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Effects of Pillar II to the principles of international taxation of immovable property

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ABSTRACT

The state's taxation can be exploited by a multinational enterprise, which can significantly affect the state's tax income. The problem at the current moment is that large multinational enterprises use profit shifting as a tool to evade taxes and increase their profits. This leads to erosion of the tax base of states that are not considered favorable in terms of taxation; otherwise, said states can be perfect for business purposes.

This leads to tax evasion schemes widely used by companies; a new global tax initiative is being developed, Pillar II by OECD. Pillar II introduces an international minimum tax. The ambition of Pillar II was to be a digital taxation package, but it has grown from it. The current Pillar II model may have effects on MNE, which can qualify as real estate companies. Therefore, questions might arise due to real estate companies having a special treatment in international taxation. In this research, the aim is to identify the special effects on fundamental reasoning behind the taxation of immovable property and if Pillar II affects immovable property taxation.

In this research, numerical data and comparative analysis will be used to determine if Pillar II will affect the taxation of MNEs that qualify as real estate companies. This thesis will examine how Pillar II and MTC will function together and what is the effect of Pillar II on MNEs that qualify as real estate companies.

Keywords: Pillar II, OECD, Model Tax Convention, Taxation, Real Estate

ABBREVIATIONS

OECD	Organisation for Economic Co-operation and Development
MNE	Multinational enterprises
BEPS	Base erosion and profit shifting
MTC	Model Tax Convention
UTPR	Undertaxed payments rule
IIR	Income inclusion rule
STTR	Subject to tax rule
ETR	Effective tax rate
EU	European Union
PE	Permanent establishment
UPE	Ultimate parent entity
IPE	Information provided by entity
POPE	Partially owned parent entity
DTA	Double Tax Treaty
CGT	Capital gains tax
REIT	Real estate investment trust
CbCR	Country-by-Country Reporting
PBT	Profit before tax
CIT	Corporate income tax
WHT	Withholding tax
DMTT	Domestic-top-up-tax

INTRODUCTION

As part of their BEPS project started in 2013, OECD has developed a new taxation package, Pillar II, which is an agreement on a global minimum tax of 15%.[1] Also, it creates a possibility for other states to tax the difference between 15% and ETR. One of its functions is to disable profit shifting for MNEs.[2] Profit shifting is a tool used by MNEs to move their profits to states with lower tax rates — tax havens. This leads to the situation where MNE Y, which has business in Z state, has a high tax rate. Y will shift its profits to X state due it has noticeably lower tax rates than Z state, and when their earnings are taxed in a form that has a lower tax rate, it will affect their income positively.[3] This can be done in various ways. In this case, the profit shifting would negatively impact Z's tax base. As enterprises are moving to the digital business model, their tax rate is significantly lower compared to companies that use the traditional business model.[4] Its market share has increased from 7% to 54% between 2007-2017.[5] The meaning of Pillar II was to be a digital taxation package, but it has changed from it, and it will have more broader effects. Even though it will provide better possibilities to tax companies functioning in digital space. Pillar II introduces new taxation rules. It only affects MNEs that have revenue over 750 million € and are not seen as excluded entities. It could create some interesting situations with regard to immovable property due to the immovable property has special treatment in the international taxation and has strong fundamental reasoning behind it. Hence, the Pillar II could interfere with the fundamentals of immovable property taxation.

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[1] OECD (2021), Tax Challenges Arising from the Digitalisation of the Economy – Global Anti-Base Erosion Model Rules (Pillar Two):Inclusive Framework on BEPS, OECD, Paris, https://www.oecd.org/tax/beps/tax-challenges-arising-from-the-digitalisation-of-theeconomy-global-anti-base-erosion-model-rules-pillar-two.htm.

[2] Brauner, Y. (2014). What the BEPS. Florida Tax Review, 16(2), pp. 57

[3] Huizinga, H., & Laeven, L. (2008). International profit shifting within multinationals: A multi-country perspective. Journal of Public Economics, 92(5-6), 1164-1182.

[4] Communication from the Commission to the European Parliament and the Council: A Fair and Efficient Tax System in the European Union for the Digital Single Market, COM(2017) 547 final, 21 September 2017; Digital Tax Index, 2017, PwC and ZEW.

[5] Ibid.

Immovable property tax rules refer to the allocation of tax rights to the country of real estate. This rule allocates some taxes to another country if the real estate country's tax rate is lower. The Pillar II effects might be against the right to tax at source, which could affect the fundamental reasoning behind real estate taxation. This means that real estate companies have special treatment in domestic and international tax law. Source state has the primary right to tax real estate. This establishes the ground rule is that real estate is taxed in the source state and not in the residency state. Pillar II introduces a top-up tax that applies in most cases where the parent company is located.[6] This could be as it shifts part of the taxation rights from source to residency state. OECD's MTC will be the tax treaty used in this research when analyzing the effects of Pillar II on real estate taxation. This paper will answer the follow research question: how Pillar II will affect the fundamentals of immovable property taxation of multinational companies and if Pillar II will override the MTC rules regarding the taxation of real estate companies.

In this research, the author will examine if Pillar II affects the fundamental reasoning behind the taxation of immovable property in the international tax context. The author will also discuss if the Pillar II is in line with the MTC and whether it has special effects on real estate MNEs that are not considered as an excluded entities by the Pillar II All this will be analyzed by the use of relevant literature and comparing how the current model of taxation functions. The author will examine the effects by comparing the current fundamental reasoning behind the immovable property taxation and if Pillar II introduces something that is not in line with current reasoning. Primary sources of this thesis will be BEPS, MTC, Pillar II, and directive draft for Pillar II EU, relevant literature, and research. To provide a holistic but simple overview of the taxation of real estate MNEs qualitative, comparative, and numerical research methods will be used.

[6] OECD. (2019, November). Public consultation document Global Anti-Base Erosion Proposal Tax Challenges Arising from the Digitalisation of the Economy. https://www.oecd.org/tax/beps/public-consultation-document-global-anti-base-erosion-proposal-pillar-two.pdf pp. 13

1. Introduction to Pillar II and how it functions in practice

1.1. Fundamental reasoning behind the development Pillar II

As the OECD's Pillar II introduces a global minimum tax of 15%. Its original function was to prevent the use of aggressive tax planning schemes used by enterprises functioning on digital platforms.[7] It has grown from it, and at the current model, it will affect every MNE within the Pillar II's scope. Only six entities are excluded from the scope. MNEs are using various methods to shift profits to low tax states, i.e., double Irish arrangement. This arrangement in practice is created by sending profits through Irish company, after that the profits are sent to Dutch company and lastly the profits are sent to other Irish company, which is in a tax haven.[8] Pillar II establishes a unique possibility to tax MNE at its residency state if the source state does not tax MNE's constituent entity to agreed global minimum tax rate. It is essential that large enterprises pay a fair share of tax because they generate a lot of income by exploiting land, individuals, smaller enterprises, etc.

One could even argue that Pillar II creates equality in the economy when it disables harmful tax competition and disables profit shifting from large MNE. It is important to note that many enterprises use profit shifting as a tool to evade paying taxes, which leads to erosion of the tax base. Hence, Pillar II will give other states the possibility to tax those companies that are not taxed at the minimum rate of 15%, it will disable the use of offshore companies to minimize taxes. In practice Pillar II, decides that one is not an offshore company and that creates a possibility to tax them if the company is not taxed to the extent demanded by Pillar II. The Source state is where the profit is made, and the residency state is where the enterprise is located.

As an example, we have company A whose residency state is state X, it has real estate in states Y and Z in each state company A has a constituent entity. In-state Y income derived from real estate is taxed at 5% and in-state Z income derived from real estate is taxed at 10 %. Company A's constituent entity makes a 1 000 € profit in state Y and in-state Z A's constituent entity makes a profit of 2 000 €. The income from real estate in state Y is taxed at 10 % therefore after-tax profit

[7] Bruno da Silva, Taxing Digital Economy: A Critical View around the GloBE (Pillar Two), 15 Frontiers L. China 111 (2020). P. 111-141

[8] Dharmapala, D. (2014). What do we know about base erosion and profit shifting? A review of the empirical literature. Fiscal Studies, 35(4), 421-448.

is 900 €. As the income from real estate is taxed at 5 % the after-tax profit is 1 900 €. The overall profit after tax for Company A is 2 800 €, which means that its ETR is taxes paid divided by PBT, therefore 200/3 000= 0,067 = 6,7 %. This would mean that Company A pays only 6,7 % in tax, but due this example is made with MTC rules, and the assumption was that tax conventions between X and Y or X and Z do not allow additional taxes to be allocated for the income derived from immovable property. This leads to a situation where company A benefits from DTT due to the residency state of company A cannot allocate additional tax to company A. When Pillar II is added to the example it can tax the difference between the agreed minimum tax and ETR by allocating a top-up tax to Company A as it's the UPE.

As the one of its goals is to end harmful tax competition that happens between states, which could, in some cases, lead to erosion of the tax base. Erosion of the tax base can have different effects on states and individuals of the state. The worst-case scenarios argue that welfare states would diminish, and unemployment would rise if the harmful tax competition got out of hand.[9] At minimum destructive tax so called a harmful tax, and competition leads to non-compliance by all taxpayers, erosion of the tax base, and increased administrative costs for tax authorities. The tax burden can shift to labor, property, and consumption, and lead to dis-belief in the tax system.[10] One could argue that competition is always beneficial for the public good; hence competition usually leads to innovations and development and discourages unbeneficial actions.[11] Pillar II isn't probably the end of harmful tax competition. Accordingly, source-states can implement DMTT and be minimum global tax rate non-compliant. This leads to a situation where states have lower tax rates than the minimum tax rates imposed by Pillar II, and still, they can collect the top-up tax opting by opting to implement DMTT.[12] Due to this, one could even argue that Pillar II establishes a minimum tax rate for MNEs and not for all enterprises. Even though it is a matter of sovereign policy, this obstructs the establishment of an actual minimum tax rate. Lowered tax can be used as a way to regenerate the economy during a crisis, which is an important aspect when discussing global minimum tax, it would be beneficial that there would be a safe clause if taxes are lowered due to a crisis. One could argue that it is not necessary when the taxes are allocated to the UPE

[9] Radaelli, C. M. (1999). Harmful tax competition in the EU: Policy narratives and advocacy coalitions. JCMS: Journal of Common Market Studies, 37(4), P. 661-682.
[10] OECD (1998), Harmful Tax Competition: An Emerging Global Issue, OECD Publishing, Paris, https://doi.org/10.1787/9789264162945-en.
[11] Smith, A. (2010). The Wealth of Nations: An inquiry into the nature and causes of the Wealth of Nations. Harriman House Limited
[12] Dourado, A. P. (2022). Pillar Two Model Rules: Inequalities Raised by the GloBE Rules, the Scope, and Carve-Outs [pre-publication]. Intertax, 50(4 [pre-publication]).

level, but some crises might have significant effects on certain industries. During COVID-19 restaurants faced a significant loss of revenue.

It is important to note that taxation is, in a principle, a domestic policy, which is a matter of the sovereign state.[13] A sovereign state can set domestic policies that can possibly draw people, businesses, investors, or capital.[14] Even though sovereign states can set out domestic tax policies it is important for the state that they are accepted by international standards.[15] Interaction between different tax systems is more important than ever before, due the world is more globalized than ever before, and individuals and businesses practice significantly more cross-border trade.[16] When different tax systems can interact without a problem CbCR can be used more easily to help implement Pillar II rules. CbCR is country by country reporting model, which is used in Pillar II to report each constituent entity's ETR and if the tax rate is over the agreed minimum tax rate or not.

1.2. Scope of Pillar II

As the Pillar II goal is to prevent harmful tax competition and disable profit shifting. Not all MNEs can be in the scope of Pillar II, due small MNE do not benefit as much about the tax competition or profit shifting as large enterprises do. Therefore, a MNE needs to fulfill few a requirements to be within the scope of GloBE rules. MNE must have revenue of at least 750 million € in the last two out of four previous fiscal years.[17] Pillar II excludes certain entities from the scope of GloBE rules. The excluded entities are government entities, international and non-profit organizations, and pension funds and real estate investment funds.[18] Due to the focus being on real estate MNEs, we will focus on what does qualify as REIT. To be qualified as REIT: it must be taxable as an enterprise that is managed by a board of directors/trustees. It has a minimum of 100 shareholders and 50% of its shares cannot be owned by five or fewer individuals. 90% of taxable income must be paid as shareholder dividends. It must have at least 75% of its assets in real estate and 75% of the gross income must generate from rents, and interest on mortgages by financing real estate of

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[13] Radaelli, C. M. (1999). *Supra nota*. 9 P. 661-682
[14] Teather, R. (2002). Harmful tax competition?. Economic Affairs, 22(4), 58-63.
[15] Radaelli, C. M. (1999). *Supra nota*. 9 P. 661-682
[16] Radaelli, C. M. (1999). *Supra nota*. 9 P. 661-682
[17] Proposal for a Council Directive on ensuring a global minimum level of taxation for multinational groups in the Union (2021)
[18] Proposal for a Council Directive on ensuring a global minimum level of taxation for multinational groups in the Union (2021) *supra nota. 17*

sales of real estate.[19] Due to the rules being strict, not every company that invests in real estate is qualified as a REIT. After that the tax residency of the MNE must be located, it can be tax resident by place of effective management or where it was established. It is important to note that entities owned by at least 95% of excluded entities or entities are also seen as excluded entities.[20] This research will include companies that invest in immovable property but are not REITs or other excluded entities. It will also include enterprises that have a holding company or companies to hold immovable property. A holding company can be used for a variety of reasons and one of the reasons is the tax advantage and risk management. The use of a holding company can significantly lower the ETR of the enterprise and therefore it can be extremely beneficial.[21] The use of offshore companies has always awakened opinions if the use of them is ethically correct, many arguments are based on risk management, even though in many cases the use of offshore companies is to minimize tax burden of enterprise.

1.3 How top-up tax is calculated

Top-up tax is calculated on a jurisdictional basis, which creates a possibility for the constituent entity's jurisdiction to apply DMTT, which means that top-up tax is allocated to the constituent entity instead of the UPE of the MNE.[22] Top-up tax is calculated only for entities that revenue exceeds 10 000 000 million € and the income/loss in the jurisdiction is less than 1 000 000 million € in the average fiscal year. The average fiscal year is calculated by calculating the average of the ongoing fiscal year and the last two fiscal years. If the entity does not qualify in these rules it is so-called *de minimis* income exclusion, for those entities the top-up tax is zero for the purpose of GloBE rules.[23] The reasoning for this is to reduce the compliance burden when the risk is low.[24] Compliance burden means additional costs created by Pillar II ie. and additional accounting costs. This also protects smaller entities from being shut down with the reasoning that the jurisdiction is not profitable enough for the MNE due to the additional costs created by Pillar II. Those additional costs can ie. risen accounting costs.

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[19] What's a REIT (Real Estate Investment Trust)? (2021). Nareit. Retrieved March 14, 2022, from https://www.reit.com/what-reit
[20] *Ibid.*
[21] Daems, H. P. (2012). The holding company and corporate control (Vol. 3). Springer Science & Business Media. P. 36
[22] Proposal for a Council Directive on ensuring a global minimum level of taxation for multinational groups in the Union (2021) *Supra nota.* 17
[23] Proposal for a Council Directive on ensuring a global minimum level of taxation for multinational groups in the Union (2021) *supra nota. 17*
[24] *Ibid.*

1.4. Determining the ETR and top-up tax rate on a jurisdictional basis

GloBE income or loss is the net income of all finances and after that, all needed adjustments are made, and as an example dividends from constituent entity are removed. After that, we calculate the GloBE tax, which is tax imputable to GloBE income. Expenses seen as tax expenses are taxes on income and equity. After we have discovered the GloBE tax, we can determine the ETR.[25]

$$\frac{GloBE\ tax}{GloBE\ income} = ETR$$

When the ETR has been determined, top-up tax rate can be calculated

$$Minimum\ tax\ rate - ETR = Top\ up\ tax\ rate$$

1.5. Determination of top-up tax

Top-up tax rate is calculated for each low tax jurisdiction by subtracting ETR from minimum tax rate. After that we need to determinate excess profits, which is substance based carve outs subtracted from GloBE income. Substance-based carve-outs are 5% of the value of tangible assets and 5% of eligible payroll costs. [26] There are transitional relief for the payroll costs carve-outs (table 1) and tangible assets carve-outs (table 2). This means that carve-outs are going to be higher

[25] *Ibid.*
[26] *Ibid.*

when Pillar II is applicable, but they will lower to 5% over the period of the next 10 years. The transitional period creates relief for companies to adjust to changes created by the implementation of Pillar II.

Table 1 transitional relief for payroll cost carve-outs

2023	10 %
2024	9,8 %
2025	9,6 %
2026	9,4 %
2027	9,2 %
2028	9,0 %
2029	8,2 %
2030	7,4 %
2031	6,6 %
2032	5,8 %

Table 2 Transitional relief for tangible assets carve-outs

2023	8 %
2024	7,8 %
2025	7,6 %
2026	7,4 %
2027	7,2 %
2028	7,0 %
2029	6,6 %
2030	6,2 %
2031	5,8 %
2032	5,4 %

Source: Proposal for a Council Directive on ensuring a global minimum level of taxation for multinational groups in the Union (2021)

With regard to immovable property, any immovable property that is used to derive income by renting, selling, or just as an investment are not considered tangible asset.[27] Costs that are derived from full-time or part-time employees and independent contractors are seen as eligible payroll costs; with regard of independent contractors, they must function as part of MNE's daily functions.[28]

$$Value\ of\ payroll\ costs \times 0{,}05 + value\ of\ tangible\ assest \times 0{,}05 = substance\ based\ carve\ out$$

After the substance based carve-out is known, excess profits can be calculated, which is used to calculate top up tax.

$$Globe\ income - substance\ based\ carve\ outs = Excess\ profits$$

[27] *Ibid.*
[28] *Ibid.*

After this, excess profits are calculated, top-up tax can be calculated:

$$Excess\ profits \times Top\ up\ tax\ rate = top\ up\ tax$$

1.5.1. Example how the top-up tax is calculated:

Company X is a multinational enterprise, which has a revenue of 772 million € and it is not excluded entity by the means of Pillar II. Company X has a GloBE income of 10 million € on jurisdictional bases and has paid 1 million € in tax. Therefore, Company X has $\frac{1\ 100\ 000}{10\ 000\ 000} = 0{,}11 = 11\ \%$ ETR, which is lower than the minimum tax rate of 15 %. Due the ETR is lower than 15%, we calculate the top-up tax rate, which is minimum tax rate less ETR $15 - 10 = 4 = 4\ \%$ Company X's top-up tax rate is 4 %. After we have determined the top-up tax rate we calculate substance-based carve out when Company Y X's payroll costs are 12 million € and the value of tangible assets is 15 million € $12\ 000\ 000 \times 0{,}05 + 15\ 000\ 000 \times 0{,}05 = 1\ 350\ 000$ Substance based carve-outs are 1 350 000 €. Calculate excess profits, which is GloBE income less substance-based carve-outs. $10\ 000\ 000 - 1\ 350\ 000 = 8\ 650\ 000$ Company X's excess profits are 8 650 000 € on a jurisdictional basis, after we know what excess profits can calculate top-up tax, which is excess profits multiplied by the top-up tax rate. $8\ 650\ 000 \times 0{,}04 = 346\ 000$ Therefore, Company X's jurisdictional top-up tax is 346 000 €

1.6. How can top-up tax be applied?

It has two components to implement in domestic legislation, which are IIR and UTPR, and one treaty-based rule, which is STTR. To ensure the proper functioning of Pillar II it enforces CbCR.[29] This is Action 13 of the BEPS project, and it requires MNEs to annually report PBT and how much CIT has been paid, it also requires MNEs to report total capital, employment, retained earnings,

[29] Communication from the Commission to the European Parliament and the Council: A Fair and Efficient Tax System in the European Union for the Digital Single Market, COM(2017) 547 *Supra nota*. 4

and tangible assets. This is done in each jurisdiction where MNE has business activity; they also need to identify each constituent entity of the group and what type of business does the constituent entity engages in[30] It is done for each jurisdiction individually to decrease the burden for the companies.

IIR's aim is to tax the by imposing a top-up tax to UPE when the directly or indirectly owned constituted entities ETR is below the minimum rate. IIR has a top-down approach, which means that it is first applied at the UPE level if UPE's jurisdiction does not apply IIR. IIR is applied at the next level that it can be applied. IIR is always prioritized over UTPR.[31] Pillar II introduces DMTT, which creates the possibility for the source-state to apply top-up tax at the domestic level instead of it being applied to UPE. If the source-state decides to apply qualified DMTT to the constituent entity of UPE, the residency state of UPE is obliged to give credit in the respect of the jurisdiction.[32] This means that if all of the top-up tax is not applied at the UPE level if the constituent entity's jurisdiction applies DMTT. The main reasoning behind the DMTT rule is to foster and enshrine the sovereignty of the states.[33]

Other implementing jurisdictions can apply UTPR if the jurisdiction of UPE does not apply IIR to the extent needed or at all. UTPR is applied to the constituent entity of UPE.[34] UTPR is seen as an interceptor for IIR. UTPR can be applied by different measures i.e., denial of a deduction, and increased tax rate.[35] There is no certainty by which measures the UTPR will be applied in practice, but those measures are speculated to be the most likely ones.[36] The reason why UTPR is used as an interceptor is that it requires deeper coordination between jurisdictions and is more complicated to apply. Hence, it can be applied in multiple jurisdictions at the same time.[37] This could lead to various problems, for example, if IIR is not being applied to the extent required by the Pillar II,

[30] OECD (2014), Guidance on Transfer Pricing Documentation and Country-by-Country Reporting, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris, https://doi.org/10.1787/9789264219236-en.
[31] OECD (2021), *Supra nota*. 1
[32] Proposal for a Council Directive on ensuring a global minimum level of taxation for multinational groups in the Union (2021) *Supra nota*. 17
[33] Noked, N. (2022). The Case for Domestic Minimum Taxes on Multinationals. Available at SSRN.
[34] Proposal for a Council Directive on ensuring a global minimum level of taxation for multinational groups in the Union (2021) *Supra nota*. 17
[35] OECD (2021), *Supra nota*. 1
[36] Englisch, J. (2021). Non-harmonized Implementation of a GloBE Minimum Tax: How EU Member States Could Proceed. EC Tax Review, 30(5/6).
[37] Cobham, A., Faccio, T., Garcia-Bernardo, J., Janský, P., Kadet, J., & Picciotto, S. (2021). A practical proposal to end corporate tax abuse: METR, a minimum effective tax rate for multinationals. Global Policy.

UTPR is applied by other jurisdictions and if the business activity is low for its UPEs constituent entities it can be hard to apply to the extent needed.

See figure 1 on how IIR and UTPR are applied.

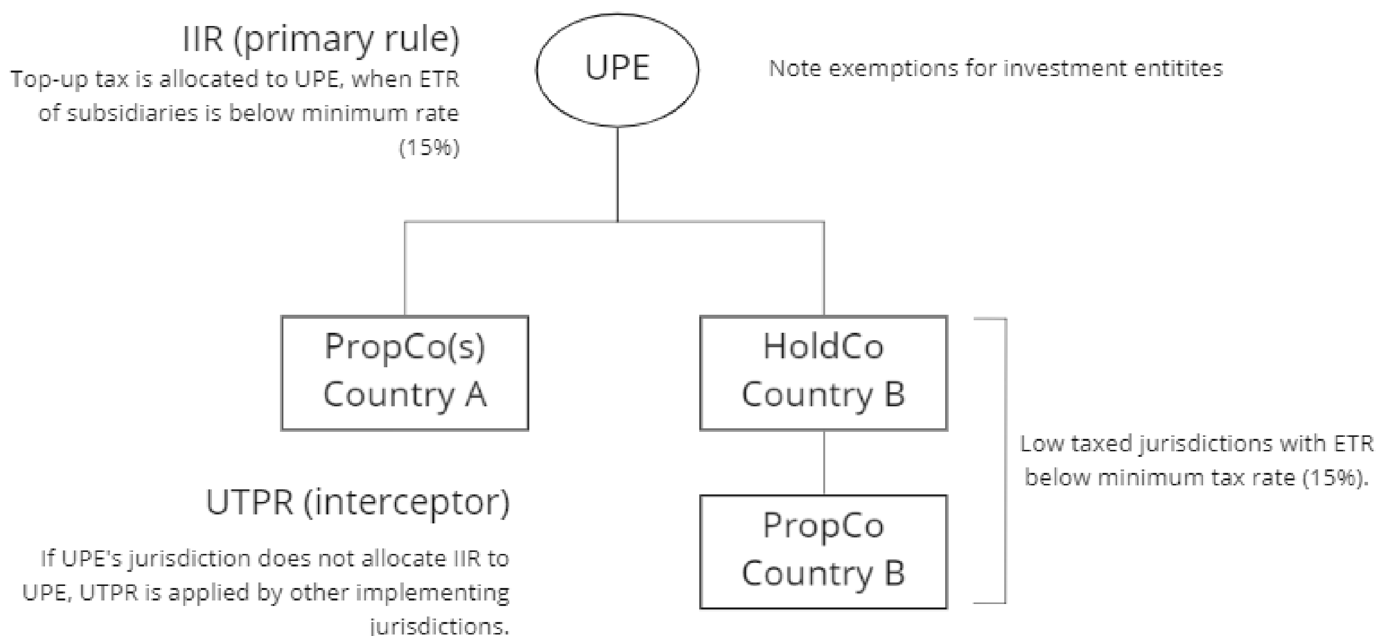

Figure 1 Example of how IIR and UTPR are applied.

Source: COUNCIL DIRECTIVE on ensuring a global minimum level of taxation for multinational groups in the Union

STTR would impose the possibility to deny DTT benefits if the income is taxed under the minimum rate.[38] In practice, this could mean that income from the immovable property could be taxed at the residency state if the immovable property is taxed below the minimum rate at the source. In other words, the residency states could provide credit or exemption methods for income derived for example from real estate. The switch-over rule would introduce a possibility for the residency jurisdiction to switch from exemption to credit method when the income derived from PE or immovable property is taxed below the minimum rate. The use of the credit method could be an extremely practical way to tax immovable property that is not taxed to the extent demanded by Pillar II, even though it could lead to a small rise in administrative costs for tax authorities.

[38] Global anti-base erosion proposal ("Globe") - pillar two. Available at: https://www.oecd.org/tax/beps/public-consultation-document-global-anti-base-erosion-proposal-pillar-two.pdf.pdf [Accessed February 7, 2022].

2. MTC and taxation of Real Estate Enterprises

2.1. Taxation real estate according to MTC

To make things simple, in this research immovable property is defined as land with or without improvements to it. Improvements are buildings. Real estate is defined as land with a building or buildings and is immobile. In this research forestry and agriculture are excluded to make matters more simple, due topic is complicated.

As the states have sovereign tax policies, they may not always function well with foreign states' tax policies, this in many cases would lead to double taxation, which is harmful to the individual. In other words, income derived and taxed at the source is taxed again at the residency state.
The meaning of double tax treaties is to relieve situations where the same taxpayer is being taxed twice. In the international context, this means that the same income is being taxed at both jurisdictions, source, and residency. States have different measures for relief in case of double taxation. They are exemption, credit, deduction, and reduced rate methods. These methods are just to deprive double taxation for individuals or enterprises. In this research, author will use OECD MTC as the DTT.

OECD MTC's Article 6 articulates how immovable property is taxed if the owner of the immovable property is not a resident of the source state. The immovable property is taxed primarily at the source state, and it also includes income from forestry or agriculture.[39] It also applies to the income of enterprises, which is derived from immovable property.[40] Therefore, Article 6 paragraph 3 applies to MNEs that exploit immovable property for income.[41] Article 13 (1) of OECD MTC states that capital gains from immovable property are also taxed at the source

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[39] OECD (2017), Model Tax Convention on Income and on Capital: Condensed Version 2017, OECD Publishing, Paris, https://doi.org/10.1787/mtc_cond-2017-en.
[40] *Ibid*.
[41] OECD (2019), Model Tax Convention on Income and on Capital 2017 (Full Version), OECD Publishing, Paris, https://doi.org/10.1787/g2g972ee-en. pp. 446

state. The sale of shares of a real estate company is also taxed at source according to Article 13 of MTC[42]. A real estate company's main income streams are sales or rent of real estate, and both are taxed at sources according to MTC. Therefore, we can say that income from real estate for MNE is taxed at the source according to MTC. In practice, this leads to a situation where the location of real estate defines where the tax is paid. What is discussed before, leads to the situation where the taxation of real estate is taxed at the source state and therefore according to MTC MNEs that exploit immovable property for business purposes are taxed in the source state. Hence, profits derived from real estate, or the sale of real estate company's shares located in state X will be taxed primarily in state X. In both articles 6 and 13 (1) of OECD MTC the word "may" appear which refers to that the source state has not exclusive taxation rights over immovable property if source state would have exclusive taxation rights over immovable property situated at their soil, it would lead to an interesting situation when the Pillar II is implemented. Therefore, OECD MTC does not deny the possibility to be taxed at the residency state. This means that both Articles provide non-exclusive taxation rights to the source state. Hence, the residency state can apply credit or exemption method to income derived from another state. Arguments could be made that only source states should be able to tax due to the close economic connection. But that could lead to interesting possibilities for investment entities if they would acquire a significant amount of immovable property from states that have low tax rates.

2.2. Why source state has the primary right to tax and is the fundamental reasoning behind the taxation of immovable property?

When discussing about tax policies it is important to remember that all sovereign states are free to create their own policies as they please. As the tax policy is in a principle a domestic policy implemented by a sovereign state.[43] The sovereign state is in principle allowed to make its own policies as they please. But in international or cross-border taxation, DTT must be made to create functional cooperation between the states and deny double taxation, which discourages work or investing abroad. For example, if in the EU there would not be DTT two out of the four freedoms would be endangered. Free movement of capital and persons would be freedoms endangered, to be specific the free movement of persons would be indirectly endangered. As the taxation is an important way to gain revenue for the state to provide services ie. health and social services, police,

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[42] *Ibid.*
[43] Radaelli, C. M. (1999). *Supra nota*. 9 P. 661-682

fire department, etc..[44] Part of this income comes from the taxation of real estate, which is an effective way to gain revenue for the state.[45] The fundamental reason why the source state has taxation rights over immovable property is that the owner is exploiting land and businesses or individuals of the state. Whether it is generated by rent or the sale of real estate it is taxed primarily at the source state due to the fact that a company or individual exploits the state's land or residents for monetary purposes. This establishes a close economic connection between the immovable property and the source state and due to this, the source state has taxation rights over immovable property.[46] This means that the close economic connection is always present. If the residency state of the immovable property owner would have taxation rights of immovable property located in another state. This would be problematic when considering source states' tax sovereignty since they would not have taxation rights over immovable property situated on their soil.[47] This cherishes the sovereignty of the state. When the source has primary taxation rights, but not exclusive right to tax other states can allocate additional tax to income derived from immovable property. In other words, they can provide credit or exemption to income derived from immovable property located in the other state.

2.3. Taxation of MNE that invests in immovable property

As discussed before the income derived from immovable property is taxed at the source state. For MNEs, this means that their constituent entities pay taxes at the source state.[48] MNE can be taxed at its residency state when it receives income indirectly due to PE of its constituent entities ie. as dividends or by other means from its constituent entities, but if the MNE owns immovable property in another state the income derived directly or indirectly from the immovable property. The income is always primarily taxed at its source. The residency state of MNE can apply exemption or credit method in a way that the DTT between the source and residency

[44] Dickescheid, T. (2004). Exemption vs. credit method in international double taxation treaties. International Tax and Public Finance, 11(6), 721-739.
[45] Prammer, D. (2020, December 1). Immovable property: where, why and how should it be taxed? A review of the literature and its implementation in Europe: Public Sector Economics. http://www.pse-journal.hr/en/archive/immovable-property-where-why-and-how-should-it-be-taxed-a-review-of-the-literature-and-its-implementation-in-europe_6348/
[46] OECD (2017), "Commentary on Article 6", in Model Tax Convention on Income and on Capital: Condensed Version 2017, OECD Publishing, Paris.
[47] Scapa, A., & Henie, L. A. (2005). Avoidance of double non-taxation under the OECD model tax convention. Intertax, 33(Issues 6-7), 266-285
[48] OECD (2017), *Supra nota 46.*

articulates.[49] In conclusion, income directly derived from immovable property is taxed primarily at the source state and the residency state can allocate additional tax if the DTT allows it. If the income is indirectly derived from immovable property the source state has still the primary right to tax, but this does not mean that income derived through PE is not considered as income of the enterprise. The main function of this is to secure that the source state is the holder of the right to primarily tax.[50] From a practical perspective it means that if the company has a holding company that holds immovable property and it pays dividends to MNE, the income is seen as income derived from immovable property and it is taxed according to Article 13 (1) of OECD MTC.

[49] *Ibid.*
[50] *Ibid.*

3. Pillar II and taxation of immovable property for MNEs

What to talk Analysis of special topics, which arise in relation of real estate companies and Pillar II. Ie. if Pillar II will override real estate provisions in DTT.

3.1. Pillar II and taxation of immovable property for MNEs

Pillar II and MTC are two completely different tax treaties that overlap in certain areas. One is preventing double taxation between states and the other is trying to prevent the use of profit shifting. Overlapping is mostly that it can deny DTT benefits provided by MTC or even change exemption method to credit method if needed. Also, it creates a possibility to tax MNE at its UPE's residency state, due it has constituent entities in low tax state.

As an example, if a company called COMPANY X is investing partly in immovable property, and it is not an excluded investment entity by Pillar II. COMPANY X is UPE, which has constituent entity X located in a low-tax state, where the minimum tax rate is not met. Constituent entity X only invests in immovable property. This leads to a situation where the taxation right for immovable property shifts from source to residency. Well to be correct the primary taxation right to does not shift, but additional tax can be allocated to COMPANY X even though the immovable property is not located at the residency state of UPE. This is where the MTC and Pillar II collide, MTC can provide protection from taxation outside of the source state and Pillar II can deny the benefit of the MTC. This leads to a situation where Pillar II in some sense changes the playing field of international taxation. As the example shows, Pillar II modifies the interaction between states regarding the taxation of MNEs. This means that constituent entity X can be taxed in the residency state of COMPANY X (UPE). If the residency state of constituent entity X does not implement DMTT residency state of COMPANY X will use IIR too, but if it does implement the DMTT they can allocate additional tax to X locally.

3.2. Switch-over rule and STTR and immovable property

With regard to immovable property, the switch-over rule can be applied to income derived from immovable property. This means that the exemption method can be changed to the credit method. The exemption method means that the residency state does not tax income that has been taxed at the source and the credit method means that taxes paid at the source state can be deducted from additional tax allocated by the residency state. The use of the credit method leads to a higher tax rate.[51] From the Pillar II perspective, this is optimal when the high tax state can apply this rule to MNE that is exploiting the low-tax state for income or using tax schemes to minimize tax burden. One author argues that the use of the credit method would interrupt the flow of capital, but the switch-over rule is only applied to MNEs that are using profit shifting as a tool to increase their profit margins. Hence, Pillar II should not interact with the flow of capital.[52] STTR can be applied to income derived from the immovable property by allocating a WHT or other type of tax and even denying DTT benefits when the income is lower than the minimum tax rate. Therefore, STTR and switch-over rules can directly affect the taxation of immovable property by creating additional taxes on income derived from the immovable property.

3.3. Changes in taxation for entities that invest in immovable property

As the real estate investment vehicles are seen as excluded entities by the Pillar II one could argue that all investments in real estate should be considered as excluded entities. If real estate income would be excluded from the GloBE income it could mean that a large proportion of some MNE would be disregarded. REITs pay more taxes than the average company. ERPA (European Public Real Estate Association) states, that for every 100€ turnover REIT pays 33€ in tax, which means significantly higher rate than average company.[53]

The biggest change is that the IIR can be applied to UPE that has constituent entities in low tax states or UTPR rule if the residency state of UPE does not apply IIR as it should.[54] See figure 1

[51] Bond, E. W., & Samuelson, L. (1989). Strategic behaviour and the rules for international taxation of capital. The Economic Journal, 99(398), 1099-1111.

[52] Dickescheid, T. (2004). *Supra nota.* 44 P. 721-739.

[53] ERPA (European Public Real Estate Association), & Jasik-Caínzos, K. (2021, December). EPRA statement on the exclusion of REITs from Global Anti-Base Erosion (GloBE) rules under Pillar Two. ERPA (European Public Real Estate Association). https://www.epra.com/application/files/2816/4009/8563/Final_EPRA_statement_on_GLoBE.pdf

[54] Proposal for a Council Directive on ensuring a global minimum level of taxation for multinational groups in the Union (2021) *Supra nota.* 17

for how IIR and UTPR can be applied. Before Pillar II, the additional tax could not be laid down to entities that are using profit-shifting legally as a tool to increase their profit margins. As one of Pillar II main functions is to disable the use of profit shifting of MNEs, it also rises the ETR of MNE.[55] This means that profit margins decrease, but due to the minimum tax rate of 15%, it should not affect the MNE's profits significantly.

The immovable property that is used to derive income cannot be used as tangible assets carve-out. [56] The entities that invest in immovable property cannot use their immovable property in tax carve-outs for the top-up tax calculations. This is understandable due if they could carve out a significant proportion of the top-up tax and it could mean that the top-up tax would lose its meaning. This leads to a situation where MNE partly investing in immovable property do not benefit as much as before from buying immovable property located in a low-tax state. This could lead to a situation where the risk-return ratio is not good enough for MNE due to political or other risks regarding the investment in a low-tax state.[57] It could mean that in some cases MNE would not invest in a low-tax state, due it is not profitable enough when calculating the risk-return ratio. Pillar II does not directly have special effects on the taxation of MNE that invest in immovable property, it can deny some DTT benefits provided by MTC, but fundamentally its effects do not differ from average MNE to MNE investing in real estate that is not considered as an excluded entity. The main effect is that it can change the risk-return ratio for MNE or its constituent entities and creates additional accounting costs for enterprises.[58] It will also affect the profit margins of MNE. The tax rates will rise for those MNEs and constituent entities that are situated in low tax states. Where the minimum tax rate does not exceed the minimum rate.

3.4. Does this change the fundamental reasoning behind real estate taxation?

As discussed before income derived from the immovable property is taxed at the source state due to the close economic connection between the source state and the property.[59] Pillar II makes some

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[55] OECD (2021) *Supra nota 1*

[56] Proposal for a Council Directive on ensuring a global minimum level of taxation for multinational groups in the Union (2021) *Supra nota*. 17

[57] Busse, M., & Hefeker, C. (2007). Political risk, institutions and foreign direct investment. European journal of political economy, 23(2), 397-415.

[58] Norregaard, M. J. (2013). Taxing immovable property revenue potential and implementation challenges. International Monetary Fund.

[59] OECD (2017) *Supra nota 46*

changes to this. If, the IIR rule is being applied to the UPE of MNE that has a constituent entity in a low tax state. This means that income derived from immovable property in a low tax state is taxed again at UPE's residency if the minimum tax rate is not exceeded.[60] On the other hand, if the UTPR rule is being applied to the entity after UPE. It means that that entity may lose its right to deductions or even the tax rate can be increased to it. This is not directly being applied to immovable property and hence the UTPR rule does not change any fundamentals behind immovable property taxation. When the switch-over rule is being applied to income derived from immovable property. The immovable property can be taxed in both states — at residency and source state. The residency state gives credit to the entity for the tax paid at the source jurisdiction. The STTR rule when being applied to income derived from immovable property denies DTT benefits.[61] This does not directly affect the taxation of immovable property, but it can create interesting situations when the DTT benefits are denied to an entity. But the source jurisdiction has still the primary right to tax to the extent that they have decided, which is important due is disables discrimination.[62] Hence, the fundamental reasoning behind the taxation of immovable property does not differ from the MTC's reasoning. The close economic connection between the source state and the property is appreciated and enforced in every rule that Pillar II introduces. DMTT rule even enforces the fundamental reasoning behind the taxation of immovable property, by creating a possibility for the source state to allocate the top-up tax.[63]

[60] Proposal for a Council Directive on ensuring a global minimum level of taxation for multinational groups in the Union (2021) Supra nota. 17
[61] Navarro, A. (2020). Jurisdiction Not to Tax, Tax Sparing Clauses and the Income Inclusion Rule of the OECD Pillar 2 (GloBE) Proposal: The Demise of a Policy Instrument of Developing Countries?. Copenhagen Business School, CBS LAW Research Paper, (20-22). P. 11
[62] Avi-Yonah, R. S. (2003). International tax as international law. Tax L. Rev., 57, P. 493-496
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CONCLUSION

The aim of the paper was to find if there are any special effects to MNEs that invest in immovable property and are not exempted entities by Pillar II and if Pillar II changes the fundamental reasoning behind the taxation of immovable property. The research used BEPS, MTC, Pillar II, and directive draft for Pillar II EU, relevant literature, and research to give a holistic, but simple overview of a complicated subject regarding the fundamentals behind the taxation of immovable property and how Pillar II changes taxation for MNE.

One could argue that Pillar II leads to a change of fundamentals behind the taxation of immovable property because the residency state can tax income derived from immovable property. But it does not due fundamentally source-state has still the primary taxation right over immovable property located on their land. Residency states can just allocate additional tax to income generated at low-tax source-states jurisdiction. As it could have been done earlier, by applying credit or exemption method to income derived from immovable property located in the other state. To be specific this is not necessarily the case if a holding company owns immovable property in another state and then the additional tax is allocated at the UPE level. It would mean that a third party would be able to tax income-derived immovable property. Hence, the fundamentals behind the taxation of income derived from immovable property do not change, it is up to the source-state if they want to exercise their power to primary right to tax at full power or not. The fundamental reason why the source state has a primary right to tax is the close economic connection Pillar II does not interfere with the fundamental reasoning and is in line with the previous fundamental reasoning. It can definitely create interesting cases when the multinational enterprise has many subsidiaries and a holding company that owns most real estate owned by MNE.

Pillar II leads to higher tax rates for MNEs that invest in immovable property, but do not qualify as an exempt entity by the rules of Pillar II. Hence, the tax burden for MNE will rise, but the rise will not be too significant that it would cause harm to enterprises. There is no data available on which rate would cause significant damage to the current economy, but the increase in Pillar II is small therefore it should not cause harm. Pillar II can affect Real Estate MNEs by introducing the

top-up tax, which is imposed on the UPE level or the top of the ownership chain. This can affect the taxation of real estate MNE due if the MNE has real estate located in low tax states, it can significantly increase the ETR of MNE when the top-up tax is allocated to UPE or allocated to the constituted entity by DMTT. It can be said that Pillar II shifts part of the immovable property taxation from source to residency jurisdiction for MNE.

As the tax policy is in principle a matter of sovereign policy. Any sovereign state can create its own tax policy, which is important due every state has different needs and economies, one tax policy will not function in every state. Therefore, the author would argue that even though the global minimum tax is important, in some situations it could be harmful if the state cannot opt-in for DMTT even though its tax rates are lower than the minimum demanded by the Pillar II. A lower tax rate can be used as a way to regenerate the economy in case of crisis, and as we are well aware that crises come unexpectedly without a warning and can have devasting results. Pillar II enforces the taxation of MNEs and changes the fundamentals of tax competition. It could be said that Pillar II is in a way trying to change the fundamental of states from harmful tax competition to positive tax competition. As the harmful tax competition is not beneficial in the long run and leads to erosion of the tax base and even diminishment of the welfare state.

Pillar II overall aim is important, but the measures do not eliminate the harmful tax competition as it can be seen as one of its functions. It disables profit shifting for MNEs and it enforces that large MNEs in its scope pay a fair share of tax. It also does not establish a genuine minimum tax rate globally. But it can be seen as the first step toward the global minimum tax rate. Pillar II imposes a minimum tax rate for MNEs — not for all enterprises. This could be changed by setting a precondition that to be able opt-in for DMTT, the jurisdiction must be at least the minimum tax rate compliant, which is established by Pillar II. If the precondition would not be fulfilled, the state could not apply DMTT to constituent entities of MNE located in their jurisdiction. For some MNEs Pillar II could affect their profit margins by creating an additional tax burden and additional costs in accounting. An important function of Pillar II is the *de minimis* rule, which protects smaller constituent entities from being shut down and reduces the risk for the MNE to operate in smaller states where the business cannot scale as high as in others. *De minimis* is also encouraging MNEs to establish new constituent entities in other states, hence it does not create additional costs for MNE. It will be interesting to see how Pillar II will affect international taxation, in the long run, but at the moment it can be said that the effects are minimal for the MNEs that own immovable property.

In conclusion, Pillar II leads to higher tax rates for MNEs and encourages states to move from harmful tax competition to positive tax competition. States can still use aggressive tax competition policies, but they do not affect the taxation of MNEs if they are within the scope of Pillar II. States can still have domestic policies, which can lead to harmful tax competition between the states. The Pillar II will not change the fundamental reasoning behind the taxation of immovable property Also, the genuine global minimum tax is still to be established, but Pillar II can be seen as the first step toward a genuine global minimum tax. Further research is needed when Pillar II is in force and the Pillar II has been implemented. Research after the Pillar II implementation will give a more holistic review of the subject. Hence, Pillar II can be modified after this research has been published and its effects can change.

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