April 4, 2022

BEPS ACTION 1, PILLAR 1 AND PILLAR 2
A CANADIAN PERSPECTIVE

The OECD has proposed a new approach to international taxation- an expanded jurisdiction to tax and a formulary approach to replace the "arm's length standard" in transfer pricing. Ostensibly, the new regime is being introduced in order to forestall the proliferation of Digital Services Taxes on a per-country basis, with the resulting risk of double or triple taxation, and to address the supposed "race to the bottom of corporate taxes".

- Under BEPS Action 1, Pillar 1, it was agreed by 140 countries worldwide to adopt new profit allocation and *nexus* rules so that 25% of large multinational enterprises' residual profits are redistributed to the countries in which consumers are located. Market jurisdictions would then have a new taxing right over those residual profits.
- While this is a major shift away from the requirement for a physical *nexus* to confer jurisdiction to tax, in today's digital world with its absence of physical presence, there is a principled basis for shifting to a market-based approach.

Pillar 1: Reallocation of Taxing Rights

This new approach to international taxation is to be implemented by a multilateral convention to come into effect in 2023, which will require all parties to remove their Digital Services Taxes. Canada has recently introduced draft legislation for its own DST, which the government says it will forego if the multilateral convention is implemented as proposed.

The formula contains two computations, Amount A and Amount B:

- **Amount A** applies to companies with global turnover above €20 Billion, and profitability above 10%. A new *nexus* rule permits the allocation of Amount A to

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a market jurisdiction in which the relevant MNE derives at least €1 Million in **revenue** from that jurisdiction.

- For such an MNE, 25% of residual profit (defined as profit in excess of 10% of revenues) will be allocated to the relevant market jurisdiction.
- Revenue will be sourced to the end market jurisdictions, with detailed source rules to be developed.

It is proposed to have a mandatory and binding dispute resolution mechanism to be developed in order to prevent and resolve issues relating to Amount A.

Amount B continues to apply the arm's-length principle to in-country marketing and distribution activities only.

Pillar 2: Global Anti-Base Erosion Mechanism

Pillar 2 consists of: two interlocking domestic rules (together, the Global anti-Base Erosion Rules ("**GloBE**") rules):

- First, there is an Income Inclusion Rule ("**IIR**"), which imposes a top-up tax on a parent entity in respect of the low-taxed income of a constituent entity; and
- Second, there is an Undertaxed Payment Rule ("**UTPR**"), which denies deductions or requires an equivalent adjustment to taxable income to the extent the low-taxed income of a constituent entity is not subject to tax under an IIR; and a treaty-based rule (the Subject to tax rule ("**STTR**")) that allows source jurisdictions to impose limited source taxation on certain related-party payments subject to tax below a minimum rate of 9%. The STTR will be creditable as a covered tax under the GloBE rules.

The GloBE rules will apply to MNE's that meet the €750 million threshold.

The UTPR allocates top-up tax from low-tax constituent entities to the ultimate parent corporation in proportion to its ownership interests in those entities having low-taxed income.

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The minimum tax rate used for IIR and UTPR is 15%.

The GloBE rules will operate to impose a top-up tax using an effective tax rate test that is calculated on a jurisdictional basis and that uses a common definition of covered taxes and a tax base determined by reference to financial accounting income (with agreed adjustments consistent with the tax policy objectives of Pillar Two and mechanisms to address timing differences).

In respect of existing distribution systems, there will be no top-up tax liability if earnings are distributed within 4 years and taxed at or above the minimum level.

The GloBE rules will provide a formulaic substance carve-out that will exclude an amount of income that is 5% of the carrying value of tangible assets and payroll.

Pillar 2 should be enacted in 2022 to be effective in 2023.

Summary

Are the Pillars a solution in search of a problem?

The following information from the OECD itself refutes the claim that Canada (or for that matter any other member of the OECD) is suffering the loss of corporate tax revenue resulting from a so-called "race to the bottom", which purports to justify this new tax.

The OECD's global corporate tax statistics database reports that average corporate tax revenues have risen from 12.3% of total revenues in 2000 to 15.3% in 2018. Corporate taxes collected as a per cent of GDP have increased from 2.7% to 3.2%- a gain of 20%.

It should be noted that the elimination of tax-preferred regimes through enforcing a minimum tax will cause income that arises elsewhere and could be outside the ambit of prevailing tax charges to be taxed by a country that has nothing to do with it.

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The GloBE rules are not mandatory for countries and there is no enforcement mechanism to ensure countries adopt them, and no penalty for countries that assert additional taxing rights that might be inconsistent with the rules.

Will the U.S. Congress adopt this new system, especially in light of initial Republican Party opposition? It is also unclear how GloBE will be coordinated with the U.S.'s Global Intangible Low-Taxed Income Tax ("**GILTI**").

In the case of Canada, this new minimum tax rule would mean that a Canadian-based MNE would face an additional 15% tax on top of its regular corporate tax of 26.5%, to the extent that any foreign affiliate faced a local income tax of less than 15% in its home country.

If the foreign affiliate paid income tax at the rate of, say, 5.5% in Barbados for example, the Canadian parent would get a credit for the 5.5% and pay 9.5% to Canada.

For over 47 years, Canadian international tax policy has been to foster capital export neutrality, so that an expanding Canadian firm can make its business decisions based on good business practices and not on lower taxes.

The method for doing so was the establishment of an international tax system anchored in the creation of a notional account called "exempt surplus" in a foreign affiliate that carried on an active business in a country with which Canada has a tax treaty or a tax information exchange agreement.

If that corporate group paid less tax on foreign earnings than would have been the case if it had only operated domestically in Canada that was seen as a positive result, permitting the Canadian-based multinational to compete and expand.

This system also recognized that good international tax policy tries to reduce barriers to entry, and so if a Canadian-based MNE wished to expand into Europe, Canada would

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not impede its decision to run its active foreign affiliate through Ireland where the corporate tax rate was 12.5% versus Germany where the corporate tax rate was 30%.

However, by imposing a minimum tax of 15% on this corporate group, the Government of Canada would be launching a direct assault against that positive international tax policy, without a justifiable rationale, as demonstrated by the OECD's own statistics.

Such a policy constitutes a "soak the rich" tax grab, in the absence of real world, principled, fiscal policy justification, and would cause serious harm to Canada's corporate sector, to the detriment of all Canadians.

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