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US Developments May Raise Canadian Tax on US Owned Canadian Subs

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Next year's US elections or a Supreme Court decision in Moore v. United States may trigger unexpected Canadian tax consequences on certain Canadian subsidiaries of US MNEs, says Nathan Boidman of Davies Ward Phillips & Vineberg.

If Canada's Global Minimum Tax Act (the "**Draft Act**") — intended to bring Pillar 2 into Canada — is passed, next year's US elections or a forthcoming Supreme Court decision in *Moore v. the United States* may trigger a Canadian tax on Canadian subsidiaries of US multinational groups that have global revenue of at least €750 million on profits that have no nexus to Canada or to Canadian taxpayers.

Pillar Two, a plan to impose a tax rate of at least 15% on all multinationals that have an annual revenue of at least €750 million, was developed and promoted by the OECD, was agreed to by 137 countries (the Inclusive Framework, including Canada and the US) and has been surrounded by controversy and heated debate since its roll out (*See* OECD/G-20 Base Erosion and Profit Shifting Project, *Statement on a Two-Pillar Solution to Address the Tax Challenges Arising from the Digitalisation of the Economy* (Oct. 8, 2021); *Tax Challenges Arising from Digitalisation of the Economy — Global Anti-Base Erosion Model Rules (Pillar Two)* (Dec. 20, 2021)). Note that the same OECD agreement also adopted "Pillar One" to reallocate certain taxing rights respecting digital giants.

On that base and basis, on August 4, 2023, Canada issued a draft of the Draft Act to bring Pillar Two into domestic tax law. Pillar Two's basic notion is simple and reasonable, if not inadvisable. For example, a Canadian corporation that earns tax-free business profit through a tax haven subsidiary will be required to pay 15% of such profit to Canada (as a "minimum tax"). That basic notion would be labelled the Income Inclusion Rule ("**IIR**") (*See* Model Rules, Pts. 2-5; Draft Act, §14 et al.; Nathan Boidman, *Pillar Two: Effects on Canadian Multinationals*, 51 Tax Mgmt. Int'l J. No. 4 (Apr. 1, 2022); Nathan Boidman, *Pillar Two: Effects on Canadian Multinationals — Part 2*, 51 Tax Mgmt. Int'l J. No. 5 (May 6, 2022)). Naturally, these rules become complex (and at times convoluted and even uncomprehensable) where the chain of ownership is anything but straightforward or there is high tax investee jurisdiction that happens in a particular situation to raise an effective tax rate of under 15%.

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However, the “Under Taxed Profits Rule” (“**UTPR**”) leg of Pillar Two (previously labelled “Undertaxed Payment Rule”) is neither simple nor reasonable but rather is a (radical) part of the Pillar Two architecture because UTPR may raise a tax in Canada on profits that have no nexus to Canada or to Canadian taxpayers. The UPTR, explained below, is also provided for in the Model Rules (Parts 2 through 5) but was held back from the August Draft Act and is to be released soon. Essentially, in its quest for at least a 15% tax on all income of an in-scope multinational, the UTPR serves to bring a third country into the gang that potentially can tax — namely, the country of the parent entity and the country of a sister subsidiary that is added to the country of operations. .

That odd, indeed strange, result is examined herein in relation to how, when, and why that tax may be triggered, in respect of Canadian subsidiaries of US multinationals, either by next year’s US elections or a forthcoming US Supreme Court decision in *Moore v. United States* (53 F.4th 507 (9th Cir. 2022), *cert. granted*, 143 S. Ct. 2656 (2023)).

US Elections

It is quite unlikely that the US elections will trigger the Draft Act tax if the Democrats emerge with control of the White House and both houses of Congress BUT the election may well trigger that tax if the Republicans emerge with control of merely ONE of the three.

The following is a brief outline of this odd matter.

Under the UTPR that Canada will be adding to the Draft Act (based on the Model Rules), Canadian subsidiaries of certain foreign parent corporations will be required to pay Canada an amount (for this purpose, the “**UTPR Tax**”) determined by reference to the *non*–Canadian income of such *foreign* parent or foreign subsidiary of such parent if the parent and foreign subsidiaries thereof have not paid (in the aggregate *somewhere*) at least 15% tax on all their non-Canadian income. In other words, if the aggregate of the taxes paid in respect of the financial statement incomes of say the foreign sister corporation in its jurisdiction (under its base tax law or under Pillar Two promoted “domestic minimum top up tax”) or in the jurisdiction of the foreign parent (under its base tax law or Pillar Two related law) is under 15%, the deficiency would be assessed by Canada (alone or together with other countries), under its UTPR against the Canadian subsidiary. And that obligation, where it arises, will arise notwithstanding that the Canadian subsidiary has *no* interest, and *never* will have an interest in the profits (of the foreign parent and/or foreign sister corporation) on which it will arise.

The UTPR (and the basic IIR, explained above) can be examined and illustrated by working through the following simple scenario of assumed facts and law.

Assume a US corporation has global revenue of at least €750 million, (making it an “in-scope” corporation), has subsidiaries in Canada, the Cayman Islands, and Germany and pays at least 15% tax on the profits in the US, Canada, and Germany and zero tax in the Cayman Islands. Assume Cayman profit is $100 million and the US parent has paid 10.5% tax to the US on the $100 million (or $10.5 million) under the US “Global Intangible Low Taxed Income” (“**GILTI**”) rule — a passive income flow thru type rule extended to active business profits in 2017 by the Tax Cuts and Jobs Act (TCJA).

If the US had adopted Pillar Two, that would trigger an application by the US to the US parent of the basic IIR and a tax of $4.5 million. But at this point, there is no indication that Congress will agree to a Biden goal of enacting the IIR by increasing the GILTI rate to 15% (and making certain other changes to GILTI) so as to have US tax law conform with the Pillar Two plan (see above) that aims to see all in- scope groups pay at least 15% tax on all profits no matter where earned.

To reiterate this crucial point, if GILTII were made compliant with Pillar Two, the prime rule (the IIR) would in our illustration see the US parent pay $15 million to the US, not only $10.5 million, and there would be no tax claim arising in Canada under the new UTPR referred to above. But because under current US law only $10.5 million is paid, there is triggered the forthcoming Canadian UTPR and a similar UTPR in Germany (to which it is also committed).

The UTPR in both Canada and Germany (where the subsidiaries of the US parent are located) following the Model Rules would basically require that they would together levy an aggregate tax of $4.5 million (i.e., the shortfall in the US) on the two US-owned subsidiaries therein, even though they have no interest in the Cayman profits in respect of which the $4.5 million shortfall arises.

But those UTPR outcomes will most likely not arise (and neither the Canadian or German subsidiary will pay UTPR tax) if the Democrats sweep next year's elections because then: (1) the relevant US law will most likely be amended to conform with Pillar Two; (2) the US parent will pay to the US government the full 15% ($15 million) on the Cayman profit of $100 million; and (3) the Canadian and German UTPR will not be triggered.

Assuming, however, no such US elections sweep, consideration will have to be given to how the UTPR will actually apply and the issues that relevant Canadian subsidiaries will face. Because absent a democratic party sweep, it is unlikely the US will adopt Pillar Two raising the UTPR threat. That prospect has been clearly signaled by both various GOP letters to the administration and the September GOP visit to OECD in Paris and GOP retaliatory initiatives, discussed below (*See GOP Tax Committee Chair Blasts Global Deal During OECD Trip*, Bloomberg Daily Tax Rpt. (Sept. 1, 2023)).

The mechanics of identifying the $4.5 million shortfall and then determining its allocation between Canada and Germany, in our illustration, may raise unanticipated issues. On identifying the $4.5 million, that will require input from the US parent, but on our assumptions — that there will be no US legislation to adopt Pillar Two — that may be difficult to accomplish because it ordinarily would involve the US parent filing Pillar Two prescribed reports. But on our assumptions, no such reports will be filed. It is difficult to see how this potential impasse will play out unless something pressures the parent to simulate the relevant report to arrive at the group's full balance sheet debt, including its Canadian UTPR liability.

If the Model Rules are adopted, in order to allocate the $4.5 million (assuming it is determined) between Canada and Germany reference is required to the number of employees in each country and the value of their tangible assets. For example, if Canco has 66 employees and German sub has 34, and the FMV of Canco tangible assets is $6.6mm and those of German sub is $3.4 million, then Canco would be liable to pay to Canada 66% of the US shortfall of $4.5 million and German sub would be liable to pay to Germany 34% of $4.5 million. Pending seeing both final rules of application being prepared by OECD and draft legislation being prepared in Canada to implement UTPR, it is not certain exactly how the parties would deal, for example, with a claim by the Canada Revenue Agency (CRA) that the $6.6 million valuation of the Canadian tangible assets in the example above is too low so that a higher allocation of the $4.5 million should be made to Canco and Canada. And consider the further complexity involved if the German tax authorities not only disagreed with CRA but took a comparable view that the German tangible asset valuation of $3.4 million was too low.

To summarize the foregoing, if the Democrats do not sweep the November 2024 elections, it is most likely that the Republicans will block the adoption of Pillar Two with the result that Canadian subsidiaries of US groups with at least €750 million of annual revenue may be subject to a tax imposed by the Canadian government, under the UTPR leg of Pillar Two, on income earned outside Canada by the US parent or one of its non-Canadian subsidiaries, income in respect of which the Canadian subsidiary has no interest. But since the parties (the OECD and the Inclusive Framework) have agreed to postpone the adoption of UTPR in respect of a group whose parent is subject to a nominal 20% tax rate, (such as the US) until 2026, if the Democrats win the White House in 2024 and then sweep Congress in the November 2026 mid-term elections, Canadian subsidiaries of US groups may yet be spared Canadian tax under UTPR for most years.

Pending US Supreme Court Decision in Moore

But the foregoing isn't the only situation where a US development may trigger the Canadian UTPR tax on Canadian subsidiaries of US multinationals. In particular, the US Supreme Court has taken on a case under a narrow rule added to the Code by the 2017 TCJA that could be decided in a way that, *inter alia*, puts into question longstanding (and more recent) rules that attribute corporate income to its shareholders — a result that could trigger the Canadian UTPR tax. This involves the case of *Moore* v. *the United States* , in which permission to appeal to the US Supreme Court was granted on June 23, 2023 (*See Supreme Court May Opt for Narrow Ruling on Foreign Earnings Tax*, Bloomberg Daily Tax Rpt. (June 28, 2023)).

The situation is as follows:

Before TCJA, there was no US shareholder level tax on the undistributed active business profits of foreign corporations in which a US person had a shareholder interest. On a dividend distribution of such profits to US persons in respect of which the foreign corporation was a Controlled Foreign Corporation, there were two basic rules. For shareholders who were individuals, the amount of the dividend was included in ordinary income. No credit was given by the underlying foreign tax paid by the foreign corporation. For shareholders who were corporations, the inclusion in income was the amount of the dividend plus the underlying foreign tax and a credit was given for the latter.

The TCJA changed the foregoing in two fundamental ways. First, all US shareholders of a CFC became subject to some US tax on the CFC' s income, whether or not distributed, under GILTI, as discussed above. Second, US corporate shareholders, but not US individuals, became exempt from US tax on distributions. The latter new rule obviously required a special transitional tax when a US corp received pre-TCJA undistributed active business profits at a time that is after TCJA came into effect.

That transitional tax took the form of a rule in new Code §965 that imposed on the US shareholder a phased in tax of 10% or 15.5% on the undistributed income accumulated since 1987 up to December 31, 2017. While this seemed reasonable for corporate shareholders, it did not for individuals, given that they remained subject to US tax on CFC dividends.

This brings us to the upcoming Supreme Court case in *Moore* that involves an individual opposing §965. The decision of the lower court (upholding §965) was based on the notion that the Code can impose tax, even if there has been no receipt of what is being taxed. That is an age-old notion. It has been suggested that the only reason the Supreme Court has taken the case is that it wants to reconsider that basic notion and it is possible the Supreme Court will reject it and do so in a manner that puts into question any Code rule that attributes corporate income (*See Supreme Court May Opt for Narrow Ruling on Foreign Earnings Tax*, Bloomberg Daily Tax Rpt. (June 28, 2023)).

If Code rules put into question by *Moore* include GILTI and/or the Pillar Two income inclusion rule, the Canadian UTPR would apply to Canadian subsidiaries of in-scope US multinationals, regardless of the outcome of the election. Since the June filing in the Supreme Court, there have been countless reports of petitions to the Supreme Court supporting or opposing an eventual decision that strikes out the fundamental attribution notion. If the decision maintains attribution, there will be one less basis for US groups to be exposed to Canadian taxation of a Canadian subsidiary under the coming Canadian UTPR rules (*See, e.g., Tax Pros Fear High Court Will Go Too Far in Transition Tax Case*, Bloomberg Daily Tax Rpt. (Sept. 5, 2023).

Related GOP Retaliatory Initiatives

Finally, it is more than relevant that the Republicans in the House of Representatives (who control the House untill at least the end of 2024) not only oppose the adoption of Pillar Two— thus potentially triggering the forthcoming UTPR tax in Canada as explained above — but are seeking to dissuade countries like Canada from enacting UTPR by moving to retaliate against such countries.

In particular on May 25, 2023, the House tabled a bill (H.R. 3556) (which, at present, would be rejected by the Democratic party controlled Senate and Biden) that would increase the rate of US tax by 20% that otherwise would be paid by Canadians on US source income. (*See* Nathan Boidman and Peter Glicklich, *US Bill Attacking Foreign DSTs and UTPR Would Hit Canadians*, Tax Mgmt. Int'l J. (July 6, 2023); see also draft H.R. 4695 (July 18, 2023)). The bill would expand the Base Erosion and Anti-Abuse Tax (BEAT) in a way to increase tax on US subsidiaries of parents in countries imposing similar extra-territorial taxes.

Concluding Comments

Overall, these are challenging times for Canada-US relations, brought about by the Pillar Two Global 15% initiative that some consider totally ill-advised.

Finally, it should be noted that there have been reports that there may be impediments to Canada or other countries) imposing the UTPR (and perhaps even other legs of Pillar Two) based on potential conflicts with international investment agreements or basic notions of illegal expropriation of property (*See, e.g.*, Catherine Brown and Elizabeth Whitsitt *Implementing Pillar Two: Potential Conflicts with Investment Treaties*, 71 Canadian Tax J. 1, 189 -207 (2023); Blazej Kizniacki, *Pillar Two and International Investment Agreements*: *QDMTT Payable Seals an Internationally Wrongful Act*, 112 Tax Notes Int'l 159 (Oct. 9, 2023).