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OECD releases consultation document on its Global Anti-Base Erosion Proposal

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In this Update

- On November 8, 2019, the OECD released a public consultation document (the Consultation Document) on its Global Anti-Base Erosion Proposal (GloBE)
- The OECD's *Programme of Work* [PDF] *to Develop a Consensus Solution to the Tax Challenges Arising from the Digitalization of the Economy* (Program of Work) contained two principal measures: Pillar One and Pillar Two
- Together these proposals under Pillar One and Pillar Two represent a fundamental overhaul of the entire international tax system
- Osler's comments on the Unified Approach under Pillar One were set out in a prior Update, and in our comments to the OECD in the link below
- The OECD Secretariat's GloBE proposal, which is the focus of this Update, was published under Pillar Two
- The GloBE proposal under Pillar Two contains four principal rules: an income inclusion rule, an undertaxed payments rule, a switch-over rule, and a subject to tax rule
- The OECD is seeking input on various issues under the GloBE proposal, including tax base determination, blending and possible carve-outs

Background

On November 8, 2019, the OECD released a public consultation document (the Consultation Document) on its Global Anti-Base Erosion Proposal (GloBE), which is intended to address certain perceived base erosion and profit shifting (BEPS) issues by introducing a co-ordinated set of new domestic rules and tax treaty changes that would result in a global minimum tax.

The OECD's *Programme of Work* [PDF] *to Develop a Consensus Solution to the Tax Challenges Arising from the Digitalization of the Economy* (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.

While Pillar One is intended to reallocate additional taxing rights to market jurisdictions,

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Pillar Two is intended to ensure that businesses which operate internationally are subject to a minimum rate of tax. Pillar Two will likely significantly increase the total amount of tax to be collected globally. Together, the proposals under Pillar One and Pillar Two represent a fundamental overhaul of the entire international tax system – and could significantly increase taxes and administrative costs of multinational enterprises – particularly those operating highly digitized business models.

In a previous Update ("OECD proposes significant international tax changes that will impact multinationals") we summarized the OECD's "Unified Approach" to Pillar One [PDF] – which is intended to allocate certain income of large consumer-facing businesses to market jurisdictions regardless of whether there is a physical presence in the jurisdiction. Osler made a submission [PDF] to the OECD in response to the proposal for a Unified Approach under Pillar One highlighting some of our concerns with the Unified Approach – including (i) the need for participating countries to agree to abandon any unilateral measures as a pre-condition to their participation in the Unified Approach; and (ii) practical issues and complexity arising under the Unified Approach which highlight the critical need for effective dispute resolution procedures.

The OECD Secretariat's GloBE proposal, which is the focus of this Update, was published under Pillar Two. The OECD has requested public comments on the GloBE proposal by December 2, 2019.

The OECD's Program of Work has been endorsed by Canada and other G20 countries. The OECD intends to develop recommendations on the core elements of the Program of Work at the beginning of 2020 and plans to deliver a final report by the end of 2020 (which is consistent with the timeline endorsed by the G20). See our previous Update on the Program of Work ("Impact of recent international tax developments on Canada").

GloBE proposal under Pillar Two

The OECD's GloBE proposal under Pillar Two calls for the development of the following rules:

- An income-inclusion rule, 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 that is below a certain minimum rate (which is to be set at a later date).
- An "undertaxed payments" rule (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.
- 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 where the profits attributable to a permanent establishment or derived from immovable property is subject to an effective tax rate below the minimum rate.
- 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.

If adopted, the GloBE proposal would require significant changes to both the *Income Tax Act* (the ITA) and Canada's tax treaties. More particularly, 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

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(the OECD proposes to reach a consensus view on the principal design elements of the proposal before establishing what the minimum rate would be). This proposal would require significant changes to the existing "foreign affiliate" rules in the ITA – effectively treating low-taxed foreign income (even if earned from an active business carried on in a treaty jurisdiction) as foreign accrual property income (FAPI) or denying access to the dividends received deduction under section 113 in respect of certain foreign affiliate distributions. By contrast, under the current rules, income earned by a "foreign affiliate" of a Canadian taxpayer from an active business carried on in a treaty jurisdiction (or a jurisdiction that has entered into a tax information exchange agreement with Canada) is generally exempt from current Canadian taxation at the level of a Canadian corporate shareholder regardless of the applicable tax rate in the local country.

In addition, the undertaxed payments 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. This 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 any withholding tax reduction or exemption under both the ITA and Canada's tax treaties) generally depends 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.

Tax base determination

The GloBE proposal requires taxpayers and tax authorities in multiple countries to reliably determine the effective tax rate that applies to the income of a multinational group or a foreign entity – in order to determine whether that effective tax rate is below the to be agreed-upon minimum threshold for purposes of each of the rules described above. The Consultation Document recognizes that a group's effective tax rate may be impacted by the calculation of the tax base, the applicable tax rate, and certain timing differences that may result in different countries reporting an amount of income in different periods. As a result, the OECD Secretariat has recommended the use of consistent standards to determine the group's income (i.e., the denominator in the calculation of effective tax rate). Since the GloBE proposal is intended to apply to multinational groups that are based in, or operate in, many different jurisdictions with different domestic tax regimes, using a consistent tax base is particularly important.

The Consultation Document suggests that financial accounting results could be used as a starting point to determine a common tax base, although a number of important issues remain to be resolved. In particular, the Consultation Document has requested comments on the following issues:

- To the extent that entities in different jurisdictions use different financial accounting standards, which standard should be applied? Should the accounting standard in the jurisdiction of the ultimate parent entity be used to determine the income of the whole group?
- Could the use of different accounting standards in different jurisdictions place some multinational groups at a competitive advantage or disadvantage compared to others?
- Are there any permanent differences between accounting income and taxable income that are common across different jurisdictions, and that therefore should be adjusted when computing the tax base for purposes of the GloBE proposal? If so, how should such

adjustments be made?

The determination of a common tax base under the GloBE proposal would involve a significantly different process than the computation of income under the ITA, since the ITA generally requires foreign income to be computed using Canadian tax rules – or in some cases foreign tax rules subject to certain modifications to better align with Canadian tax rules. Under the ITA, foreign income is not derived from any particular accounting standards.

In addition, the Consultation Document includes a number of proposals to address temporary differences between taxable income in a local jurisdiction and financial accounting income used to compute an effective tax rate under the GloBE proposal. Temporary differences may cause a taxpayer's effective tax rate (based on accounting income) in a particular period to vary significantly from the applicable statutory tax rate – which creates volatility and may result in additional tax under Pillar Two in circumstances where such tax may not be warranted.

The Consultation Document includes the following possible suggestions for dealing with temporary differences, and has asked for comments on the merits of these proposals:

1. Local tax paid in excess of the minimum tax rate in one year could be carried forward and applied in a subsequent year (when the local tax paid may otherwise fall below the minimum rate);
2. Tax paid under the GloBE proposal in one year could be refunded or credited against another tax liability when local tax paid in a subsequent year is in excess of the minimum tax rate;
3. Accounting losses could be carried forward to reduce accounting income earned in a subsequent period for purposes of determining effective tax rate;
4. Compute effective tax rate by using deferred tax accounting rules (where the numerator of the effective tax rate calculation is tax expense for accounting purposes, rather than actual tax paid);
5. Compute effective tax rate based on total taxes paid and total income of the relevant entities over a multi-year period ending on the current year.

Many of these options would require additional record keeping by taxpayers.

Blending

Another open question with respect to the GloBE proposal is the degree to which taxpayers will be allowed to mix low-tax and high-tax income earned within the same entity or group when determining the relevant effective tax rate.

The Consultation Document describes a potential "worldwide blending approach," where a multinational group can aggregate its total foreign income and total foreign tax on that income – and would only be subject to tax under the GloBE proposal to the extent that tax on the total foreign income was below the minimum rate.

Alternatively, the Consultation Document also notes that blending could be restricted to within each taxing jurisdiction (i.e., tax under the GloBE proposal could apply to the extent that tax paid on income in *any* jurisdiction was below the minimum rate), or within each legal entity (i.e., tax under the GloBE proposal could apply to the extent that tax paid by *any entity or branch* was below the minimum rate). A more restricted blending approach would likely result in higher tax burdens for multinational enterprises.

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The Consultation Document asked for feedback on the impact of a worldwide, jurisdictional, or entity blending approach on (i) compliance costs, (ii) economic effects, and (iii) volatility in effective tax rates.

Depending on the blending approach that is employed, overall profit of a multinational group may need to be assigned to different jurisdictions. Such allocation could be particularly complex in cases of branches or fiscally transparent entities (such as partnerships and certain hybrid entities that are fiscally transparent in one jurisdiction but not another). There is also a need to assign the overall tax burden of a multinational group to different jurisdictions, taking into account the fact that foreign jurisdictions may impose tax on income derived from other foreign jurisdictions (e.g., through a controlled foreign corporation regime). Note that under a worldwide blending approach, there would not be any need to allocate profit or tax burden between different *foreign* jurisdictions, which may result in lower compliance costs.

Possible carve-outs

The Consultation Document suggests there may be various carve-outs that will restrict the application of the GloBE proposal. Such carve-outs will be broader in scope than accounting adjustments made in determining the appropriate tax base, discussed above. In determining whether a carve-out will exist, issues surrounding tax policy and tax system neutrality will be considered, as well as the costs and complexities of compliance.

While there are no definitive carve-outs as of yet, the GLoBE proposal suggests the OECD is open to considering carve-outs for (i) regimes that are already compliant with the standards of BEPS Action 5 on harmful tax practices; (ii) a return on tangible assets; or (iii) related party transactions of controlled corporations that remain below a certain threshold. The Consultation Document has requested feedback on these possible carve-outs as well as certain others (such as potential size thresholds, *de minimis* thresholds, or potential exclusions for specific sectors or industries).

The Consultation Document recognizes that any carve-outs could apply on a qualitative, facts-and-circumstances basis, or on an objective and formulaic basis. Carve-outs applied on a qualitative or facts-and-circumstances basis may create uncertainty for taxpayers and increase compliance and administration costs. On the other hand, carve-outs applied on the basis of objective criteria may be simpler to apply, but could create significant costs for taxpayers wishing to fit within the carve-out – through the production and maintenance of required documentation to demonstrate that the carve-out ought to apply.

The Consultation Document also requests feedback on the preferred design of the carve-out system, taking into account factors such as simplicity, compliance costs, certainty, incentives, and behavioural impacts.

Conclusion on Pillar Two

The OECD Secretariat notes that implementation of the GloBE proposal under Pillar Two will require countries to agree on many complex issues relating to (i) the scope of the additional rules; (ii) the calculation of a common tax base; and (iii) the degree to which high-tax and low-tax income can be blended across different entities, jurisdictions, and taxation periods. The GloBE proposal is exceedingly complex. While the Consultation Document discusses some of the many practical difficulties that will arise, many others have yet to be addressed. In addition, it may be difficult for countries to reach a consensus on the many significant policy choices that will need to be made.

One of the alternatives considered would be to simply apply the new GloBE proposals to income earned in "harmful regimes" – which could match a list of jurisdictions or regimes identified by the OECD through its ongoing work under BEPS Action 5. This would be a significant improvement as it would reduce the requisite modifications to existing tax rules, and would not adversely impact many cross-border business activities. In addition, this approach would ensure that the administrative burden to determine which regimes should be subject to a new minimum tax rests with the OECD – rather than every taxpayer to which the GloBE proposal could otherwise apply. This could also allow greater flexibility for countries to adopt the new regime at different times in accordance with their own domestic legislative procedures.

The options being considered by the OECD each involve different tradeoffs between achieving the desired policy goal of discouraging base erosion and profit-shifting, and minimizing the burden of compliance and administration. Detailed proposals on these issues should be monitored closely by multinational enterprises.

As the GloBE proposals under Pillar Two could have a fundamental impact on the entire international tax system, multinational enterprises should let the OECD know of any concerns that they have during the consultation process. Osler intends to make a submission to the OECD on these proposals. Please contact any member of Osler's National Tax Group should you have any questions or comments on the GloBE proposal or any other tax matters.