patent boxes), depreciation, amortizations, among others.

In the authors' view, this extension would even lead to an enhancement of the Pillar Two project as a whole. If the rules are applied only in a cross-border scenario, they may lead to several cases of hidden (and not so hidden) tax protectionism [110] and distortion of competition.

For instance, in a post-Pillar Two scenario, a low-taxed entity could prefer to operate only in the domestic market since payments made under this scenario would never be subject to the undertaxed payments or subject to tax rule.[111] On the other hand, a company carrying out an activity subject to an objectively low level of taxation (for instance, because it generally benefits from a patent box) would prefer to set up the subsidiary in the same Member State, so to avoid the application of the income inclusion rule.

Asymmetrical application of Pillar Two rules would inevitably lead to more elaborate schemes of tax planning, in which groups would organize themselves to ensure that investment in low-tax jurisdictions is made from non-Pillar Two participating jurisdictions[112] . That income flows first to sufficiently taxed entities before it is shifted to a Pillar Two jurisdiction.

According to some authors, the extension of the rule would not suffice since it would be "very doubtful that within a domestic context a risk of tax avoidance and profit shifting of the kind contemplated here would ever be present." Even with the extension, "the rule would entail a de facto discrimination of cross-border transactions, which is prohibited by EU law".[113]

In the authors' view, the extension will not amount to any de facto discrimination. Again, the authors consider that the Court's orientation for assessing cases of indirect discrimination is quite helpful in this case. When applying that test to the proposed Pillar Two rules, it can be easily concluded that low(er) taxation is not inherently a cross-border issue. Several entities without cross-border exposure are subject to low effective tax rates just because they are entitled to a (subjective or objective) exemption or an incentive. It may also be the case of market conditions, such as losses. Thus, and in conclusion, domestic companies would also be effectively targeted, removing any hint of indirect discrimination.

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[109] UK: ECJ, 29 Jun. 2016, Case C-524/04, Opinion of Advocate General Geelhoed in Test Claimants in the Thin Cap Group Litigation v. Commissioners of Inland Revenue, Case Law IBFD

[110] See further, P. Pistone, *BEPS, Capital Export Neutrality and the Risk of Hidden Tax Protectionism. Selected Remarks from an EU Perspective*, in R. Danon. (ed.), *Base Erosion and Profit Shifting (BEPS). Impact for European and International Tax Policy*, ISBN: 978-3-7255-8605-9, Schulthess Verlag, 2016, 319-364, in particular at 321.

[111] Even if it does not lead to an increase of the burden of the paying agent, it surely leads to an increase of its administrative burden in comparison with a payment done to a domestic counterpart.

[112] This consideration appears particularly significant shall the Pillar Two package be labelled as a "best practice" rather than as a "minimum standard".

[113] De Broe, *OECD's Global Anti-Base Erosion Proposal*, *supra* n. 40, section 2.3.

It is true that this solution reshapes the intended outcome of the Pillar Two initiative, which will no longer be targeted at cross-border profit-shifting. However, such reshaping would not deprive this initiative of achieving – and achieving in its entirety – the goals towards which it was designed in the first place.

10.9 Conclusions

This chapter focused on addressing the compatibility of the proposed Pillar Two rules with EU primary law and, in particular, with fundamental freedoms.

In this respect, the authors observe that, as the Pillar Two package is a composite one, a distinction needs to be made between, on the one hand, the GloBE rules stricto sensu that would have to be introduced in the domestic laws of the MS, namely the IIR and the UTPR and, on the other hand, other sets of rules that would have to be included in the MS' tax treaty network, namely the SOR and the STR.

With regard to the two GloBE rules stricto sensu, there are concrete grounds to foresee that these rules would need to be assessed on the basis of free movement of capital, hence leading to an impact not only on intra-EU relations but also on relations involving third Countries.

Both rules would appear to raise issues in that regard as, in substance, they would virtually end up creating a link between the exercise of a fundamental freedom and the imposition of a top-up tax, which would likely be found to entail a discriminatory and less favourable treatment of taxpayers exercising fundamental freedoms. Moreover, it is doubtful whether the most traditional justifications that have been invoked to uphold measures triggering such consequences may apply to the proposed GloBE rules.

As such, the only way by which such friction could be overcome would be to foresee the extension of the scope of application of such rules also to domestic situations. Such a development would not be deprived of potential adverse consequences but, in the view of the authors, it may also contribute to a greater overall policy consistency of the GloBE initiative by minimising the room for disparities. Such an extension should not be discarded as the analysis of the connected trade-offs may ultimately be resolved positively.

On the other hand, when it comes to treaty-based rule, a distinction should be made between the SOR and the STTR.

The former would appear to come across as much less problematic when it comes to its interaction with EU primary law and, in particular, with fundamental freedoms and may ultimately be upheld in light of the Columbus Container legacy.

In what concerns the STTR, the analysis was divided into two parts. As far as the prong of the rule consisting in the source state regaining taxing rights is concerned, it is the authors' view that this should likely be considered as not incompatible with fundamental freedoms. On the other hand, with regard to the prong consisting in the triggering of a top-up tax, the main issue at stake would concern the asymmetrical application of the rule, which would place companies making cross-border payments in a different and worse tax situation than that of comparable companies making payments to domestic counterparts. At the same time, EU constraint would be somewhat less disruptive than what has been observed in connection to the IIR and UTPR, as it would apply only to closely related persons, hence most likely falling under the purview of the freedom of establishment.

In conclusion, and despite the amendments introduced by the Blueprint, there are still many issues in what concerns the compatibility of Pillar Two with EU law, which

ought to be solved before the rules are adopted. Otherwise, more than likely, the Court will tackle them as incompatible with EU Law.