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Canada

OECD Provides Pillar One and Pillar Two Update

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Large multinational enterprises (MNEs) should review the Organization for Economic Cooperation and Development's (OECD) latest publications related to its two-pillar approach to address tax challenges from the digitalization of the economy. In an update to its work on Pillar One, the OECD advises that it is proceeding with work on the Multilateral Convention (MLC) to implement "Amount A" and is seeking further feedback on the design of "Amount B". In addition, the OECD has released a model provision and commentary for the Subject to Tax Rule (STTR) under Pillar Two, a standard template for the "global anti-base erosion" (GloBE) Information Return and related administrative guidance, including two new safe harbours.

The OECD states that it currently expects the MLC to implement Amount A under Pillar One to be open for signature later in 2023 to enable it to come into force in 2025, while worldwide implementation of the Pillar Two rules is intended to be effective as early as 2024. MNEs should prepare for these upcoming changes by continuing to monitor developments and the timing of legislative proposals in the different jurisdictions in which they operate. In addition, affected MNEs should model the potential impacts of these complex changes and assess the potential financial reporting impact.

Background
The OECD first released details of the proposals under review to address challenges of tax and the digital economy in 2019 as part of its base erosion and profit shifting (BEPS) project. Generally, the OECD/G20 Inclusive Framework is working on the global implementation of tax proposals under two specific "pillars".

Pillar One focuses on the allocation of taxing rights, including nexus issues. MNEs with global revenue above €20 billion and profit before tax above 10% of revenue will be covered by the new rules under this Pillar, with 25% of profit above the 10% threshold (i.e., Amount A) to be reallocated to market jurisdictions. Pillar One also outlines a proposed approach to mandatory binding dispute prevention and resolution for Amount A. Pillar One also contemplates simplifying the application of the arm's length principle to in-country baseline marketing and distribution activities (Amount B), which would have a broader scope and would not be subject to the revenue and profitability thresholds applicable to Amount A. The OECD previously launched several consultations asking for public feedback on various aspects of Pillar One, including Amount B (see *TaxNewsNow*, "OECD Pillar One Work Continues with New Amount B Consultation").

Pillar Two focuses on ensuring large MNEs pay a minimum rate of tax. As part of this pillar, the OECD/G20 Inclusive Framework released model global minimum tax rules in December 2021. The release of the model rules followed the agreement of over 135 countries, including Canada, on several key aspects of the two-pillar framework, in a statement on October 8, 2021. Under these rules, MNEs with revenue above €750 million will be subject to a minimum 15% tax rate under Pillar Two. Since the release of the GloBE model rules, the OECD has also released additional guidance and launched several public consultations on various aspects of the implementation of the rules.

For details, see *TaxNewsFlash-Canada* 2023-05, "OECD Offers More Guidance on Pillar Two Tax Rules", *TaxNewsFlash-Canada* 2022-56, "OECD Asks for More Feedback on Pillar One and Two Specifics", *TaxNewsFlash-Canada* 2022-13, "OECD Pillar Two — KPMG Analysis Available Now", *TaxNewsFlash-Canada* 2022-12, "OECD Offers Guidance on Global Minimum Tax Rules" and *TaxNewsFlash-Canada* 2021-63, "OECD Releases Model Global Minimum Tax Rules".

Pillar One

Amount A

According to the OECD update, the Inclusive Framework is working to resolve issues raised by a few jurisdictions with the text for its MLC to implement Amount A. The OECD advises that it hopes to prepare the MLC for signature in the second half of 2023, to enable the convention to enter into force in 2025.

The OECD also notes that 138 of the in-scope jurisdictions subject to Pillar One have agreed to refrain from imposing new digital services tax (DST) or other similar measures before the earlier of December 31, 2024 or entry into force of the MLC to implement Amount A, provided certain progress has been made. Specifically, these jurisdictions agree not to impose new DSTs where at least 30 jurisdictions (accounting for at least 60% of the Ultimate Parent Entities (UPEs) of in-scope MNEs) sign the MLC before the end of 2023.

KPMG observation

It's important to note that Canada is not one of the 138 jurisdictions that has agreed to the delay of the implementation of a DST. Specifically, Canada has indicated that, although it fully supports the substance of the multilateral convention, it does not support the extended delay of the implementation of a DST absent any firm and binding multilateral timeline to implement Pillar One. It appears that Canada intends to implement the previously announced 3% DST effective January 1, 2024 if the MLC to implement Pillar One has not come into force by that date. The 2023 federal budget had noted that Finance would release revised draft legislation for the DST for comment prior to including the measures in a bill, but it has not released such revised measures to date. Under these proposals, businesses that earn revenue from certain digital services may be liable for the DST, applicable retroactively for certain revenues earned as of January 1, 2022. For details, see *TaxNewsFlash-Canada* 2023-17, "2023 Federal Budget Highlights" and *TaxNewsFlash-Canada* 2021-64, "Canada Lays Out Digital Tax Proposals for Businesses".

Amount B

The OECD is asking for additional input on certain technical aspects of Amount B of Pillar One, which is intended to provide a simplified and streamlined approach to the application of the arm's length principle to in-scope, in-country baseline marketing and distribution activities. Specifically, the OECD has released a consultation document that outlines the design elements of Amount B. In addition, it sets forth the actual margins that distributors would be expected to earn under Amount B which would allow potentially affected groups to have enough information to model out the expected impact of Amount B and compare to their existing transfer pricing policies. The OECD consultation is largely focused on scoping and price considerations, with shorter sections on exceptions where an internal comparable uncontrolled price is available, documentation, transitional issues and tax certainty. The OECD also requests feedback on the application of the framework to the wholesale distribution of digital goods, country uplifts within geographic markets, and the criteria to apply Amount B utilizing a local database in certain jurisdictions. The OECD consultation document notes that there are a number of open issues remaining and the proposal does not reflect the consensus view of the Inclusive Framework.

The OECD will accept input from stakeholders until September 1, 2023.

KPMG observation

Two alternative approaches, based on qualitative and quantitative criteria, have been proposed to define baseline distribution activities. There is disagreement between Inclusive Framework members on which alternative better fulfils the aims of Amount B. The two approaches can lead to potentially different outcomes which may decrease the extent of the reduction in compliance burden for businesses or tax controversy originally anticipated.

For the first time, businesses are able to see the actual Amount B return that has been proposed by the Inclusive Framework. Canadian taxpayers can prepare the empirical data and run the analysis for their baseline distribution activities to model out the expected impact and consider whether or not it aligns with their existing transfer pricing policies.

However, though progress has been made to provide a more developed approach to Amount B compared to the prior consultation document, a number of open items still remain and the ambitious timeline to finalize Amount B in January 2024 means that the September 1 deadline may be the last formal opportunity for stakeholders to provide comments.

Pillar Two

Subject to Tax Rule — Model provision and commentary

The OECD's STTR model provision and commentary outline the defined set of "intra-group'" payments to which the STTR applies. The STTR will enable developing countries to "tax back" affected intra-group income that is subject to low or no nominal taxation in the other jurisdiction, increasing the nominal tax rate to 9% on these payments.

The OECD advises that it intends to release a Multilateral Instrument and Explanatory Explanation to implement the STTR for signature starting October 2, 2023.

KPMG observation
The 2022 federal budget included a public consultation on implementing Pillar Two in Canada. In that consultation it was suggested that the STTR was "not expected to impact Canada" – presumably based on prevailing Canadian income tax rates. However, it is possible that the STTR could have application in respect of certain types of payments received by foreign subsidiaries located in lower-tax jurisdictions.

GloBE Information Return and further administrative guidance

The OECD released a standardized GloBE Information Return that is intended to facilitate compliance with the GloBE rules and their administration. The information return includes simplified reporting requirements that will form part of a centralized filing and exchange framework.

The OECD also released 90 pages of additional administrative GloBE guidance that includes two new safe harbors. One of the safe harbors is for jurisdictions that introduce a qualified domestic minimum top-up tax (QDMTT), if certain standards are met. The second safe harbor includes a transitional undertaxed profits rule (UTPR) safe harbor. Under this safe harbour, the UTPR top-up tax in the jurisdiction of a company's ultimate parent entity will be deemed to be zero if that jurisdiction has a corporate tax rate of at least 20%, for fiscal years commencing on or before December 31, 2025 and ending before December

31, 2026. This GloBE guidance also includes details on the currency conversion rules, the substance-based income exclusion, the QDMTT and the treatment of tax credits.

KPMG observation

Finance may turn to the OECD's new guidance as it continues work to enact the Pillar Two model rules in Canada. Although Finance has not yet released draft legislation to implement these rules, it launched a public consultation in 2022 on how the model GloBE rules and domestic minimum top-up tax could be implemented in Canada. KPMG in Canada made a submission to Finance as part of this consultation that included a discussion on the potential impact of these rules on the business community, as well as other related technical analysis. Following this consultation, Canada reaffirmed its commitment to enact Pillar Two in Canada in both the 2022 federal fall economic update and the 2023 federal budget. Most recently, Deputy Prime Minister and Minister of Finance, Chrystia Freeland issued a statement on July 12, 2023 confirming that Canada is moving ahead with legislation to implement the Pillar Two global minimum tax, with effect beginning at the end of 2023.

Large MNEs should consider whether they may be affected by the OECD's two-pillar approach. In particular, given the complexity of these rules and the timeline for implementation, MNEs should monitor developments and use appropriate assessment tools to model impacts and evaluate interdependencies to prevent double taxation or other inadvertent effects. As part of this assessment, MNEs will need to understand the relevant timelines and requirements of the various legislative and parliamentary processes in different jurisdictions and track when domestic laws will come into effect. MNEs should also consider how these new measures may interact with other international tax proposals in Canada such as new anti-hybrid rules and interest deductibility limitations.

Next steps

The OECD notes that technical work on the new MLC for Amount A under Pillar One continues, with a view to having the MLC open for signature in the second half of 2023, enabling it to enter into force in 2025. The OECD also notes that the Inclusive Framework plans to approve a final report on Amount B under Pillar One and incorporate any key content into the OECD Transfer Pricing Guidelines by January 2024. With respect to Pillar Two, the OECD plans to release the multilateral instrument implementing the STTR and have it open for signature starting October 2, 2023. The OECD further notes that it will incorporate the new administrative guidance into a revised version of the GloBe commentary that will be released later in 2023, alongside a revised set of detailed examples.

For further details, see the following reports prepared by KPMG tax professionals, "Administrative Guidance on the Global Anti-Base Erosion Model Rules (Pillar Two)", "Pillar

One: Amount B", "Pillar Two: Subject to Tax Rule", and "Pillar Two: GloBE Information Return".

Upcoming KPMG global webcast on July 26, 2023
KPMG in Canada invites you to attend "Understanding the OECD's July Outcome Statement and other BEPS 2.0 developments", a 1.25-hour webcast on July 26, 2023. During this webcast, leading global professionals will speak about the most recent developments on Pillar One and Pillar Two and the broader global landscape related to the introduction of the GloBE rules.

To register for this webcast, click here.

We can help

Your KPMG adviser can help you assess the effect of the OECD's proposals on your business and provide guidance on how this might impact you going forward.

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