The BEPS “Pillar 2” Model Rules

and

their compatibility with primary EU law

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A. Introduction

Apple, Amazon, Fiat or Deutsche Bank, to only name a few.[1]

Meanwhile, financial crisis, refugee crisis, corona crisis and now, horrible and beforehand unimaginable, even war in Europe.

While private corporates celebrate skyrocketing profits, governments and the public hand are confronted with ever greater expenses in the interest of the public good. Yet, the beforementioned multinational companies (MNEs) and an unknown number of others try to evade their responsibility as taxpayer and profit from loopholes, mismatches and opacities of the international tax systems. With up to 240 billion USD lost annually due to tax avoidance by multinational companies, states cannot tolerate the harmful practice anymore, both from an economical, as well as from a social fairness point of view.[2]

In astounding regularity, leaks and publications such as the *Swiss, Luxembourg* and *Offshore Leaks* or the *Paradise* and *Panama Papers* have revealed the horrendous scale of those harmful tax evasion strategies.

The G20/OECD's Pillar Two initiative to combat the practice of base erosion and profit shifting (BEPS) along with the implementation of a 15% global minimum corporate tax rate therefore appears to be one of the most promising and exciting projects in international taxation.

This paper attempts to explore and explain the core mechanism behind the project's approach and develop an understanding of the complexities and challenges alongside.

Furthermore, as it is the largest internal market in the world and hence especially interesting in terms of MNE's and tax, the second part of the paper focuses on the implementation of Pillar Two in the European Union and into EU law. However, the paper will not enter into a discussion of the specific operational elements.[3] Instead, as some authors have expressed concerns in that regard, it will rather take a fundamental approach and assess the European Commission's directive proposal in terms of its compatibility with primary EU law.[4]

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[1] https://www.dw.com/en/apple-ireland-tax-avoidance/a-54274213, retrieved 25.03.2022; https://www.theguardian.com/technology/2021/may/04/amazon-sales-income-europe-corporation-tax-luxembourg, retrieved 25.03.2022; https://www.dw.com/en/starbucks-fiat-to-repay-illegal-tax-advantages/a-18794830, retrieved 25.03.2022; https://www.dw.com/en/from-panama-to-paradise-the-biggest-tax-evasion-data-leaks-in-history/a-41277967, retrieved 25.03.2022.

[2] https://www.oecd.org/tax/beps/about/, retrieved 25.03.2022.

[3] On this, see also: Nogueira, J.F.P., *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*, World tax Journal, Vol. 12.2020, 3, p. 470 ff.

[4] de Broe, L., *OECD's Global Anti-Base Erosion Proposal ("GloBE") – Pillar Two Raises Fundamental Concerns of Compatibility with EU Law,* KU Leuven (3 Dec. 2019), https://serval.unil.ch/resource/serval:BIB_D8C1987EFA9C.P001/REF, p. 12, retrieved 26.04.2022.

However, in order to understand the underlying issues of international taxation, a short explanation of general assumptions and challenges regarding international taxation and the development of the BEPS project will, first, lead into the subject matter.

I. The concept of international taxation

Both the basis, as well as the issues of international taxation lie within the sovereignty of states. According to the general theory of state by Georg Jellinek, a state consists of state territory, state authority and state people.[5] Out of territory and people, the state authority creates the state. Said state authority contains the ability to manifest internal order, the so-called internal sovereignty, and external independence, the so-called external sovereignty.[6]

Important for international law is the concept of external sovereignty, as it determines that a state is subject to no legal order other than the international law, especially not subject to the legal order of any other state.[7]

This key concept of international law sets the framework for any international interaction and is, hence, also essential to international tax law.

1. Origin of a tax claim

From a state's perspective, therefore, a state has the internal sovereignty to impose taxes on events occurring on its own territory as well as in a foreign state (although practically there might not be a possibility to enforce the tax claim without breaching international law).

In contrast, the international law, taking into account the external sovereignty of each state, demands states and their tax claim to have a genuine link or connection to the taxable subject.[8]

Despite several possible connecting factors, in the field of direct taxation, two main principles have crystallized in order to define if a state has a tax claim towards a potential taxpayer, known as the principle of residence and the principle of source.[9]

The principle of residence is defined by a subjective connection between state and taxpayer, which results from the general or habitual place of the taxpayer's residence.[10] In the specific case of corporations, this principle has been construed over the years to mean place of incorporation and/or place of effective management of the corporation.

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[5] Jellinek, G., A*llgemeine Staatslehre*,3. Auflage, Verlag von O. Häring, Berlin 1914, pp. 394 ff.
[6] Epping, in: Ipsen, *Völkerrecht*, 7. Auflage, §7 Rn. 137 (p. 139).
[7] Stein/v. Buttlar/Kotzur, *Völkerrecht*, 14. Auflage, Rn. 515 (p.188).
[8] Lang, M., *Introduction to the Law of Double Taxation Conventions*, 3rd edition, Linde Verlag, p. 1.
[9] Ecclestone, R., *The Dynamics of Global Economic Governance: The Financial Crisis, the OECD and the Politics of International Tax Cooperation*, Edward Elgar Publishing Limited 2012, p. 18.
[10] Brähler, G., *Internationales Steuerrecht*, 8. Auflage, p. 4.

The principle of source, on the other side, is defined, in its essence, by an objective connection between state and taxpayer. It results simply from any income generated on the state's territory, independent from any personal connection of the taxpayer to the relevant state.

Although these principles are the main concepts in the area of direct taxation, potential connecting factors, especially in other areas of taxation, can also be found e.g. place of consumption or location of transaction.[11]

2. Extension of the tax claim

Depending on the connecting link the state applies to justify the tax claim, the extension is concluded.

When the claim is based on the residency principle, the so-called universality- or world-income -principle is applied. According to said principle the state's tax claim extends to the entire income generated by a taxpayer, both within the state's territory and abroad.[12]

On the other side, when the claim is based on the objective connection in terms of the source principle, the so-called territoriality principle is applied. Hereby, the state's tax claim only extends to the taxpayer's income generated within the state's territory.[13]

3. The issue

As explained above, it is the exercise of a sovereign right of each state to tax any natural or legal person within its authority as it sees fit.

However, several negative consequences result from frictions between source- and residency taxation within the international tax order.

The first to mention is the risk of double taxation. Generally defined, double taxation occurs when the same person or thing is taxed twice.[14] Economic double taxation occurs, when the same amount is taxed twice, for example when a corporate income tax is levied, and later on, the company's shareholders are taxed in terms of a personal income tax as well. Essential in the context here however is the juridical double taxation, describing the taxation of the same taxpayer and the same subject for the same time period by more than one jurisdiction.[15] It occurs, when for example source and residence country both levy taxes according to territory-

[11] Brähler, G., *supra Fn 10,* pp. 4 ff.
[12] Wilke, K.-M./Weber, J.-A., *Lehrbuch Internationales Steuerrecht*, 13. Auflage, p. 6.
[13] Homburg, S., *Allgemeine Steuerlehre*, 7. Auflage, p. 274.
[14] Seligman, E.R.A., *Essays in Taxation*, The Macmillan Company, 1921, 9th Edition, p. 98.
[15] OECD (2019), *Model Tax Convention on Income and on Capital 2017 (Full Version)*, OECD Publishing, Paris, https://doi.org/10.1787/g2g972ee-en, p. I-1; Jogarajan, S. (2018). *Double Taxation and the League of Nations* (Cambridge Tax Law Series). Cambridge: Cambridge University Press, p. 7.

and universality income principles, respectively. It appears obvious, that the multiple imposition of a tax burden is obstructive to international trade as well as to the businesses themselves. States often use double taxation agreements (DTAs) to settle potential conflicts around said issue.[16]

However, a more pressing concern in regard to international taxation is the opposite of the beforementioned double taxation, the so-called double non-taxation. It describes the consequence of cross-border operating persons escaping taxation due to mismatches between national tax systems.[17] Although generally the unharmful double non-taxation is imaginable in specific cases, the current challenges are rather posed by intentional and harmful exploitation of mismatches by cross-border operating companies.[18]

According to the OECD the exploitation of such mismatches, also described as base erosion and profit shifting (BEPS) costs countries 100-240 billion USD in revenue annually.[19]

Alongside, when jurisdictions themselves decide to use tax incentives to attract foreign investments up to the point of the creation of tax havens, investment choices are distorted, economic competition hindered, welfare reduced and generally, taxation efficiency limited.[20]

MNE's use said mismatches, for example, to transfer intellectual property from low-tax to high-tax jurisdictions, charge licensing fees high above the market average to the related company, which in turn can deduct a large amount of that investment under domestic tax law. Hence, the MNE has managed to secure a significantly higher amount of profit due to the exploitation of mismatches between the tax systems, to name only one example.[21] Apart from such transfer pricing strategies, MNE's have been creative in developing various mechanisms to avoid paying taxes.[22]

[16] https://www.un.org/development/desa/financing/sites/www.un.org.development.desa.financing/files/2020-06/TT_Introduction_Eng.pdf, p. 1, retrieved 25.03.2022.
[17] IP/12/201, *Tackling double non-taxation for fairer and more robust tax systems*, European Commission - Press Release, p. 1.
[18] Marchgraber, Christoph (2018): Double Non-Taxation: Not only a Policy but also a Legal Problem, Kluwer International Tax Blog, January 5, 2018, available: http://kluwertaxblog.com/2018/01/05/double-non-taxation-not-policy-also-legal-problem/, retrieved 21.03.2022.
[19] https://www.oecd.org/tax/beps/, retrieved 21.03.2022.
[20] Shaxson, N., *Tackling Tax Havens – The billions attracted by tax havens do harm to sending and receiving nations alike,* Finance & Development, September 2019, Vol. 56, No. 3.; NOU Official Norwegian Reports 2009: 19, *Tax havens and development – Status, analyses and measures*, p. 48.
[21] Mason, R., *The Transformation of International Tax*, American Journal of International Law, Vol. 114 Issue 3, pp. 357 ff.
[22] Mason, R., *supra Fn. 21*, p. 358.

II. Historic development of the BEPS project

During most of the 20th century such tax avoidance by multinational corporations was not seen as a significant risk for economic or political prosperity, or otherwise ignored as the workload was feared to be too intense.[23]

However, with globalisation on the rise, the global economies became increasingly intertwined in terms of trade and financial flows, allowing corporates to grow in unforeseen dimensions and generating ever higher amounts of profits. Simultaneously, new forms of telecommunication and especially the upcoming of the internet, as well as the accompanying liberalisation of trade and finance allowed corporates to expand in terms of mobile business and investments.[24]

Furthermore, opposite to the early 20th century and with regard to legal access, the residence of a corporation could not be determined as easily anymore. The classic national identity of a company, that most likely derived from its headquarters location, where also most likely its shareholders were located and that most likely coincided with the country the corporation was found in, has dissolved in the context of the global economy.[25]

In consequence, the exploitation of differences in tax systems could flourish.

However, by the end of the 1990s, experts started to realize the harmful impact of unscrutinised and unharmonized tax competition which continued leading to aggressive tax avoidance by wealthy individuals and MNEs.[26] Nevertheless, the negligence of governments and public towards the blatant harmful behaviour of MNEs only came to an end ten years later when the world was confronted with the harsh reality of the financial crisis in 2008.[27]

While, on the one side, thousands lost their jobs and, on the other side, companies received public bailouts, the tolerance of the public opinion for tax evading mechanisms and, generally, the tolerance for unethical corporate behaviour, achieved its point of exhaustion.[28] As a result, public pressure on governments increased and, hence, several public investigations were launched, forcing a greater focus on tax evasion schemes by individuals and corporates.[29]

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[23] Mason, R., *supra Fn. 21*, p. 356.
[24] Mason, R., *supra Fn. 21*, p. 357.
[25] Nakayama, K./Perry, V. *Chapter 7 Residence-Based Taxation: A History and Current Issues*, in: Corporate Income Taxes under Pressure, International Monetary Fund 2021, p. 108.
[26] van Apeldoorn, L., *BEPS, tax sovereignty and global justice*, Critical Review of International Social and Political Philosophy, 21:4, p. 478.
[27] Mason, R., *supra Fn. 21*, p. 364.
[28] https://www.ft.com/content/96ec9414-39a6-11de-b82d-00144feabdc0, retrieved 23.03.2022; https://www.politico.com/story/2009/05/obama-targets-offshore-havens-022094, retrieved 23.03.2022.
[29] https://www.wsj.com/articles/SB123685028900906181, retrieved 24.03.2022; https://www.independent.co.uk/news/world/europe/adidas-and-michelin-in-taxhaven-fraud-inquiry-1658974.html, retrieved 24.03.2022; https://bernews.com/2010/12/bermuda-named-in-india-tax-probe/, retrieved 24.03.2022.

These events also sensitized governments for the necessity of international cooperation regarding the international challenges of base erosion and profit shifting schemes, and led to the Organisation for Economic Cooperation and Development (OECD) becoming an integral part in combatting said development.[30]

Thus, in 2013 the G20 member states developed jointly with the OECD the so-called BEPS Action Plan, in order to address weaknesses of the international tax systems by increasing transparency and the exchange of tax related information.[31]

Regarding the strategy, the BEPS Action Plan consisted of reports on 15 actions including different measures, from new minimum standards, the revision of existing standards, up to common approaches aiming at facilitating the convergence of national practices, and guidance drawing on best practices.[32] Furthermore, participating states agreed on a general policy direction in terms of hybrid mismatch practices and best practices on interest deductibility.

In 2015 the participating countries of the OECD and G20 member states agreed on the implementation of the beforementioned Action Plan, leading to the introduction of the Inclusive Framework (IF) in 2016, a platform for participating states to coordinate and overlook the implementation process.[33] From its initial 82 members at the inaugural meeting in July 2016 the Inclusive Framework has grown up to more than 130 Inclusive Framework members, representing more than 90% of global GDP.[34]

In 2021, amid the coronavirus pandemic, the Inclusive Framework agreed on a two-pillar solution to address the tax challenges arising from the digitalisation of the economy. While Pillar One focusses on the introduction of taxation rights for digitally supplied services, Pillar Two aims at the introduction of a global minimum corporate taxation for MNEs, with a meanwhile determined minimum tax rate of 15%. The earliest implementation is set for 2023.[35]

[30] Oei, Shu-Yi, *World Tax Policy in the World Tax Polity? An Event History Analysis of OECD/G20 BEPS Inclusive Framework Membership*, Yale Journal of International Law, Vol. 47, 2021-22, Boston College Law School Legal Studies Research Paper No. 568, p. 3.
[31] *BACKGROUND BRIEF – Inclusive Framework on BEPS*, OECD January 2017, p. 9.
[32] *BACKGROUND BRIEF, supra Fn. 31*, p. 9.
[33] OECD/G20 Inclusive Framework on BEPS Progress report July 2018 – May 2019, p. 2.
[34] OECD/G20 Inclusive Framework on BEPS Progress report July 2020 – September 2021, p. 2.
[35] OECD (2022), OECD Secretary-General Tax Report to G20 Finance Ministers and Central Bank Governors, Indonesia, February 2022, OECD, Paris, p. 4.

B. Pillar Two Mechanics – Overview

As this paper focuses on the functioning and implementation of the IF's Pillar Two, the mechanics behind this particular part of the two-pillar solution have to be explained thoroughly.
The Pillar Two system developed by the IF consists of a "three rules concept", connecting OECD GloBE rules with double taxation treaties by the individual states.
Implemented by a model jurisdiction and listed in order of their application those are the *Subject to tax rule* (STTR), the *Income Inclusion Rule* (IIR) and the *Undertaxed Payment Rule* (UTPR).[36] The general intention behind this system is the effective implementation of the minimum effective tax rate (ETR) established at 15% and the prevention of Base Erosion and Profit Shifting (BEPS).[37]
The following paragraphs will describe the mechanics of those rules with the intent to allow a profound understanding of potential implementation challenges and possible friction with fundamental EU law.

C. Income Inclusion Rule

Central to the functioning of the BEPS Pillar Two Initiative is the IIR, whose aim is the allocation of taxing rights regarding the income of constituent entities located in low tax jurisdictions. One of the main issues for BEPS identified by the OECD is the transfer of income from high tax to low tax jurisdictions. MNEs use that strategy in order to avoid higher taxation and therefore lower profits. The IIR's aim is to tackle that problem by returning those "lost" income transfers to BEPS-applying jurisdictions.

I. General requirements for application of IIR

In order to allow such allocation of otherwise "lost" income transfers, the definition of *high* and *low tax* jurisdiction is of crucial importance.
It is primarily dependant on the ETR calculated for the jurisdiction hosting the relevant entity. As the agreed minimum effective tax rate is set at 15%, any jurisdiction that levies a lower ETR is regarded as a low tax jurisdiction, whose taxing rights can potentially be allocated.
Any jurisdiction that levies a 15 % ETR or higher is regarded a high tax jurisdiction and the GloBE rules do not apply to the relevant entity located in said jurisdiction.

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[36] OECD (2020), *Tax Challenges Arising from Digitalisation – Report on Pillar Two Blueprint: Inclusive Framework on BEPS*, OECD/G20 Base Erosion and Profit Shifting Project, p. 171 f.
[37] Tax Challenges Arising from the Digitalisation of the Economy – Global Anti-Base Erosion Model Rules (Pillar Two): Inclusive Framework on BEPS, OECD 2021, p. 60.

Apart from the low tax jurisdiction requirement, the IIR has to be actively applied. The member states of the Inclusive Framework have recognized the IIR as a common approach. Hence, the IIR is not an obligatory rule and in consequence member states have to actively choose to apply the rule. In case of acceptance, they are expected to apply the IIR according to the GloBE rules and accept the application by other International Framework members as well.[38]

Finally, as the IIR requires a state that applies the rule and a state the rule is applied to, a link between those states must exist in the form of both being host to entities of the same MNE.

Thus, so far, several factors have to be fulfilled before even considering the application of the IIR. The International Framework member must have accepted the GloBE rules and must apply the IIR. The relevant state must host an MNE entity, that has at least one further, foreign entity and lastly, that foreign entity must be located in a low tax jurisdiction.

II. Specific requirements for application of IIR

Usually however, MNEs consist of more than only two entities, have distinct organisational structures and are located across the globe in many jurisdictions. Therefore, the features explained above do not suffice for a clear allocation of taxing rights to one single jurisdiction. If implemented in such manner the consequence would be chaos and double taxation, which has to be avoided. Hence, a further distinction is necessary.

The GloBE rules therefore have established a concept of categorizing the MNE into two general types of entity, the Ultimate Parent Entity (UPE) and the Constituent Entity (CE). These are characterized by their ownership structure and hierarchy level.

Therefore, acc. to Art. 1.4. BEPS Model Rules a UPE is defined as an entity, that

> *"a) […] owns directly or indirectly a sufficient interest in one or more other Constituent Entities of such MNE Group […] and*
>
> *b) there is no other Constituent Entity of such MNE Group that owns directly or indirectly an interest described in paragraph (a) above in the first mentioned Constituent Entity."*[39]

In consequence a Constituent Entity acc. to Art. 1.3. BEPS Model Rules is roughly described as

> *"any separate business unit of an MNE Group that is included in the consolidated financial statements of the MNE Group […]"*[40]

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[38] *Statement on a Two-Pillar Solution to Address the Tax Challenges Arising from the Digitalisation of the Economy*, OECD/G20 Base Erosion and Profit Shifting Project, p. 8.

[39] OECD (2020), *supra Fn. 36*, p. 24.

[40] OECD (2020), *supra Fn. 36*, p. 24.

1. The Top-down approach

This ownership concept results in a hierarchal structure which is crucial for the application of the IIR.[41] It results in a chain of ownership, comparable to a chain of command in administrative or military structures.

The *top-down approach* is described in Art. 2.1.3. BEPS Model Rules and generally follows that logic. It presents a mechanism to coordinate the right of allocating taxes deriving from an entity located in a low tax jurisdiction. It establishes that the primary taxing right under such circumstances falls to the jurisdiction hosting the "highest" entity in the chain, hence the UPE, acc. to Art. 2.1.3. lit. a) BEPS Model Rules.

If, however, the UPE-hosting jurisdiction does not apply the IIR, acc. to Art. 2.1.3. lit. b) BEPS Model Rules the right is "passed down" to the jurisdiction hosting the next constituent entity in its ownership chain. Any constituent entity, that is owned by a superior MNE entity, but at the same time has ownership over further constituent entities, is regarded an Intermediate Parent Entity (IPE).[42]

The taxing right is therefore passed down from the UPE-hosting jurisdiction to the next IPE-hosting jurisdiction, until it "arrives" in a jurisdiction applying the IIR and consequently is allowed to apply that specific taxing right.

2. ETR & Top-up tax in regard to IIR

Said taxing right allows the IIR-applying member state to impose a "top-up tax" on the IPE located in its jurisdiction, which it allocates from the CE located in the low tax jurisdiction according to Art. 5.2.1. BEPS Model Rules. However, further distinction regarding the amount of tax allocable is required. The mechanism works as follows:

As the top-up tax calculation itself is based on the ETR, firstly the effective tax rate has to be calculated.[43] Earlier rules, such as the CFC rules, have computed the ETR regarding subsidiaries mainly based on a standalone entity basis.[44]

The Model Rules, however, impose a jurisdictional blending approach according to Art. 5.1. BEPS Model Rules. In order to calculate the actual ETR accruing to the MNE Group's income in a low tax jurisdiction it takes into account all the relevant tax factors not of each CE

[41] OECD (2020), *supra Fn. 36*, pp. 114 f.
[42] OECD (2020), *supra Fn.36*, pp. 114 f.
[43] Tax Challenges Arising from the Digitalisation of the Economy, *supra Fn. 37*, p. 28.
[44] OECD (2020), *supra Fn.36*, pp. 113 f.

individually, but of all CEs of the MNE Group in the relevant jurisdiction combined.[45] Those factors are described in Art. 3.2. BEPS Model Rules.

Secondly, the ETR is measured against the minimum rate of 15%.

As a result, the top-up tax represents the percentage that makes up the difference between the ETR of the low tax jurisdiction and the minimum rate of 15%.[46]

This difference is then allocated as a top-up tax from the CE in the low tax jurisdiction to the controlling IPE of the IIR-applying jurisdiction, compare Art. 2.1.1 – 2.1.3. BEPS Model Rules.[47] However, the top-up tax is only applied in proportion to the ownership share of the UPE which the controlling IPE of the IIR-applying jurisdiction has in the low-taxed CE, acc. to Art. 2.2. BEPS Model Rules.

3. Interim result

As a conclusion, the following example illustrates the previous explanations:

Jurisdiction A, that does not apply the IIR, hosts an UPE of MNE Group "X".

Jurisdiction B, that does apply the IIR, hosts an IPE of MNE Group "X".

Low tax jurisdiction C hosts a CE of MNE Group "X".

All entities are 100% owned by the UPE.

Due to a lack of IIR application, the "hypothetical" taxing-right from jurisdiction A is passed down by the top-down approach to the next IIR-applying jurisdiction, which is Country B. Country B now computes the ETR of CE in Country C by including all relevant tax factors of all CEs owned by the MNE Group "X" in Country C.

Next, it measures the resulting ETR against the difference to the minimum tax rate of 15% and computes the top-up tax. Finally, it considers the ownership share the UPE has in the low-taxed CE and proportionally allocates the top-up tax to "its" IPE in Country B.

4. Split-ownership issues

Globally operating MNEs however often do not own IPEs and CEs to their entirety but allow third parties to participate through the distribution of shares. Roughly 3000 companies above the 750M threshold are publicly traded allowing thousands of owners to participate.[48]

In such a scenario, the application of the top-down approach could lead to significant imbalances regarding the distribution of tax burdens.

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[45] Tax Challenges Arising from the Digitalisation of the Economy, *supra Fn. 37*, pp. 28 f.
[46] Tax Challenges Arising from the Digitalisation of the Economy, *supra Fn. 37*, p. 29.
[47] Tax Challenges Arising from the Digitalisation of the Economy, *supra Fn. 37*, p. 11.
[48] https://companiesmarketcap.com/largest-companies-by-revenue/page/30/, retrieved 15.12.2021

As described in II.2., the allocation of the top-up tax is proportionate to the ownership share of the UPE, being "passed down" the ownership chain. Regarding the example above, that means the UPE in jurisdictions A owns the IPE in jurisdiction B to 100% and therefore also the CE in jurisdiction C to a 100%. Hence the top-up tax is allocated from CE to IPE to 100% and in consequence the UPE wholly owning both bears the full tax burden.

If the UPE was again located in a non IIR-applying jurisdiction, however only owned 60% of the IPE, the tax burden would decrease significantly:

According to Art. 2.2. BEPS Model Rules only 60% of the CE's income in Country C would in total be attributable to the MNE Group, as that is equivalent to the MNE's ownership share. In consequence, Country B would apply the top-up tax only to 60% of the CE's GloBE income and therefore only allocate 60% of the calculated top-up tax to the IPE. However, as country B would lay the top-up tax burden on the entire IPE, including all the IPE's shareholders, also the 40% non MNE-related minority shareholders would pay the tax. Hence, the UPE would only pay 60% of the IPE's tax burden, which in consequence would lead the MNE to only pay 36% of the initial top-up tax burden, contrary to the original aim of taxing the 60% ownership of the MNE Group.

This result could lead to economic distortions, as the tax burden would depend on the corporate structure.[49]

To avoid said negative incentives for corporate structuring and economic distortion the split ownership rules according to Art. 2.1.4. et seq. BEPS Model Rules provide an exemption to the top-down approach.[50]

According to Art. 2.1.4. BEPS Model Rules the IIR is not "passed down" the ownership chain until it "arrives" in a jurisdiction applying the IIR. Instead, even if a wholly owned IPE "further up" is located in an IIR applying jurisdiction, the IIR is applied by the "primary" partially-owned IPE that owns interest in the low taxed CE. The IIR application again is based on that entity's ownership share of the low taxed Constituent Entity.

Recalling the example above, Country B hosting the partially-owned IPE would not orient the IIR on the ownership share of the MNE Group in the CE, but rather on the ownership share of the partially-owned IPE itself. As the partially-owned IPE owns the CE in Country C to 100%, Country B would also allocate the calculated top-up tax to 100% to the partially-owned IPE. In consequence, the UPE owning 60% of the IPE, would bear proportionally 60% of the IPE's tax burden.

[49] OECD (2020), *supra Fn. 36*, p. 118.
[50] OECD (2020), *supra Fn. 36*, pp. 117 f.

If, however, that "primary" partially-owned IPE owns further "derivative" partially-owned IPEs to 100% (which would by definition also be partially-owned IPEs), the IIR would remain by the "primary partially-owned IPE" acc. to Art. 2.1.5. BEPS Model Rules and not pass "further down". This mechanism aims to ensure to apply the IIR more comprehensively to the low taxed income of the MNE Group where a significant portion of that income is not beneficially owned by the Ultimate Parent Entity.[51]

Eventually, if the income of the CE is subject to tax under an IIR at the level of a partially-owned IPE, the split-ownership rule exempts that income from taxation "further up" the ownership chain according to the offset mechanism described in Art. 2.3 BEPS Model Rules.

Hence, double taxation can be avoided, and the tax burden is borne proportionally between the MNE Group and the minority shareholders based on their ownership share.[52]

III. IIR Conclusion

The IIR displays a rule to coordinate the allocation right for the top-up tax, a core instrument for the BEPS initiative. With mechanisms such as the top-up tax, top-down approach or ownership rules it aims to secure legal certainty and clear tax liability.

It appears to be a straightforward concept, however only as long as the corporate structure is similarly straightforward.

The split-ownership rules give an impression of the complexity that might await this instrument in terms of corporate reality. Furthermore, the amount of coordination and communication between jurisdictions and corporates, amongst each other and amongst themselves appears to be intense in order to reach a smooth functioning.

D. Undertaxed Payment Rule

As described above, the IIR aims to allocate the taxing rights for undertaxed MNE-income from low tax jurisdictions to IIR-applying jurisdictions. The rule follows the general idea of denying MNEs to unproportionally profit from differences in taxation between different jurisdictions.

Whereas the unwelcome tax benefits targeted by the IIR result from systemic differences between jurisdictions, the UTPR targets the unwelcome tax advantages gained by MNEs through specific exploitation of these differences. In doing so, it serves a hybrid function both as a backstop to the IIR, as well as a specific tool against base erosion.[53]

[51] OECD (2020), *supra Fn. 36*, p. 119.
[52] OECD (2020), *supra Fn. 36*, p. 119.
[53] OECD (2020), *supra Fn. 36*, p. 128.

The fundamental prerequisite for the application of the UTPR is the existence of deductibles in the UTPR-applying jurisdiction. Deductibles in this regard are items of current expenditure such as service payments, rents, royalties, interest and other amounts that may be set-off directly against ordinary income.[54] If available in the relevant jurisdiction, they can be subtracted from the total taxable income which can substantially reduce taxes owed by an individual or corporation.[55]

The simplest approach to use deductibles as base erosion mechanism is explained in the following example:

MNE Group "X" has an IPE A in high tax jurisdiction A and an IPE B in low tax jurisdiction B. IPE B charges IPE A 100 for a service, which IPE A pays to IPE B. That service is deductible in jurisdiction A. IPE A then sets-off the paid 100 against its income and reduces its tax liability. IPE B pays the low tax on the received payment in jurisdiction B. MNE Group "X" benefits by actively exploiting the differences.

The approach of Art. 2.4. BEPS Model Rules therefore lays in the denial of deductibility. Regarding the example above, IPE A would not be allowed to set-off the paid 100 against its income.

However, the UTPR is not simply a denial of deductibility, but rather the allocation of a tax which is levied as a denial of deductibility. As for the IIR, this tax is again a top-up tax which also operates by the same calculational mechanisms as the IIR.[56] Therefore, again the ETR of the relevant jurisdictions is calculated, measured against the minimum tax rate of 15% and finally the tax is computed. The conformity of the top-up tax calculation mechanism for IIR and UTPR is supposed to improve coordination and reduces implementation and compliance costs.[57]

I. Order of application

However, as the UTPR can potentially be applied in any CE-hosting jurisdiction and the outcomes under UTPR will vary based on specific factors, the application of the UTPR is regarded to be more complex with the requirement of increased coordination between jurisdictions compared to the IIR.[58]

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[54] OECD (2015), *Neutralising the Effects of Hybrid Mismatch Arrangements, Action 2 - 2015 Final Report*, OECD/G20 Base Erosion and Profit Shifting Project, p. 51.
[55] Legal Information Institute, Cornell Law School, search: "deductible", access via https://www.law.cornell.edu/wex/deductible, retrieved 28.04.2022.
[56] OECD (2020), *supra Fn. 36*, p. 126.
[57] OECD (2020), *supra Fn. 36*, p. 126.
[58] OECD (2020), *supra Fn. 36*, p. 175.

Therefore, acc. to Art. 2.5.2 BEPS Model Rules no top-up tax is allocated under the UTPR if a CE is wholly owned by an IIR-applying parent entity. Furthermore, the UTPR-top-up tax is reduced by a corresponding amount, if an IIR-applying PE holds shares in the low taxed CE, acc. to Art. 2.5.3. BEPS Model Rules.
Hence, the UTPR is only fully applied acc. to Art. 2.5.1. BEPS Model Rules, when the relevant CE is not otherwise taxed by an IIR-applying jurisdiction.

II. Allocation of the top-up tax

Different to the IIR, the mechanism to allocate the top-up tax when applying the UTPR does not follow any top-down approach and ownership chain. Rather, it focuses on two specific factors explained in Art. 2.6.1 BEPS Model Rules. The former two-step approach described in the draft has not been incorporated in the Model Rules.
Instead, the allocation mechanism is orientated on a more general and comprehensive method, based on two factors, the Total UTPR Top-up Tax amount and the UTPR Percentage, acc. to Art. 2.6.1. BEPS Model Rules.

1. The Total Top-Up Tax Amount

First, the total top-up tax amount is calculated. It hereby accounts acc. to Art. 2.5.1. BEPS Model Rules to the sum of the top-up taxes of all low-taxed CEs combined.
For example, the MNE Group "X" has CEs is jurisdiction A, B, C and D, respectively called Co A, Co B, Co C and Co D. Furthermore, except jurisdiction A, all other jurisdictions are low tax and the relevant CEs therefore low-taxed CEs. Using the same calculation mechanism as for the IIR, the top-up tax percentage for each low-taxed CE is calculated and in proportion to their profit a top-up tax amount is computed. In the example above, that could result in the top-up tax amounting to Co. B, Co. C and Co. D being 10 each. The total top-up tax amount would therefore be the sum of all the top-up taxes, hence 30.

2. The UTPR percentage

The UTPR percentage calculation is described in Art. 2.6.1. BEPS Model Rules and includes two more aspects from two more perspectives.

a) Workforce

The first aspect is the workforce component.

From a single-jurisdictional perspective, the UTPR percentage calculation first counts the total number of employees of all the CEs of the MNE Group located in that one specific jurisdiction, that applies the UTPR and that the top-up tax is allocated to, described in Art. 2.6.1. lit. a) BEPS Model Rules.

From a multi-jurisdictional perspective, it measures the total amount of all employees of all CEs of that MNE Group in all jurisdictions that apply the UTPR and simultaneously host CEs of that MNE Group, acc. to Art. 2.6.1. lit. b) BEPS Model Rules.

The UTPR percentage calculation now measures the results of those two calculations against each other, and therefore, by proportion, computes the "workforce importance" of the relevant UTPR-applying jurisdiction compared to all the other UTPR-applying jurisdictions.

This "workforce importance" accounts for 50% of the UTPR percentage.

b) Assets

The second aspect is taken into account similarly, but focuses on tangible assets, rather than workforce. Again, a single and a multi-jurisdictional perspective are applied.

Acc. to Art. 2.6.1. lit. c) BEPS Model Rules, first the sum of the net book values of tangible assets of all the CEs in the single relevant jurisdiction is calculated.

Subsequently, in terms of the multi-jurisdictional perspective, the sum of the net book values of tangible assets of all CEs in UTPR-applying jurisdictions is calculated, described in Art. 2.6.1. lit. d) BEPS Model Rules as total value of tangible assets.

The results are again measured against each other and compute the "tangible asset importance", which also accounts for 50% of the UTPR percentage.

c) Interim Result

This calculation is depicted in Art. 2.6.1. BEPS Model rules as follows:

$$50\% \times \frac{\textit{Number of Employees in the jurisdiction}}{\textit{Number of Employees in all UTPR jurisdictions}} + 50\% \times \frac{\textit{Total value of Tangible Assets in the jurisdiction}}{\textit{Total value of Tangible Assets in all UTPR jurisdictions}}$$

The combination of workforce and assets of a PE represents the intra-group value and profit generating proportion. By applying the allocation mechanism to the said proportion, also the undertaxed profits of low taxed CEs are proportionally considered.

This general approach to allocate the UTPR solves former profit shifting concerns the intra-group payment mechanism caused.[59] It allows a comprehensive view of the entire MNE Group and takes into account any untaxed profit in low taxed jurisdictions.

[59] OECD (2020), *supra Fn. 36*, p. 132.

III. Sanctions

Although the UTPR rules according to Art. 2.6. BEPS Model Rules do not implement sanctions in a traditional sense, they do provide a detrimental mechanism, if jurisdictions do not apply the rules as intended.

If a certain UTPR tax amount is allocated to jurisdiction A, acc. to Art. 2.4. BEPS Model Rules, said jurisdiction A is supposed to deny a deduction to the relevant CEs in its jurisdiction. That denied deduction shall result in those CEs having additional cash tax expense. That cash tax expense shall be equal to the top-up tax amount.

If, however, jurisdiction A fails to achieve the pursued result of Art. 2.4. BEPS Model Rules and the cash tax expense stays below the allocated top-up tax amount, Art. 2.6.3. BEPS Model Rules applies. For the next fiscal year, the UTPR percentage of jurisdiction A counts as "0", resulting in zero UTPR top-up tax being allocated to jurisdiction A for the next year. At the same time, the number of employees and tangible assets of the relevant MNE Group located in jurisdiction A is left out of the calculation for the total UTPR top-up tax amount of that fiscal year.

Continuing to allocate the top-up tax to entities located in jurisdictions that insufficiently apply the UTPR would significantly reduce the effectiveness of the rule, as the allocated top-up tax would not be collected.[60] Therefore, the mechanism does not primarily sanction the insufficiently applying jurisdictions, but rather protects the intended and proper functioning towards the jurisdictions that correctly apply the UTPR.

IV. UTPR Conclusion

The UTPR rules serve as a hybrid instrument both as backstop mechanism to the IIR, as well as a specialised tool against base erosion strategies.

Applied only in case taxes are not allocated by the latter rule, it compensates for inequalities in untaxed profits of MNE Groups.

Like the IIR, the UTPR operates by allocating a top-up tax, but levies the tax by denying the deductibility. Furthermore, in focussing on workforce and tangible assets it uses parameters that are essential for income and profit of an MNE Group and therefore also have high informative value in regard to a fair allocation of the tax burden.

However, each state's rules on deductibles have to be precisely known, as well as each CE's workforce and tangible assets. Hence, the amount of coordination and information exchange

[60] OECD (2020), *supra Fn. 36*, p. 136.

could lead to an overwhelming workload both for businesses and tax administrations. The next years of practical implementation will tell if the targeted objective is feasible within the narrow timeframe.

E. Subject to Tax Rule

Despite the STTR not being part of the Global Anti-Base Erosion Model Rules (Pillar Two), it is vital for its proper functioning. So far, the rule has not been developed yet, but is expected to be published by the OECD in 2022.[61]

The STTR focusses on cross-border payments and is applied when one jurisdiction has ceded taxing rights to another jurisdiction, as explained in the following example:[62]

Country A hosts Co. A, that pays a certain amount of royalties to Co. B in Country B. Both belong to the same MNE Group "X". However, due to an income tax treaty, Country A is prevented from taxing the payment, and in Country B said payment is excluded to 80% from taxation. The result would be the MNE Group "X" only paying taxes on 20% of the payment. Those tax treaties and the according taxing rights might in consequence protect certain income from being taxed according to the BEPS Model Rules.

The consequences would be an ineffective application of the Model Rules as the individual tax treaties might prevent the proper calculation and allocation of top-up tax. The risk of intra-group corporate structuring arises, that attempt to exploit individual treaty provisions. Especially in situations where cross-border payments are regarded differently for tax reasons by the different jurisdictions, profit shifting behaviour of MNE Groups would be encouraged. Cross-border payments from source countries to residence jurisdictions, where those payments are low taxed, would undermine the goal of the BEPS Model Rules. Regarding those cross-border structures relating to intragroup payments, the STTR aims at preventing BEPS risks. In these cases, it aims at helping source countries to protect their tax base by restoring their taxing rights and is of special importance to countries with lower administrative abilities.[63]

I. Scope of the STTR

The STTR is not intended to target general issues regarding cross-border taxation and the allocation of taxing rights. Instead, it identifies specific base erosion risks and aims at preventing

[61] https://www.ey.com/en_gl/tax-alerts/oecd-releases-model-rules-on-pillar-two-global-minimum-tax--deta, accessed 15.01.2022.
[62] OECD (2020), *supra Fn. 36*, p. 150.
[63] OECD (2020), *supra Fn. 36*, p. 150.

those. Therefore, it will only apply to certain categories of payments that pose said risk.[64] Furthermore, it applies only at the level of the relevant entity and to the individual payments.[65]

1. Connected persons

In order to efficiently target the goals explained above the STTR will only apply to connected persons. That means, regarding payor and payee

> *"One has control of the other or both are under the control of the same person or persons".*[66]

The assumption behind this requirement is the necessity of control for structuring corporate entities and their transactions in order to avoid taxes. Only if an MNE Group has control over certain entities it can influence structure and payment mechanisms for BEPS purposes. Furthermore, expanding the application of the STTR to other than connected persons would increase the administrative and practical effort necessary to capture BEPS behaviour significantly, potentially leading to ineffectiveness.[67]

2. Payment requirement

Moreover, the STTR will only apply to specific payments that are covered by the rule and that are made between residents of two contracting states.

Therefore, the rule will not include any jurisdictional or entity blending but will instead operate by reference to the tax applicable to an item of income.[68]

Consistent with the scope of application of the GloBE proposal, however, it will not apply to payments made to or by individuals.

The payments in scope of the STTR are twofold, easily to identify are payments of interest and royalties that represent a simple mechanism to allocate profits.

However, also other payments are considered to present great risk of BEPS behaviour. In case the value of the payment primarily serves as a compensation for mobile factors (e.g. capital, assets or risk) and those factors are owned by the person entitled to the payment, BEPS risks have to be taken into consideration.[69]

In consequence, when the value of a payment rather serves as a compensation to a function performed by the person entitled to the payment, BEPS risks are considerably lower.

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[64] OECD (2020), *supra Fn. 36*, p. 150.
[65] OECD (2020), *supra Fn. 36*, p. 152.
[66] OECD (2020), *supra Fn. 36*, p. 152.
[67] OECD (2020), *supra Fn. 36*, p. 152.
[68] OECD (2020), *supra Fn. 36*, p. 151.
[69] OECD (2020), *supra Fn. 36*, p. 155.

The different risk evaluation results from the assumption that a function performed by a person is less mobile and more difficult to transfer compared to the ownership or takeover of capital, assets and risk.[70]

In a similar approach low return payments will be left out of scope. The risk of BEPS behaviour is only assumed when a certain threshold of return is to be expected.[71]

II. Mechanism

Similar to the IIR and UTPR a differentiation between high and low tax is essential for the further allocation process. However, as established above, the high or low tax category refers not to entire jurisdictions but rather to the specific and treaty-covered type of payment.

1. Adjusted Nominal Tax Rate

After isolating the relevant payment, the nominal tax rate for said payment is determined.

Different to the IIR or UTPR, the STTR is not based on a ETR calculation.

In the context of e.g. a withholding tax measure, the ETR would be too difficult to use. As the ETR measures the imposed tax over a defined accounting period, the ETR could not be determined at the exact time of the payment made in the jurisdiction of the payee. Therefore, when the withholding tax would be levied at the occasion of the payment, the ETR could not be precisely calculated.

Hence, a nominal tax rate (NTR) is easier for tax administrations to administer and is more in line with the policy goal of the STTR to focus on specific low-tax outcomes in respect of specific payments.[72]

However, the statutory or nominal tax rate stated in the tax codes of the individual jurisdictions could fail to describe the true nature of taxation in the relevant jurisdictions. Provisions of the individual tax codes, that reduce the amount paid e.g. by excluding a certain percentage of the payment from tax, would need to be considered in order to avoid BEPS behaviour.

Therefore, the statutory tax rate has to be adjusted. Any exemptions or beneficial provisions by the payee jurisdiction, that are directly linked to the received payment, are taken into account. The percentage of payments, that such a special provision is applicable to, is left out of the calculation. Following this adjustment, the statutory tax rate is multiplied by the proportion of payment, that is not taxed, and consequently produces the adjusted nominal tax rate.

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[70] OECD (2020), *supra Fn. 36*, p. 155.
[71] OECD (2020), *supra Fn. 36*, p. 159.
[72] OECD (2020), *supra Fn. 36*, p. 163.

For example, country A has a statutory CIT of 20%, but implemented special provisions regarding certain royalty income that is excluded to 80%. Following the calculation above, the 20% statutory tax is only applied to 20% of royalty income. In consequence, only 4% of the original royalty income will be taxed, leading to an adjusted nominal tax rate of 4%.[73]

2. Top-up Tax

As the IIR and UTPR, the STTR also works with a top-up tax. However, as it is a separate treaty provision, the minimum tax rate has not been decided yet.

Apart from the missing minimum rate, the allocation mechanism resembles the ones from the IIR and UTPR. The aim of the STTR is to allow the source jurisdiction, where the payor is located, to tax payments up to the minimum rate.

The approach so far is the imposition of a withholding tax on the covered payment by the source state. The tax would be equal the difference between the minimum rate of the top-up tax for the STTR, which still has to be determined, and the adjusted nominal tax rate that is applicable to the specific payment in the payee jurisdiction.[74]

Regarding the example above and presumed the minimum top-up tax rate would be 10%, Country A could levy a 6% top-up tax on the relevant payment made by Co. A to Co. B, as the remaining 4% are taxed by Country B. The overall tax levied would correspond to the presumed 10% minimum rate of the STTR.

3. Order of application

The STTR is applied primarily to IIR and UTPR.

If individual tax treaties exist and the STTR is applied by a contracting state, first the top-up tax according to the STTR is calculated and levied before the IIR and UTPR.

Afterwards, the ETR for the relevant jurisdiction is determined by dividing the amount of covered taxes by the amount of profits. The covered taxes hereby include the withholding taxes imposed by the source jurisdiction on the specific payment due to the STTR, whereas the amount of profits includes all profits (not only the profit linked to the relevant payment).[75]

[73] OECD (2020), *supra Fn. 36*, p. 237.
[74] OECD (2020), *supra Fn. 36*, p. 165.
[75] OECD (2020), *supra Fn. 36*, p. 244.

III. STTR Conclusion

As a separate treaty rule, the STTR will primarily be applied to contracting parties and refer to cross-border transactions.

It is supposed to clarify uncertainties regarding the allocation of taxing rights, but only focusses on specific payments by connected persons, that will be categorised in the treaty.

By allowing source states to tax said payments according to the STTR and up to a minimum tax rate, which still has to be determined, specific BEPS risks in relation to cross-border payments are aimed to be reduced, if not eliminated. However, as with the IIR and the UTPR, the practical implementation will challenge tax authorities and businesses alike, due to the immense amount of coordination regarding the ANTR-calculation and the continuous assessment of payments within the STTR scope.

F. BEPS Model Rules Conclusion

The BEPS Model rules have created a set of mechanisms, that aim at eliminating the risk of profit shifting and base erosion.

The STTR with the focus on cross-border payments by connected persons serves as a first and very specific tool to target disapproved BEPS behaviour in the case of specific tax treaties and specific payments undermining the approach of the BEPS Model Rules.

Second in place and applicable in the absence of specific tax treaties is the IIR. With the top-down approach and the allocation of top-up tax it attempts to generate clear rules on the allocation of taxing rights among the applying states.

However, as seen when encountering split-ownership structures, the mechanisms gain complexity and potential confusion.

The same applies for the third rule in place, the UTPR. As backstop mechanism for the IIR it serves as an important tool to reach the minimum tax rate by levying the tax as a denial of deductibility when applied to low-taxed entities.

In order to reach a proportional allocation of the tax liability, the important categories of workforce and tangible assets are taken into account, aiming for a fair distribution of the burden but also increasing the burden of administrative work and data collection.

Despite administration and transition rules in Art. 8 and Art. 9 BEPS Model Rules as well as the 2022 published commentary aiming to guide the implementation, many voices have been heard being sceptical about the compliance and applicational burden for corporates.[76]

Nonetheless, the general concept has widely been regarded as a ground-breaking development both in tax and global law.[77] It is the first time that more than 130 nations agree on the same approach to allocating taxes and target corporate behaviour that is seen as economically distorting.

The success in future, however, will very much depend on continuous work between the applying nations, developing smooth communication and dispute resolution mechanisms to name only two of the upcoming challenges.

G. The European Union and the OECD Project

Regarding this ground-breaking initiative and the fight against harmful tax behaviour by MNEs, the European Union and its internal market, as the largest internal market of the world, are of special importance and interest.

Hence, already in 2011, the European Commission attempted to introduce the so-called Common Consolidated Corporate Tax Base (CCCTB) as a project aiming at achieving uniform rules for the computation of taxable profits of EU located companies. The proposal failed due to resistance of several member states. The commission tried again in 2015 and intended to replace the proposal with a new framework project in 2021, but eventually did not include any of it in its 2022 Commission work program.[78] Instead, the "Proposal on implementation of the OECD global agreement on re-allocation of taxing rights" is on the agenda.

But even before, the European Union knew about the dangers of harmful tax practices and was interested in a coordinated and agreeable approach for EU member states to target the challenges of international taxation.[79]

Hence, the BEPS Model Rules now signal a new opportunity for the European Union to expand the economic and legal integrational process among the member states.

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[76] https://news.bloombergtax.com/tax-insights-and-commentary/global-minimum-taxation-for-large-multinationals, accessed 19.01.2022; https://blog.handelsblatt.com/steuerboard/2022/01/05/oecd-legt-finales-rahmenkonzept-fuer-globale-mindeststeuer-vor/, accessed 19.01.2022.

[77] https://law.asia/oecd-global-tax-overhaul/, accessed 19.01.2022; https://news.bloombergtax.com/daily-tax-report-international/cross-border-taxation-reset-for-global-companies, accessed 19.01.2022.

[78] *Annexes To The Communication From The Commission To The European Parliament, The Council, The European Economic And Social Committee And The Committee Of The Region,* Commission work programme 20, Strasbourg, 19.10.2021, COM(2021) 645 final ANNEXES 1 to 5 p. 3.

[79] *Communication From The Commission To The Council, The European Parliament And The European Economic And Social Committee*, Brussels, 28.4.2009, COM(2009) 201 final, p. 7.

Nevertheless, the essential question of compatibility of the Model Rules and the related Commission's proposal with primary EU law is of core importance for a successful applicability of this new taxation framework, and will, therefore, be assessed in the next chapters.

H. Legal Issues: Competence

Whenever the European Union wants to act, the question of competences arises. More competence for the European Union corresponds necessarily with a loss of sovereign power and a limit of political leeway for the member states.[80]

In order to define the boundaries of power distribution, the European Union is based on the principle of conferred powers, the principle of subsidiary and the principle of proportionality described in Art. 5.1. TEU.

That means, acc. to Art. 5.2. TEU, that the member states generally have the competence to regulate and legislate, and only in case they have explicitly transferred those rights to the European Union, the bloc is allowed to act.[81]

In consequence and as described in Art. 2 TFEU, the competences of the European Union can be roughly divided into exclusive competence, non-exclusive competence and no competence.[82] Only when the European Union has the competence, manifested in the European Treaties, it is allowed to take legal action.

Exclusive competences are listed in Art. 3 TFEU and include e.g. tariffs union, single market competition rules or monetary policy (in this latter case, only for those member states whose currency is the euro, such as Portugal or Germany).[83] Within these fields only the Union is allowed to take legislative action and pass binding legal acts, while member states are only allowed to act when authorized by the Union.[84]

Non-exclusive competences represent the usual case and are described in Art. 4 TFEU. Regarding those competences, including the internal market, infrastructure, and environment, both the European Union and the member states are allowed to take legislative action.[85]

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[80] Scharf, D., *Die Kompetenzordnung im Vertrag von Lissabon – Zur Zukunft Europas: Die Europäische Union nach dem Vertrag von Lissabon, p. 5.*

[81] Calliess, C., *Rechtsangleichung in der EU – wie weit reicht die Einzelermächtigung zur Binnenmarktharmonisierung?*, in: Berliner Online-Beiträge zum Europarecht, Nr. 117, p. 5.

[82] Vedder, in: Vedder/Heintschel von Heinegg, *Europäisches Unionsrecht*, 2. Auflage, Art. 5, Rn. 10.

[83] Streinz/Mögele, in: Streinz, *EUV/AEUV*, 7. Auflage, Art. 3 AEUV, Rn. 3.

[84] Haratsch/Koenig/Pechstein, Europarecht, 10. Auflage, p. 74, Rn. 149.

[85] Bieber/Kotzur, in: Bieber/Epiney/Haag/Kotzur, *Die Europäische Union*, 13.Auflage, §3 Rn. 25 (p. 112).

Member states, however, are only allowed to act as long the EU has not taken legislative action, whereas such action only blocks legislative measures for the regulated elements and not the entire policy field.[86]

The policy field of taxation is neither included in the exclusive competence catalogue of Art. 3 TFEU, nor within the non-exclusive competence catalogue of Art. 4 TFEU.

However, Art. 4 TFEU mentions the European Single Market and therefore leaves space for legal action for any internal market related issues. Furthermore, the member states included specialised provisions in the Lisbon Treaty in order to allow the bloc to increase harmonization relating to the internal market, although specific requirements have to be met for their applicability.[87]

I. Legal Basis

When the European Union has the competence to take legal action, said competence is manifested in the treaties as legal basis for its action.

Hence, a legal basis is necessary for the EU to act in terms of corporate income taxation as intended with the Model Rules and the Commission's proposal.

Problematic in this regard is that the European Treaties have originally and principally assumed the fiscal and financial sovereignty of the member states and, therefore, they do not contain a comprehensive and complete chapter regarding taxes.[88]

1. Tax provisions in the TFEU as legal basis

Despite the regulation of tax equalisation in Art. 110 – 112 TFEU or of indirect taxes in Art. 113 TFEU, no further general competences in the field of taxation are referred to the Union by the treaties.[89] The competence of harmonizing direct taxes, such as e.g. a corporate income tax, is not described in the TFEU under the heading "*Tax Provisions*", in its Chapter 2 of Title VII. Therefore, the tax provisions in the TFEU cannot be applied as legal basis for the implementation of the BEPS Model Rules and therefore do not refer the necessary competence to the European Union.

[86] Schoebener, *Europarecht*, Rn. 2886 (p. 764).
[87] Streinz, R., *Europarecht*, 10. Auflage, C.F. Müller, p. 378.
[88] Koenig/Paul/Kamann, in: Streinz, *EUV/AEUV*, 7. Auflage, Art. 110 AEUV, Rn. 2.
[89] Koenig/Paul/Kamann, in: Streinz, *supra Fn. 88*, Rn. 2.

2. Internal market as legal basis

However, acc. to Art. 3 (3) TEU, one of the main objectives of the Union is the establishment of the internal market and, acc. to Art. 4 TFEU, the EU has non-exclusive competence regarding legislative action in that field of policy.

Generally, when the establishment of the single market is concerned, Art. 114 TFEU gives the EU the possibility of legislative approximation, meaning the possibility to take legislative action and pass directives to achieve the objective of Art. 3 (3) TEU.[90]

However, Art. 114 (2) TFEU does not allow legal measures in regard to taxes.

Therefore, the current proposal by the European Commission considers the broader Art. 115 TFEU as legal basis for the implementation of the BEPS Model Rules.[91]

Still, opinions vary regarding the applicability of Art. 115 TFEU, as the provision gives the EU the competence to harmonize direct taxes only under specific conditions.

a) Direct Impact on Internal Market

Acc. to Art. 115 TFEU the Council is allowed to issue directives for the approximation of laws, regulations or administrative provisions that directly affect the establishment or functioning of the internal market.

The essential connecting factor and condition for the applicability of Art. 115 TFEU is therefore any direct impact of national regulations for the European Single Market.[92]

The wording of the provision, however, is rather unprecise when orientated on the interpretation of Art. 114 TFEU, as any regulation can be said to have some influence on the single market.[93]

Therefore, special attention has to be given to the feature of *direct* impact. The ECJ interpreted said characteristic as *appreciable distortion*, meaning the relevant regulation of the member state needs to have some amount of intensity.[94]

b) Direct Impact of Direct Taxes

The question of whether direct taxes are generally to be seen as the cause for direct impact on the internal market, is discussed differently and therefore the applicability of Art. 115 TFEU is debatable as well.

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[90] Schröder, M., in: Streinz, *EUV/AEUV*, 7. Auflage, Art. 114 AEUV, Rn. 4.

[91] *Proposal for a COUNCIL DIRECTIVE on ensuring a global minimum level of taxation for multinational groups in the Union* {SWD(2021) 580 final}, COM(2021) 823 final, 2021/0433 (CNS), p. 13.

[92] Korte, S., in: Calliess/Ruffert (Hrsg.), *EUV/AEUV*, 6. Aufl. 2021, Art. 115, Rn. 7.

[93] Classen, in: v. d. Groeben/Schwarze/Hatje, *Europäisches Unionsrecht*, 7. Auflage, Band 3, Art. 115, Rn. 11.

[94] ECJ Case 91/79, p. 1106; ECJ Case 92/79, p. 1122; Schröder, M., in: Streinz, *supra Fn. 90*, Rn. 8.

Some have argued that Art. 115 TFEU can only restrictedly apply as direct taxes are only intermediate price-setting factors that are not equally important for the realisation of the internal market.[95] At the same time, these direct taxes have immense importance for the individual member states, due to their considerable revenue effect, their distributive key function for social justice and their socio-political impact.[96] As the TFEU does not contain any special provisions for the approximation of regulations regarding direct taxation, Art. 115 TFEU cannot simply be applied without further requirements. Otherwise, the harmonization of e.g. corporate income tax would be upgraded to a treaty objective without clear and definite legal basis.[97]

Others, however, come to different conclusions. In their opinion direct taxes might be only intermediate price-settling factors, but in terms of the internal market do not simply apply to goods and services, but also to the free movement of persons and capital.[98]

In consequence, as they have profound influence on the choice of establishment and investment behaviour of corporates and individuals, direct taxes also have immense importance for the internal market and must be regarded as having *direct* impact.[99]

The latter opinion takes into account the significant effect direct taxes have on economic behaviour within the internal market and appreciates comprehensively the ratio legis of Art. 115 TFEU, which gives the Union strong competences to achieve its main objectives when special conditions are met.

As the elements of *direct* and *appreciable* impact are fulfilled, Art. 115 TFEU is, therefore, applicable as legal basis for the approximation of direct taxes.

II. Subsidiarity

A legal basis however is not enough for the European Union to be rightfully allowed to take legal action.

As mentioned above and according to Art. 5.1, 5.3 TEU, the European Union is based on the principle of subsidiarity.

Said principle states that within non-exclusive competences the Union is only allowed to act if and as long the objectives pursued cannot be reached by measures implemented by the member states on central, regional, or local basis. Rather, due to their magnitude and impact, the objectives must be pursued by the Union.[100]

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[95] Oppermann/Classen/Nettesheim, *Europarecht*, 9. Auflage, §35, Rn. 56 (p. 608 f.).
[96] Seiler, in: Grabitz/Hilf/Nettesheim, *Das Recht der Europäischen Union*, Band II, Art. 113, Rn. 51.
[97] Seiler, in: Grabitz/Hilf/Nettesheim, *supra Fn. 96*, Rn. 53.
[98] Classen, in: v. d. Groeben/Schwarze/Hatje, *supra Fn.93*, Rn. 17.
[99] Oppermann/Classen/Nettesheim, *supra Fn. 95*, Rn. 56 (p. 608 f).
[100] Lienbacher, in: Schwarze, *EU-Kommentar*, 4. Auflage, Artikel 5 EUV, Rn. 15 (p. 103).

In order to determine the scope of this relatively vague requirement of increased efficiency, the *Test of comparative efficiency* evaluates if member states are not able to reach the relevant objective in a satisfactory way.[101]

Art. 5.3 TEU defines hereby the negative criterion of *insufficient performance of the member states* and the positive criterion of *better achievement* by the Union on a cumulative basis.[102]

However, an overall assessment of the situation within the Union and the member states has to be continuously applied.[103]

1. Criterion of necessity

The negative criterion evaluates if an intervention of the EU is necessary. According to the Commission's proposal for the council directive this requirement is fulfilled.[104]

As the OECD initiative is a common approach, it also needs common rules, uniform definitions, and equal measurements. In short, it needs harmonisation in order to protect the internal market from competitive distortions.

The individual member states, however, cannot guarantee such unanimity. Different methods for computing the ETR or top-up tax might lead to the distortion of fair competition and economic mismatches regarding the internal market.[105]

a) Tax revenue loss as negative impact

The underlying issue regarding the Commission's argument is the questionable negative impact on the internal market.

The proposal is based on the BEPS Model rules tackling Base Erosion and Profit Shifting.

BEPS-behaviour is hereby described as the "exploitation of gaps and mismatches between the tax systems of different nations".[106]

As described already in the introduction to the OECD working paper concerning BEPS and increased by current reports naming MNEs such as Apple or Facebook, there is a growing perception by the public, the media and even the states themselves, that governments lose essential

[101] Bergmann, *Handlexikon der Europäischen Union*, 6. Auflage, p. 990
[102] Weber, in: Blanke/Mangiameli, *The Treaty on European Union (TEU)*, p. 264.
[103] Bast, in: Grabitz/Hilf/Nettesheim, *Das Recht der Europäischen Union*, Band I, EUV Art. 5, Rn. 54 (p. 26).
[104] *Proposal for a COUNCIL DIRECTIVE on ensuring a global minimum level of taxation for multinational groups in the Union* {SWD(2021) 580 final}, COM(2021) 823 final, 2021/0433 (CNS), p. 3.
[105] *Proposal for a COUNCIL DIRECTIVE on ensuring a global minimum level of taxation for multinational groups in the Union* {SWD(2021) 580 final}, COM(2021) 823 final, 2021/0433 (CNS), p. 3.
[106] OECD (2013), Action Plan on Base Erosion and Profit Shifting, OECD Publishing, http://dx.doi.org/10.1787/9789264202719-en, p. 10.

amounts of corporate tax revenue due to BEPS-behaviour such as tax planning strategies and the exploitation of differences in tax systems by cross-border operating MNEs.[107]

As mentioned in the introduction of our paper, the OECD calculates an annual revenue loss of 240 billion USD. Another report published in 2019 estimated the loss even higher and calculated that in 2015, tax evasion, including tax fraud, accounted for between €750 and €900 billion in lost revenue for EU Member States alone. This included €190 billion for Italy and almost €120 billion for France.[108]

The anger by the public, media, and national tax administrations about the loss of tax revenue is understandable, but it provides no direct rationale in terms of the requirement of subsidiarity in regard to the approximation of direct taxes.

It is explicitly said that Art. 115 TFEU can only be invoked when it serves the establishment or functioning of the internal market. Therefore, according to the principle of subsidiarity manifested in Art. 5 (3) TEU, any measure must be necessary regarding the establishment and functioning of the European Single market. The generation of tax revenue for member states, however, does not directly serve the functioning or establishment of the internal market. Therefore, it cannot justify any legal action with regard to the approximation of corporate income taxes.

b) Tax competition as negative impact

However, BEPS-behaviour caused by the differences in tax systems might also lead to another negative consequence, a phenomenon described as "tax competition".

Tax competition is characterized by the uncooperative setting of taxes where a country is constrained by the tax setting behaviour of other countries.[109]

Admittedly, due to the increase of globalisation and the continuous intertwining of economies, it is only a "natural" consequence, that the growing links between nations also have unavoidably led to national tax systems being conditioned by other tax sovereignties.[110] Furthermore, so far the development of globalisation has only fuelled economic growth and the rise of living standard.[111]

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[107] OECD (2013), *supra Fn. 106*, p. 13.
[108] Rivoli, E., *Harmful Tax Competition Overcoming Unfair Frugality*, European Labour and Social Affairs, Policy Paper No. 255 September 2020, p. 6.
[109] Devereux, M./ Loretz, S., *What Do We Know About Corporate Tax Competition?*, National Tax Journal, 2013, Vol. 66, Issue 3, p. 746.
[110] Lampreave, P., *Fair tax competition vs. harmful tax competition*, https://globtaxgov.weblog.leidenuniv.nl/2018/10/01/fair-tax-competition-vs-harmful-tax-competition/, retrieved 18.02.2022.
[111] OECD (1998), *Harmful Tax Competition: An Emerging Global Issue*, OECD Publishing, Paris, https://doi.org/10.1787/9789264162945-en, p. 9.

Therefore, the question remains if and under which circumstances tax competition might lead to negative impact on the European single market and if it could potentially justify legal action by the European Union acc. to Art. 115 TFEU.

aa) Positive tax competition

With regard to that debate, several positive examples are brought forward supporting the hypothesis of positive impacts of the coexistence of different tax regimes. States might, for example, purposely implement different tax regimes compared to their neighbours in order to prevent tax cartels and promote investment and innovation. Furthermore, it might have the positive side effect of restraining a state's enthusiasm for higher taxation and generally push the individual state to become more efficient regarding tax collection and spending.[112] Especially the investment promotion can serve as an opportunity for lower income economies within the European Union to attract businesses and boost economic growth.
Hence, at first sight, tax competition might not be able to serve as justification for the necessity of the approximation of direct taxes.

bb) Negative tax competition

The positive examples above, however, view tax competition as a substitute for market competition and applaud the potential positive effect of signalling and boosting efficient spending in the public sector as well as attracting investment.[113]
In that regard market competition is seen as the most efficient usage of resources, free from any distortion or interference that could result in inefficiencies.[114]
Under a set of strict assumptions, this tax competition would lead to an efficient sorting and, therefore, to welfare enhancing tax competition. It would therefore be more efficient than unified tax rates across all jurisdictions.[115]
However, this perspective is dependent on entirely equal market access by the taxpayers, which naturally is not the case in real life, either by language barriers, locational or legal obstacles.[116]

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[112] Highly debatable theory, see, e.g., Lampreave, P., *Fair tax competition vs. harmful tax competition*, https://globtaxgov.weblog.leidenuniv.nl/2018/10/01/fair-tax-competition-vs-harmful-tax-competition/, retrieved 18.02.2022; https://taxjustice.net/2015/04/23/tax-competitiveness-was-charles-tiebout-joking/, retrieved 26.04.2022.
[113]Bénassy-Quéré, A./Trannoy, A./Wolff, G., *Tax Harmonization in Europe: Moving Forward*, Notes du conseil d'analyse économique 2014/4 (No 14), p. 4.
[114] Schröder, M., in: Streinz, *supra Fn. 90*, Rn. 24.
[115] Keuschnigg/Loretz/ Winner, *Tax competition and tax coordination in the European Union: A survey*, Working Papers in Economics and Finance, No. 2014-04, p. 11.
[116] Bénassy-Quéré, A./Trannoy, A./Wolff, G., *supra Fn. 113*, p. 4.

Instead, a steady downward trend regarding statutory tax rates can be monitored across the EU, a phenomenon called "the race to the bottom", rebutting the assumption of reaching a market equilibrium.[117] Such downward tendency, however, may have negative consequences on regulatory standard and thus EU-granted rights.[118]

Furthermore, tax competition includes not only tax rates, but also tax bases. Differences in tax bases, however, might lead to double taxation, non-taxation and especially compliance costs for each cross-border operating company.[119]

Moreover, when governments grant allowances for interest payments in order to boost investments, further negative consequences for the market may ensue. As deductions for interest payments narrow the tax base, they can necessitate higher rates and therefore increase the negative impact of taxation on economic efficiency. Similarly, they have the potential to distort funding choices of companies between debt, retained earnings and equity, resulting in the possibility of excess leverage.[120]

Consequently, aggressive tax planning by MNEs have the potential to distort price signals in the single market and thereby corrupt the allocation of resources. Companies which engage in tax avoidance practices due to the exploitation of cross-border caused loopholes are more profitable and face lower capital costs compared to domestic companies.[121]

Accordingly, the OECD estimates that mark-ups of multinational entities are on average 9% higher than those of domestic groups with similar characteristics supporting the hypothesis of distorting effects of differences in tax systems.[122]

c) Interim result on tax competition

In consequence, the negative effect of tax competition seems to outweigh the potential benefits that can only be assumed in perfect conditions. Instead, tax competition rather turns to harmful competitive behaviour.

Similarly, the OECD determined the negative results of harmful tax competition as distorting financial and real investment flows, undermining the integrity and fairness of tax structures,

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[117] Candau, F./Le Cacheux, J, *Taming Tax Competition with a European Corporate Income Tax*, Revue d'économie politique, 2018/4 (Vol. 128), p. 589 f.
[118] Oatley, T., *International Political Economy*, 6th Edition, International Student Edition, p. 274 f..
[119] Bénassy-Quéré, A./Trannoy, A./Wolff, G., *supra Fn. 113*, p. 5.
[120] Bénassy-Quéré, A./Trannoy, A./Wolff, G., *supra Fn. 113*, p. 5.
[121] COMMISSION STAFF WORKING DOCUMENT IMPACT ASSESSMENT - Accompanying the document Proposals for a Council Directive on a Common Corporate Tax Base and a Common Consolidated Corporate Tax Base (CCCTB), p. 16.
[122] Sorbe, S./Johansson, Å., *International Tax Planning, Competition And Market Structure*, Economics Departments Working Papers No. 1358ECO/WKP(2016)82 OECD 06-Feb-2017, p. 12.

discouraging compliance by all taxpayer, reshaping the desired level and mix of taxes and public spending, causing undesired shifts of parts of the tax burden to less mobile tax bases such as labour property and consumption, and increasing the administrative costs and compliance burdens on tax authorities and taxpayers.[123]

Therefore, as tax competition appears to increase inefficient usage of resources, it harms market competition and therefore also the functioning of the internal market.

The determination of a minimum tax rate combined with rules regarding its calculation and application could build a level playing field, stop the race to the bottom and generally boost economic efficiency.

Consequently, the requirement of necessity for the harmonisation of direct taxes in regard to the subsidiary application of Art. 115 TFEU seems to be met.

It has to be pointed out, though, that the debate around the harmfulness of tax competition is highly controversial, and many economists are sceptical regarding clear links between negative impacts of tax competition, market inefficiency and on the other side, benefits of harmonisation.[124]

Furthermore, when implementing the BEPS Model Rules into European Law reasonable expectancy towards positive results must be brought forward.

In order to avoid uncertainties regarding the criterion of necessity and potential legal action it would therefore be in the interest of the Commission to prepare and publish more precise economic studies that prove the damaging effects of the lack of harmonization of corporate taxes for the internal market.[125] Similarly, supporting evidence for the economic benefit of minimum taxation for the internal market would prevent upcoming scepticism.

2. Criterion of efficiency

The second criterion decisive for the applicability of Art. 115 TFEU in regard to the principle of subsidiary acc. to Art. 5 (3) TEU is the positive criterion, the criterion of efficiency.[126]

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[123] OECD (1998), *supra Fn. 111*, p. 16.

[124] Salin, P., *The Case Against "Tax Harmonisation": The OECD and EU Initiatives*, in: Gissurarson H.H./ Herbertsson T. T., *Cutting Taxes to Increase Prosperity*, Reykjavik: RSE Center for Economic and Social Research, 2007, pp. 61-84; Bond/Chennells/Devereux/Gammie/Troup, *Corporate tax harmonisation in Europe: A guide to the debate*, IFS Report, No. R63, Institute for Fiscal Studies (IFS), London, http://dx.doi.org/10.1920/re.ifs.2000.0063 p. 46.

[125] Although some research financed by the Commission exists in this front (see, in particular, some of the CIT papers listed on https://ec.europa.eu/taxation_customs/news/taxation-paper-no-62-financial-transaction-taxes-european-union-available-line-2016-02-11_en), more detailed research is needed in this field.

[126] Bast, in: Grabitz/Hilf/Nettesheim, *supra Fn. 103*, Rn. 57 (p. 26).

Essential hereby is the prognosis that the objectives pursued can be achieved "better" and more efficiently when tackled by the European Union instead of by the individual member states.
As described above, tax competition has advantages and disadvantages, but the differences in tax systems allowing said competition predominantly seem to cause disruptions and distortions for the internal market.
As harmonisation according to the BEPS Model Rules includes tax base calculation, tax rate, computing methods and allocation mechanisms, the problematic differences could be eliminated. Such a full harmonisation of the European Corporate Income Tax would promise immense advantages.[127] Furthermore, the removal of said obstacles cannot be achieved by the member states individually, as their individual approach is the root of the differences and therefore the cause of the issue.
Therefore, the prognosis supports the approach of increased efficiency due to harmonisation of direct taxes according to the BEPS Model Rules and in that regard also fulfils the criterion of efficiency.

III. Proportionality

Whereas the principle of subsidiarity answers the question, if the European Union is allowed to act, the principle of proportionality described in Art. 5 (4) TEU addresses the intensity of the individual measure.[128]
Acc. to Art. 5 (4) TEU the implementation of the BEPS Model Rules should not *exceed what is necessary to achieve the objectives of the Treaties.*
Despite the wording, the principle of proportionality does not only include the aspect of excess in terms of necessity.[129] Instead, since early the ECJ has determined that the principle has to be applied in a comprehensive manner and counts as a general principle of the Union law.[130] In consequence, measures of the European Union are proportionate as long as they are suitable, necessary, and the imposed negative impact of the measures is not entirely out of proportion to the proposed objectives.[131]

[127] Bond/Chennells/Devereux/Gammie/Troup, *supra Fn. 124*, p. xi.
[128] Langguth, in: Lenz/Borchardt, *EU-Verträge Kommentar*, 6. Auflage, Art. 5, Rn. 36 (p. 43).
[129] Hirsch, G., *Das Verhältnismäßigkeitsprinzip im Gemeinschaftsrecht: Referat im Rahmen der Vortragsreihe "Grundfragen der Europäischen Rechtsordnung"*, Zentrum für Europäisches Wirtschaftsrecht: Vorträge und Berichte 80, p. 10 ff.
[130] ECJ, C 8/55, *Fédération charbonnière de Belgique*, p. 299.
[131] ECJ, C 265/87, *Hermann Schräder HS Kraftfutter GmbH & Co. KG v Hauptzollamt Gronau*, p. 2269, Rn. 21.

The principle of proportionality is hereby applied not only to individuals affected by EU legal acts, but also to member states.[132]

1. Suitable Measure

According to the case law of the European Court of Justice the measure of suitability does not play a major role regarding the evaluation of proportionality of a measure.[133]

Instead, the court states that

> *"the legality of a measure adopted […] can be affected only if the measure is manifestly inappropriate having regard to the objective which the competent institution is seeking to pursue*." [134]

The BEPS Model Rules and the commission's corresponding proposal aim at harmonizing the foundation of corporate income taxation and implement a minimum corporate tax. Both measures are not manifestly inappropriate in order to eliminate competitive distortions and inefficient behaviour referring to the European Single Market.

Therefore, in our view, the Commission's proposal should be suitable according to the principle of proportionality.

2. Necessity

Necessity in regard to the principle of proportionality differs from the necessity requirement discussed in terms of subsidiarity above.

In this context it aims at the implementation of the softest means. Therefore, if several options are available to achieve the objective, the European Union has to choose the measure that is the least interfering for the member states.[135]

According to the wording of Art. 5 (4) TEU, the necessity of an EU measure applies both substantively and formally. Therefore, the instrument chosen by the EU to implement the measure, as well as the measure itself, have to be the softest option available.[136]

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[132] Langguth, in: Lenz/Borchardt, *supra Fn. 128*, Rn. 36 (p. 44).
[133] Weber, in: Blanke/Mangiameli, *supra Fn. 102*, p. 266.
[134] ECJ, C 40/72, *Schröder KG v Germany*, p. 146, Rn. 32; C 331/88, *The Queen v Ministry of Agriculture, Fisheries and Food*, p. I-4063, Rn. 13, 14.
[135] Wollenschläger, in: Hatje/Müller-Graf, *Europäisches Organisations- und Verfassungsrecht*, 1. Auflage, §8, Rn. 73 (p. 414).
[136] Trstenjak/Beysen, *Das Prinzip der Verhältnismäßigkeit in der Unionsrechtsordnung*, EuR – Heft 3 – 2012, p. 271.

a) Formal necessity

In consequence, and according to the Commission's proposal the choice of instrument will be a directive acc. to Art. 115 TFEU.[137]

Contrary to other provisions, directives can only be issued to member states and cannot be invoked by individuals.

They are binding for member states regarding the main objective but leave discretion regarding the actual implementation.[138] Member states translate the directive into national law by eliminating existing rules, modifying, creating new, or maintaining old regulations.[139]

As a result, directives do not address the individual directly, hence they neither directly infringe the individual's right nor do they grant any rights. They rather leave the member states considerable freedom in terms of design and implementation while assuring achieving the main objectives described in the directive. Thus, from a formal perspective, choosing a directive as a measure to act should be the softest means available to achieve the aimed objective.

b) Substantive necessity

Whereas the formal necessity evaluates the choice of the instrument regarding the Union's measure, the substantive necessity focuses on the content of the measure. Hence, the measure itself has to be assessed regarding the question whether the possibility of less intrusive measures has been taken into account and the softest option has been chosen.

aa) Alternative approaches to reach the functioning of the internal market

On the road that led to the current proposal by the European Commission and the underlying approach of the OECD BEPS Model Rules, several different scenarios have been discussed in order to eliminate negative market impacts potentially caused by non-harmonised corporate income taxes in the European Union.

They mainly include approaches regarding the tax rate or the tax base.[140]

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[137] *Proposal for a COUNCIL DIRECTIVE on ensuring a global minimum level of taxation for multinational groups in the Union* {SWD(2021) 580 final}, COM(2021) 823 final, 2021/0433 (CNS), p. 4.
[138] Geismann, in: v. d. Groeben/Schwarze/Hatje, *Europäisches Unionsrecht*, 7. Auflage, Band 4, Art. 288, Rn. 39.
[138] ECJ Case 91/79, p. 1106; ECJ Case 92/79, p. 1122; Schröder, M., in: Streinz, *supra Fn. 90,* Rn. 8.
[139] Nettesheim, in: Grabitz/Hilf/Nettesheim, *Das Recht der Europäischen Union*, Band III, Art. 288, Rn. 104.
[140] Kopits, G., *Tax harmonization in the European Community – Policy Issues and Analysis, Overview*, USA: International Monetary Fund 1992, p. 4.

(1) Harmonisation of statutory tax rates

A potentially less interfering measure available to the European Union would be the approximation of statutory tax rates (STR) in order to eliminate the obstacles for the internal marked posed by tax system differences.

According to said approach, the European member states would apply the same or at least similar tax rates in terms of CIT.

However, other elements defining the effective tax burden would not be harmonised. Definition of taxable profits, carve-outs, exemptions, deductibilities etc. would hence be left to the preferences of each member state. The harmonisation of STRs would therefore be significantly less intrusive to the competences of the member states than the Commission's approach.

However, it is questionable, if it would also be able to achieve the targeted objective.

The approximation of STRs could on first sight ease if not prevent the competitive pressure between EU member states. Officially, corporates would encounter similar tax burden across the EU, which could reduce the amount of market distortion caused by different tax rates.[141]

However, the lack of approximation in the definition of taxable profits or the possibility of exemptions could eliminate any positive effect assumed with the harmonisation of STRs. Officially, the CIT might be at 20%, but if for example a member state has the opportunity to exclude business activities entirely by its own perception, or exclude any amount of profit due to individual definitions, it can bring the effective tax burden down to any number it prefers.

In consequence, and on second sight, negative tax competition and corresponding distortions would still be present within the European Single Market.

Therefore, although being less intrusive, the approach of harmonising only the statutory tax rates could not achieve the targeted objective in the same satisfying manner as the Commission's approach promises to do.

(2) Harmonisation of statutory tax bases

Another potentially less intrusive approach to eliminate internal market obstacles by harmonising tax systems could be the approximation of tax bases.

As described in the STR-approach above, the lack of effectiveness regarding said method lies within the failure to provide corresponding definitions of deductible taxes, exemptions etc. The tax base, however, defines the total amount of economic activity subject to taxation by a tax authority.[142]

[141] Bond/Chennells/Devereux/Gammie/Troup, *supra Fn. 124*, p. 67 f.
[142] https://taxfoundation.org/tax-basics/tax-base/, retrieved 03.03.2022.

Accordingly, tax base harmonisation would need to include similar tax treatment of deductible items, such as e.g. depreciation or interest, a precise range of allowed tax incentive measures, agreements on the treatment of income earned in other EU jurisdictions and on the treatment of dividends, interest and other payments between EU countries as well as agreements regarding foreign tax regulations.[143]

Tax base harmonisation would set an even level playing field for the EU member states, as all states would "play by the same rules".

However, with regard to negative tax competition and market distortions, member states could still compete by applying varying tax rates, resulting once again in a market distorting race to the bottom.

Hence, similarly to the harmonisation of STRs, also the sole harmonisation of statutory tax bases cannot achieve the objective of eliminating market distortions in an effective manner.

bb) Interim result on alternative approaches and substantive necessity

Despite the Commission's proposal being more intrusive for the member states' competences, it appears to be necessary in terms of the principle of proportionality. Other options to target CIT harmonisation have been discussed and are certainly less intrusive. However, they do not appear to be as effective to achieve the objective of eliminating market competition obstacles and therefore the functioning of the European Single Market.

In consequence, in our view, the Commission's proposal regarding the implementation of the BEPS Model Rules is substantively, and generally necessary in the sense of the principle of proportionality acc. to Art. 5 (4) TEU.

3. Proportionality in a narrow sense

According to the judgments of the ECJ, the final level within the principle of proportionality is weighing all possible factors regarding the imposed negative impact of the measures against the proposed objectives. As long as the measures are not entirely out of proportion, they are within the scope of the proportionality principle.[144]

Nonetheless it has to be noted, the more important the public interest pursued, the more are greater restrictions justified.[145]

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[143] Bond/Chennells/Devereux/Gammie/Troup, *supra Fn. 124*, p. 65 f.
[144] Wollenschläger, in: Hatje/Müller-Graf, *supra Fn. 135*, Rn. 73 (p. 415).
[145] ECJ, C 317/00, I-9563, "*Invest" Import und Export and Invest Commerce v Commission*, Rn. 60.

In the present case, the public interest pursued is the functioning of the European Single Market, an objective displaying a core concept of the European Union and manifested already in the preamble of the TEU. It is one of the most important objectives for the Union, meant to unify the EU and increase both economic integration as well as economic prosperity.[146]
On the other side there are infringements primarily to the member states which have to apply the Commission's proposal as well Corporates, that will be taxed accordingly.

a) Member States and proportionality

The Commission's draft and therefore the Model Rules propose a new approach to covered taxes and the tax base computation, which in turn triggers an entirely new mechanism for the allocation of taxes, as explained above.
Member states therefore potentially have to modify their tax base computation systems and especially their communication methods, both with the corporations located in their jurisdiction, as well as with other tax authorities. Optimally, tax authorities should have a constant and precise flow of information about businesses regarding their revenues, activities, the location of their constituent entities, the amount of taxes paid in other jurisdictions, the ETRs in other jurisdictions, the ownership structure, tax exemptions granted etc.
Hence, the amount of information necessary as well as the amount of workforce necessary to process all this information is immense. Furthermore, with regard to the STTR, member states will have to change their bilateral tax treaties individually or through a multilateral agreement. Nonetheless, a fundamental change in international taxation alongside the harmonisation of such an important branch of tax law requires a considerable amount of work and effort. That alone does not put the measure out of proportion.
However, the proposed timeline is quite narrow. The Commission's proposal matches the OECD's aim of IIR implementation until the first of January 2023 and the UTPR one year later, until the first of January 2024.[147]
Regarding the described workload and the possible restructuring of entire national tax authority departments said timeframe might be too ambitious for some member states. Especially member states with low administrative capabilities have disadvantages. Imposed fines for member states unable to comply with the directive could therefore be unproportionate and the need for the possibility of extension should be considered.

[146] Pache, in: Schulze/Janssen/Kadelbach, *Europarecht*, 4. Auflage, §10, Rn. 1 (p. 454).
[147] *Proposal for a COUNCIL DIRECTIVE on ensuring a global minimum level of taxation for multinational groups in the Union* {SWD(2021) 580 final}, COM(2021) 823 final, 2021/0433 (CNS), p. 12.

b) Corporations and proportionality

Regarding the impact on business at first the threshold of 750 million euros of consolidated revenue has to be considered.

According to the Commission's proposal adverse impacts on smaller MNE's in the internal market must be avoided. Therefore, the directive applies only to members of MNE or large-scale domestic groups that meet the annual threshold of at least EUR 750 million euros.[148]

However, that threshold has to be put into perspective. For example, in Germany around 3,3 million companies exist, in France around 2,9 million and in Ireland around 291,365.[149] Yet, from those exemplary 3,3 million companies in Germany only around 14,318 have more than 50 million in revenue, not to speak of reaching the threshold of more than 750 million euros.[150] The figures are likely to be similar in the other member states.

In consequence, the amount of companies within the scope of the Model Rules will be considerably small and the compliance burden therefore only affecting a small fraction of internal market participants.

However, those within the scope will likely be confronted with a challenging and costly transformation of their administrative processes. The determination of the relevant income, potential credits by local tax authorities, taxes that have already been paid by constituent entities and the computation of outstanding payments are only some of the factors to be considered. In short, the symmetrical amount of information the national tax authorities require, on a private business scale, has ultimately to be coped with by the MNEs. It will likely require new systems and global collaboration at unprecedented levels.[151]

However, as said before, the transformation and harmonisation of tax systems inevitably causes the transformation of the underlying processes. For private businesses, those might be communicative, administrative and computational processes. But as those challenges only apply to a limited amount of companies, pave the way for a long-lasting tax system, and promise to support the aim of the functioning of the internal market, the Commission's proposal is not entirely out of proportion in this regard.

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[148] *Proposal for a COUNCIL DIRECTIVE on ensuring a global minimum level of taxation for multinational groups in the Union* {SWD(2021) 580 final}, COM(2021) 823 final, 2021/0433 (CNS), p. 14.

[149] https://www.destatis.de/DE/Themen/Branchen-Unternehmen/Unternehmen/Unternehmensregister/Tabellen/unternehmen-umsatzgroessenklassen-wz08.html, retrieved 11.03.2022, https://stats.oecd.org/index.aspx?queryid=81354, retrieved 11.03.2022; https://www.cso.ie/en/releasesandpublications/ep/p-syi/statisticalyearbookofireland2020/bus/businessinireland/, retrieved 11.03.2022.

[150] https://www.destatis.de/DE/Themen/Branchen-Unternehmen/Unternehmen/Unternehmensregister/Tabellen/unternehmen-umsatzgroessenklassen-wz08.html, retrieved 11.03.2022.

[151] https://www.grantthornton.global/en/insights/articles/understanding-the-global-implications-of-pillar-two-model-rules/, retrieved 11.03.2022.

Again though, the time frame might be too narrow for businesses to comply accordingly. The challenges mentioned above and potentially more have to be overcome within the next eight months, in order to apply the IIR as demanded.

However, companies that fail to comply with the reporting rules or other aspects of the provision will be confronted with considerable penalties. Acc. to Art. 44 (2) of the Commission's proposal a company that

> *"does not comply with the requirement to file a top-up tax information return pursuant to Article 42 for a tax year within the prescribed deadline or makes a false declaration shall be charged an administrative pecuniary penalty amounting to 5 % of its turnover in the relevant fiscal year."*[152]

In that regard business voices and concerns must be heard and the development be awaited in order to evaluate if the expectancy of compliance was proportionate or impossible and therefore unproportionate for MNEs.

4. Interim Result on proportionality

The principle of proportionality acc. to Art. 5 (4) TEU and the corresponding test evaluate a measure in terms of suitability, necessity and proportionality in a narrow sense.
As the Model Rules transformed into EU law are not entirely unsuitable and no softer alternatives can be found by adopting tax base or tax rate specific measures the Commission's proposal satisfies these points of examination.

However, a closer look and an awaiting of the further development has to be given towards the implementation period, as the possibility has been voiced, that member states and MNEs could be overwhelmed with the expected restructuring and transformation of current administrative, communicational and computational systems. The developments within the next eight-month period will therefore be crucial for further assessments.
Otherwise, the impacts on member states and corporates are not entirely out of proportion.

Hence, in terms of a current analysis the measures by the EU Commission's proposal appear not to breach EU law.

[152] *Proposal for a COUNCIL DIRECTIVE on ensuring a global minimum level of taxation for multinational groups in the Union* {SWD(2021) 580 final}, COM(2021) 823 final, 2021/0433 (CNS), p. 66.

I. Conclusion

The BEPS Pillar Two project is a milestone for international taxation. But concomitant and unsurprisingly, it requires a lot of complexity and detail to achieve its goal.

From the general challenges of international taxation, stemming from the sovereignty of states and their associated practice of source and residence taxation, arises the risk of double taxation, non-taxation and tax competition. It results in mismatches between tax systems and exploitation by MNEs. These consequences caused the international approach of the G20 and OECD to tackle the immense loss of tax revenue and the harmful tax avoidance practice by MNEs, leading to the BEPS Action Plan.

As a solution, there are the BEPS Model Rules with the IIR, that allows IIR-applying states to allocate the top-up tax from low-taxed Constituent Entities to Parent Entities located in their jurisdiction. The UTPR, the so-called backstop, that allocates taxes by denying deductibility and uses workforce and assets for fair computation of the tax burden. And eventually the STTR, that solves issues emerging from the application of bilateral tax treaties and specific cross-border payments.

However, the precise mechanics of the BEPS Model rules do not only challenge businesses and tax administrations with their complexity, but the general approach of tax harmonisation also causes concerns with regard to a potential implementation into EU law.

As the European treaties do not hand over any direct competences regarding taxation from the member states to the bloc, the legal basis has to be found and justified in Art. 115 TFEU. The establishment and functioning of the European Single market serves as a justification for the approximation of direct taxes and hence can also generally justify the BEPS Model Rules approach proposed by the Commission.

However, diving deeper into the requirements of Art. 115 TFEU, the analysis reveals that the often-cited loss of revenue is not a sufficient argument for the implementation of the commission's proposal, as no direct link is drawn by the Commission between the functioning of the internal market and revenue loss for member states. However, the negative impacts of tax competition and the distorting effects on business choices caused by low-tax member states on the internal market are reasonable arguments in support of the applicability of Art. 115 TFEU.

Despite said plausible arguments, economic studies precisely proving the damaging effects of the lack of harmonization in the field of corporate taxes, as well as the benefit of a minimum tax for the internal market would help to avoid uncertainties regarding the criterion of necessity and potential legal action.

Arriving at the subsequent test of proportionality no less intrusive approach appears to be realisable and the expected obstacles for market participants seem generally not to be out of proportion, neither for companies nor for tax administrations. However, the ambitious timeline and implementation period, which is connected to strict fines for private businesses in case of failure, have to be monitored, as they could transpire to be unproportionally tough.

All in all, the BEPS Model Rules and the Commission's proposal have rightfully been regarded as a ground-breaking initiative with the potential to transform international taxation as a whole. With the aim to achieve a fairer international economic order and distribution of international tax burdens an ambitious bar has been set.
Accordingly, as our analysis demonstrated, the challenges are considerable.
However, in a field that combines the complexities of international economics, international politics and international law, the solution could hardly be simple. And in a world, that has been ridden by economic, political and humanitarian crises complexity is a price worth to pay for a more just future.

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