Analysis

Pillar Two: compatibility of the UTPR with double tax treaties

Speed read

The Pillar Two undertaxed profits rule could, in theory, be susceptible to challenge under applicable double tax agreements (for example, under business profits or non-discrimination articles). However, even if theoretically possible, there are practical obstacles to raising such a challenge and it is uncertain how, if a UTPR charge was challenged under the mutual agreement procedure of a DTA, countries' competent authorities would approach the issue. A multilateral convention would presumably be needed to resolve such uncertainties. In the meantime, businesses must continue to navigate an uncertain international tax landscape.

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The OECD's Pillar Two model rules (the 'model rules') are designed to ensure that MNE groups that have annual revenues of at least €750m pay an effective tax rate (ETR) of at least 15% on all of their profits on a country-by-country basis. Where an MNE's profits in a country are taxed below the minimum ETR, the rules require other group entities to pay commensurate top-up taxes.

The OECD states in its administrative guidance on the model rules that the imposition of Pillar Two top-up taxes will be compatible with the provisions of the UN and OECD model tax conventions. This article identifies some arguably anomalous outcomes that might arise under the rules in practice, and tests whether the OECD's assertion is correct – or whether businesses may have scope to challenge top-up tax charges in certain circumstances on the grounds that they contravene existing double tax agreements (DTAs).

The undertaxed profits rule (UTPR)

The main rule under which top-up tax will be charged is the income inclusion rule (IIR), under which a group's ultimate parent entity (UPE) or, in some situations, its intermediate holding companies, will pay top-up tax in respect of the profits of their low-taxed foreign subsidiaries.

If a group's UPE is located in a jurisdiction that has not yet brought the IIR into effect (for example, Hong Kong, Singapore or Jersey, all of which intend to implement Pillar Two with effect from 1 January 2025), some of the group's top-up tax may not be collected under the IIR. In those situations, the back-up undertaxed profits rule (UTPR) applies. Under the UTPR, top-up tax is allocated among all the UTPR-implementing jurisdictions in which the group has a presence in proportion to the group's employee headcount and tangible asset value in those jurisdictions. Those jurisdictions then impose a top-up tax charge on the group's entities.

Under the IIR, top-up tax is paid by parent entities in respect of their subsidiaries. This leads to coherent outcome given that a parent has both an economic interest in and power to control its subsidiary. Under the UTPR, however, top-up tax may be payable by a company that has no economic interest in or other nexus with the low-tax profits on which the tax is charged.

In an extreme case where a group has a presence in only one UTPR-implementing jurisdiction all of that group's UTPR top-up tax will fall to be collected by that one jurisdiction

In a situation where – as the OECD appears to intend – the UTPR top-up tax is shared among many implementing jurisdictions in which a group has a presence, the UTPR charges may be a relatively minor addition to the paying entities' ongoing tax liabilities. However, in an extreme case where a group has a presence in only one UTPR-implementing jurisdiction all of that group's UTPR top-up tax will fall to be collected by that one jurisdiction. There is a risk of this happening in South Korea, which has enacted legislation that would implement the UTPR from 1 January 2024, a year earlier than many other large jurisdictions. We understand the South Korean legislative process requires the government to issue a presidential decree to bring the legislation into effect, which provides an opportunity to defer implementation of the UTPR; however, for now the position is uncertain.

There is considerable scope for anomalous outcomes where groups UTPR top-up tax is due in a single jurisdiction. The entity from which the top-up tax is due might have modest profits and assets – for example if it is a local distributor that earns a relatively small margin on its sales – and those profits and assets could be matched or even exceeded by the top-up tax charge.

In such circumstances, some businesses may consider whether the UTPR charge can be challenged on legal grounds, for example under existing bilateral DTAs.

Is DTA relief available?

Before examining the specific DTA provisions that might preclude a UTPR charge, it is necessary to consider whether the UTPR charge is a 'covered tax' that is subject to the DTA at all.

Under the UK/US treaty, which we have considered in

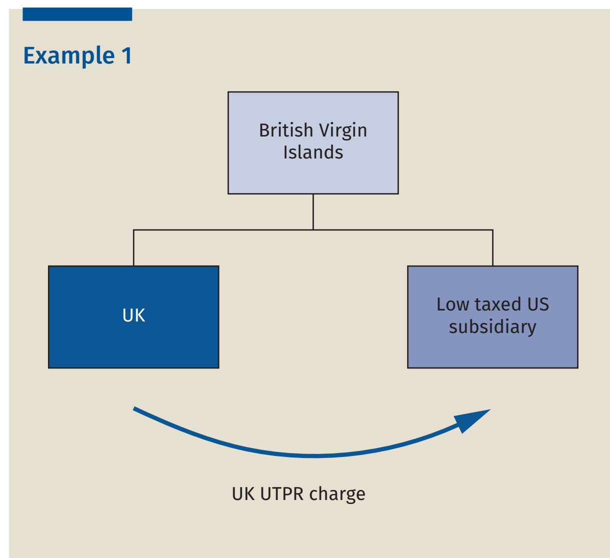
further detail below, 'covered taxes' are defined as 'taxes on income and on capital gains ... irrespective of the manner in which they are levied' (the general definition). The DTA then identifies several specific existing taxes that meet this definition, including UK corporation tax, and states that it applies to 'any identical or substantially similar taxes that are imposed after the date of signature of this Convention in addition to, or in place of, the existing taxes' (the specific definition).

The UK's Pillar Two implementing legislation in the Finance (No. 2) Bill 2023 introduces the IIR as a novel tax charge, rather than characterising it as a charge to corporation tax, and it can reasonably be assumed that the UK UTPR will take the same approach. It is therefore necessary to consider whether the UTPR charge meets either the general or specific definitions.

The Pillar Two tax base starts with accounting profits and makes certain conventional adjustments to them. In that respect, it is similar to most domestic corporate income taxes (CITs) and to UK corporation tax specifically. The Pillar Two charges are different to many CITs in that they only apply to the extent that a group's profits are taxed below the minimum rate. However, this can be seen as analogous to the credit mechanism for giving double tax relief that is common in domestic CIT systems. And, while the way in which top-up taxed is allocated to jurisdictions and then collected is novel, that does not alter the fundamental nature of the tax or how it is quantified. We consider it is therefore arguable that the UTPR charge meets both the general and specific definitions.

Possible treaty challenges

We have considered the possible grounds on which the UTPR charges depicted in examples 1 and 2 below might be challenged under the applicable DTAs.



Business profits article

In example 1, we have assumed that the UK will introduce the UTPR before the British Virgin Islands implements the IIR. The UK entity is subject to a UTPR charge that arises because the group's US subsidiary has low taxed profits. It could be argued that this contravenes the business profits article (article 7) of the UK/US DTA which provides that 'the business profits of an enterprise of a Contracting State shall be taxable only in that State unless the enterprise carries on business in the other Contracting State through a permanent establishment situated therein'.

There are two main arguments that could be made in defence of the UTPR charge:

- First, it could be argued that article 7 of the UK/US DTA does not apply in this situation because of the savings clause in article 1(4), which provides that 'notwithstanding any provision of this Convention ... a Contracting State may tax its residents ... as if this Convention had not come into effect.'
- Second, it could be argued that the UTPR charge is not a tax on the US entity's profits per se but rather a charge on a notional amount calculated by reference to those profits, among other things. Following that reasoning, article 7 of the UK/US DTA would not be relevant, because the UK would not be taxing the US entity's business profits.

Both arguments have been raised in defence of controlled foreign company (CFC) rules' compatibility with DTAs. The commentary on article 1 of the OECD Model Tax Convention (the MTC) emphasises that the saving clause confirms that states are free to apply CFC rules to their own residents.

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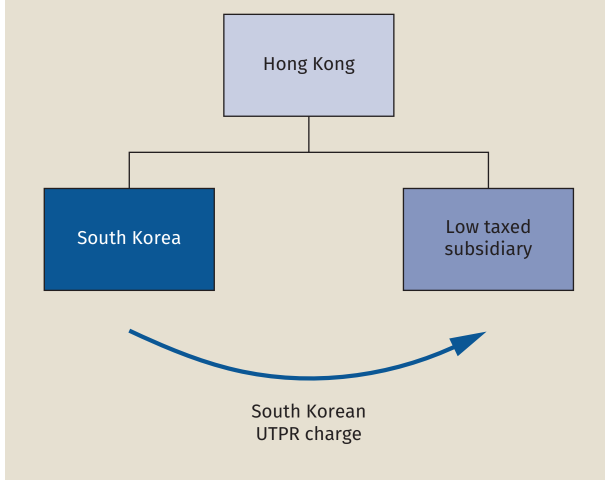
Paragraph 14 of the commentary on article 7 of the MTC reiterates this and goes on to explain that article 7 'does not limit the right of a Contracting State to tax its own residents under controlled foreign company provisions found in its domestic law even though such tax imposed on these residents may be computed by reference to the part of the profits of an enterprise that is resident of the other Contracting State … Tax so levied does not reduce the profits of the enterprise of the other State and may not, therefore, be said to have been levied on such profits.' This is similar to the reasoning of the Court of Appeal in the case of *Bricom Holdings Ltd v IRC* (1997) 70 TC 272 in which it held that the UK's pre-2012 CFC rules did not breach the UK/Netherlands DTA because they did not tax the income of the Dutch CFC in question but rather a 'conventional or notional sum'.

Both arguments might seem unattractive from a policy perspective in that, taken to their logical conclusion, they would allow countries to circumvent the substantive provisions of their DTAs simply by ensuring that their offending measures are appropriately designed. The UK case law on these points is limited and does not address these counter arguments. However, in practice this has been enough to ensure that countries including the UK have been able to implement CFC rules without sustained challenge on DTA compatibility grounds. It is not clear that an article 7 challenge would be any more successful in relation to the UTPR.

Example 2



Non-discrimination article

In example 2 (above), we have assumed that South Korea will implement the UTPR during 2024, before Hong Kong implements the IIR. The South Korean entity is subject to a UTPR charge that arises because the group has other subsidiaries with low taxed profits. In general terms, South Korea will apply the UTPR to foreign-parented groups that are not subject to the IIR in their own parent jurisdiction. It could be argued that this represents South Korea applying more burdensome taxation to foreign-owned enterprises than it does to similar South Korean enterprises, contravening the non-discrimination article (article 22) of the Hong Kong/South Korea DTA. That article prohibits contracting states from taxing enterprises that are owned or controlled by residents of the other contracting state in a way that is 'other or more burdensome than the taxation and connected requirements to which other similar enterprises of [that Contracting State] in the same circumstances, in particular with respect to residence, are or may be subjected'.

> Even if, in theory, the UTPR charge might be susceptible to challenge under DTAs, there may also be practical obstacles

To establish discrimination under article 22(4), it is necessary to:

- identify a relevant comparator (the 'similar enterprise' mentioned in the article);
- demonstrate that the South Korean entity in question is taxed less favourably than that comparator; and
- demonstrate that the reason for that less favourable treatment is because that entity has a Hong Kong parent.

The most straightforward comparators would be a South Korean entity in (a) a South Korea-parented MNE group and (b) a wholly South Korean group. In both cases, the comparator entity would not face a UTPR charge: in the former, the group's top-up tax would be collected under the IIR; and, in the latter, the group would not be subject to the GloBE rules at all. In both cases, the only difference that means the UTPR applies to the South Korean entity is the fact that its parent is Hong Kong resident rather than South Korea resident.

This reasoning has force. However, the South Korean tax authority could argue that, even if the UTPR strictly fails the comparability analysis when looked at in isolation, the IIR should be considered as well, and that both rules work together as part of a system to ensure the same outcome is achieved irrespective of where a group is parented. The wording of the DTA does not obviously support that kind of argument – the issue is whether the entity in question is less favourably taxed, not whether the overall group is – but it might be seen by a court as giving better effect to the policy objectives underlying the DTA.

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Conclusion

Even if, in theory, the UTPR charge might be susceptible to challenge under DTAs, there may also be practical obstacles. It is uncertain how, if a UTPR charge was challenged under the mutual agreement procedure of a DTA, countries' competent authorities would approach the issue. Some may see attempts to dispute the legality of charges under the GloBE rules as unhelpful or in conflict with their political commitment under the OECD Inclusive Framework statement, and therefore readily accept arguments in defence of the UTPR.

The OECD has mooted the possibility of developing a Pillar Two multilateral convention (MLC) that would be legally binding on signatory countries and potentially amend or supersede their existing bilateral DTAs. An MLC could resolve any uncertainty about whether and how Pillar Two charges can be called into question under DTAs. It appears, however, that there is not a plurality of support for an MLC among the Inclusive Framework countries. For now, then, businesses must continue to navigate an uncertain landscape. ■

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