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US Bill Attacking Foreign DSTs and UTPR Would Hit Canadians

ANALYSIS

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Nathan Boidman and Peter Glicklich from Davies Ward Phillips & Vineberg LLP discuss H.R. 3665, proposed legislation introduced on May 25th in the GOP-controlled House of Representatives, that if adopted could impose retaliatory taxes (and possible future trade and other sanctions) on citizens and companies from countries that adopt the OECD-sponsored "Pillars."

This commentary describes a recent development — proposed legislation introduced on May 25th in the GOP-controlled House of Representatives (**"H.R. 3665**" or the "**Bill**") — that if adopted could impose retaliatory taxes (and possible future trade and other sanctions) on citizens and companies from countries that adopt the OECD-sponsored "Pillars." The Bill is called the "Defending American Jobs and Investment Act" and would add §899 to the Code and be entitled "Enforcement of Remedies Against Extraterritorial and Discriminatory Taxes." As described further below, the main focus of the proposed legislation is on Pillar Two involving the global 15% minimum tax and unilaterally imposed digital services taxes ("DSTs") related to Pillar One, described in the next paragraph.

Pillar One, at base, provides a creative, novel framework which, if adopted as a multijurisdictional consensus, would reallocate the jurisdiction to tax large multinational enterprises. It evolved from OECD work over the past 20 years, to reduce base erosion and profit shifting. Both Pillars have now been embraced by many affected countries (known collectively as the "Inclusive Framework"), but not by the United States. Yet the United States multinationals would appear to be the most affected by adoption and implementation of the Pillars and DSTs. This column reviews the 20-year odyssey of how we got here and how the Bill could change the dynamics of this process going forward.

Introduction

This odyssey began in 2013, with the OECD and G-20 agreeing to put together a plan to counter "Base Erosion and Profit Shifting" ("**BEPS**") by the world's largest multinationals, most of which were based in the United States and the EU, and especially focusing on those hard-to-tax operations within the digital sector/economy. The evolution of BEPS occurred in three phases: (1) the first phase that started in 2013 and ended in October 2015; (2) the second phase that lasted from October 2015 to October 8, 2021; and (3) the third phase that lasted from October 9, 2021, until introduction of H.R. 3665, the objective of which is to derail and undo a significant part of the prior developments.

From Inception to October 2015: The Feb 13 BEPS initiative saw the OECD, its member countries, and G-20 countries that were not part of OECD, adopt a plan in July 2013 of developing 15 approaches ("Actions") to countering BEPS.

The very first Action was to address how to reign in the prolific tax planning of the global digital giants. Ironically, however, the final 15 reports that were issued by the OECD some two and a three years later on October 5, 2015 (and subsequently approved by both the Finance ministers and Heads of state of the G- 20), made recommendations on all 15 **except** the first one dealing with the digital economy. Action on the approach for the digital economy was deferred for further study. But the report on Action one reached several conclusions, including the following: Chapter 9 of The Report "Addressing the Tax Challenges of the Digital Economy" (Action 1: 2015 Final Report), said any approach should respond to the following criteria: neutrality, efficiency, certainty and simplicity, effectiveness and fairness, flexibility and sustainability and proportionality. The Report also states that certain other BEPS Actions (number 3 (respecting CFCs), 7 (respecting permanent establishments) and 8 to 10 (respecting transfer pricing) "substantially address the BEPS issues previously identified with respect to the digital economy." One might wonder whether the criteria and conclusion reached in that Report makes adoption of the Pillars, or any other substantial changes addressing the digital economy, unnecessary. Elsewhere, however, in Chapter 10 (entitled "Summary of conclusions and next steps") the Report states that "Because the digital economy is increasingly becoming the economy itself, it would be difficult if not impossible to ring fence the digital economy from the rest of the economy for tax purposes" and stipulates "next steps " that bear no relationship to what later transpired.

From October 2015 to October 8, 2021: Following the first phase, the OECD-led group expanded to over 100 Countries (now operating under the banner of the Inclusive Framework) which worked through a plan to deal with not only the digital sector but with all large corporate multinational taxpayers in two distinct projects.

One project was labeled "Pillar One" and the other was labeled "Pillar Two". The two Pillars were politically accepted by the Inclusive Framework, and thus adopted in principle in an agreement among all 137 countries of the Inclusive Framework on October 8, 2021.

Pillar One. Pillar One would provide for taxation by "market countries" in which a covered group operated and generated at least $1 million in sales. Covered groups would include those with at least Euro 20

billion of revenue. Market countries collectively would share 25% of the excess profits of the multinational group. Excess profits would consist of the group's earnings over a 10% margin. In addition to its somewhat arbitrary rules, Pillar One represented a radical departure by abandoning the need for the group companies to have any traditional tax nexus — that is they need not be engaged in a local trade or business or have a permanent establishment — before being subject to tax in the place purchases occur. The consensus on Pillar One required countries to lay off imposing any digital services taxes as long as the affected countries also adopted Pillar One.

Pillar Two. Pillar Two would require that multinational corporate groups with annual revenue of at least €750 million pay at least a minimum tax of 15% on all of its worldwide profits. Some of the details of Pillar Two — of which there are many — are considered a bit further below.

Since October 8, 2021: *Development of Pillar 1 and Segue to H.R. 3665.* The OECD has been working towards a multilateral agreement to implement Pillar 1. Part of the process has been to have the participating countries agree to scrap any unilateral law to tax digital giants - that is, a DST on the value of digital services purchased by residents of the jurisdiction imposing the DST. In the United States, both Republicans and Democrats are concerned that U.S. mega groups will be hit by DST. For example, Canada has a 3% DST ready to come into effect on January 1, 2024 - with retroactive effect to 2022 if Pillar One is not implemented by January 1, 2024.

If enacted, H.R. 3665 would impose retaliatory taxes on Canadians, in the manner described below, on account of the DST.

Development of Pillar Two and Segue to Retaliatory Bill H.R. 3665. Starting with the issue on December 20, 2021 of "model rules" to be used by participating countries to implement Pillar Two, OECD has been working towards finalizing Pillar Two and its implementation by January 1, 2024. Under the first element of Pillar Two, the residence jurisdiction of each ultimate parent company is supposed to enact an "income inclusion rule" ("**IIR**") that requires the residence jurisdiction of the parent to be paying tax on the financial profits of each group member at a minimum rate of 15%. Each participating country will also enact a rule (the undertaxed profit rule ("**UTPR**")) under which it will collect tax not paid by a nonparticipating parent or on income of a sister company, if the foreign parent has not paid on such amounts under an IIR to its country of residence.

Assume for example, a U.S. multinational ("U.S. Parent") wholly owns subsidiaries in Canada ("Canco") and Bermuda ("Bermudaco") and has worldwide revenue over €750 million. Assume further that Canada levies a tax on Canco in excess of 15%, but Bermuda does not impose any income tax. Assume that Bermudaco earns $1,000 after Pillar Two and that the United States has not adopted Pillar Two. Assume that the U.S. parent applies GILTI (at a rate of 10.5%) to the earnings of Bermudaco GILTI does not constitute an IIR and is not levied at 15%. Therefore, the UTPR will be invoked. The Inclusive Framework should have some sympathy for the United States, which enacted GILTI before Pillar 2 was proposed. Legislative efforts in the United States to expand GILTI to be based

on book income and to include a per-country limitation, required under an IIR, failed in the last Congress. Since Canada has adopted Pillar Two, Canada will thus have to impose an additional tax of up to $150 on Canco, EVEN though Canco has absolutely no legal or economic interest in the $1,000 earned by its sister, Bermudaco, or in the net assets of Bermudaco. If GILTI is not an IIR, there is double taxation of the income (in the United States and Canada) as well. Administrative guidance issued by the OECD in February 2023 would appear to reduce the UTPR for taxes levied on CFC, but apply that tax to the income earning entity, which is Bermudaco in our example. So double tax would arise to Canco but at a reduced rate.
In other words, under UTPR, the U.S. group in our example will bear Canadian minimum tax of 15% on income in which the Canadian subsidiary has no interest (and never will have any interest), and in the worst case, GILTI tax will not be creditable there. The Republicans, but not the Democrats or the Biden Administration, think this is ridiculous, and on May 25 proposed H.R. 3665 to retaliate against Canada and similar countries that have adopted Pillar Two with its accompanying UTPR.

H.R. 3665

Overview: H.R. 3665, introduced in the House on May 25, 2023, would first require the IRS to evaluate and continue to monitor the laws of other countries to determine if they impose extraterritorial or discriminatory taxes (which we refer to as "offending taxes" imposed by an "offending jurisdiction"), described further below. Specifically, proposed §899(a) would require the Treasury Department to determine the countries that have either offending taxes and report that to two committees of the Senate and of the House (this is to be done 90 days after the Bill is enacted and every 180 days thereafter).
Furthermore, §899(b) would require the Treasury to engage each such country in discussion - to try to convince them not to apply such taxes to U.S. interests and advise them of the consequences under the Bill if they do.
Where such offending taxes are found, citizens or corporations of the offending jurisdiction would begin to be subject to additional U.S. income and withholding tax rates (which we call the "retaliatory tax rates") until the offending taxes imposed by the offending jurisdiction no longer apply.

When it applies, new Code §899 would at first increase U.S. tax by 5%, to the otherwise applicable rate on U.S. source passive income and effectively connected income of non-U.S. taxpayers. This added tax would continue to ratchet up by 5% per year (so that by the fourth year following the imposition of the retaliatory tax rates the added tax would be maxed out at an additional 20%). Withholding taxes would also rise by the same amounts. The resulting U.S. tax rates would eventually reach 50% on passive income of foreign persons, 41% on ECI of foreign corporation, and 40% or 57% on FIRPTA income of foreign individuals. Covered foreign persons would include citizens of offending jurisdictions who are not U.S. citizens or residents and non-U.S. corporations (other than 10% U.S.-owned corporations) formed there or subject to tax there.

While the Bill would not directly and immediately override treaties, the Bill provides that the Treasury Department

would have to "take into account" the offending taxes "in assessing whether to enter into a bilateral tax treaty or to participate in negotiations with respect to updating a bilateral tax treaty" with such nations. The Bill anticipates that Treasury would have to notify Congress within 30 days of beginning treaty negotiations and in that notice describe "the manner in which such [offending] taxes are being taken into account."

Offending taxes are broadly defined: an extraterritorial tax is one were imposed on a corporation by a foreign country and determined by reference to income or profits of another connected corporation (the latter would have to be connected through a chain of corporate ownership other than as a subsidiary; the ownership threshold for a chain is not specified). A discriminatory tax is also broadly defined to include (a) tax on foreign source income (that would not be taxed under the Code if the subject taxpayer were in the United States), (b) tax on gross income (not allowing for deductions), (c) tax imposed (in practice or by its terms) exclusively or predominantly on non-residents (due to revenue thresholds, exclusions for local taxpayers, or restrictions against the tax on residents providing comparable goods or services), or (d) tax not considered an income tax under the local laws of the imposing country (or outside the scope of a local income tax treaty).

As noted, imposition of the added U.S. tax would end when an offending jurisdiction repealed and no longer applied "any" offending taxes.

Analysis of Bill and Impact on Canadians: It seems clear that UTPR would be an extraterritorial tax under the Bill. Similarly, a DST would be a discriminatory tax. Indeed, the main focus of the Bill appears to be to describe adoption of the DST and UTPR (which the Canadian government and others have said they will adopt) of up to 15%.
Is it surprising that, under the Bill, the tax increases would not be restricted in scope to punishing foreign based multinationals but will also punish non-U.S. citizens investing in U.S. assets, even though foreign countries generally do not tax their citizens if they are non-residents. There are at least two points of interest here. First, Canada does not tax on a citizenship basis so that a Canadian citizen resident in a tax haven which has no treaty with the United States and who is under current law subject to 30% withholding taxes on U.S. source dividends will see that rate potentially increase to 50% under the Bill. Second, but on the other hand a third country citizen who is resident in Canada will not be affected by offensive Canadian taxes. And in a way conversely, a corporation formed in a tax haven but managed and controlled in Canada so as to be treated as a Canadian resident and therefore potentially eligible for benefits of the Canada-U.S. Treaty, probably would suffer no more than 15% U.S. tax on U.S. source dividends (on less than a 10% (voting)shareholder interest).

The Bill would potentially increase the tax rate, by up to 20 percentage points, on any Canadian citizen living in Canada or elsewhere who earns U.S. source passive income or FIRPTA income.

The design of the retaliatory tax surprisingly seems to favor foreign investors and foreign corporations holding interest in U.S. subsidiaries. This is because the Bill does NOT increase

taxes paid by U.S. corporations, (by CFCs or by any foreign corporation having a 10% U.S. shareholder) even if the U.S. corporation is ultimately owned by a foreign investor or foreign corporation.

In the above example, the Bill oddly would not result in immediate additional tax of the Canadian parent, or alleviate Canadian tax on the Canadian-based CFC. Thus, retaliatory taxes may not directly solve the problem of DSTs and UTPRs, only press jurisdictions adopting them by increasing taxes on their citizens (wherever resident) and corporations formed in or conducting a local business there.

The new law would not be very easily administered. For example, withholding agents would be expected to implement the new withholding tax rates, which would change over time and require keeping tabs on potentially affected investors and their citizenship(s).

Concluding Comments

The Bill reflects a novel approach to indirectly press other countries into dropping DSTs and UTPRs. While the former may be expected, the latter may not be realistic ("hasn't the horse already left the barn?" as they say). At best, the end result may be elimination of DSTs and a UTPR stalemate. Perhaps more likely is a delayed implementation of Pillar Two (by some nations) for a limited period of time. Ironically, this may give cover and help reduce resistance within the U.S. Congress to adoption of both Pillars.

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