Withholding Taxes—A Baseless Pillar One Issue

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Withholding Taxes—A Baseless Pillar One Issue

By Nathan Boidman2022-09-14T03:00:45000-04:00

Recent articles in the Bloomberg Daily Tax Report: International have discussed one of the more baseless of the plethora of issues raised by the political agreement, known as Pillar One, reached on Oct. 8, 2021 by 136 countries, to extend certain taxing rights to the “market countries” in which certain large multinationals do business.

The issue is whether pre-existing withholding taxes should continue to apply where the new taxing rights under Pillar One arise. The issue, and my contention that it lacks any credence, may be explained/illustrated by the following hypotheticals.

US/Ireland—Canada

Assume an Irish subsidiary of a US group that is in scope of Pillar One (entailing, inter alia, a group having at least 2 billion euros ($1.99 billion) of gross revenue) is selling products or providing services or licensing intangibles to Canadian end customers/users (without using a Canadian marketing subsidiary) and realizes gross revenue of $500 million and net profit of $250 million.

Assume—under pre Pillar One laws—the Irish subsidiary is either not liable to tax under Canadian domestic tax law or, if it is, it does not have a permanent establishment in Canada under the Canada–Ireland tax treaty. But also assume that the combination of certain aspects of the Canadian Income Tax Act (comprising Part XIII), and the terms of the Canada–Ireland treaty and the prevailing facts allow Canada to levy a withholding tax of 10% on $50 million of the $500 million gross revenue.

That amount of tax ($5 million) would comprise all the Canadian taxes that could be imposed under current laws. Presumably Ireland would tax all of the $250 million net profit at, say, 12.5% and allow a credit for the Canadian withholding tax.

Now assume Pillar One is enacted in both Canada and Ireland through a multilateral convention that overrides existing treaty permanent establishment limitations, and perhaps by amending Section 3 and/or Section 115 and/or Section 253 of the Canadian Income Tax Act.

The latter amendments would be required to give Canada the relevant taxing rights if, notwithstanding its business with Canadian customers/users, the Irish subsidiary is not considered or deemed under current Canadian law to be “carrying on business in Canada”. That actual or deemed status entails a number of discrete factors. Alternatively, it is possible these domestic law factors will be built into the multilateral convention.

The basic design of the Pillar One agreement would see Canada being entitled to tax 25% of the excess of the $250 million of net profit over 10% of the $500 million gross revenue (being 25% of $200 million) or $50 million, with the Canadian tax rate (including branch tax) being say 30% or $15 million of tax, before considering any Part XIII withholding tax.

There should be no application of the pre-existing $5 million of Canadian withholding tax in light of both logic and the scheme of Canadian tax law, in particular the Part XIII withholding tax rule that makes Part XIII inapplicable where the just noted net income taxation (Part I of the Canadian Income Tax Act) applies.

It is difficult to see Canada taking a contrary position and seeking to change its rules to impose the pre-existing $5 million tax. That would be irrational.

And yet that is exactly what developing countries are seeking, according to the Daily Tax Report article published Aug. 25. That report contrasts the position of BDI, a German industry group, and of Microsoft and Unilever, which decry the notion that there should be both the pre-existing withholding taxes and the new Pillar One allocations, with that of the Group of 24 developing countries, who support the idea.

EU/Ireland—US

It is important to note that the underlying scheme of the Canadian income tax law that would make continued withholding tax claims irrational if Pillar One comes into play is also seen in the US and most other countries.

Assume, for example, that the Irish subsidiary in the above hypothetical was owned by an EU in-scope Pillar One group and the market country was the US.

Under current laws, assume the Irish subsidiary either is not considered to earn income effectively connected to a US trade or business (under the Internal Revenue Code) or, if it is, it does not have a permanent establishment in the US under the Ireland–US tax treaty. Instead, assume that it is liable to US withholding tax under the combined provisions of the Internal Revenue Code and the treaty.

If Pillar One came into effect in the US and Ireland, the US could impose tax on the actual or deemed effectively connected income of the Irish subsidiary and the pre-existing withholding tax would undoubtedly, as in the Canadian hypothetical, fall away. As in the case of Canada, the Pillar One tax may require amendments of the Internal Revenue Code or relevant additions to the multilateral convention to provide the underlying domestic rules.

Conclusion

The foregoing indicates there is neither logic nor underlying tax systems to support the contention of the Group of 24 developing countries that where Pillar One is adopted there should be both the new market country taxing rights and the old market country withholding taxes.

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