OSLER

Osler submission on *Public Consultation Document Reports on the Pillar One and Pillar Two Blueprints*

December 14, 2020

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Tax Policy and Statistics Division
OECD Centre for Tax Policy and Administration

Dear Sirs/Mdms

Re: Reports on Pillar One and Pillar Two Blueprints and Public Consultation Document

Executive Summary

1. We are writing in response to the request of the Centre for Tax Policy and Administration of the OECD for comments on the October 12, 2020 *Public Consultation Document Reports on the Pillar One and Pillar Two Blueprints* (the "**Pillar One and Pillar Two Blueprints**").

2. If adopted, these measures will fundamentally change the existing international tax framework of Canada and many other countries.

3. 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 Canadian Liberal Party and other major Canadian political parties).

4. The Global Anti-Base Erosion ("**GloBE**") proposal under Pillar Two would introduce a global minimum tax (at a rate to be determined) to prevent the shifting of profits to certain low-tax jurisdictions.

5. Our comments on the Pillar One Blueprint are principally directed to:
    a. the need for participating countries to agree to abandon unilateral measures as a pre-condition to their participation in Pillar One;
    b. the practical issues that remain outstanding under Pillar One which highlight the importance of effective dispute resolution procedures (including beyond Amount A); and
    c. the need for the OECD (or others) to consider practical "Plan B" alternatives in the event that a broad consensus on Pillar One is not obtained in a timely manner.

6. Our comments on the Pillar Two Blueprint are principally directed at the need to:
    a. carefully define the scope of Pillar Two such that the proposals are focused on the intended policy objectives;
    b. address the practical issues that remain outstanding under the GloBE proposal; and
    c. ensure that the GloBE proposal is designed in a coordinated manner that prevents double (or multiple) taxation and minimizes administrative complexity and compliance costs.
7. Our comments are not limited to the specific questions asked by the OECD in the public consultation document published with the Pillar One and Pillar Two Blueprints.

Pillar One Blueprint

8. Osler previously submitted comments on:
    a. the February 13, 2019 *Public Consultation Document Addressing the Tax Challenges of the Digitalisation of the Economy*, which explored three proposals under Pillar One, all of which called for the reallocation of taxing rights in favour of user/market jurisdictions: the "user participation" proposal, the "marketing intangibles" proposal and the "significant economic presence" proposal; and
    b. the October 9, 2019 *Public Consultation Document Secretariat Proposal for a "Unified Approach" under Pillar One* (the "**Unified Approach**"), which incorporated aspects of each of the prior proposals relating to scope, nexus, and profit allocation but left details outstanding, including with respect to administration, enforcement, dispute resolution, and the elimination of double taxation.
9. Under the Unified Approach, the OECD proposed the following amounts to give market jurisdictions greater taxing rights over residual profits based on a formulaic system, while the arm's length principle would continue to apply to routine profits:
    a. "**Amount A**" The portion of deemed residual profits (i.e., a group's overall profit less a return for routine activities) that is allocated to a market jurisdiction based on a formulary approach, thus providing market jurisdictions with a nexus for taxing that allocation.
    b. "**Amount B**" A fixed return (which may vary by industry or region) for certain routine marketing and distribution activities taking place in a market jurisdiction (intended to be consistent with the arm's length principle ("**ALP**")).
    c. "**Amount C**" Any profit attributable to activities in a market jurisdiction that go beyond routine marketing and distribution activities, to be calculated based on the ALP.
10. The Pillar One Blueprint has three key elements: a new taxing right for market jurisdictions to obtain a share of residual profit of an MNE (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 (Amount B), and dispute prevention and resolution mechanisms (referred to by the OECD in the Pillar One Blueprint as "**Tax Certainty**").
11. The Amount A and Amount B concepts, while developed in further detail and refined from previous proposals in the Pillar One Blueprint, still have the same broad outline. The OECD has dropped Amount C (which would have allowed a jurisdiction to tax an amount in excess of Amount B based on existing tax rules). However, jurisdictions may still apply their existing transfer pricing rules to tax income based on the ALP, and to the extent there is any overlap between existing tax rules and the Amount A or Amount B concepts, this will lead to disputes and the potential for double taxation.
12. This potential for double taxation highlights a fundamental issue with Pillar One. The new taxing right created under Amount A diverges from existing international tax rules, and the Pillar One proposal does not necessarily follow how taxable income is calculated in Canada and elsewhere. This potential for inconsistency is further compounded by the unilateral measures targeting similar activities discussed below.

(A) Unilateral Measures Targeting Similar Activities

13. The Pillar One Blueprint acknowledges that the Pillar One proposal seeks to balance the different objectives of the members of the OECD/G20 Inclusive Framework on BEPS (the "**Inclusive Framework**") and result in the removal of unilateral tax measures targeting non-resident multinational corporations operating highly digitized business models – many of which are based in the United States.

14. The OECD has set an appropriately high bar of having the proposals approved by all members of the Inclusive Framework. Yet, the Pillar One Blueprint does not discuss requiring countries to abandon unilateral measures targeting similar activities that may have been adopted prior to the development of a consensus view. In this regard, the Pillar One Blueprint states that the Amount A and Amount B concepts, coupled with the discussion on Tax Certainty, are intended to "result in the removal of unilateral tax measures", but this is not described as a pre-condition to participation in Pillar One.

15. In our view, the OECD should require participating countries to agree to abandon any unilateral measures as a minimum standard and pre-condition to their participation in any new global standards. Otherwise, there is a significant risk that taxpayers will be faced with an unduly burdensome requirement of simultaneously complying with three separate tax regimes: (i) the existing international tax framework which is generally based on taxable income computed using the ALP, (ii) the new Pillar One approach which is based on a formulaic allocation of certain consolidated accounting income, and (iii) various digital services taxes and other "unilateral measures" based on an allocation of a percentage of gross revenues. This will inevitably lead to additional complexity, disputes, and double or multiple taxation.

16. Rather than allowing these regimes to co-exist (potentially for prolonged periods of time while countries attempt to achieve consensus on Pillar One and ultimately implement new rules to bring Pillar One into effect), the OECD should provide clear minimum standards that must be followed (such as strict deadlines for abandoning all "unilateral measures" – and clear guidelines for relieving double tax through a simplified exemption mechanism – so that a particular item of income is not taxable more than once).

17. 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. If Pillar One were to take the form of an elective "safe harbour," countries may decide to continue to levy their digital services taxes or other unilateral measures on multinationals that do not "opt-in" to the Pillar One regime. As a result, it is quite possible that Pillar One could simply add additional complexity to the international tax system – rather than replacing such unilateral measures.

(B) Practical Issues Remaining Outstanding

Scope of Amount A

18. The Pillar One Blueprint contemplates a business activity test and a threshold test.

19. The in-scope activities outlined in the Pillar One Blueprint are:
    a. automated digital services ("**ADS**"), 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; and
    b. certain consumer-facing businesses ("**CFB**"), broadly defined as businesses that generate revenue from supplying consumer products or providing digital services that have a consumer-facing element, provided that they exceed a certain global revenue threshold.

20. 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.

21. We agree with the OECD's decision to carve-out certain industries – particularly the resource sector, commodities, and financial services. In addition, in our view, the OECD should consider further excluding any other industries that trade in fungible property (such as commodities or cash) on the basis that they should not be considered to derive value from marketing intangibles in a manner consistent with businesses trading in unique properties. This rationale would support excluding FinTech and operating infrastructure businesses from the Pillar One proposal.

22. Further consideration should also be given to whether Pillar One should be limited to ADS – rather than more broadly also applying to certain CFBs. In particular, the complexity arising through the proposed alternative taxing mechanism under Pillar One should be limited as much as possible – and should ideally only apply to the extent required to cause participating countries to remove their digital services taxes or other unilateral measures.

23. In addition to the activities test, there is a revenue threshold test. The Pillar One Blueprint provides that the Amount A determination would only apply to MNE groups with consolidated revenue of more than a threshold amount. It is also proposed that MNEs with aggregate foreign source revenue below a *de minimus* amount would be excluded from having to compute Amount A.

24. In our view, a high global revenue threshold would be appropriate considering the administrative compliance burden that will inevitably be involved. A high global revenue threshold would also be in line with the policy rationale underlying the OECD's *Programme of Work to Develop a Consensus Solution to the Tax Challenges Arising from the Digitalisation of the Economy* (the "**Program of Work**").

25. The OECD should consider using the current EUR 750 million threshold used for purposes of Country-by-Country reporting ("**CbCR**"). This way, MNE groups would know that once they were subject to CbCR requirements, they would also be subject to the new global standards under Pillar One. In this regard, the Pillar One Blueprint acknowledges that there may be little advantage in using a threshold below the threshold used for CbCR.

Nexus and calculating Amount A

26. 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 Pillar One 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.

27. In designing any "plus factors" the OECD should ensure that the thresholds are clear and unambiguous – and should ideally be consistent with existing tax principles (such as the test for a fixed place of business under existing tax treaties). In addition, the threshold should be set sufficiently high to ensure that the rules remain focused only on a narrow subset of businesses.

28. The Pillar One 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 Pillar One 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.

29. The new profit allocation rule for businesses in scope contemplated under Pillar One ignores the ALP. In our view, this mix of fundamentally different approaches to allocating profits (e.g., the ALP combined with formulary apportionment) could result in tax disputes and double taxation. While the OECD has repeatedly cautioned countries that country-by-country reports should only be used as a risk-assessment tool, the Pillar One proposal's use of different methods to allocate income could increase the risk that those reports may be used by some countries as a proxy for allocating income.

30. The Pillar One Blueprint outlines a number of complex revenue sourcing rules. The OECD appears to have tried 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.

31. The Pillar One Blueprint appropriately recognizes that the lack of common tax base amongst the members of the Inclusive Framework is an issue. Accounting standards are not uniform across the globe, and significant permanent and temporary timing differences may arise between different accounting standards, and when compared to computing income for relevant tax purposes. The OECD should address comments received from MNEs during the public consultation process about practical issues and how best to standardize the manner in which revenues and expenses are to be calculated and allocated across jurisdictions (including with respect to both timing and quantum).

32. The Pillar One Blueprint does not specify how the OECD will account for different taxation periods and functional currencies between MNE group members (including across multiple jurisdictions and including having regard to minority investors). The OECD should carefully study and provide a mechanism to address foreign exchange differences, possibly by adopting the currency and fiscal period used for purposes of determining the consolidated groups' financial results, and should also carefully consider the potential impact of potentially significant variances in the tax bases in different countries – as well as potentially significant timing differences for when various amounts of income or expenses are recognized.

33. In addition, in our view, if a MNE group carries on both "in-scope" and "out-of-scope" activities, the OECD should ensure that only the "in scope" income is eligible for reallocation under Amount A. This could be done, for example, by excluding entities or lines of business where a significant portion of the underlying economic activity is derived from "out-of-scope activities" through segmentation of out of scope activities.

34. The Pillar One Blueprint states that 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. Paragraph 472 of the Pillar One Blueprint states that "Amount A losses will be reported and administered through a single account for the relevant group or segment, and kept separate from any existing domestic carry-forward regime", further highlighting the compliance burden for MNEs in reporting their income for domestic and Pillar One purposes.

35. Certain pre-regime losses will be allowed to offset profits earned after Pillar One comes into effect. In our view, pre-regime losses should be taken into account and not simply ignored. If, for example, losses will be allowed to be carried forward for 20 years then the rules should allow pre-regime losses for the prior 20 years to be taken into account. This is particularly important for existing ADS businesses that may have had significant start-up losses in the past.

Scope and calculating Amount B

36. Under the Pillar One proposal, an appropriate return for "routine" (Amount B) activities would be excluded from overall profit, and the remainder would be deemed to be "non-routine" profits, a portion of which would be allocated amongst different eligible market jurisdictions.

37. Amount B in the Pillar One Blueprint is intended to provide an allowable fixed return based on the ALP for "baseline marketing and distribution activities" defined as distributors that (i) buy from related parties and resell to unrelated parties; and (ii) have a routine distributor functionality profile.

38. 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 remain free to argue that the actual functions, assets and risks differ from those assumed as "baseline marketing and distribution activities."

39. The OECD should include specific rules (together with examples) setting out the circumstances in which activities will be considered routine or "have a routine distributor functionality profile", including the associated risks assumed, with a specific and limited amount of related income. The Blueprint's list of positive and negative qualitative indicators is a start to this task; however, using terms like "limited" when setting criteria leaves much open to interpretation. It is essential that the inclusion of an Amount B concept in Pillar One not lead to jurisdictions using Amount B as a floor while seeming to always find a way to ratchet up the amount reassessed on the basis that existing ALP rules require an additional return to the entity.

40. It is not clear how the OECD intends Amounts A and Amount B to be allocated to specific entities in a MNE group (particularly in jurisdictions, such as Canada, that do not have a consolidated tax regime), and to ensure that specific entities in the MNE group (i) do not pay tax on the same profits more than once, and (ii) eliminate double taxation through the appropriate use of foreign tax credits. It is very difficult to determine which entities are paying tax and entitled to relief under Amounts A and B.

41. The OECD should adopt more specific measures to avoid double taxation. For example, if the starting point for allocating profits is the current ALP standard, Pillar One should clearly set out which jurisdictions and entities should reduce their income allocations by any amounts allocated to other jurisdictions under Amounts A and B. In particular, where the MNE group has income allocated to a jurisdiction under Amount A, the rules should clearly exempt an equivalent amount of income under existing rules – with clear exemptions applied to particular entities or branches in the relevant jurisdictions to prevent double taxation. Otherwise, double taxation and disputes will almost inevitably arise. If clear objective rules cannot otherwise be established, then taxpayers should be allowed to elect which entity or branch the relevant income should be allocated to within an MNE group.

Tax Certainty

42. To increase tax certainty, the Pillar One Blueprint outlines a proposed approach to mandatory binding dispute prevention and resolution for Amount A.

43. The Pillar One Blueprint also contemplates 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.

44. 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.

45. With respect, any system that relies on an agreement of 6 – 8 affected tax administrations will be destined to fail. In our experience, the application of domestic tax rules that only rely on one tax administration often involve material disputes and significant delays. The Pillar One rules should be designed, wherever possible, to objectively allocate income and remove any subjective interpretations which could otherwise differ from country to country. In particular, the rules should be designed to ensure that disputes only arise in exceptional circumstances.

46. In order to promote transparency and to ensure that countries implement the minimum standards to be agreed under Pillar One, the OECD should consider implementing a robust peer review process to evaluate the implementation of the minimum standards similar to the Mutual Agreement Procedure peer review and monitoring processing under Action 14 of the BEPS Action Plan with all members of the Inclusive Framework participating on equal footing. In order to ensure the process is enforceable, countries should be precluded from collecting any taxes under Amount A if they are not in compliance with the minimum standards (which should include their abolishment of any digital services tax or other unilateral measure).

47. The Pillar One Blueprint appropriately recognizes that dispute mechanisms are also needed for amounts beyond Amount A. The Blueprint on Pillar One discusses the possibility of 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.

48. In our view, relief from double taxation would be best achieved through mandatory binding arbitration. This applies to Amount A as well as amounts beyond Amount A. While the Report on Action 14 Dispute Resolution readily admits the OECD's failure to achieve consensus on binding arbitration, and not all countries have signed on to mandatory binding arbitration in the *Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting* ("**MLI**"), the OECD should commit participating countries to binding arbitration (or equivalent) as a pre-condition to their participation in Pillar One. In addition, even where countries have agreed to binding arbitration under the MLI there remains disagreement between various countries on the manner in which arbitrations should be conducted. These differences must be resolved prior to countries participating in Pillar One. The OECD should consider how best to assist countries adopting mandatory-binding arbitration (or equivalent) under Pillar One to help address the potential mismatch between countries that regularly deal with the Competent Authority process and arbitration proceedings, and those that do not.

(C) Need for a "Plan B"

49. In an apparent effort to encourage a consensus on the Pillar One approach, the OECD has indicated that it does not have a "Plan B" – and that if consensus is not reached the counter-factual must be a chaotic combination of unilateral measures and trade wars.

50. With respect, in our view the OECD should be doing more to work on an acceptable Plan B – particularly since it appears very likely that some countries may be unable or unwilling to implement any agreed approach to Pillar One in a timely manner or at all.

51. At a high level, there are three basic approaches to international taxation: (i) taxing net income as allocated to jurisdictions under existing rules (generally based on the ALP), (ii) taxing the gross amount of payments (generally through withholding taxes), and (iii) taxing the amount of consumption in a jurisdiction (generally through a VAT or other indirect taxes). The various digital services taxes that have been introduced attempt to tax based on an amount of gross receipts allocated to a jurisdiction (generally resembling a VAT or consumption tax). The Pillar One approach deviates significantly from these other approaches – which creates significant (and perhaps untenable) complexities. As some countries expect to lose tax revenue under Pillar One, it will obviously be difficult for them to justify such a significant deviation from international tax norms.

52. Rather than narrowly focusing all efforts exclusively on the Pillar One approach, in our view the OECD should also be actively considering a viable Plan B. The OECD should be further considering whether an international consensus may be reached on an alternative that does not deviate so significantly from international tax norms. The following are some potential alternatives:

   a. Working within the framework of existing tax rules (based on the ALP), consideration could be given to expanding the circumstances in which a "permanent establishment" is considered to arise. In addition, existing sourcing rules could be revised to deem all or a portion of certain income to be sourced in relevant market jurisdictions.

   b. Consideration could be given to expanding the rights of market jurisdictions to impose withholding taxes or taxes based on a limited amount of gross revenue – with an elective regime based on net income (along the lines of the approach considered by the United Nations, or the approach that Canada has followed for many years with respect to certain income from real property under section 216 of the *Income Tax Act* (Canada)).

   c. Consideration could be given to negotiating a common digital services tax – turning the many so-called unilateral measures into an agreed common approach. This could potentially lead to streamlined administration, as well as an international agreement on not imposing such taxes beyond an agreed negotiated tax rate and tax base.

   d. Consideration could also be given to market jurisdictions simply expanding their rights to collect VAT or similar consumption taxes to ensure an adequate source of revenue.

53. Unfortunately, it appears that the current lack of focus on potential viable alternatives to Pillar One could itself be the cause of a prolonged period of uncertainty, trade wars and conflict.

Pillar Two Blueprint

54. Osler previously submitted comments on the November 8, 2019 *Public Consultation Document – Global Anti-Base Erosion Proposal - Pillar Two*, which would impose a minimum tax on internationally operating businesses. The GloBE proposal under Pillar Two calls for the development of:

   a. an Income Inclusion Rule ("**IIR**"), which would 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 ("**ETR**") that is below a certain minimum rate (which is to be set at a later date);

   b. an Undertaxed Payments Rule ("**UTPR**") (for source countries), which would either deny a deduction or impose a possible withholding tax on base eroding payments unless that payment was subject to tax at or above a specified minimum rate in the recipient's jurisdiction;

   c. a switch-over rule, which would be introduced into tax treaties to permit a residence jurisdiction to switch from an exemption to a credit method for relieving double taxation where the profits attributable to a permanent establishment or derived from immovable property is subject to an ETR below the minimum rate; and

   d. a Subject to Tax Rule ("**STTR**"), which would ensure that treaty benefits (particularly with respect to interest and royalties) are granted only in circumstances where an item of income is subject to tax at a minimum rate in the recipient jurisdiction.

55. In our prior comments on Pillar Two, we advocated that the GloBE proposal should be applied more narrowly and should be designed in a manner that prevents double (or multiple) taxation and minimizes administrative complexity and compliance costs. We reiterate those comments here.

(A) Scope of Pillar Two

56. The scope of the GloBE proposal should be carefully targeted to ensure that it addresses the unresolved BEPS concerns identified by the OECD without unnecessarily interfering with cross-border business activities or well-understood norms of international taxation.

57. The GloBE proposal has been described as a "global minimum tax". However, any proposal for a global minimum tax must be reconciled with the reality that policy decisions regarding how much tax should be imposed on individuals and businesses in each jurisdiction ultimately belong to the national government in that jurisdiction. The sovereign ability of a jurisdiction to decide its own tax and fiscal policies should not be effectively usurped by allowing third countries to impose a top-up tax on income earned in the first-mentioned jurisdiction. Moreover, if a global minimum tax were determined to be beneficial then the jurisdiction in which the relevant business activities occur should generally be the country that is entitled to retain the relevant tax revenues.

58. In the case of "active businesses" in a local jurisdiction, the capital import neutrality principle suggests that in order to have a level playing field, all businesses carried on in a jurisdiction should be subject to a similar tax rate (determined by the local jurisdiction) regardless of the residence of the investor.[1] This would suggest a broad exemption from the minimum tax for active businesses – allowing fair competition at comparable tax rates between (i) large, medium and small businesses, and (ii) multinational and domestic-only businesses. This would also preclude the otherwise arbitrary result that could arise if the level of taxation of a business in a particular jurisdiction were dependant on the amount of revenues or assets of affiliated companies that may be engaged in unrelated business or other activities.

59. On the other hand, many countries already have complex and sophisticated controlled foreign corporation ("**CFC**") rules (such as Canada's "foreign accrual property income" or "**FAPI**" regime) which identify scenarios where certain passive income or certain income connected to the parent jurisdiction should be taxed at a rate that is not less than the tax rate applicable in the parent jurisdiction. In those cases, the parent jurisdiction already applies an additional "top up" or minimum tax at the shareholder level to ensure that the relevant income is taxed at a rate that is not less than the rate applicable in the parent jurisdiction. These regimes recognize that, for certain types of income, an investor's tax burden should be the same regardless of whether that capital is invested locally or abroad (pursuant to the capital export neutrality principle). In our view, profit-shifting concerns relating to passive income or base eroding payments are best addressed through domestic CFC rules, without the additional layer of complexity associated with the GloBE proposal.

60. The policy concerns articulated in the GloBE proposal should generally only apply to passive or similar types of income which can be easily "shifted" between jurisdictions for tax reasons – and not to income from active business operations. While the application of a minimum tax on passive income (in the absence of adequate CFC regimes in the parent jurisdiction) may be consistent with the policy objectives of the GloBE proposal, requiring a minimum tax to be paid on profits derived from active business operations could inappropriately discourage bona fide cross-border investment, and appears to be inconsistent with one of the stated goals of the BEPS initiative – to tax profits in the jurisdiction where economic activities take place.[2] Hence, a substance and activity-based exclusion from the GloBE proposal is important. Otherwise, the GloBE proposal could result in the abandonment of any notion of taxation matching the underlying functions, assets and risks (or taxation based on the location of value creation), and could instead result in arbitrary taxation based on the location of a particular parent company or holding jurisdiction.

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1 The significance of a level playing field between economic actors was stressed in the OECD's 2015 Final Report on BEPS Action 1, at page 98.

2 As expressed in the Forewords in each of the BEPS Final Reports.

61. In our experience, the distinction in Canadian tax law between "income from an active business" and FAPI could be helpful in determining the types of income to which a minimum tax should apply (or not apply) – in the absence of an adequate CFC regime in the parent jurisdiction. Specifically, Pillar Two should generally apply only to passive forms of income earned by large multinational corporations in circumstances where adequate CFC rules (such as Canada's FAPI rules) are not otherwise applicable.

62. The Pillar Two proposals currently contemplate a carve-out for a fixed return in a jurisdiction based on payroll and accounting depreciation on tangible assets. However, there does not appear to be a principled basis for adopting such an arbitrary formulaic approach rather than using the actual income generated from an active business in that jurisdiction (particularly where transfer pricing and other rules are designed to ensure that the quantum of income allocated to that jurisdiction is appropriate). It is not possible to use a single formulaic threshold to determine the "appropriate" rate of return on payroll costs and tangible assets for all taxpayers across all industries and all markets. Any attempt to use a formulaic threshold as a proxy for "excess income" on a blanket basis is likely to result in significant distortions from commercial reality, and result in income inherently connected to substantive activities in a local jurisdiction being inappropriately treated as "excess income".

63. For example, if an MNE operates an active business in a particular jurisdiction (say a hotel, mine or bank) then the income from such business operations should be taxed in the same manner as a domestic business operating in that jurisdiction (whether it be a hotel, mine or bank). It is not appropriate for a third country to tax the profits earned in the local country in which an active business is carried on solely on the basis that the country has decided as a matter of its sovereign domestic tax policy to impose a lower tax rate on income earned in its jurisdiction than the rate that the third country deems appropriate to it. The policy concerns articulated in the GloBE proposal also suggest that income derived from tangible or immovable property (regardless of whether it exceeds a formulaic threshold) should not be subject to a minimum tax – since these types of income are local by nature, and do not engage the types of BEPS concerns identified in the GloBE Proposal.

64. The GloBE proposal under Pillar Two could also apply to income earned in regimes that are considered by the OECD to be harmful under the agreed standards of BEPS Action 5. The exclusion of active business income (and income from countries which comply with BEPS Action 5) from the scope of the GloBE proposal should not be seen as a "carve-out" or an exception, but rather, as a principled way to focus the GloBE proposal on its core policy objectives.

65. Limiting the scope of the GloBE proposal, for example, to regimes identified by the OECD as being harmful through its Action 5 review would appropriately limit the significant administrative complexity that would arise under that proposal. The burden would then be on the OECD (rather than individual taxpayers) to identify regimes as being non-compliant. Income earned in those jurisdictions could be subject to the minimum tax rules of the GloBE proposal. Income earned in other countries could be subject to ordinary tax principles – with no need to adopt controversial and complex procedures such as recomputing accounting income for global tax purposes.

66. It will be important to maintain specific exceptions to the GloBE proposal for income earned directly or indirectly by tax exempt entities (such as pension funds and charities) having regard to public policy or other considerations. Also, the rules should appropriately take into account fiscally transparent entities. Income earned through investment funds or other collective investment vehicles should not be unduly subject to the GloBE proposals solely because they invest funds on a collective basis (including through fiscally transparent or low taxed holding entitles). The taxation of such funds should not deviate from the taxation that would otherwise have arisen if the ultimate investors in a fund had separately invested in any underlying operating entity. Exemptions or adaptations should also be considered for industries (for example, insurance) where accounting results often differ from the pattern of cash flows and where those differences can be long lasting due to the nature of the product or industry business cycle.

67. In our view, the GloBE proposal should be focused on low-tax income derived from activities without economic substance in the local jurisdiction – which should be the only type of income that may result in artificial profit-shifting. A safe-harbour should be available for taxpayers that are already part of a group that is subject to an adequate CFC regime (such as Canada's FAPI rules) in the parent jurisdiction.

68. Consistent with the intended focus of the GloBE proposal on mobile and low-tax income, the minimum tax rate under the GloBE proposal should be set at a low rate, in order to minimize opportunities for third countries to impose taxes on substantive economic activities not connected with it.

(B) Practical issues with the GloBE proposal

69. The Pillar Two Blueprint contains 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 ETR and the allocation of the top-up tax.

70. The application of both the IIR and the UTPR requires the calculation of (i) ETRs for each relevant jurisdiction, and (ii) an amount of top-up tax for each group entity. If an MNE group's ETR 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.

71. 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 FAPI, which would effectively result in a dramatic expansion of the Canadian FAPI rules to also apply to active business income (computed formulaically based on applicable accounting income rather than under Canadian income tax rules).

72. 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.

73. These rules will add significant complexity and distort the fundamental tax principles agreed to under the BEPS project (by creating mismatches between taxing rights and the location of the underlying economic activates that generate income).

74. Moreover, fundamental issues may arise due to various differences in the manner in which income is generally computed for tax purposes and the computation under relevant accounting principles as modified for purposes of the GloBE proposals. These differences could potentially result in the GloBE rules applying by virtue of an apparently low tax rate notwithstanding that the actual tax rates applied under ordinary tax rules may be materially higher. These differences could relate to various factors including: (i) foreign currency differences, (ii) differences between the treatment of a consolidated group and a separate entity, (iii) differences resulting from M&A activity – including where entities are combined, added to, or removed from an MNE group, (iv) differences in fiscal periods or taxable year ends, (v) differences in treatment of capital gains compared with ordinary income, (vi) differences in the treatment of losses or foreign tax credits, (vii) differences in treatment of various payments in lieu of taxes (including with respect to certain mining royalties or payments under certain regulatory regimes), (viii) intra-group distributions and share sales, and (ix) timing differences on the recognition of income.

75. The GloBE proposals allow taxpayers to carry forward "excess" local taxes and recognizes that tax under the IIR can be recovered in a later year through a tax credit mechanism if excess local taxes arise in a subsequent year. However, the tax credit mechanism likely will not capture all timing mismatches (especially for industries with long business or investment cycles), and the GloBE proposals do not give recognition for pre-regime excess local taxes. Much of this complexity and potential for distortion could be removed, and the underlying principle of the BEPS proposals respected, if the rules generally did not apply to income from an active business.

76. 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.

77. The tax policy reasons for including the STTR in Pillar Two are debateable. In particular, many countries have already introduced domestic earnings stripping or thin capitalization rules to address similar concerns to those covered by the STTR. The rate of withholding tax that currently applies to payments such as interest and royalties are determined by both domestic legislation and applicable tax treaties, which have been drafted or negotiated with anti-base erosion objectives in mind. For example, interest payments made by a Canadian resident to non-resident related parties is already subject to a 25% withholding tax under Canadian domestic law (and a complex back-to-back loan rule applies to conduit arrangements). Although this withholding tax rate may be reduced under applicable tax treaties, benefits under many tax treaties are (or will be) limited by the application of the "principal purpose test" under the MLI, which can apply to many scenarios that involve the routing of related party payments through low-tax jurisdictions. Given the extent to which earnings stripping concerns are already addressed in existing domestic tax legislation and international tax treaties, we would recommend for the STTR to be abandoned, particularly since there is already too much complexity with the remaining aspects of the proposals.

(C) Avoiding double taxation under Pillar Two

78. Despite the additional detail in the Pillar Two Blueprint, including with respect to the rule order, we anticipate that there will likely be many interpretive disputes on a number of technical issues between taxpayers and revenue authorities and between the Competent Authorities of different jurisdictions regarding how the minimum tax under the GloBE proposal should be applied. Accordingly, as with the Pillar One proposal, it will be important to implement effective dispute resolution procedures to prevent the chaos that could potentially otherwise arise as a result of countries' differing interpretations of the GloBE proposal.

79. The rules to prevent double taxation should be further developed in a variety of respects. For example, where income is indirectly taxed under the GloBE proposals there should be a deemed increase to the tax cost of the relevant subsidiary shares (generally analogous to the Canadian rules in section 92 of the *Income Tax Act* (Canada)). Otherwise, double taxation could arise where underlying income is first taxed indirectly in the hands of the parent company, and then taxed again as a result of a sale of the subsidiary's shares. Similarly, any taxes arising under the CFC rules of a parent jurisdiction should offset any current or future income that may otherwise arise under the GloBE proposals (including as a result of timing differences, foreign currency differences, or otherwise). Further rules should apply to allow losses in a parent jurisdiction to offset any taxes that would otherwise be imposed under the GloBE proposals – including through any applicable loss carryforward or loss carryback rules. A simple way to considerably reduce the potential for double-taxation is to provide a safe-harbour to MNE groups that are already subject to an adequate CFC regime (such as the FAPI regime in Canada) in the parent jurisdiction.

80. We note that it appears that U.S. entities subject to the domestic GILTI regime will likely be exempt from the GloBE proposals. To prevent double taxation and to maintain fairness with other jurisdictions, significant additional rules will be required to properly integrate the two regimes. For example, detailed rules will be required to determine the circumstances in which the GILTI rules should not apply as a result of the GloBE proposals (such as where a U.S. intermediate holding company should cede taxing rights to a parent holding company in another jurisdiction under the GloBE proposals). In addition, detailed rules will be required to effectively turn-off the application of the U.S. domestic BEAT regime where the relevant entities are otherwise subject to the GloBE proposals. Relatedly, the relevant countries participating in the GloBE proposals should be required to agree, as a minimum standard, not to impose new tax rules (similar to the U.S. BEAT regime) that could otherwise result in double taxation or an attempt to alter the agreed allocation of taxing rights under the proposals.

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