OSLER

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International Co-operation and Tax Administrative Division
OECD Centre for Tax Policy and Administration

Dear Sirs/Mdms

Re: Global Anti-Base Erosion Proposal under Pillar Two

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 November 8, 2019 *Public Consultation Document - Global Anti-Base Erosion Proposal - Pillar Two* (the "**GloBE Proposal**"). Our comments on the GloBE Proposal are principally directed at a need to:

    (a) carefully define the scope of Pillar Two proposals such that they are focused on the intended policy objectives; and

    (b) ensure that the GloBE Proposal is designed in a coordinated manner that prevents double (or multiple) taxation and minimizes administrative complexity and compliance costs.

2. In our view, the OECD should consider the applicable tax rate under the GloBE Proposal simultaneously with its consideration of the applicable tax base and scope of the GloBE Proposal. In the event a strong consensus cannot be reached among a clear majority of stakeholders on each of these issues, the GloBE Proposal will likely result in international tax "chaos" – rather than providing a coordinated approach to prevent the shifting of profits to low-tax jurisdictions. Therefore, the GloBE Proposal should only proceed if a strong consensus

is reached on its scope, the applicable tax rate and tax base. It would not be appropriate for the OECD to proceed with such significant revisions to the international tax framework without a strong consensus from a clear majority of stakeholders on all key issues, as well as specific and well-developed proposals to prevent and resolve tax disputes and cases of double (or multiple) taxation.

3. Our comments in this submission are not limited to the specific questions asked by the OECD in its publication of the GloBE Proposal.

Background to the GloBE Proposal and Prior Comments

4. In its Report on Action 1 - *Addressing the Tax Challenges of the Digital Economy*, the OECD acknowledged that it would be difficult, if not impossible, to "ring-fence" the digital economy from the rest of the economy for tax purposes, further concluding that digitalisation presents no unique BEPS issues, but that some highly digitalised business models may exacerbate certain BEPS concerns.

5. On March 16, 2018, the OECD's Task Force on the Digital Economy ("**TFDE**") delivered an Interim Report on the *Tax Challenges Arising from Digitalisation*, and signalled that the OECD was looking at fundamental changes to the existing international tax framework in the context of the digital economy. On January 29, 2019, the OECD/G20 Inclusive Framework on BEPS issued a Policy Note that recognized that the proposals go beyond the arm's length principle and expand taxing rights in source or market jurisdictions where the business being taxed has no physical presence.

6. The Policy Note also indicated that this work would be expanded to two "pillars" that will form the basis of the OECD's final year of work in this area:

(a) **Pillar One** – taxing the digital economy, initially focussing on the allocation of taxing rights among countries through three separate proposals – user participation, marketing intangibles and significant economic presence; and

(b) **Pillar Two** – addressing unresolved BEPS issues (including the introduction of a minimum tax to prevent the shifting of profits to low-tax jurisdictions).

7. The OECD provided further details on the proposals in its February 13, 2019 *Public Consultation Document Addressing the Tax Challenges of the Digitalisation of the Economy* (the "**2019 Public Consultation Document**"). Osler responded to the 2019 Public Consultation Document on March 6, 2019 [PDF] (the "**March 2019 Comments**"). In the March 2019 Comments, our firm stressed that it was inappropriate for the OECD to address general unresolved BEPS issues by proposing fundamental changes to the arm's length standard and the permanent establishment threshold and advocating for a global minimum tax - in a discussion draft on the "digitalisation of the economy". We also stressed in the March 2019 Comments that the OECD should not proceed with the proposals under either pillar without a strong consensus from a clear majority of stakeholders, and that in order for the proposals to work effectively, countries must, as a minimum standard, agree to abandon any unilateral measures targeting similar activities that may have been proposed or adopted prior to the development of a consensus view. Examples of such unilateral measures include the United Kingdom's and Australia's Diverted Profits Tax, the GILTI (Global Intangible Low-taxed Income) and BEAT (Base Erosion and Anti-Abuse Tax) regimes in the United States, and the proposals for a digital services tax by the governments of France and the United Kingdom, among others.

8. On May 31, 2019, the OECD published its *Programme of Work to Develop a Consensus Solution to the Tax Challenges Arising from the Digitalisation of the Economy* ("**Program of Work**"), which followed the "two-pillar" approach set out in the Policy Note. The GloBE Proposal was released under Pillar Two of the Program of Work. The stated goal of the proposals under Pillar Two was to address unresolved BEPS issues through the development of inter-related rules to ensure that all multinational enterprises – regardless of whether they operate in the digital economy – pay a minimum level of tax.

9. The OECD has stated that it is seeking a coordinated approach to address the shifting of profits to low-tax jurisdictions to prevent the chaos that would arise from multiple countries adopting unilateral measures.[1] However, as discussed below, the OECD's current GloBE Proposal risks creating chaos by proposing multiple new tax rules without any indication of how competing claims by countries under these new rules should be resolved. As currently drafted, the GloBE Proposal may compound the resulting complexity for multinational enterprises and revenue authorities alike, and would inevitably and significantly increase tax disputes around the world.

10. On October 9, 2019, the OECD Secretariat released the *Public Consultation Document Secretariat Proposal for a "Unified Approach" under Pillar One* (the "**Unified Approach**"). Osler responded to the OECD's Unified Approach on November 11, 2019 [PDF]. In our submission, we identified the need for participating countries to agree to abandon any unilateral measures as a pre-condition to their participation in the Unified Approach under Pillar One. We also identified and discussed practical issues arising under the Unified Approach such as differences in tax base and the application of losses and highlighted the

[1] See the OECD's 2013 BEPS Action Plan at page 10.

importance of effective dispute resolution procedures. These comments apply equally to the GloBE Proposal.

The GloBE Proposal

11. The OECD's GloBE Proposal under Pillar Two calls for the development of:

    (a) 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);

    (b) 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;

    (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 effective tax rate below the minimum rate; and

    (d) 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.

12. The GloBE Proposal does not include a clear ordering mechanism between these competing rules, even though these rules could apply to the same payment.

Scope of the GloBE Proposal

13. The most significant open issue with respect to the GloBE Proposal is its intended scope of application. While Pillar One is intended to apply to "large consumer-facing businesses", the scope of Pillar Two thus far does not have any recognizable boundaries, although the GloBE Proposal does refer to the possibility of certain carveouts and thresholds.

14. As a threshold matter, we note that the GloBE Proposal has not attempted to define the fixed rate of minimum tax that will be applied under the proposal. In our view, discussions on the scope of the GloBE Proposal cannot be separated from discussions of the appropriate minimum rate of tax, since the minimum tax rate is itself an important scoping issue. A lower minimum rate automatically narrows the scope of the GloBE Proposal (since the proposal would apply to a smaller portion of income currently earned by multinational enterprises), while a high minimum rate necessarily broadens the scope of the GloBE Proposal. The required minimum tax rate will likely affect the positions of countries on other scoping issues (*e.g.*, carveouts) and technical issues (*e.g.*, blending) raised by the OECD. Therefore, it is important for the minimum tax rate to be established as soon as possible to ensure fairness and transparency for both countries and taxpayers. In our view, it is not appropriate for the OECD to defer discussion on the appropriate minimum rate until after other elements of the GloBE Proposal have been decided.

15. Separately, 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.

16. 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 of that jurisdiction. 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.[2]

17. 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.

18. The policy concerns articulated in the GloBE Proposal should only apply to passive or similar types of income which can be easily "shifted" between jurisdictions for tax reasons – and not

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[2] 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.

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 shareholder 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*.[3] Hence, a substance and activity-based exclusion from the GloBE Proposal is important.

19. 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 otherwise) – in the absence of adequate CFC regimes in the shareholder jurisdiction.

20. The policy concerns articulated in the GloBE Proposal also suggest that income derived from tangible or immovable property 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.

21. The OECD also identified its desire to avoid a "harmful race to the bottom" on corporate taxes as a policy objective. As part of its work on Action 5 – "Harmful Tax Practices", the OECD has already reviewed a significant number of tax regimes in different countries. In our view, to the extent that the GloBE Proposal is intended to discourage "harmful" tax competition through the shifting of profits to low-tax jurisdictions, the minimum tax should only apply to regimes found to be non-compliant with the standards of BEPS Action 5. Application of a

[3] As expressed in the Forewords in each of the BEPS Final Reports.

minimum tax more generally would be inconsistent with the OECD's own statement that its work (on harmful tax practices) is not about "dictating to any country what should be the appropriate level of tax rates".[4]

22. As part of BEPS Action 5, the Inclusive Framework agreed to a "substantial activities requirement" for "no or only nominal tax" jurisdictions requiring such tax regimes to have substantial activities to not be considered to have harmful tax practices. Most of the jurisdictions initially identified by the OECD's Forum on Harmful Tax Practices as being "no or only nominal tax" jurisdictions have implemented economic substance legislation to be in line with the substantial activities standard and are therefore not "harmful".[5] These changes, implemented through the domestic legislation of local jurisdictions, prevent taxpayers from engaging in operations that are purely tax-motivated and that involve no substantial activities in the jurisdiction. As currently drafted, the additional taxes under the GloBE Proposal would apply regardless of whether an entity carried on substantial activities in a "no or nominal tax" jurisdiction – which contradicts the policy choices involved in BEPS Action 5. The GloBE Proposal should be focused on low-tax income derived from activities without economic substance in the local recipient jurisdiction – which is the only type of income that could result in artificial profit-shifting.

23. Limiting the scope of the GloBE Proposal to regimes identified by the OECD as being harmful through its Action 5 review would also appropriately limit the significant administrative complexity that would arise under that proposal. Specifically, the burden would be on the

[4] 2015 Final Report on BEPS Action 5, "Harmful Tax Practices", at para 3.

[5] Substantial Activities in No or Only Nominal Tax Jurisdictions: Guidance for the Spontaneous Exchange of Information dated October 31, 2019.

OECD to identify particular regimes as being non-compliant. Income earned in those regimes would be subject to the minimum tax rules of the GloBE Proposal. Income earned in other regimes would be subject to ordinary tax principles – with no need to adopt controversial and complex procedures such as recomputing accounting income for global tax purposes.

24. When considering the scope of the GloBE Proposal, the OECD should also consider the characteristics of the entity earning the particular income (or making the particular payment). For example, entities such as pension funds, sovereign wealth funds and charities that may be domiciled in a "high tax" jurisdiction may not be taxable in that jurisdiction having regard to public policy or other considerations. The OECD has decided on other occasions that international tax measures intended to prevent tax avoidance/minimization have to be designed and interpreted with a view to not prejudicing such entities.[6] It will be important to ensure that income earned (or payments made) by such tax-exempt entities is excluded from the GloBE Proposal, particularly the minimum tax requirements of the proposal. For example, if a pension fund in Country A holds interest-bearing bonds issued by a corporation

[6] For example, while Article 4 of the OECD Model Tax Convention is drafted in such a way as to disallow treaty benefits to persons that are not liable to comprehensive taxation in the purported residence state, the Commentaries on Article 4 take a deliberately nuanced approach to pension funds: "8.6. Paragraph 1 also refers expressly to a "recognised pension fund". Most member countries have long considered that a pension fund established in a Contracting State is a resident of that State regardless of the fact that it may benefit from a limited or complete exemption from taxation in that State. Until 2017, that view was reflected in the previous version of paragraph 8.6, which referred to "pension funds, charities and other organisations" as entities that most States viewed as residents. Paragraph 1 of the Article 4 was modified in 2017 to remove any doubt about the fact that a pension fund that meets the definition of "recognised pension fund" in paragraph 1 of Article 3 constitutes a resident of the Contracting State in which it is established." Far from being a vestige of an earlier more lenient era of tax rulemaking, these changes to the OECD Model Tax Convention and related Commentaries flowed directly from the work done on BEPS by the OECD, as evidenced by the 2015 Action 6 Final Report, at p. 15: "Additional work will also ensure that a pension fund should be considered to be a resident of the State in which it is constituted regardless of whether that pension fund benefits from a limited or complete exemption from taxation in that State. This will be done through changes to the OECD Model Tax Convention, to be also finalised in the first part of 2016…".

actively engaged in business and resident in Country B, the fact that the pension fund is not taxable in Country A on the interest income should not make the interest non-deductible in Country B. If Country A would not deny a deduction to a domestic bond issuer making a similar payment to a Country A pension fund, it is not clear why Country B should do so. Separately, various entities (such as partnerships) may be treated as being fiscally transparent for income tax purposes in a particular jurisdiction. The GloBE Proposal should apply in a manner that takes into account the fact that income earned (or payments made) by fiscally transparent entities may be taxable (or deductible) in the hands of one or more other entities.

25. In summary, the policy concerns identified in the GloBE Proposal should apply only to a narrow subset of all profits earned by a subset of investors and businesses. That is, they should apply only to passive forms of income earned by large multinational corporations in circumstances where adequate CFC rules are not otherwise applicable. In addition, the GloBE Proposal should only 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. Specific exceptions should apply to income earned by tax exempt entities (such as pension funds and charities) – and the rules should appropriately take into account fiscally transparent entities.

Tax Base Calculation and Blending

26. Any application of 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 GloBE Proposal 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).

27. There are a number of practical issues in relation to calculating the tax base, which may be more difficult to resolve if the GloBE Proposal is given a wider application. For example, differences between accounting income and taxable income could be caused by:

    (a) Foreign exchange and inflationary adjustments to taxable income which may not be reflected in accounting income.

    (b) Certain financing costs that are deductible in computing income for tax purposes but not accounting purposes.[7]

    (c) Substance over form differences (*e.g.*, IFRS accounting standards generally follow economic substance while the tax rules of many jurisdictions (including Canada) generally respect legal form).

    (d) The use of tax losses that are realized prior to the GloBE Proposal being effective.

[7] See, for example, paragraph 20(1)(e) of the *Income Tax Act* (Canada).

(e) Equity accounting income inclusions, or changes that may arise, for example, when an entity enters or leaves a consolidated group.

(f) Mark-to-market inclusions.

(g) Income subject to different rates of tax or income not fully subject to tax (*e.g.*, 50% capital gain inclusion in Canada), and deductions that may be wholly or partly denied (*e.g.*, restriction in Canada on meals and entertainment expenses).

(h) Areas where financial accounting gives discretion to management to choose between one of several methods.

28. A precondition to the application of the GloBE Proposal should be an agreement by all countries to calculate the tax base (*i.e.*, the denominator) the same way when applying the proposal. However, a wider application of the GloBE Proposal over income earned in, and taxpayers operating in, a greater number of countries is likely to compound these complexities, making agreement over such technical issues more difficult.

29. When determining whether any subset of income earned by a multinational group is taxed at a sufficiently high tax rate, blending should be allowed between all income subject to the GloBE Proposal, although we expect that the practical differences between the blending approaches discussed in the GloBE Proposal will be reduced if the scope of the GloBE Proposal is appropriately focused (as discussed above).

Dispute Resolution and Mitigating Double-Tax

30. While the OECD appears committed to ensuring that the GloBE Proposal under Pillar Two does not result in double taxation, there are a number of remaining issues, which highlight

the importance of developing and agreeing on a detailed set of rules for the application of the GloBE Proposal and effective dispute resolution procedures.

31. In our view, if the GloBE Proposal were to move forward, much more work would need to be done to prevent instances of double taxation. For example, under the current proposal, as a result of a single payment that is not considered to be taxed at a sufficiently high rate:

    (a) The income inclusion rule could apply to impose additional tax liability on the parent entity in Jurisdiction A;

    (b) The undertaxed payments rule could apply to impose additional tax liability on the payor entity in Jurisdiction B; and

    (c) The subject-to-tax rule could apply to impose additional tax liability in Jurisdiction B (in the form of non-resident withholding tax) on the payee entity (which is resident in Jurisdiction C).

32. The implementation of a minimum tax across multiple jurisdictions through an income inclusion rule, an undertaxed payments rule, a switch-over rule, and a subject to tax rule without a well-defined set of priority or ordering rules can only lead to more disputes and the potential for double or multiple taxation. A clear set of ordering rules is required to determine priority between the competing tax claims of source jurisdictions (under the undertaxed payments and subject to tax rules) and the shareholder/residence jurisdictions (under the income inclusion and switch-over rules).

33. A detailed ordering rule is also important for reasons of transparency – since it will allow countries to more accurately evaluate the extent to which they will benefit from (or be harmed by) the GloBE Proposal before agreeing to any such proposal.

34. In addition, the “effective tax rate” calculation should not just take into account the effective tax rate imposed locally but should also include any taxation imposed on related income by third countries (*e.g.*, under an applicable CFC regime such as Canada’s FAPI rules), with the result that if the shareholder jurisdiction already has an applicable CFC rule, there should be no additional tax under the GloBE Proposal.

35. We anticipate that there will likely be interpretive disputes on any 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. In addition to the need for detailed priority rules, it will be equally important to implement effective dispute resolution procedures to prevent the chaos that could potentially otherwise arise.

36. While the Report on Action 14 *Dispute Resolution* readily admits the failure among the OECD and G20 countries 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*, the members of the OECD/G20 Inclusive Framework on BEPS should commit to effective dispute resolution procedures as part of any consensus on the GloBE Proposal.

37. We note that a narrower scope of application for the GloBE Proposal (as discussed above) may increase the probability of consensus over dispute resolution procedures – since the application of any agreed-upon bilateral or multilateral dispute resolution procedures would likely be more limited if the GloBE Proposal is applied more narrowly.

Conclusion

38. In order to achieve the OECD's objectives of discouraging artificial profit-shifting and harmful tax competition, the GloBE Proposal should focus its application on passive forms of income earned in jurisdictions which are not compliant with the standards of BEPS Action 5. Application of the GloBE Proposal to active business operations in countries that are compliant with the standards of BEPS Action 5 would not advance the policy objectives of the Program of Work and would likely significantly increase tax disputes and discourage cross-border business activities (since purely local businesses would not be subject to the GloBE Proposal). A broader application of the GloBE Proposal is also likely to compound the complexity of technical issues such as the computation of tax base and blending of income and issues relating to dispute resolution, making it more difficult for countries to reach agreement on these issues. An exception to the GloBE Proposal should apply for tax exempt entities (such as pension funds and charities).

39. The current articulation of the GloBE Proposal is also missing key pillars such as the proposed rate of minimum tax, and a clear set of ordering rules between the multiple "top-up" rules contained in the GloBE Proposal. These two issues can have a significant impact on the scope and architecture of the GloBE Proposal, and therefore cannot be separated from the other issues discussed in the GloBE Proposal. The OECD should release its proposals on these two issues as soon as possible. If a strong consensus cannot be reached among a clear majority of stakeholders on the scope of the proposals, relevant tax rate, clear ordering rules and effective dispute resolution procedures, the GloBE Proposal should not proceed (particularly on the aggressive timeframe currently proposed).

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