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OECD proposes significant international tax changes that will impact multinationals

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Authors: Patrick Marley, Taylor Cao, Kaitlin Gray

In this Update

- Earlier in 2019, the OECD published its *Programme of Work* [PDF] *to Develop a Consensus Solution to the Tax Challenges Arising from the Digitalization of the Economy* (Program of Work)
- This Program of Work contained two principal measures: Pillar One, which would allocate additional taxing rights to market jurisdictions, and Pillar Two, which would introduce a global minimum tax to prevent the shifting of profits to low-tax jurisdictions
- On October 9, 2019, the Secretariat of the OECD released a proposal for a "Unified Approach" under Pillar One (Consultation Document)
- Details of Pillar One and Pillar Two and next steps for implementation

Background

Earlier this year the OECD published its *Programme of Work to Develop a Consensus Solution to the Tax Challenges Arising from the Digitalization of the Economy* (Program of Work). This Program of Work was intended to lead to a global consensus on revisions to the international tax system in an effort to prevent countries from imposing unilateral measures to tax the income of multinationals (particularly those operating highly digitized businesses).

The OECD's Program of Work contained two principal measures: Pillar One, which would allocate additional taxing rights to market jurisdictions (such as by revising the "permanent establishment" nexus for establishing source country taxing rights and revising the "arm's length" standard for allocating profits), and Pillar Two, which would introduce a global minimum tax to prevent the shifting of profits to low-tax jurisdictions. This Program of Work was endorsed by Canada and other G20 countries, noting that they will "redouble our efforts for a consensus-based solution with a final report by 2020." See our previous Update on the Program of Work ("Impact of recent international tax developments on Canada").

The Program of Work on Pillar One was originally focused on highly digitized businesses, and explored three separate proposals based on "user participation," "marketing intangibles," and "significant economic presence." However, following consultations it appears that a consensus was unlikely to form under any of the three proposals (particularly since they appeared to disproportionately impact U.S.-based multinationals operating highly digitized businesses).

On October 9, 2019, the Secretariat of the OECD released a proposal for a "Unified Approach" under Pillar One (Consultation Document), with comments from stakeholders due November 12, 2019. The OECD hopes that a global consensus will be reached on this new Unified Approach for taxing large consumer-facing multinational enterprises (including highly digitized and traditional businesses). If adopted globally, the proposal will mark a significant departure from the manner in which income is currently allocated between jurisdictions. The proposal will allocate a portion of a multinational's income to market jurisdictions on a formulaic basis – regardless of whether the multinational maintains a physical presence or "permanent establishment" in the jurisdiction, and regardless of whether the allocated income exceeds an "arm's length" return having regard to the functions, assets and risks located in the jurisdiction. While the OECD intends to keep this new approach as simple as possible, with proposed dispute resolution mechanics, it will undoubtedly lead to increased complexity – and many significant details remain outstanding. The OECD also proposes to release further details on a separate global minimum tax as part of its proposed its Global Anti-Base Eroding (GLoBE) rules under Pillar Two in November.

Pillar One proposals – Unified Approach

The Pillar One proposals are intended to respond to a number of unilateral tax measures adopted by various countries that are targeted at non-resident multinational corporations (particularly those operating highly digitized business models – many of which are based in the United States). For example, earlier this year, France approved a 3% tax on revenue generated by companies from certain digital businesses, if such companies supplied €750 million of taxable digital services worldwide and €25 million of taxable digital services in France. The Liberal Party of Canada recently announced that, if re-elected, it would "replicate the proposed digital services tax announced by the French government" by introducing a new 3% value-added tax on the income of businesses engaged in targeted advertising and digital intermediation services, if they have worldwide revenues of at least C$1 billion and Canadian revenues of more than C$40 million. The Conservative Party (the principal rival to the Liberal Party in Canada's federal election to be held on October 21) has also made statements that such multinational companies should "pay their fair share" of Canadian tax, although they have not proposed any specific related tax measures. The introduction of Pillar One proposals is in part intended to reach a global consensus that would prevent the need for countries to enact unilateral tax regimes targeting the income of multinationals.

A prior public consultation document on the Program of Work (released on February 13, 2019) had explored three separate proposals under Pillar One, all of which would reallocate taxing rights in favour of user/market jurisdictions:

- The "user participation" proposal, which would target social media platforms, search engines, and online marketplaces by focusing on the value created by such highly digitalized businesses through developing an active and engaged user base.
- The "marketing intangibles" proposal, which would have a broader scope of application than the user participation model by targeting all industries and not only highly digitalized business models, and would allocate marketing intangibles to market jurisdictions, together with a proportionate share of non-routine profits.
- The "significant economic presence" proposal, which effectively establishes a taxable presence or a virtual permanent establishment where revenues are generated in a jurisdiction on a sustained basis combined with other factors suggesting a significant economic presence, such as a large user base and billing and collection in local currency, among others. Unlike the user participation and marketing intangibles proposals, the

significant economic presence proposal targets all profits realized by a multinational group, and is not restricted to the reallocation of non-routine profits.

For more information on the proposals described above, see our previous Osler Update on this issue and our submission to the OECD (March 7, 2019 Osler submission to OECD on Public Consultation Document Addressing the Tax Challenges of the Digitalisation of the Economy).

In releasing the "Unified Approach," the OECD appears to have acknowledged that none of the three prior proposals were likely to form a consensus view. In order to encourage consensus, the "Unified Approach" incorporates aspects of each of the three prior proposals by introducing a unified approach relating to scope, nexus, and profit allocation. Each aspect of the Unified Approach is described below, although many details remain outstanding, including with respect to administration, enforcement, dispute resolution, and the elimination of double taxation. (For a complete list of questions included in the Consultation Document, see pages 17-18 of the Consultation Document).

Scope – The "Unified Approach" would apply Pillar One proposals to large consumer-facing businesses, broadly defined in the Consultation Document 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. There may be carve-outs for certain sectors (such as extractive industries, commodities and possibly financial services). In order to further clarify the scope of the Pillar One proposals, the Consultation Document requests comments on the following issues:

- How should consumer-facing businesses be identified? What types of business models should be included (e.g., should sales to intermediaries be considered)? How should a multinational enterprise group be defined?
- What carve-outs should be formulated? The Unified Approach assumes that extractive industries will be carved out, and also raised the possibility of a carve-out for financial services.
- How should the scope of a multinational enterprise be defined? What is the appropriate size threshold to determine whether an enterprise is subject to the Pillar One proposals (e.g., the €750-million revenue threshold used for country-by-country reporting requirements)?

New nexus rule for taxpayers in scope – The "Unified Approach" introduces a new nexus rule for businesses in scope that does not depend on physical presence in the user/market jurisdiction. Instead, nexus will be determined based on a revenue threshold (which can vary based on the size of the market), which is assumed to indicate sustained and significant involvement in the user/market jurisdiction. The revenue threshold may be combined with a time threshold, and other activities (such as online advertising targeted at a jurisdiction) may also be relevant. This new nexus rule would be introduced through a standalone rule – layered on top of the existing permanent establishment rule – to minimize spillover effects. The Consultation Document requests comment on the following issues relating to nexus:

- How should country-specific sales thresholds be defined and applied?
- How should a sales threshold be calibrated to ensure that jurisdictions with smaller economies can also benefit from Pillar One proposals?

New and revised profit allocation rule for taxpayers in scope – The "Unified Approach" creates a new profit allocation rule for businesses in scope that goes beyond the arm's length principle. The proposal begins with identifying a multinational group's profits, which may be based on consolidated financial statements and may be separated on a business line and/or

regional/market basis. An appropriate return for routine activities (which may be based on fixed percentages) is excluded from overall profit, and the remainder is deemed to be non-routine profits, a portion of which will be allocated amongst different eligible market jurisdictions based on variables such as sales.

Under the "Unified Approach," a market jurisdiction may be entitled to tax the following three types of amounts:

- **Amount A**: The portion of deemed residual profit (i.e., a group's overall profit less a return for routine activities) that is allocated to a market jurisdiction.
- **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.
- **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 arm's length principle, which should not duplicate Amount A above.

The open issues regarding profit allocation include the following, some of which are included as questions in the Consultation Document:

- How should a multinational group's profit be calculated? If profit is calculated based on consolidated financial statements, what standard adjustments should be made? How should profit be split between business lines? Should regional profitability be considered?
- What portion of deemed residual profit should be allocated to market jurisdictions? How should such percentage be determined?
- What is the best approach to eliminating double taxation, particularly with respect to the interaction between Amount A and Amount C?
- Which activities qualify for a fixed return, and how should the quantum of the fixed return be determined? Should the quantum of the fixed return vary based on industry and/or region?
- What is the best way to ensure enforcement and compliance for collecting tax without a physical presence? Consideration is being given to the possible use of withholding taxes for countries to collect tax on income allocated under Amount A.

Dispute resolution — While the OECD appears committed to ensuring that the "Unified Approach" does not result in double taxation, there are a number of remaining issues (including those that we identified in our submission of March 7, 2019), which highlight the importance of effective dispute resolution procedures. These issues include:

- Differences in taxation periods and functional currencies between multinational group members (including across multiple jurisdictions and including having regard to minority investors).
- The manner in which losses are applied (the "Unified Approach" simply states that the new rules will apply to both profits and losses and that the OECD is considering a claw-back or "earn-out" mechanism for losses under Amount A, without specifying the applicable timing or manner in which profits and losses may be recognized across different entities and jurisdictions – particularly for countries like Canada that do not have a consolidated tax regime).
- The manner in which revenues and expenses are to be calculated and allocated across

jurisdictions (including with respect to both timing and quantum).

The proliferation of existing transfer pricing disputes could increase exponentially if the details surrounding the Unified Approach are not sufficiently clear and agreed to by all relevant jurisdictions. While the OECD has helpfully recognized the importance of robust dispute resolution procedures – their effectiveness will need to be reviewed once further details become available.

Pillar Two proposals

While Pillar One is intended to reallocate additional taxing rights to market jurisdictions, Pillar Two is intended to increase the amount of tax to be collected globally – partially making up for any lost tax revenue allocated to other jurisdictions. Proposals under Pillar Two seek to address unresolved BEPS issues through the development of both an income-inclusion rule (for residence countries) and an anti-base erosion rule (for source countries) to ensure that all multinational enterprises – regardless of whether they operate in the digital economy – pay a minimum level of tax. If implemented, both proposals are likely to result in significant changes to existing international tax rules in the *Income Tax Act* (ITA).

The income-inclusion rule 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 that is below a certain minimum rate. Such a rule would require significant changes to the existing "foreign affiliate" rules in the ITA. Under current rules, income earned by a "controlled foreign affiliate" of a Canadian taxpayer from an active business carried on in a treaty jurisdiction is generally exempt from current Canadian taxation at the shareholder level regardless of the applicable tax rate in the local country. Benefits provided under tax treaties for profits attributable to exempt foreign branches or derived from exempt foreign immovable property could also be subject to a "switch-over" rule, which would replace the exemption with a credit method where the relevant income was subject to a low effective rate of tax in the foreign jurisdiction.

The anti-base erosion rule would either deny a deduction or impose possible withholding tax on base eroding payments unless that payment was subject to tax at or above a specified minimum rate in the recipient jurisdiction. In addition, Pillar Two proposals include a "subject to tax" rule, 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. This rule would also require a significant change from existing rules, since the applicability of withholding tax under Part XIII of the ITA (and the availability of withholding tax exemptions under both the ITA and Canada's tax treaties) generally depend on the character of a payment and the relationship between the parties, rather than the rate at which a payment is taxed in the recipient jurisdiction. The availability of deductions for business expenses (including interest) is also not currently dependent on the rate of foreign tax imposed on the relevant payment.

Separately, the Liberal Party of Canada recently proposed to limit the amount of interest deducted by corporations to no more than 30% of its income before interest, taxes, depreciation and amortization (EBITDA) or the worldwide group ratio of interest expense to EBITDA, whichever is higher, if a corporation has net interest expense of more than $250,000. The Liberal Party has also proposed to limit hybrid debt mismatch arrangements. The interaction between Canada's existing rules (such as the thin capitalization rules that generally limit interest deductibility where a 1.5:1 debt to equity ratio is exceeded), these domestic proposals and the Pillar Two proposals will need to be reviewed carefully.

The most significant open issues with respect to Pillar Two proposals include the following items, which will likely be the subject of public consultation after further details on Pillar Two

are released in November:

- **Scope —** Will Pillar Two proposals apply to all multinational businesses? Will there be carveouts based on industry or revenue thresholds – perhaps matching the Scope of Pillar One?
- **Threshold** — Which set of rules should be used to compute the relevant tax base and the effective tax rate on income? Should the effective tax rate calculation be done on a country-by-country basis, or on a pooled basis by blending the income earned and taxes paid in all foreign jurisdictions?
- **Mitigating double-taxation** — How should the income-inclusion rule and the anti-base erosion rule be co-ordinated?

Next Steps

The Unified Approach will be considered by the G20 finance ministers on October 17, and the OECD has organized public consultations to be held on November 21 and 22. Assuming a consensus is reached at the G20, a further consensus on the Unified Approach will be sought in January 2020 from the 130+ countries comprising the OECD/G20 Inclusive Framework on BEPS. The OECD then intends to complete its technical work on the Unified Approach (and Pillar Two) throughout 2020.

As a practical matter, the OECD's proposals will require significant changes to tax treaties and domestic law. We expect that the OECD will seek to implement the tax treaty changes through the Multilateral Instrument (MLI), which was developed to allow large numbers of tax treaties to be amended in an efficient manner. The MLI has been ratified by Canada and over 30 other countries (but has not yet been signed by the United States). Of course, since the Unified Approach is intended to prevent many of the unilateral measures which targeted U.S. multinationals operating highly digitized businesses – it will be important to confirm the timing and manner in which any proposes will ultimately be adopted by the United States. In particular, the OECD has stressed that simultaneous implementation will be needed to ensure a level playing field.

According to the OECD, the combined effect of Pillars One and Two will lead to a "significant increase in global tax revenues." As a result, the proposals are expected to adversely affect many multinational businesses. Multinationals (particularly those in digital-oriented and intangible-intensive sectors) should carefully review the Unified Approach to determine how the proposals may impact their businesses, including whether any sector exemptions or size limits may apply.

We will continue to monitor the progress of the OECD's proposals and other international tax developments that may be of interest to Canadians. For any questions on international or other tax matters contact any member of our National Tax Group.