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OECD releases blueprint reports on international tax reform (Pillar One and Pillar Two) and launches public consultation

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In this Update

- The OECD recently released blueprint reports on Pillar One and Pillar Two and launched a public consultation process on its two-pillar approach to international tax reform, with comments due from stakeholders by December 14, 2020. While Canada and the 136 other countries comprising the Inclusive Framework on BEPS approved the public release of the reports, several political and technical issues remain outstanding.
- The Pillar One proposals are intended to provide source/market countries with increased taxing rights over certain multinational corporations operating automated digital services or consumer-facing businesses and replace various unilateral tax measures targeted at non-resident multinational corporations (including the digital services tax that formed part of the 2019 election platforms of the Liberals and other major Canadian political parties).
- The GloBE proposal under Pillar Two would introduce a global minimum tax (at a rate to be determined) to prevent the shifting of profits to low-tax jurisdictions.
- If adopted, these measures will fundamentally change the existing international tax framework of Canada and many other countries.
- Osler intends to submit comments to the OECD on the blueprints, focusing on the implications for Canada and Canadian businesses.
- There is currently no consensus on the scope of Pillar One, with the United States continuing to push for Pillar One to be adopted on a voluntary "safe harbour" basis.
- The remaining work on Pillar Two will be focused on an agreement on applicable minimum rates, and administration and compliance simplification, with the new regime coexisting with the U.S. GILTI regime.

Introduction

On October 12, 2020, the OECD/G20 Inclusive Framework on BEPS (the Inclusive Framework) released three reports as part of its two-pillar approach to international tax reform consisting of the *Report on the Pillar One Blueprint* [PDF], the *Report on the Pillar Two Blueprint* [PDF] and an *Economic Impact Assessment* [PDF] (the Blueprints). The Blueprints provide highly anticipated technical details about Pillar One, which would revise the permanent establishment nexus for establishing source country taxing rights and the arm's length standard for allocating profits, and Pillar Two (also referred to as the "Global Anti-Base

Erosion" or "GloBE" proposal), which would introduce a global minimum tax to prevent the shifting of profits to low-tax jurisdictions.

The OECD had previously committed to reach a consensus-based solution by the end of 2020, but there have been numerous setbacks (including as a result of the COVID-19 pandemic), and the OECD is now looking to resolve the remaining political and technical issues by mid-2021.

The Blueprints provide an indication of the additional work that needs to be done to reach consensus in this area. Most notably, the scope of Pillar One, and whether it will be mandatory or operate as a safe harbour, is yet to be determined. In addition, the remaining work on Pillar Two will be focused on administration and compliance simplification. If adopted, these measures will fundamentally change Canada's existing international tax framework.

The OECD also released a Public Consultation Document [PDF] with a series of questions on both pillars, with comments from stakeholders due December 14, 2020. As these proposals are not limited to highly digitized business and could have a fundamental impact on the entire international tax system, multinational enterprises should ensure that any concerns they have are shared with the OECD during the consultation process. Osler intends to make a submission to the OECD on the Blueprints.

Osler's summary of global efforts towards international tax reform are set out in prior Updates. In addition, Osler has made two prior submissions to the OECD in response to earlier consultation documents on Pillar One and Pillar Two.

- Our comments [PDF] to the OECD in response to its February 13, 2019 public consultation document on the possible solutions to the tax challenges of digitalization were principally directed at the impact of the proposals on the international tax framework, including fundamental changes to the existing profit allocation (transfer pricing) and nexus (permanent establishment) rules.
- Our comments [PDF] to the OECD in response to the November 8, 2019 *Public Consultation Document – Global Anti-Base Erosion Proposal – Pillar Two* (the GloBE Proposal) [PDF] were principally directed at a need to
  1. carefully define the scope of the Pillar Two proposals such that they are focused on the intended tax policy objectives; and
  2. ensure that the GloBE Proposal is designed in a coordinated manner that prevents double (or multiple) taxation and minimizes administrative complexity and compliance costs.

Pillar One

The Blueprint for Pillar One has three key elements: a new taxing right for market jurisdictions to obtain a share of residual profit of an MNE (this new taxing right is known as "Amount A"), a calculation of a fixed return for certain baseline and marketing and distribution activities in jurisdictions where an MNE has a physical presence (this amount is known as "Amount B"), and dispute prevention and resolution mechanisms (referred to by the OECD as "Tax Certainty").

The Amount A and Amount B concepts, while developed in further detail and refined from previous proposals, have the same broad outline. "Amount C" — allowing a jurisdiction to tax

an amount in excess of Amount B (based on existing tax rules) has been dropped from prior proposals though jurisdictions may still apply their existing transfer pricing rules to tax income based on the arm's length principle.

To underscore the difficult political environment still facing these proposals, the Blueprint does not resolve various key issues including the following:

- To date, political agreement has not been reached on the full scope of activities to which the proposals would apply.
- The percentage of residual profits of an MNE that will be reallocated to market jurisdictions.
- Whether Pillar One is a mandatory regime or a safe harbour — indeed there is explicit recognition that there is a dispute between the U.S. and other members on this element.
- The scope of Amount B — the Blueprint identifies that some members believe the scope of activities should be broadened, while others have expressed the need to further refine the design, and others suggest that it should be implemented through a pilot program.
- Whether dispute resolutions (extending to issues other than Amount A) should be subject to binding determinations.

Scope

The in-scope activities outlined in the Blueprint are automated digital services (ADS) and certain consumer-facing businesses (CFB). These broad categories are consistent with those outlined in the prior Pillar One proposal. ADSs are defined to include various online advertising, search, intermediation, teaching and cloud computing services, search engines, social media platforms, sale of user data and online gaming.

CFBs include businesses that generate revenue from the sale of goods and services commonly sold to consumers (i.e., acquired for personal use rather than for commercial or professional purposes). CFBs include pharmaceuticals (possibly limited to non-prescription over-the-counter), franchising/licensing, and consumer goods/services. The Blueprint notes there is a difference in views as to whether dual use intermediate products and components (such as car tires, batteries or bandages) should be in scope.

Excluded activities include customized professional services, online sale of physical goods and the provision of internet access. Also excluded are certain natural resources (including non-renewable/extractives and renewable), financial services (banking, insurance, asset management), construction/infrastructure, sale and leasing of residential property, and international air and shipping businesses. Further work is contemplated for determining whether FinTech and operating infrastructure businesses (such as electricity generation and distribution, natural gas and water distribution, certain telecommunications, railways, airports and public transportation) are considered in scope.

In addition to the activities test, there is also a revenue threshold test. The Amount A determination would only apply to MNE groups with consolidated revenue of more than a threshold amount (such as EUR 750 million). It is also proposed that MNEs with aggregate foreign source revenue below a *de minimus* amount (likely EUR 250 million) would be excluded from having to compute Amount A.

Nexus and calculating Amount A

In order to determine whether an MNE has a sufficient nexus to a market jurisdiction such that an Amount A must be calculated for that jurisdiction, the Blueprint suggests a minimum revenue test (though the amount has not yet been agreed) for ADS with a two-pronged nexus test for CFB based on a minimum revenue test and a "plus factor" test designed to ensure significant and sustained engagement with the market. These "plus factors" might include whether the MNE has a subsidiary located in the jurisdiction, a fixed place of business in the jurisdiction, or revenue above an agreed higher threshold. Further work on determining appropriate factors remains to be done.

The Blueprint maintains the complicated three-step process of (1) identifying residual profit by establishing a profitability threshold, (2) reallocating a percentage of that profit to market jurisdictions and (3) using an allocation key to share the allocated residual profit among the market jurisdictions. The Blueprint indicates that more work is needed to determine whether that approach should be done based on profits or a profit margin basis. The actual profitability threshold, percentage to be reallocated and allocation key amounts have yet to be agreed upon.

The Blueprint outlines over the course of more than two dozen pages a number of complex revenue sourcing rules. The OECD tries to standardize the computation to the extent possible by using IFRS or other eligible GAAP (including Canadian or U.S. GAAP) as the relevant starting point. The rules may require MNE groups to segment the profit before tax measure between ADS, CFB and out-of-scope activities. There are also certain exceptions to these proposals and work is ongoing on their scope.

Losses will be preserved and carried forward (but not carried back) to subsequent years through an "earn out" mechanism to reduce future Amount A calculations.

Scope and calculating Amount B

Amount B is relevant for MNE groups that perform defined "baseline marketing and distribution activities" in a market, regardless of whether the activities are ADS or CFB. The goal of Amount B is to provide an arm's length guide to an allowable fixed return for marketing and distribution activities. This baseline amount would be determined using the Transactional Net Margin Method (based on third-party comparables). While the goal of simplification is laudable, it is difficult to see a standardized approach to Amount B eliminating the risk of transfer pricing disputes, as tax authorities would be free to argue that the actual functions, assets and risks differ from those assumed as "baseline marketing and distribution activities."

Further consideration is being given to implementing Amount B on a phased basis as a pilot program to evaluate whether it can meet its objective of simplification and reduced disputes (and to monitor any behavioural responses to its implementation).

Tax Certainty

The Blueprint recognizes that absent multijurisdictional coordination, the Pillar One proposals would be unworkable. Despite the complexity of the proposals, the Blueprint holds out hope of providing MNEs with some Tax Certainty concerning Amount A through a self-assessment return and documentation package detailing Amount A calculations that would be shared with all relevant market jurisdictions.

An MNE could proactively seek a review (referred to as "early certainty") of its Amount A calculations by the lead tax administration in the parent's home country. After an optional initial review, and consultation with the tax administrations in the affected market jurisdictions, a review panel could be assembled by the lead tax administration (ideally with 6-8 affected tax administrations). If the review panel cannot agree on the calculation and allocation of Amount A, a further "determination panel" would be struck (rules would need to be developed for choosing panelists) to make a determination that would be binding on all parties. Details of this process are still under consideration.

The MNE would be able to reject the conclusions of either a review panel or a determination panel. The MNE would then need to deal with any disputes through existing dispute mechanisms in each market jurisdiction.

Notwithstanding these efforts to provide certainty under Amount A, transfer pricing disputes under ordinary rules (based on the arm's length principle) may continue in the ordinary course in parallel to any Amount A dispute — notwithstanding that both may relate to the same underlying activities and income.

The Blueprint proposes a new mandatory and binding dispute resolution mechanism for issues apart from Amount A, including for Amount B disputes, and potentially, as a last resort, for all disputes related to transfer pricing and permanent establishment adjustments (if there is no other existing dispute mechanism). There remain political differences as to the scope and acceptability of such a mandatory and binding dispute mechanism. The Blueprint also notes the OECD's ongoing work on improving existing dispute prevention steps (such as ICAP, APAs, standardized transfer pricing benchmarks) and improving existing mutual agreement procedures.

Application in Canada

As the Pillar One proposals are intentionally designed (particularly in the case of Amount A) to move away from existing arm's length and permanent establishment legal principles, which are an important basis of Canada's existing international tax approach, their implementation in Canada would require significant new legislation and their implementation would be complex.

For example, under the *Income Tax Act*, each entity must calculate its income on a non-consolidated basis using detailed Canadian tax rules. That entity is then subject to potential transfer pricing adjustments based on the arm's length standard and permanent establishment principles; however, those could be affected by the Amount B simplification measures. The parent of an MNE based in Canada would also have to prepare a new Amount A return and documentation package starting with consolidated accounting income and then allocate those amounts to the separate entities of the MNE depending on whether they had in-scope activities in market jurisdictions (possibly on a segmented basis). All of these calculations will require detailed rules for the sourcing and segmentation of income, allocation of amounts, filing of returns, assessments and disputes among others. Detailed rules will also be required for relief from double taxation, provincial allocations and collections matters.

While there are considerable political differences to overcome among the members of the Inclusive Framework, even if agreement is reached, it may only represent the beginning of a long and complex journey to implement the proposals.

If the Pillar One proposals are not swiftly adopted, many countries (possibly including Canada) may adopt or maintain digital services taxes or other "unilateral measures." The

Liberals (and other major Canadian political parties) had proposed a digital services tax for Canada prior to the 2019 federal election — and the recent Throne Speech promised to tax the income of "digital giants." However, the United States has threatened to impose tariffs on various countries that have enacted digital services taxes and is refusing to allow credits in respect of such taxes — which may result in double taxation.

Pillar Two

The Blueprints contain significant additional detail on the main components of the Pillar Two proposal, including the Income Inclusion Rule (IIR), the Undertaxed Payments Rule (UTPR), the Subject to Tax Rule (STTR), the rule order, the calculation of effective tax rate and the allocation of the top-up tax. Although no agreement has been reached by members of the Inclusive Framework, the Blueprint is intended to provide a basis for resolution of remaining issues. Implementation of the Pillar Two proposals will require significant changes to both domestic tax legislation and tax treaties.

Scope

The Pillar Two proposals apply to "MNE groups" with total consolidated group revenue of at least EUR 750 million in the immediately preceding fiscal year, in line with the threshold for the country-by-country reporting regime. An MNE group includes entities (and permanent establishments) operating in multiple jurisdictions that would be required to be consolidated for financial reporting purposes if equity interests in at least one member of the group is publicly traded. Investment funds, pension funds, government entities (including sovereign wealth funds), international organizations, non-profit organizations and their wholly owned subsidiaries that do not carry on a trade or business are excluded from the scope of the Pillar Two proposals.

Amount

The application of both the IIR and the UTPR requires the calculation of (i) effective tax rates for each relevant jurisdiction, and (ii) an amount of top-up tax for each group entity. If an MNE group's effective tax rate in a jurisdiction is below the agreed minimum rate under the Pillar Two proposals, a top-up tax will generally be allocated to each group entity in such jurisdiction and collected under either the IIR or the UTPR.

The effective tax rate (ETR) in a jurisdiction is calculated by dividing "covered taxes" by the profit or loss in that jurisdiction. Covered taxes includes taxes on income, profits, retained earnings and corporate equity, withholding tax applied by a source jurisdiction and taxes paid by a parent entity under regimes similar to the U.S. CFC or Canadian "foreign accrual property income" (FAPI) regimes. Profit or loss in a jurisdiction is generally determined based on the applicable accounting standard used by the group's parent, with adjustments for an enumerated list of permanent differences. Losses incurred in a jurisdiction (including pre-regime losses) can be carried forward or carried back to reduce the tax base as part of the ETR calculation. In addition, "excess" local taxes (i.e., covered taxes paid above the agreed minimum rate) can either give rise to a tax credit (to the extent of prior top-up tax paid for that jurisdiction) or be carried forward to increase the group's jurisdictional ETR in a future tax year.

The amount of top-up tax is calculated by multiplying (i) the difference between the agreed minimum rate and a group's jurisdictional ETR by (ii) an entity's assigned income less loss carryforwards, losses incurred by other group entities in the same jurisdiction, and a formulaic carveout. The formulaic carveout effectively shelters a portion of a group's profits

that are considered to be related to substantive activities in a jurisdiction from the top-up tax and represents the sum of (i) a fixed percentage of eligible payroll costs of eligible employees in a jurisdiction, and (ii) a fixed percentage of accounting depreciation (or deemed depreciation) for property, plant and equipment, land, resource properties and lessee's right-of-use asset in a jurisdiction.

Application mechanism

Once calculated, top-up tax is first allocated to other group members under the IIR, and the UTPR acts as a backstop for the IIR. Under the IIR, the entity liable to pay top-up tax is generally identified on a "top-down" basis, with an exception for split-ownership structures. Therefore, if the ultimate parent entity in a wholly owned MNE group is located in a jurisdiction that has adopted the IIR, such parent entity will generally be liable to pay any top-up tax under the IIR. For Canadian-based MNE groups, the consequences of an IIR adopted by Canada would be generally analogous to requiring the relevant income to be included in computing "foreign accrual property income" (although it could include active business income and would be computed using a formulaic method based on applicable accounting income rather than under Canadian income tax rules).

The IIR also applies to low-tax permanent establishments, and a supplementary "switchover rule" modifies any relevant tax treaties to ensure that the head-office jurisdiction has no obligation to apply the exemption method.

If a group entity is not controlled by any parent in a jurisdiction that has adopted the IIR, the UTPR applies to allocate any remaining top-up tax for that entity to other group members subject to the UTPR based on (i) deductible payments made to the entity by such group members, and (ii) net intra-group expenditure incurred by such group members. No allocation under the UTPR can be made to entities situated in low-tax jurisdictions (where the jurisdictional ETR is less than the agreed minimum rate), and allocations to group members under the UTPR is subject to caps calculated by reference to the domestic tax rate applicable to such members. The UTPR can be implemented by the denial of deductions (resulting in additional tax equal to the appropriate amount of top-up tax) or an additional tax. Implementation of the UTPR will likely require significant changes to the *Income Tax Act*, since the tax consequences of outbound payments under current Canadian law generally does not depend on tax consequences in other countries.

The STTR is a separate treaty-based rule, which would apply to a defined set of payments between connected persons located in different contracting states. Payments covered by the STTR will include interest, royalties and fees for certain types of "mobile" services (such as guarantee fees, franchise fees and marketing service fees). The application of the STTR will be subject to materiality thresholds based on group size and size of covered payments, and the STTR will allow the source country to apply a top-up withholding tax equal to any difference between an agreed minimum rate and the adjusted nominal tax rate applicable to the covered payment in the recipient jurisdiction. The agreed minimum rate for the STTR will be a lower rate than the agreed minimum rate for the IIR and the UTPR. Withholding tax collected under the STTR will be treated as a covered tax for purposes of computing top-up tax under the IIR and the UTPR.

Path to implementation

The Blueprint acknowledged that diverging views continue to exist on a number of design features of the Pillar Two proposals, and the interaction between the Pillar Two proposals and the U.S.'s GILTI and BEAT regimes will also require further political discussion. Other outstanding items for the Pillar Two proposals include the agreed minimum tax rates for the

IIR, UTPR and the STTR, and possible simplification mechanisms to reduce the cost of compliance and administration by taxpayers and tax authorities.

Changes to domestic legislation will be required to implement the IIR and the UTPR, and the Inclusive Framework intends to develop model legislation and guidance to assist countries in implementing the IIR and the UTPR. In addition, a multilateral instrument between members of the Inclusive Framework will likely be required to implement the STTR and the Switchover Rule and to ensure consistency, coordination and effective dispute resolution in the application of the IIR and the UTPR.

Next steps

Osler intends to submit comments to the OECD on the Blueprints, focusing on the implications for Canada and Canadian businesses. In particular, we note that Pillar One is exceedingly complex and will likely result in increased compliance costs and international tax disputes. If countries like the United States are unable or unwilling to adopt Pillar One on a mandatory basis, then it is quite likely other countries may retain or adopt digital service taxes (DSTs) or other unilateral measures. In that case, Canada and other members of the Inclusive Framework should consider abandoning Pillar One and instead focusing on best practices to achieve consistency and administrative efficiency on DSTs or other measures while attempting to mitigate double taxation and trade disputes.

Pillar Two is expected to increase corporate income tax revenues globally by approximately 4% — with the tax increases for some MNEs being much higher. Canada should review in detail any adverse impacts that such a new corporate tax would have — including with respect to investment in Canada and the competitiveness of Canadian-based MNEs. Consideration should also be given to ensuring that sufficient relief is provided from the U.S. GILTI and BEAT regimes — to ensure that Pillar Two is implemented in a manner that is fair and consistent to all countries.

The OECD will meet again in early 2021 to consider the comments received from stakeholders. If a consensus is reached, this could then start a years-long process of adopting and implementing new rules through domestic legislation and multilateral changes to tax treaties.

Please contact any member of our National Tax Group should you have any questions or comments on the Blueprints or any other tax matters.