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International tax: A year of transition

In 2019, global efforts towards international tax reform – spearheaded by the G20 and the OECD – continued to move forward. Two developments in particular are expected to have a major impact in Canada.

First, on December 1, 2019, the Multilateral Instrument (MLI) entered into force in Canada. The MLI – formally the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting – makes significant amendments to many of Canada's bilateral tax treaties. Chief among these is the adoption of the OECD-agreed mandatory "minimum standards" on tax treaty abuse. Also significant is Canada's choice to opt into mandatory binding arbitration for tax treaty disputes.

Second, recent proposals from the OECD to alter the manner in which global profits are allocated among countries – "BEPS 2.0" – would expand the taxing rights of market jurisdictions (Pillar One) and impose a global minimum tax on multinational enterprises (Pillar Two). If adopted, these measures will fundamentally change Canada's existing international tax framework. These proposals are currently being reviewed by Canada and other members of the G20 and the OECD, as well as the more than 130 countries comprising the Inclusive Framework on BEPS.

Some countries have already adopted unilateral measures to impose new taxes on digital services providers without waiting for a broader consensus on the OECD's proposals. In Canada, the governing Liberal Party – re-elected with

a minority government in October 2019 – proposed a new 3% value-added tax on the income of businesses engaged in targeted advertising and digital intermediation services. This proposed new tax (included in the Liberal Party's election platform) would apply to such businesses with global revenues of at least C$1 billion and Canadian revenue of at least C$40 million, and would be eliminated once an international consensus is reached on the OECD's Pillar One proposals.

International tax treaties – Multilateral Instrument

The MLI entered into force in Canada on December 1, 2019 and operates to integrate tax treaty measures arising from the OECD/G20 BEPS Project with many of Canada's bilateral tax treaties. The MLI modifies a bilateral tax treaty where the MLI has been ratified by each treaty partner. A tax treaty to which the MLI applies is referred to as a "covered tax agreement." The coming-into-force provisions of the MLI are complex: the OECD's website features a "toolkit" – including a matching database – which assists in determining whether or not a bilateral tax treaty is a covered tax agreement, which provisions apply and when it comes into force. In Canada, the MLI will apply to covered tax agreements (a) on January 1, 2020 for withholding taxes, and (b) for other taxes (including capital gains taxes), for tax years beginning on or after June 1, 2020 (which for calendar year taxpayers would be January 1, 2021).

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Most significantly, the MLI adopts the OECD-agreed mandatory "minimum standards" on tax treaty abuse and international tax dispute resolution. In addition, Canada has chosen to opt into mandatory binding arbitration for tax treaty disputes, which has the potential to transform the manner in which Canada and its tax treaty partners resolve disputes about their rights to tax the profits of multinational enterprises.

The MLI contains two measures to address tax treaty abuse: (a) an amended tax treaty preamble which states that the affected treaty is intended to eliminate double taxation without creating opportunities for non-taxation or reduced taxation through tax evasion or avoidance; and (b) a broad anti-avoidance rule aimed at "tax treaty shopping," referred to as the "principal purpose test" (PPT). Under the PPT, a tax treaty benefit may be denied where it is reasonable to conclude that one of the principal purposes of an arrangement or transaction is to obtain the treaty benefit, unless granting the benefit would be in accordance with the object and purposes of the relevant provisions of the treaty.

In the tax treaty context, dispute resolution may be necessary where more than one country asserts a right to tax the same portion of a multinational enterprise's income. In order to avoid double taxation, the relevant tax authorities of each treaty country (called the "competent authorities") negotiate with a view to reaching an agreement about an appropriate allocation of taxing rights. The MLI includes a Mutual Agreement Procedure (MAP) that requires the competent authorities of each country to attempt to resolve certain disputes in a timely manner (within three years of being notified of the dispute).

Canada has chosen, under the MLI, to opt into the mandatory binding arbitration provisions. Canada has had similar mandatory binding arbitration in its tax treaty with the U.S. since 2008, which has proven successful in resolving cross-border tax disputes involving the U.S. Under the MLI regime, mandatory binding arbitration applies when a case remains unresolved through the MAP for a prescribed period of time. The default under this rule is "baseball-style" final offer arbitration: each country presents its position, and the arbitration panel – whose decision is binding and final – has to choose one or the other. Mandatory binding arbitration will apply where a bilateral tax treaty partner has also chosen to opt in; to date, tax treaty partners including Australia, Austria, Barbados, Belgium, Finland, France, Ireland, Italy, the Netherlands, New Zealand, Singapore and Spain have opted into mandatory binding arbitration under the MLI.

The MLI will not affect Canada's tax treaties with the U.S. (which has not signed the MLI), or Germany and Switzerland (with which Canada has announced bilateral treaty negotiations).

BEPS 2.0 – OECD Program of Work

In May 2019, 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). The Program of Work proposed sweeping changes consisting of two principal measures: (a) Pillar One, which allocates additional taxing rights to market jurisdictions (for example, by revising the "permanent establishment" nexus for establishing source country taxing rights and revising the "arm's length" standard for allocating profits), and (b) Pillar Two, which introduces a global minimum tax to prevent the shifting of profits to low-tax jurisdictions.

The Program of Work has been endorsed by Canada and other G20 countries. The OECD intends to recommend core elements of both pillars in early 2020, and plans to deliver a final report by the end of 2020, in accordance with the timeline endorsed by the G20.

Pillar One originally focused on highly digitized businesses, and explored three separate proposals based on "user participation," "marketing intangibles" and "significant economic presence." However, after consultations, it was apparent that a consensus on any of the three proposals was unlikely to be reached, particularly since they appeared to disproportionately impact U.S.-based multinational enterprises operating highly digitized businesses.

The OECD Secretariat released a proposal for a "Unified Approach" under Pillar One in October 2019. If adopted, the Unified Approach will introduce a revised profit allocation rule applicable to all multinational enterprises that are "in scope" based on a yet-to-be-determined revenue or other threshold, with potential carve-outs for certain sectors such as extractive industries, commodities and possibly financial services. The profit allocation rule adopts a taxation nexus to a jurisdiction that no longer depends on physical presence in the jurisdiction. A sufficient nexus will instead be determined based on revenue thresholds, which is assumed to indicate sustained and significant involvement in the market jurisdiction. For taxpayers in scope with a sufficient nexus to

particular jurisdiction(s), an appropriate return for routine activities will be excluded from overall profit. The remainder will be deemed to be non-routine profits, a portion of which will be allocated amongst different eligible market jurisdictions based on variables such as sales.

While Pillar One is intended to allocate new taxing rights to market jurisdictions based on a new nexus rule, Pillar Two is intended to ensure that businesses which operate internationally are subject to a minimum global rate of tax, thereby increasing the global tax collected on significant multinational enterprises. While some jurisdictions are expected to lose tax revenue under Pillar One because of the allocation of new taxing rights to market jurisdictions, they may recover such lost tax revenue under Pillar Two.

The OECD Secretariat released its Global Anti-Base Erosion ("GloBE") proposal under Pillar Two in November 2019. The GloBE proposal addresses unresolved BEPS issues through the development of a number of rules:

- An income-inclusion rule imposing current taxation on the income of a foreign-controlled entity (or foreign branch) that is subject to an effective tax rate below a certain minimum rate.
- An "undertaxed payments" rule for source countries which either denies a deduction or imposes a withholding tax on base eroding payments not subject to tax at a specified minimum rate in the recipient jurisdiction.
- A "switch-over" rule in bilateral tax treaties which permits the residence country to switch from an exemption system to a credit system where the profits attributable to a permanent establishment in the source country or derived from immovable property in the source country are subject to an effective rate below the minimum rate.
- A "subject-to-tax" rule ensuring that treaty benefits (particularly benefits applicable to interest and royalties) are granted only in circumstances where income is subject to tax at a minimum rate in the recipient jurisdiction.

If adopted, the OECD's GloBE proposal will require significant changes to Canada's bilateral tax treaties and to domestic rules relating to foreign affiliates and non-resident withholding tax.

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. We will continue to monitor the progress of the proposals in 2020 and detailed proposals on these issues should be monitored closely by multinational enterprises.

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