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Draft Canadian Pillar Two global minimum tax legislation and revised DST legislation

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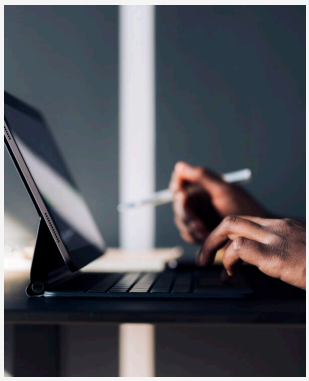

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Osler's National Tax Group has been following these developments closely. See our Updates on the draft tax legislation package, revised EIFEL rules and clean energy tax credits.

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On August 4, 2023, the Department of Finance released draft legislation [PDF] implementing two key measures of the OECD's Pillar Two global minimum tax (GMT) in Canada, namely, the income inclusion rule (IIR) and a domestic minimum top-up tax that is intended to be a qualified domestic minimum top-up tax (QDMTT), as defined in the GloBE Model Rules. These rules will apply to fiscal years of qualifying MNE groups beginning on or after December 31, 2023 in line with the OECD's recommended timing. The draft legislation to implement the undertaxed profits rule (UTPR), which is to be effective one year later, is expected to be released at a later date. The draft *Global Minimum Tax Act* (GMTA) is a self-contained statute for computing and imposing Pillar Two top up taxes, including enforcement, assessment, collection and other administrative provisions (with material penalties for non-compliance).

The general anti-avoidance rule in section 245 of the *Income Tax Act* (Canada) (ITA) will apply to the determination of any amount under the GMTA, with such modifications as the circumstances require.

The draft legislative proposals implementing Canada's IIR and domestic minimum top-up tax closely follow the OECD GloBE Model Rules, the GloBE Commentary on the Model Rules (GloBE Commentary) and the administrative guidance agreed to by the OECD/G20 Inclusive Framework. The Department of Finance released a table of concordance [PDF] that cross-references provisions of the GMTA with the source GloBE documents on which they are based.

The Department of Finance has requested comments on the GMTA by September 29, 2023. The interaction of the GMTA with the ITA is expected to be a significant topic during the consultation process. In particular, the GMTA does not contain any details with respect to how various provisions of the GMTA will interact with provisions in the ITA (including with respect to the Canadian foreign affiliate and foreign accrual property regimes). It is expected, however, that losses or other tax attributions under the ITA will not be available to shelter taxes owing under the GMTA.

On the same date, the Department of Finance also released a revised draft of Canada's digital services tax (DST), which is intended to serve as a backstop to the Pillar One proposals. The DST is expected to apply as of January 1, 2024 (with retroactive effect to 2022) assuming that a multilateral convention implementing the Pillar One framework has not come into force by January 1, 2024. Submissions on the revised DST legislation are due by September 8, 2023.

GMTA implements GloBE model rules, commentary and administrative guidance

Part I of the GMTA contains definitions and interpretive rules, including a provision which provides that the domestic legislation implementing the IIR, UTPR, and certain administrative and enforcement provisions are intended to implement the GloBE model rules, GloBE commentary and administrative guidance, and that those parts of the GMTA are to be interpreted consistently with those GloBE sources, unless the context otherwise requires, as amended from time to time. The Governor in Council can also designate additional sources through regulation. (To the extent future amendments to any of those GloBE sources result in an additional amount of tax owing under the GMTA, this interpretive rule may be considered an unlawful delegation or subdelegation of Parliament's authority to impose taxes to the OECD and/or the Inclusive Framework).

Part II of the GMTA implements the IIR, Part III of the GMTA contains a placeholder for legislation to implement the UTPR (which may be inconsistent with Canada's bilateral treaty obligations), and Part IV of the GMTA implements the QDMTT.

The draft legislative proposals include, among others, charging provisions for the IIR and QDMTT, criteria for qualifying multinational groups that fall within the scope of the rules, the calculation of the effective tax rate and adjusted covered taxes, the calculation and allocation of top-up taxes, as well as transitional rules, elections and safe harbours.

Scope of GMTA

Consistent with the Pillar Two proposals, the GMTA introduces a 15% global minimum tax on the income of large multinational enterprises (MNEs). Specifically, a qualifying MNE group must have a business presence in more than one jurisdiction and consolidated revenues of

€750 million or more in at least two of the four fiscal years immediately preceding the particular fiscal year. The rules do not apply to "excluded entities", such as government entities, international organizations, non-profit organizations, pension funds, as well as investment funds and real estate investment vehicles that are ultimate parent entities (UPEs). There are also circumstances where an entity owned by an excluded entity can also be treated as an excluded entity. This applies where specific ownership thresholds are met, and where substantially all of the particular entity's financial accounting income for the fiscal year is comprised of excluded dividends or excluded equity gains or losses (such that the income is excluded from the computation of GloBE income or loss.)

Income inclusion rule

The income inclusion rule (IIR) in the GMTA closely follows the GloBE model rules, GloBE commentary and administrative guidance approved by the Inclusive Framework – which is required to ensure that Canada's IIR is treated as a "qualified IIR" under the GloBE model rules.

The IIR is payable by a person in respect of a qualifying MNE group for the fiscal year if:

1. The particular person is a relevant parent entity of the MNE group and is located in Canada at any time in the fiscal year that has a direct or indirect ownership interest in one or more constituent entities of the qualifying MNE group that is not located in Canada and has a top-up amount for the fiscal year; or
2. The particular person would include in its income for purposes of Part I of the ITA the income of a relevant parent entity that is not a person located in Canada that has a direct or indirect ownership interest in one or more constituent entities of the qualifying MNE group that is not located in Canada and has a top-up amount for the fiscal year.

Depending on the circumstances, a relevant parent entity can include the ultimate parent entity (UPE), an intermediate parent entity or a partially-owned parent entity of the MNE group that is located in either Canada or a foreign jurisdiction where the entity is subject to a top-up tax under a qualified IIR.

The amount of the top-up tax under the GMTA is computed by determining the MNE group's effective tax rate, excess profits and top-up tax for each jurisdiction in which it has a business presence. The starting point is the net GloBE income or loss, which is the financial accounting income or loss of all constituent entities of the MNE group located in the jurisdiction, subject to a number of GloBE adjustments. The resulting net GloBE income is then used along with adjusted covered taxes to calculate the effective tax rate and whether any top-up tax is due in respect of the jurisdiction, subject to some potential adjustments and net of a QDMTT paid in the source jurisdiction.

1. GloBE income or loss

Consistent with the GloBE model rules, financial accounting income or loss is generally based on the accounting standards used for consolidated financial statements of the UPE. The financial accounting income or loss is subject to a number of adjustments to arrive at the GloBE income or loss.

In computing GloBE income or loss the adjustments to financial statement net income include: net taxes expense; purchase accounting adjustments in connection with certain share acquisitions; excluded dividends; excluded equity gains and losses (unless an election

is made); asymmetric foreign currency gains or losses; certain policy disallowed expenses (such as fines and penalties); prior period errors and changes in accounting principles; certain transfer pricing adjustments to accord with the arm's length principle; refundable tax credits (to the extent their accounting treatment is different from the GloBE treatment); and stock-based compensation expenses (where an election is made).

There is also a specific anti-avoidance rule that excludes expenses in a low-tax entity attributable to intragroup financing arrangements that can reasonably be expected not to be included in the taxable income of a high-tax counterparty over the expected duration of the arrangement.

In addition, there are specific rules that apply to calculate GloBE income or loss in the context of reorganizations and asset transfers.

Numerous elections can be made in line with the GloBE model rules for purposes of computing the net GloBE income or loss for the jurisdiction.

The GloBE income or loss of constituent entities in a jurisdiction is totaled to arrive at the net GloBE income or loss for the jurisdiction.

Consistent with the GloBE model rules, the GMTA includes a de minimis exclusion for operations in a jurisdiction that are below €1 million in income and €10 million in revenues by averaging the current and the two preceding fiscal years. Where the requirements are met and the filing constituent entity of the MNE group files an election in respect of the jurisdiction, the top-up tax of each eligible constituent entity of an MNE group located in the relevant jurisdiction is deemed to be nil.

1. Adjusted covered taxes

Net GloBE income for the jurisdiction is the first element necessary to calculate the effective tax rate to determine whether any top-up tax is due. The second element is adjusted covered taxes for the jurisdiction.

Covered taxes are adjusted before calculating the effective tax rate. Adjusted covered taxes of a constituent entity for a fiscal year are equal to the current tax expense accrued in the constituent entity's financial accounts as adjusted by the following amounts:

1. The net amount of additions and reductions to covered taxes specified in the GMTA;
2. The total deferred tax adjustment amount (TDTAA) to account for temporary differences; and
3. Any increase or decrease in covered taxes recorded in equity or other comprehensive income relating to the GloBE income or loss that is subject to tax under the laws of the jurisdiction where the constituent entity is located.

The GTMA includes a definition of covered taxes, as well as excluded taxes. Covered taxes include income (profit) taxes and their substitutes, but exclude, among others, any tax paid under a qualified IIR, qualified UTPR, or a QDMTT.

Consistent with the GloBE model rules, the GMTA allocates covered taxes to constituent entities to align taxes with the underlying income. This principle drives the tax allocation keys where covered taxes are not necessarily allocated to the constituent entity that pays or withholds these taxes. This includes the allocation of covered taxes to:

1. A permanent establishment;
2. An owner of a tax transparent entity where the income or loss is allocated to the owner of the tax transparent entity, but the tax is reflected in the financial accounts of the tax transparent entity;
3. An entity that earns income which is taxed in the hands of its direct or indirect group owner under a controlled foreign company tax regime (subject to restrictions in respect of passive income);
4. A hybrid entity even if taxes are paid by and reflected in the financial accounts of the group owner of the hybrid entity (subject to restrictions in respect of passive income); and
5. A distributing entity even if taxes are paid by the direct group owner on dividends or similar distributions from that distributing entity.

The GMTA does not contain an allocation key for withholding taxes. The GloBE commentary states that withholding taxes should be allocated to the recipient of the payment subject to withholding tax, except for payments that are dividends or similar distributions mentioned in item (e) above.

TDTAA is the second important component of adjusted covered taxes, addressing the impact of temporary differences on current tax expenses that, in the absence of this component, would give rise to tax distortions resulting in an unintended top-up tax.

TDTAA involves numerous GloBE adjustments to deferred tax expenses recorded in the financial accounts. If TDTAA yields a negative value, it can lead to negative adjusted covered taxes. In certain scenarios, such as where there is a net GloBE loss for a particular jurisdiction, a negative amount for adjusted covered taxes can in certain circumstances trigger a top-up tax. The GMTA addresses this through the concept of excess negative tax expense introduced in administrative guidance approved by the Inclusive Framework.

Instead of complex TDTAA calculations, a GloBE loss election can be made for a jurisdiction to account for situations where GloBE losses reduce or eliminate GloBE income and, accordingly, a top-up tax, in a subsequent fiscal year. If a GloBE loss election is made, a GloBE loss deferred tax asset is deemed to arise in any election year in which the MNE group has a net GloBE loss for the jurisdiction. A GloBE loss deferred tax asset is reversed and included in the adjusted covered taxes for the jurisdiction in a subsequent election year where the MNE group has net GloBE income, resulting in an increase to the effective tax rate for the jurisdiction.

Where a corporate income tax system gives rise to numerous and material temporary differences, a GloBE loss election prevents accounting for deferred taxes in computing the adjusted covered taxes for the jurisdiction. This can give rise to low adjusted covered taxes and can result in top-up tax for the jurisdiction. In such cases, the default TDTAA is typically more advantageous. A GloBE loss election can be considered as a GloBE simplification measure for jurisdictions where taxable income or loss is more or less consistent with the financial accounting income or loss, and a qualifying MNE group does not have a material pre-GloBE accumulated deficit.

Finally, there are special rules regarding how post-filing tax adjustments in respect of previous fiscal years impact the adjusted covered taxes for the jurisdiction in the adjusted and post-adjusted fiscal years.

Effective tax rate

The effective tax rate (ETR) for a jurisdiction is calculated by dividing the adjusted covered taxes by the net GloBE income for the relevant fiscal year. The result of the ratio is expressed as a percentage, and the top-up percentage is the difference between the 15% minimum rate and the ETR.

1. Determination and allocation of top-up amount

The top-up amount is determined by multiplying the excess profit of the MNE group for the jurisdiction by the top-up percentage of the MNE group for the jurisdiction, subject to some potential adjustments and net of a QDMTT paid in the source jurisdiction.

The tax base for the IIR is the excess profits of an MNE group for the jurisdiction for each fiscal year. The excess profit is computed with reference to the net GloBE income and the substance-based income exclusion (SBIE) amount of the MNE group for the jurisdiction.

The SBIE is 5% of the carrying value of (i) tangible assets and (ii) payroll costs in respect of the jurisdiction. There are transitional rates in place instead of the regular 5% rate for fiscal years that begin in 2023. These transitional rates apply for a period of 10 years. During this period, the transitional rates gradually decrease from 10% for payroll and 8% for eligible tangible assets until they reach the regular 5% rate for fiscal years that begin in or after 2033. The SBIE amount is deducted from the net GloBE income of the MNE group for the jurisdiction, and the resulting positive difference is the excess profit.

The top-up amount is allocated among the constituent entities of the MNE group located in the jurisdiction that have GloBE income (if there is a net GloBE income for the jurisdiction) or GloBE loss (if there is a net GloBE loss for the jurisdiction).

Safe harbours and simplifications

1. Permanent QDMTT safe harbour

The GMTA includes a permanent QDMTT safe harbour that deems a top-up amount for a qualifying jurisdiction to be nil, provided that three requirements are met: the constituent entity is located in a jurisdiction that has a QDMTT, the jurisdiction's QDMTT has qualified domestic minimum top-up tax safe harbour status, and an election is filed.

1. Transitional CbCR safe harbour

The GMTA also includes a transitional CbCR safe harbour that deems a top-up amount for a qualifying lower-risk jurisdiction to be nil and simplifies the relevant GloBE calculations in respect of that jurisdiction during the transitional period that starts before January 1, 2027 and ends before July 1, 2028.

The transitional CbCR safe harbour applies to the MNE group in the particular year provided that the following five requirements are met:

1. The particular fiscal year falls within the transitional period referred to above;
1.
2. A qualified CbCR report is prepared by the MNE group with respect to the jurisdiction for

the particular fiscal year;

3. An election is filed in respect of the jurisdiction for each preceding fiscal year in which one or more constituent entities of the qualifying MNE group (or a joint venture entity with respect to such group) is located in the jurisdiction;
4. A subsection 37(1) election is not made in respect of the jurisdiction, which has an eligible distribution tax system, for the particular fiscal year; and
5. At least one of three tests is met for the jurisdiction in the particular fiscal year, namely:
    1. A de minimis threshold test where the total revenues and pre-tax income of the MNE group for the jurisdiction are less than €10 million and €1 million, respectively;
    2. A simplified effective tax rate test where a simplified effective tax rate for the jurisdiction is at least 15% for a fiscal year beginning before 2025, 16% for a fiscal year beginning in 2025, and 17% for a fiscal year beginning after December 31, 2025; or
    3. A routine profits test where there are no excess profits in the jurisdiction, including if a SBIE amount is claimed for the jurisdiction.

The GMTA contains a set of special rules that specify the application of the transitional CbCR safe harbour to joint ventures, minority-owned constituent entities, tax-neutral UPEs and investment entities.

1. Simplification for non-material entities

Qualifying MNE groups may apply the simplified income and tax calculations in respect of their non-material constituent entities outlined in the Safe Harbours and Penalty Relief Rules approved by the Inclusive Framework in December 2022.

QDMTT

A qualifying domestic minimum top-up tax (QDMTT) allows jurisdictions to introduce a domestic top-up tax that is aligned with Pillar Two and applies to domestic entities that are within the scope of Pillar Two. The QDMTT offsets the global minimum tax liability under Pillar Two.

The domestic minimum top-up tax is payable by a particular person in respect of a constituent entity located in Canada that is a member of a qualifying MNE group if:

1. The particular person is the constituent entity; or
2. The particular person would include the income for the fiscal year of the constituent entity in its income for purposes of Part I of the ITA if the constituent entity is not a person.

The GMTA provides that the domestic minimum top-up amount of each constituent entity of an MNE group located in Canada is the amount that would be determined for IIR purposes, subject to certain applicable adjustments outlined in Parts II and IV of the GMTA.

For example, Part IV prescribes that in computing the domestic top-up amount of a constituent entity of the qualifying MNE group located in Canada:

1. The adjusted covered taxes of the constituent entity do not include certain covered taxes that would be allocable to the constituent entity under the IIR;
2. The top-up amount is not reduced to the extent of a domestic top-up tax (as this is the

case for the top-up amount payable under the IIR); and

3. All made or revoked elections relevant for determining the top-up amount should be taken into account provided that these elections are included in a GloBE information return (GIR) that is received by the Minister.

The Canadian domestic top-up tax is intended to meet the requirements to be considered as a "qualified" domestic minimum top-up tax set out in the administrative guidance approved by the Inclusive Framework. As a result, the Canadian domestic top-up tax is intended to prevent other countries from applying an IIR (or a UTPR) to impose additional taxes on such Canadian source income. However, the Canadian domestic top-up tax could result in increased Canadian taxes on the domestic income of Canadian entities (particularly those benefiting from certain tax credits or deductions in Canada).

Global minimum tax administration and compliance

The GMTA includes rules for assessments, objections, appeals, audit, collection, enforcement, penalties, offences and all other aspects for the administration of the GMTA. The proposed penalties are significant, including (i) up to $1 million for failing to timely file the requisite GloBE information return, (ii) penalties based on a percentage of any taxes owing under the GMTA in respect of a failure to file a Part II or Part IV return, and (iii) 10% of any disputed tax amount if an appeal is determined not to have been reasonable.

Consistent with the GloBE model rules, the administrative provisions of the GMTA require that a GloBE information return (GIR) be filed within 15 months of the end of the group's fiscal year, which is generally defined as the accounting period covered by the group's consolidated financial statements prepared by the ultimate parent entity (the filing due date of the GIR is extended to 18 months for the first fiscal year that the MNE group is in scope).

The GIR must include, among other things:

- An identification of all the entities in the MNE group and the jurisdiction in which they are located;
- Information relevant to determine the effective tax rates and top-up tax for the fiscal year;
- The overall corporate structure of the MNE; and
- The appointment of any designated filing entity for the fiscal year.

The GMTA provides rules for who is required to file the GIR for the MNE group. Generally speaking, where the MNE group appoints a constituent entity that is located in Canada as the "designating filing entity", this entity will be required to file the GIR in respect of the group. If no such constituent entity is appointed, and the ultimate parent entity is located in Canada, the ultimate parent entity must file the GIR. Where neither of the foregoing applies, each constituent entity located in Canada may be required to separately file a GIR in respect of the group. However, there are several exceptions to this rule. For instance, the Minister will generally accept a GIR filed by a constituent entity located in another jurisdiction with which Canada and the relevant competent authority have agreed to an automatic exchange of GIRs. Another exception exists where a constituent entity located in Canada is appointed as a "designated local entity" and files the GIR in respect of the MNE group.

In addition to the GIR, a person liable to tax under Part II (income inclusion rule) or Part IV (domestic minimum top-up tax) of the GMTA is required to file a return containing an estimate of the taxes payable. The due date for this filing is the same as for the due date to file the GIR for the fiscal year.

In general terms, other administrative provisions of the GMTA mirror those in the ITA. There

are notable differences that account for the fact that the GMTA may tax one constituent entity for the undertaxed income of another constituent entity, which may present collection challenges. In particular, the Minister may be able to assess any constituent entity located in Canada for a tax liability under the GMTA of another constituent entity of the group, pursuant to which each such entity becomes jointly and severally liable.

The limitation period under the GMTA is seven years after the latter of two dates: (i) the day the relevant return was filed, and (ii) the day the Minister received the GIR. The general retention period for keeping necessary records is eight years after the end of the fiscal year to which they relate.

Revised DST legislation

The federal government first released draft legislation for Canada's DST on December 14, 2021. The revised draft legislation released on August 4, 2023 is the first update to the original draft *Digital Services Tax Act* (DSTA). The Canadian DST is expected to apply on January 1, 2024 (with retroactive effect to January 1, 2022) assuming no multilateral Pillar One agreement is reached by the end of 2023.

The revised draft DSTA includes changes to certain key definitions and concepts, new sections regarding the application of the DST to taxpayers that become bankrupt or go into receivership and to partnerships, and certain other procedural and administrative changes. Unfortunately, no changes were proposed to many of the key issues with the proposals (including their retroactive effect and the failure to provide a credit for DST against income taxes otherwise payable in Canada). In addition, the United States Trade Representative has urged Canada to abandon the proposed DST, and has threatened trade tariffs or other retaliatory measures if Canada nevertheless proceeds with its DST.

Key definitions and concepts

The definitions of "digital content" and "financial instrument" are modified to be mutually exclusive. "Digital content" now excludes financial instruments, while "financial instruments" now excludes property that confers a right to be exchanged, redeemed or converted into specific property or services; property primarily used in a gaming, affinity/reward, or other similar platforms; or other property prescribed by regulation.

Certain concepts have been refined and restructured. These include (1) multiple definitions and provisions relevant to the determination of revenue have been refined in respect of references to financial statements and acceptable accounting principles; and (2) replacing the concept of the "reporting period" with a calendar year, and instead introducing a new provision in respect of taxpayers that only become a constituent entity of a consolidated group that is liable for DST part way through a calendar year.

The scope of online marketplace services revenue for purposes of section 14 is expanded to include any supply of a service between users of an online marketplace that is (1) physically performed and received in Canada, (2) in respect of real property located in Canada, or (3) in respect of tangible property that is (i) normally located in Canada, and (ii) is located in Canada at the time the service is performed. The prior draft only included services delivered in physical form in Canada.

Election for retroactive years

For calendar years that will be retroactively subject to DST (currently expected to be 2022 and 2023), the revised rules allow taxpayers to elect to compute their digital services revenue with reference to their digital services revenue from the first year of application (currently expected to be 2024). Taxpayers can choose to determine the ratio of the total revenue of the earlier year to the total revenue of the first year of application, then multiply that ratio to the digital services revenue from the first year of application. The result can be reported as their digital services revenue for the retroactive year(s). The election is only available to taxpayers who have elected for at least one earlier retroactive year. This election appears to have been added in response to concerns that taxpayers would be required to determine digital services revenue earned before the final rules were released.

New sections on bankruptcy/receivership and partnerships

The revised DSTA adds several provisions concerning bankruptcy and receivership, including the obligations on trustees and receivers under the DSTA (including their responsibility to file required returns and pay any DST owing for the period after the bankruptcy or receivership commences).

A new section deems actions by a person, as a member of a partnership, to have been done by the partnership and establishes joint and several liability for certain partners. Limited partners that are not general partners are excluded from this liability.

Procedural and administrative changes

Various procedural and administrative provisions have been amended, including to more closely align those provisions with their equivalent ITA provisions. These include amendments to section 53, which governs non-arm's length transfers, and a new penalty for section 53 avoidance planning; amendments to the audit powers provision; and a new provision that allows the Minister to make an *ex parte* application for an order to collect a tax debt without having sent a notice of assessment if a judge agrees that receipt of the assessment would further jeopardize collection.

For further information on the implications of the draft legislation introducing the Pillar Two global minimum tax in Canada and the revised DST rules please contact any member of our National Tax Group.

Further reading

For further details on the OECD's two pillar approach and Canada's commitment to the pillars, please see the Osler Updates on:

- October 14, 2020 (Blueprint Reports on International Tax Reform – Pillar One and Pillar Two)
- Osler submission on the OECD Pillar One and Pillar Two Blueprints, dated December 14, 2020
- October 12, 2021 (Statement on the Two-Pillar Solution)
- December 21, 2021 (Draft DST legislation)
- December 23, 2021 (GloBE Model Rules)

- December 22, 2022 (Transitional and Permanent Safe Harbours, Temporary Penalty Relief and two consultation papers on the GloBE Information Returns and certainty for the GloBE matters)
- February 7, 2023 (Administrative Guidance)
- March 28, 2023 (Budget 2023 update on Pillar One and Pillar Two)
- July 14, 2023 (Subject-to-tax-rule and Canada's position on DST moratorium extension)