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UTPR: Harmful Effects in Canada?

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OVERVIEW

This commentary examines harmful effects the 136 country Pillar Two minimum tax project (see footnote 1) could have on Canadian workers and communities.

CONTEXT

Imagine the shock, indignation, and apprehension if a Canadian party were to receive a letter from the Canada Revenue Agency, purportedly based on some new Canadian antiavoidance tax laws, claiming taxes — perhaps in amounts that would bankrupt the party — owed by the party's father and a sibling to one or more other countries (and to be clear not to Canada) on income they derived from those other countries and in which the party contacted has absolutely no interest (either directly or indirectly).

The party probably would dismiss it as just another of the endless stream of fraudulent/scam communications received every day — that is, until a follow-up was sent by registered mail or other means that the party could no longer just dismiss.

And the party would then determine that the demand could be enforced against the party even if the party could not secure a binding undertaking from the father or sibling that they would reimburse the party.

ENTER PILLAR TWO

Well, that unthinkable situation must unfortunately now be directly transposed to the affairs of certain Canadian subsidiaries of U.S.- or other foreignbased multinationals and indirectly to employees of such Canadian subsidiaries and the local communities in which they operate as a result of a worldwide OECD-led crusade against the tax planning of multinationals that have at least EUR 750 million of gross revenue.[1]

What Is the Exact Problem?

A profitable corporation formed in and operating exclusively in Canada ("Canco") which has always incontrovertibly paid fully and timely every dollar of tax it owes on its profits, may receive from the Canada Revenue Agency a substantial tax bill not related to Canco's own profits (the tax on which all agree has been fully paid) but rather determined and calculated by reference to profits earned in a foreign country (say, Bermuda or the United States or both) by a corporation (say, "Bermco") owned by the same parent ("USco") that owns Canco or by the parent itself.

Canco's assets will be depleted — perhaps leading to layoffs of its Canadian employees or jettisoning of expansion plans or insolvency, etc. — by a tax bill related not to its own profits but rather to the profits of a Bermuda corporation which Canco does not own directly or indirectly, or to the profits of its parent USco. In either case, Canco has no interest in such foreign profits, yet may be made to pay tax on those foreign profits. This is totally different than Canco being assessed tax on income of a foreign subsidiary it owns

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[1] OECD/G20 Base Erosion and Profit Shifting Project, *Statement on a TwoPillar Solution to Address the Tax Challenges Arising from the Digitalisation of the Economy (October 8, 2021) and related Tax Challenges Arising from the Digitalisation of the Economy Global Anti-Base Erosion Model Rules (PillarTwo)* (Dec. 21, 2021).

under Canada's controlled foreign affiliate/foreign accrual property income rules,[2] akin to the U.S. CFC/ Subpart F rules or under the prime Pillar Two rule — the Income Inclusion Rule.

How Will This Problem Arise?

This will arise under new Canadian law, now being drafted, sponsored on October 8 of last year by Canada and 135 other countries — through the OECD (as Pillar Two 15% Minimum Tax) and touted by Canada's Department of Finance in its spring budget as fighting international tax avoidance and ending a ''race to the bottom'' tax competition between countries.[3]

But what international tax avoidance has Canco engaged in? NONE. What race to the bottom is Canada engaged in, with an average corporate tax rate of 27%? NONE.

Therefore, it is difficult to see any nexus between the purposes of Pillar Two and the affairs of Canco. That's because, viewed rationally, there is none. Only when the OECD's propaganda is stripped away and the devil in the details is examined does this illogical, inappropriate result come into focus.

The Underlying Factors?

There are three interrelated factors in the USco-Bermco-Canco illustration, above.

First, Pillar Two invites tax havens like Bermuda to impose a 15% tax on its companies owned by large multinationals. If it does, the saga ends. If it doesn't — on to factor two.

That (factor two) is the basic Pillar Two rule (the Income Inclusion Rule) that, absent the first factor (Bermuda levelling a 15% tax), the parent of Bermco — USco — should pay to the U.S. government 15% of the income of Bermco. But the United States has not adopted the Pillar Two rule — even though the Biden Administration favours it — because of opposition in Congress (namely from Democratic Senator Joe Manchin who vetoed it in the recent ''Inflation Reduction Act,'' as discussed in the Portman article cited in footnote 3).

The United States has a separate rule (the 2017-enacted Global Intangible Low-Taxed Income (GILTI) rule) which will impose a 10.5% U.S. tax on USco in respect of Bermco's income.[4] But that 10.5% falls short of the requirements of Pillar Two (it has paid only 10.5%[5] not 15%) and that brings us to the third and fatal factor of Pillar Two and the depletion of Canco.

That (third factor) is Pillar Two's bizarre notion — which is being legislatively adopted by Canada — that if a foreign corporation (here Bermco) that is the subsidiary of another foreign corporation (here USco) has earned income in its foreign country but between those two foreign countries a full 15% tax has not been paid, the shortfall (4.5% of Bermco's income — or perhaps greater per footnote 5) can be claimed against a third company (Canco) by the country where Canco is based just because Canco is owned by the parent (USco) of the foreign company (Bermco) that earned the foreign income.[6]

WHERE DOES THIS LEAVE THE CANADIAN PARTY?

This surreal and essentially untenable result will, upon enactment, be part of Canadian law and govern Canco, unless (1) Canco can successfully sue Canada for unlawfully expropriating or confiscating its property under the transparent guise of taxing Canco on phantom imaginary non-existent income or (2) Canco can invoke tax treaty protection.

The expropriation (confiscation) notion merits a bit of discussion. It stems from but is different from comments made by Dr. Catherine Anne Brown at a recent Canadian Tax Foundation seminar on Pillar Two respecting whether foreigninvestor rights under international investment agreements might be a basis for foreign investors to challenge Pillar Two.[7]

Here, the question is whether a domestic Canadian taxpayer has any right under Canadian domestic law to challenge the Canadian government for levying a tax under domestic law based on Pillar Two tax.

Dr. Brown looked at a foreign investor in Canada who claims, under an international investment agreement, that a Canadian tax law (here one related to Pillar Two) amounts to an indirect expropriation or confiscation of the investor's property. So this is dealing with a foreign party and an investment agreement and a claim against Canada. The focus here has no foreign

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[2] *See* §91 and §95(1) and (4) of Canada's *Income Tax Act*.

[3] See n. 1, above. For prior comments by this writer on Pillar Two, see Nathan Boidman, *Pillar Two: Effects on Canadian Multinationals*, 51 Tax Mgmt. Int'l J. No. 4 (Apr. 1, 2022); *Pillar Two: Effects on Canadian Multinationals — Part2*, 51 Tax Mgmt. Int'l J. No. 5 (May 6, 2022); *Senator Rob Portman's Inadvertent, Profound Criticism of OECD's 15% Global Minimum Tax*, 51 Tax Mgmt. Int'l J. No. 9 (Sept. 2, 2022).

[4] *See* I.R.C. §78, §250, §951A with regard to GILTI and related 80% foreign tax credit Iimitation.

[5] Worse yet, various key differences in the determination of the Pillar Two 15% and the GILTI 10.5% may increase the differential above 4.5%.

[6] See chapters 2 to 5 of the Model Rules (above, n.1).

[7] C. Brown and E. Whitsitt, ''Implementing Pillar Two: Potential Conflicts with Canada's Global Foreign Investment Policy Agreements (FIPAs),'' Can. Tax Found., Pillar Two Symposium (July 27, 2022, Ottawa).

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claimant nor an investment agreement, but only a potential Canadian claimant and Canadian domestic law — hypothetically a Canadian corporation being levied tax by Canada under the UTPR because its foreign parent owed topup tax but it had not adopted Pillar Two.

The objective would be to have UTPR overturned as an invalid expropriation, under Canadian laws (without regards to any international law or treaty). Arguably, this is expropriation or confiscation because the Canadian subsidiary has no direct or indirect interest in the income of its foreign parent or foreign subsidiary of its foreign parent in respect of which Canada is claiming a payment from Canco.

The statute under which Canada is making the UTPR claim may be called an income tax statute — but is it not a sham claim, because Canco has no interest and never will have an interest in the income on which the claim against Canco is based? Is it not pure expropriation or confiscation without compensation? Is Canco an innocent pawn in a massive hunt, orchestrated by OECD, for tax dollars?

Quite apart from any domestic law relief under the notion of expropriation is the question as o whether there is a tax treaty block. The notion[8] is that, in the hypothetical UTPR issue discussed herein, Canco could claim exemption under Article Vll of the Canada-U.S. Income Tax Treaty, which says ‘‘the business profits of a resident of [the United States] shall be taxable only in [the United States] unless the resident carries on business in [Canada] through a permanent establishment situated therein.’’

That would seem to say Canada cannot apply the UTPR here. But can Canada argue as follows?

First, the assessed party under the *Canadian Income Tax Act* is the Canadian sub of the U.S. parent (and is not the U.S. parent) and it is only that Canadian sub that can ask a Canadian court to use a provision of the Canada-U.S. treaty to override the operation of the *Income Tax Act*.

However, not only is it generally understood that a treaty to which Canada is a party cannot affect the manner in which Canada can tax its own residents (here the Canadian sub), but that notion is specifically confirmed by Article XXIX(2) of the Canada-U.S. treaty.

Second, a totally different argument is that Canada is not simply/merely adding the profits of the U.S. sub (measured under usual Canadian tax accounting rules) to the usual taxable income base of the Canadian sub and applying the usual corporate tax rates, but instead it is mechanically calculating against the Canadian sub a claim which in substance is totally weird and different (and gives very different results) from the usual claim and is simply not contemplated by the treaty.

Finally, the probability that, in our illustration, USco will make Canco whole does not reduce the inappropriateness of this aspect of the Pillar Two 15% minimum tax proposals, which elsewhere have been criticized as being against Canadian interests.

CONCLUDING COMMENTS

The issue discussed above is a significant part of the 180degree turn Canada is making from a 50year-old tax policy that sought by its design to foster Canada’s economy by encouraging, through tax measures, both outbound and inbound investment.

The imposition of Pillar Two taxes under either the prime Income Inclusion rule (referred to only briefly above) or the harmful UTPR discussed above is a far cry from the true and tested approaches adopted since the massive 1972 tax reform. This highlighted the essentially tax-free environment for outbound and the reasonably measured set of rules for inbound.

There is growing concern that this 180degree turn is simply not in Canada’s interest — whether for the reasons discussed above or otherwise.

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[8] *See, e.g.*, Jefferson VanderWolk. *Would GloBE Adoption by Europe’s Big Five Have a Domino Effect*, Daily Tax Rpt. (Oct. 5, 2022).

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