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# Tax planning developments: Important international tax changes

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In 2021, a number of significant changes were proposed for international taxation in Canada. The 2021 Canadian federal budget (Budget 2021) introduced three key international tax proposals relating to earnings stripping, anti-hybrid measures and a digital services tax. Individually, each proposal represents a significant change to existing practice and gives rise to complex tax issues affecting a wide range of large international corporations. Collectively, they represent an ambitious project intended to conform with some of the core proposals coming out of the OECD Base Erosion and Profit Shifting (BEPS) work. Budget 2021 provided descriptions of the expected rules with varying degrees of specificity, but without specific statutory language.

In addition, Canada continues to work with the OECD, G20 and approximately 140 members of the Inclusive Framework on BEPS on significant international tax reform proposals (the Two Pillar Solution or BEPS 2.0).

## Earnings stripping proposals

The first key proposal is a new limit on interest deductibility (reflecting OECD BEPS Action 4). Its purpose is to reduce earnings stripping through the use of third-party, related party and intragroup debt by taxpayers to achieve interest deductions considered by the government to be excessive or that finance the production of exempt or deferred income. A new limit would be created that would preclude the deductibility of interest above a specified threshold, which is expected to be 30% of EBITDA (calculated in accordance with the new rule).

Interest expenses denied under the new rule may be carried forward for up to 20 years or back for up to three years. Certain taxpayers – generally, smaller taxpayers and most corporate groups that do not include any non-resident members – will be exempt entirely from the limit. Some taxpayers may be able to deduct interest to a higher limit if the ratio of net third-party interest to EBITDA of their consolidated group suggests this would be appropriate (for example, because some sectors or groups may be more highly leveraged, such as real estate and infrastructure). The new rules are expected to be phased in with an initial fixed ratio of 40% for taxation years beginning on or after January 1, 2023, but before January 1, 2024. The 30% limit will apply to subsequent years.

Separately, Canada has had thin capitalization rules for many years that generally limit interest deductibility where the ratio of debt owing to certain non-resident shareholders to equity exceeds 1.5:1. The government has proposed to retain the existing thin capitalization rules and have them apply alongside the proposed earnings stripping rules. The new rules will significantly increase the complexity faced by taxpayers in respect of cross-border interest deductibility, particularly compared to the relatively straightforward approach under the thin capitalization rules. In addition, unlike the existing thin capitalization rules, the proposals will apply to borrowings from arm's length persons and Canadian residents.

## Anti-hybrid proposals

The second key proposal concerns new anti-hybrid measures. These are designed to reduce the tax advantages currently available in some situations as a result of an entity being treated differently by different jurisdictions (reflecting OECD BEPS Action 2). Four types of hybrid mismatch arrangements will be targeted:

- "deduction/non-inclusion mismatches" where an amount is deducted in Country A, but not included in income in Country B
- "double deduction mismatches" where one economic expense gives rise to tax deductions in two or more countries
- "imported mismatches" where an entity in Country A deducts a payment and an entity in Country B includes the payment as ordinary income but offsets that inclusion by a deduction from an arrangement with an entity in Country C
- "branch mismatches" where the residence country of a taxpayer and the country where its branch is located have different views of how to allocate income and expenditures between the branch and the taxpayer

The proposed rules are expected to deny deductions relating to such arrangements on a mechanical basis (i.e., without any consideration of purpose). In particular, the proposals are expected to target certain inbound hybrid structures involving a U.S. parent company and a Canadian subsidiary that have been the subject of CRA audit activity.

## New digital services tax

The third key proposal is a 3% digital services tax (DST) on revenue in excess of C$20 million from digital services that rely on the engagement, data and content contributions of Canadian users. In-scope revenue will include revenue from online marketplaces, social media, online advertising and user data. The DST would only apply to groups with global revenue from all sources in the previous calendar year of at least €750 million.

The DST proposal is framed as an interim measure pending a global deal under the OECD/G20 Pillar One framework. One annual return and payment would be required for each group, though all members are jointly and severally liable for the tax. The DST is expected to apply from January 1, 2022, though the tax will only be collectible starting in 2024 if a global Pillar One deal does not come into effect prior to the end of 2023.

## International tax reform – BEPS 2.0

Canada continues to work with the OECD, G20 and the Inclusive Framework on international tax reform proposals. A high-level agreement was reached in 2021 that is expected to be refined in 2022. These proposals are generally expected to come into force in 2023.

Two pillars form the agreement:

- **Pillar One** provides a new taxing right for market jurisdictions (where customers are located) to obtain a share of residual profit of a multinational enterprise (MNE) (Amount A).

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It further contemplates the calculation of a fixed return for certain baseline and marketing and distribution activities in jurisdictions where an MNE has a physical presence (Amount B). It also contains dispute prevention and resolution mechanisms (referred to by the OECD as Tax Certainty).

  - Under this proposal, 25% of residual profit (defined as profit in excess of 10% of revenue) will be allocated to market jurisdictions with sufficient nexus and measured using a revenue-based allocation key.
  - The tax will apply initially to MNEs with global turnover in excess of €20 billion and profitability above 10%. The revenue threshold will be reduced to €10 billion pending successful implementation (determined seven to eight years after Pillar One comes into effect).
  - Profits and losses are required to be measured by reference to financial accounting income, with a small number of adjustments. Losses will be carried forward, although it is currently unclear whether the carry-forward period will be indefinite.
  - Pillar One will be implemented by means of a to-be-developed multilateral convention expected to be signed in mid-2022 and to come into effect in 2023.
  - Once implemented, participating countries will remove any DSTs or similar measures.
- **Pillar Two** provides a global minimum tax of 15% imposed by means of two domestic rules and one treaty-based rule.
  - The domestic income inclusion rule (IIR) will impose current taxation on the income of a foreign-controlled entity (or foreign branch) if that income was otherwise subject to an effective tax rate that is below a certain minimum rate.
  - The domestic undertaxed payments rule (UTPR) will either deny a deduction or require an equivalent adjustment on base eroding payments unless the payments are subject to tax at or above a specified minimum rate in the recipient's jurisdiction.
  - The treaty-based rule, known as the subject to tax rule (STTR), will allow source countries to impose withholding taxes on certain related party payments (particularly interest and royalties) that are subject to tax below a minimum rate of 9% in the recipient jurisdiction. STTR taxes will be creditable in determining the effective tax rate for purposes of the IIR and UTPR.
  - These new rules will apply to MNEs with total consolidated group revenue of at least €750 million. Countries can also choose to apply the IIR to MNEs headquartered in their country that do not meet the threshold.
  - The calculation of the effective tax rate in a jurisdiction, which will drive the application of Pillar Two, will use 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).
  - Certain exclusions and carve-outs will be available. The two most significant exclusions are (i) a formulaic substance carve-out that will exclude an amount of income that is 5% of the carrying value of tangible assets and payroll in a jurisdiction, and (ii) a *de minimis* exclusion, which applies where the MNE has revenues of less than €10 million and profits of less than €1 million. During an initial 10-year transition period, the carve-

out will be more generous but will decrease over the 10-year period to the proposed amounts.
- Rules to give effect to the Pillar Two changes are expected to be developed by the end of November 2021, with an additional multilateral instrument to be developed by mid-2022 and an implementation framework by the end of 2022.

Both pillars come after years of international political negotiations, which remain ongoing. While many details remain to be determined and final implementation of the pillars is not guaranteed, the International Framework agreement represents an important milestone towards a consistent, global approach to these issues. It will be important to closely monitor these developments – and the responses of Canada, the United States and other countries – as they could have a significant impact on many multinational enterprises.

As Canada and the rest of the world look to reshape the international tax system, there will be many new challenges (and potential planning opportunities) for multinational enterprises. Osler's national tax group can assist in determining the optimal manner in which to anticipate or respond to these changes.

Osler's Federal budget briefing 2021 offers additional insight into the three budget proposals, as well as other proposals and changes from Budget 2021. Further information about the OECD/G20 Inclusive Framework two pillar proposals is available in our Osler Update on osler.com.