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Effective Minimum Tax Implementation by the EU: Which Alternatives?

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Just two weeks ago on 8 October 2021, 136 of 140 member countries of the OECD/G20 Inclusive Framework agreed on a global tax deal that also features the GloBE international effective minimum tax (the so-called Pillar 2 of their work program). The G20 finance ministers backed the deal in their subsequent meeting, too. The agreement is mostly identical with the joint Statement on global tax reform of 1 July 2021, with some important amendments: It now also includes an implementation plan, the minimum rate has been politically agreed to be exactly 15 % (instead of previously "at least 15 %"), and the formulaic carve-out for routine profits from substance-based activities will be more extensive than originally planned, at least during a 10 year transition period. Finally, and probably most importantly from an EU perspective, in the light of those amendments the former three holdout countries Ireland, Estonia and Hungary have given up their opposition and they have now endorsed the agreed "common approach" towards the minimum tax project. In an official announcement Cyprus, which is not an IF member country, has also "welcomed" the agreement and it has pledged to "work constructively" at EU level on a corresponding legislative framework.[1]

This means that all 27 EU Member States are now politically committed to the minimum tax. This is a good starting point for the EU Commission, which intends to propose a directive already in December 2021 in order to implement the GloBE minimum tax uniformly in all EU Member States. The proposed legislation will be based on the internal market competence of the EU and as a tax measure, it will require unanimity in Council to be adopted. Clearly, such unanimity is still not guaranteed. In particular, the international agreement envisages GloBE as a "common approach", not as a minimum standard, which means that countries willing to implement a minimum tax should respect the international guidelines, but there is no official political commitment to implementation as such. Some Member States such as Ireland might feel tempted to revert to this position should the proposed reform of the US GILTI rules, which seeks to align them more with the GloBE concept, not make it through the US Senate. Nevertheless, there is now somewhat more reason for optimism regarding the prospects of a unanimous solution. At the same time, concerns that it could become necessary to dilute the international compromise in order secure such unanimity does no longer carry the same weight: As stated above, the original GloBE proposal has now already been somewhat watered down at the *international* level, precisely to get the EU holdout countries on board.

With the political obstacles to EU legislation on an effective minimum tax thus significantly reduced, the focus shifts to the legal challenges that also need to be met if EU harmonisation is to

be successful and withstand the scrutiny of the European Court of Justice. The problem in this regard is not so much the competence of the EU: In my view, it can be well defended that the proposed minimum tax legislation would facilitate the "establishment or functioning of the internal market"; and the general principles of subsidiarity and proportionality would also be met.[2] Consequently, most commentators assume that the crucial legal challenge lies elsewhere: to make the minimum tax compatible with the freedom of establishment enshrined in the EU and EEA treaties. With respect to tax measures affecting EU and EEA companies, this free movement right has essentially been interpreted as a non-discrimination standard by the CJEU: A cross-border establishment must not entail tax burdens that exceed the tax burdens imposed with respect to similar but domestic establishments. Any infringement of this non-discrimination principle must be justified by "imperative reasons of public interest" and it must moreover be proportionate.

This is problematic, because the two instruments for the collection of top-up tax to be levied if profits in a particular jurisdiction are taxed too low are meant to apply in a cross-border context only: Primarily it would be the (ultimate) parent jurisdiction that collects the top-up tax for undertaxed foreign subsidiaries and permanent establishments through the so-called income inclusion rule (IIR), which technically resembles a CFC regime for foreign-sourced profits. As a backup, top-up tax for undertaxed foreign group entities would be collected by way of an undertaxed payment rule (UTPR) in the source country. Both rules lead to higher national tax burdens at the level of the group entity that is liable to pay the top-up tax for foreign affiliates, as compared to the tax burden incurred in relation to domestic affiliates. With respect to technically similar rules that were put into place unilaterally by some EU Member States in the past, the European Court of Justice has repeatedly held them to constitute restrictions of the freedom of establishment, e.g. in the *Cadbury Schweppes* decision[3] (CFC regimes) and the *Eurowings* judgement[4] (compensatory source country taxation). Furthermore, the Court has only considered such rules to be justified and proportionate if they are designed as targeted anti-abuse rules, which apply only to "artificial arrangements" that lack sufficient economic substance.[5] However, the collection of top-up tax under the GloBE minimum tax concept is not limited to such narrowly defined abuse, nor should it be. In particular, the formulaic carve-out for substance-based activities had not been designed to shield *all* the profits generated by *any* substantial activity from minimum taxation.

This leads us to the key question: How should an EU minimum tax directive be designed in order to avoid such issues, with sufficient legal certainty? It is here where a political choice between several alternatives needs to be made, first by the Commission and then ultimately in Council:

(1) A first option is merely theoretical in nature. It would consist in significantly expanding the scope of the internationally agreed substance-based carve-out and transform it into a targeted "artificial arrangement" test such as the one demanded by the CJEU for national anti-abuse measures. However, this would undermine the policy objectives of the international minimum tax, which aims at a general reduction of incentives for BEPS and furthermore also seeks to establish a floor for international tax competition at least regarding entrepreneurial activities and IP holdings in particular. It would also fall short of the international agreement on GloBE.

(2) A feasible but risky alternative would be to simply enact the GloBE minimum tax as internationally agreed, and closely aligned with the detailed model rules still to be published in November 2021. Such an approach would bet on the leniency of the European Court of Justice with the Union legislator. In the past, the Court has occasionally accepted justifications for Union legislation that it would not accept in case of unilateral national measures, and moreover it

routinely practices only a light-touch proportionality review. However, such an approach would not offer a great degree of legal certainty. The Court has repeatedly strongly rebuked *discriminatory* “compensatory tax arrangements” (for lower taxation abroad) by considering them to “prejudice the very foundations of the single market”; in its view, such measures could therefore not be justified at all.[6] It is not so certain that the CJEU would fully backtrack from this position in case of Union law in order to clear the path for a harmonized minimum tax. This should therefore be, at most, a fallback option if Member States cannot agree on anything else but a strict adherence to the international GloBE rulebook.

(3) A third possibility would consist in applying the GloBE minimum tax concept also to *domestic* MNE entities in every EU Member State. This approach is apparently favoured by the Commission; among others, the TAXUD Director-General recently indicated this direction of travel.[7] As a consequence, the top-up tax would no longer be merely collected cross-border, and at least regarding the Income Inclusion Rule as the main collection mechanism, the establishment of foreign subsidiaries would therefore no longer be formally discriminated against. Admittedly, in high tax jurisdictions, the collection of top-up tax would then still *de facto* predominantly affect foreign profits. However, from recent case law of the Court, and from the Hungarian progressive turnover tax cases in particular,[8] it can be inferred that such a disparate impact does not infringe the freedom of establishment if it is neither inherent to the rule design nor motivated by protectionism. The last point could certainly be ruled out for EU legislation, and so could the first since the relevant benchmark would be the effective tax rate of individual MNEs in a particular jurisdiction, which is not determined by Union law.

So, the extension of GloBE to domestic group entities is, in principle, a legally viable option that offers a considerable degree of legal certainty. It might be further enhanced if the internationally agreed collection mechanisms were substituted by a system of unitary taxation at group level, per jurisdiction and for GloBE purposes only. This would make the approach even more robust against CJEU scrutiny, and it might furthermore facilitate the future integration of the minimum tax regime in an eventual BEFIT legislation.[9]

However, this approach also implies the conversion of GloBE into a *domestic* minimum tax within the EU. If all EU Member States need to adopt this approach, there will be no longer any *foreign* undertaxed profits for in-scope MNEs in the EU. This has certain policy implications: Revenues will accrue to low-tax Member States where MNE entities are established, no longer to high-tax Member States where they are headquartered. This could be regarded as a positive feature, because it is more aligned with the new “value creation” paradigm for allocating taxing rights than taxation in the ultimate parent jurisdiction. But EU Member States can then also simply refer to EU harmonization as an excuse to create an asymmetric domestic system of business taxation, with a domestic minimum tax of 15 % only for constituent entities of large in-scope MNEs. Other groups and companies that are not within the scope of GloBE would then automatically continue to benefit from lower national levels of taxation. This has, for example, already been indicated by the Irish Finance Minister.[10] The objective of GloBE to curb international tax competition *in general* by giving low-tax jurisdictions an incentive to raise their overall level of corporate taxation to the effective minimum rate would therefore be somewhat weakened by such an approach.

(4) My colleague *Johannes Becker* and I have developed yet a fourth alternative design that is also in compliance with Union law, that would avoid such effects and would still provide flexibility regarding the revenue allocation. This would work through what we call the “Avoider Pays” principle which would replace the collection mechanisms of IIR and UTPR.[11] According to this

principle, the foreign undertaxed MNE entity itself would be liable to pay top-up tax in the ultimate parent jurisdiction (or in a case where the UTPR would apply, in the source country). Parent companies would not incur any additional tax liabilities, nor would the foreign subsidiary or PE normally be subject to higher *domestic* tax burdens there than resident MNE entities. The non-discrimination standards inherent to the EU fundamental freedoms could thus be met. Furthermore, tax collection by the Member State entitled to levy the top-up tax from the under-taxed entity could be facilitated by a One-Stop-Shop mechanism, as already in use for VAT purposes. This approach would also allow for an alternative revenue allocation formula or the collection of the revenue as an EU own resource.

Regardless of which one of the aforementioned alternative paths will eventually be chosen by the Union legislator, it would be advisable to keep an EU minimum tax directive flexible, in order to allow its adaptation to future developments. Otherwise, every single EU Member State could veto subsequent amendments with effect also for the domestic legislation of all other Member States. In particular, the international compromise does currently not allow for a minimum tax rate above 15 % (except in the case of the US GILTI), and it requires a substance-based carve-out with initially high percentages. While these constraints are not legally binding, and they would moreover not apply to a *domestic* minimum tax, a more ambitious approach is certainly politically not feasible if a directive is to be adopted in 2022 with unanimity. But EU legislation could allow more ambitious Member States to "level up" under certain conditions after a certain minimum period of uniform application. For example, the authorisation for national deviations could be made contingent on minimum tax developments in certain benchmark jurisdictions such as the USA, or on a revised international agreement that is endorsed by a certain minimum number of jurisdictions. In a similar vein, it seems advisable to authorise an opt-out for individual Member States if it turns out that after a predefined period of time, the global uptake of the agreed minimum tax concept is still insufficient in terms of coverage of global GDP. If the Union legislator were unable to agree on such flexibility mechanisms, the Commission and EU Member States should not be surprised to see the power to shape the future of business taxation in the 21st century shift further away from Brussels to the OECD and other international fora. In any event, the Commission should be granted broad implementing powers with comitology so as to facilitate technical adjustments, in particular with respect to internationally agreed revisions of the GloBE model rules.

[1] See http://mof.gov.cy/en/press-office/announcements/oecd-tax-deal-on-the-global-minimum-tax-rate (last accessed 20 Oct. 2021).

[2] For an extensive analysis, see *Becker/Englisch*, Implementing an International Effective Minimum Tax in the EU, 2021, https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3892160.

[3] CJEU, 12 September 2006, case C-196/04, Cadbury Schweppe*s*, EU:C:2006:544.

[4] CJEU, 26 October 1999, case C-294/97, Eurowings, EU:C:1999:524.

[5] In particular, the design of a measure as an anti-BEPS instrument is not, in itself, sufficient justification for a restriction of a free movement right; see CJEU, 20 January 2021, case C-484/19, Lexel, EU:C:2021:34, para. 67.

[6] See, e.g., *See* CJEU, 26 October 1999, case C-294/97, Eurowings, EU:C:1999:524, paras. 44-45; settled case law.

[7] See speech by TAXUD Director-General *Gerassimos Thomas* at the Annual Tax Conference of Finland Chamber of Commerce, 22 September 2021, accessible at https://ec.europa.eu/taxation_customs/news/speech-taxud-director-general-gerassimos-thomas-annual-tax-conference-finland-chamber-commerce_en (last accessed 20 Oct. 2021).

[8] See CJEU, 3 March 2020, case C-75/18, Vodafone Magyarország, EU:C:2020:139, in particular paras. 49, 52, and 54; 3 March 2020, case C-323/18, Tesco-Global Áruházak, EU:C:2020:140, paras. 72-75.

[9] See *Englisch*, 5/6 EC Tax Review 2021, forthcoming.

[10] See https://www.gov.ie/en/speech/615f7-statement-by-minister-donohoe-on-decision-for-ireland-join-oecd-international-tax-agreement/; https://www.independent.co.uk/business/rise-in-corporate-tax-rate-is-right-decision-donohoe-b1934322.html (each last accessed 20 Oct. 2021).

[11] For a detailed description and analysis, see *Becker/Englisch*, Implementing an International Effective Minimum Tax in the EU, 2021, https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3892160.

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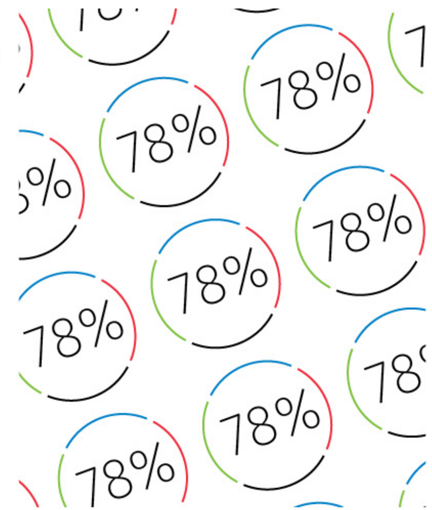

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