Introducing a Global Minimum Tax (Pillar Two) in Canada: Some Knowns and Unknowns

Jinyan Li
Osgoode Hall Law School of York University, jli@osgoode.yorku.ca

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Jinyan Li

Professor and co-academic director of LLM Tax Programs, Osgoode Hall Law School, York University.

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Key words: Pillar Two; Global Minimum Tax; Multinational Enterprises; Base Erosion and Profit Shifting; International Tax; G20/OECD BEPS Inclusive Framework

Abstract

This paper provides a high-level overview of Pillar Two Global Minimum Tax in terms of its policy objectives, technical design and implications for Canada. After teasing out some significant known and unknown challenges, it offers some thoughts on whether, and if so, how and when Canada can proceed with implementation.

I. INTRODUCTION

Pillar Two is part of a political agreement reached by Canada and 136 other countries on October 8, 2021 to address tax challenges arising in a digitalizing economy.[1] It is a framework for countries to introduce a new global minimum tax (GMT) on large multinational enterprises (MNEs) in respect of their profits that are taxed below an effective tax rate (ETR) of 15% in any country. The GMT is to be imposed under domestic law that follows a common approach set forth in the model Global anti-Base Erosion (GloBE) rules developed by the OECD and approved by the G20/OECD BEPS Inclusive Framework (Model Rules).[2] The GMT can be charged under the IIR and/or UTPR in Model Rules.

Canada is committed to implementing Pillar Two as far as the GMT is concerned.[3] Since Canada launched a public consultation in the summer of 2022, other countries have taken measures. The United States (US) decided not to implement Pillar Two and adopted a unilateral corporate alternative minimum tax (CAMT).[4] The European Union (EU) members adopted a directive to implement Pillar Two.[5] Korea enacted implementation legislation.[6] Switzerland triggered a process for a mandatory referendum

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[1] OECD, Statement on a Two-Pillar Solution to Address the Tax Challenges Arising from the Digitalisation of the Economy by the Inclusive Framework, October 8, 2021 (the "October 2021 Statement" or "Global Political Agreement").

[2] OECD, *Tax Challenges Arising from the Digitalisation of the Economy – Global Anti-Base Erosion Model Rules (Pillar Two): Inclusive Framework on BEPS*, (Paris: OECD, 2021) (the "Model Rules"). For *Commentary to the Global Anti-Base Erosion Model Rules, Examples, Safe Harbours and Penalty Relief,* see https://www.oecd.org/tax/beps/tax-challenges-arising-from-the-digitalisation-of-the-economy-global-anti-base-erosion-model-rules-pillar-two.htm.

[3] Pillar Two framework includes three rules: IIR, UTPR and STTR (Subject-To-Tax-Rule). It also contemplates the introduction of domestic minimum top-up tax (DMTT). Budget 2022 indicates that STTR is unlikely relevant for Canada: Canada, Department of Finance, 2022 Budget, A Plan to Grow Our Economy and Make Life More Affordable, April 7, 2022, 210. The STTR allows a country to impose a higher rate of withholding tax than the treaty rate on certain base-erosion payments (including interest and royalties) made between related entities in cases where the payment is subject to tax at a nominal tax below 9% in the recipient's country. STTR is not discussed in this paper.

[4] See US Internal Revenue Code (IRC): section 951A, GILTI (Global Intangible Low-taxed Income, introduced under the Tax Cuts and Jobs Act of 2017, and section 55 – CAMT (Corporate Alternative Minimum Tax, introduced in the Inflation Reduction Act of 2022 (P.L. 117-169). GILTI would have been modified in certain respects (to apply on a jurisdiction-by-jurisdiction basis, to make it align better with the Pillar Two regime) under the failed *Build Back Better* bill. The CAMT is based on book income of a corporate group, which includes the income of the US parent and its controlled foreign companies (CFCs). The tax rate is 15%. This tax is offset by a credit for normal corporate income tax, foreign taxes and various US domestic credits. If the final amount of CAMT is higher than the regular US corporate income tax, then the CAMT is payable. For a discussion of GILTI or CAMT in the context of Pillar Two, see Reuven S. Avi-Yonah and Bret Wells, "Pillar 2 and the Corporate AMT", *Tax Notes Int'l*, Aug. 8, 2022, p.693; Jasper L. Cummings, Jr., "The 2022 Corporate AMT", *Tax Notes Federal,* Sept. 26, 2022, p.2005; Nadia C. Altenburg and Magadlena Schwarz, "Pillar 2, the Role of CFC Rules, and GILTI as a Qualified Income Inclusion Rule," *Tax Notes Int'l*, Jun. 14, 2021, p.1469; Mindy Herzfeld, "How Many Minimum Taxes Are Enough?" *Tax Notes Int'l*, Nov. 7, 2022, p. 647; and Mindy Herzfeld, "The Remade Corporate AMT Walks and Talks like a Duck", *Tax Notes Int'l,* Aug. 22, 2022, p. 869.

[5] Council of the European Union, "Council Directive on ensuring a global minimum level of taxation for multinational enterprise groups and large-scale domestic groups in the Union" (the "EU Directive"), Brussels, 25 November 2022 (OR.en), 8778/22, FISC 106, ECOFIN 396 was adopted unanimously by Member States. Member States have until December 31, 2023 to transpose the Directive into national legislation. The IIR will be applicable in EU Member States for fiscal years starting on or after December 31, 2023, and UTPR will apply for fiscal years starting on or after December 31, 2024.

[6] Korea, *International Tax Adjustment Act*, enforced on January 1, 2023, Law No.19191, Dec.31, 2022.

to amend the constitution in order to implement Pillar Two.[7] The United Kingdom (UK) released draft legislation and announced to enact it in the near future.[8] Australia and New Zealand had public consultations.[9] Japan,[10] Singapore[11] as well as Indonesia and India (rotating presidency of G20 in 2022 and 2023, respectively) expressed interest in implementation.[12] ATAF (African Tax Administration Forum) released a suggested approach for member countries to implement a domestic minimum top-up tax (DMTT).[13] It appears that a tipping point has been reached towards implementation.

Should Canada enact an GMT by implementing Pillar Two? If so, when and how? What other strategic responses should Canada consider? To help answer these questions, this paper and its companion papers published in this issue[14] and the following issue[15] of the Canadian Tax Journal provide some analysis, insights and observations.

The present paper provides an overview of Pillar Two through presenting and commenting on some key known and unknowns. The knowns include Pillar Two's nature, historical context, policy objectives and technical design, as well as key considerations and challenges in transposing the model rules into Canadian law. The unknowns range from big picture issues, such as impact on the Canadian economy and tax sovereignty to the specific "elephant in the room" issue – what to do with the American exceptionalism? Other unknowns are about behavioral responses of taxpayers, other countries and the United Nations. The paper concludes with some observations, including:

- Canada should proceed with caution as the impact on the tax system goes beyond what concerns with large MNEs;
- Consider peeling off the UTPR from Pillar Two;
- Consider reforming the outbound rules by making FAPI GILTI-shi and simplifying the foreign affiliate rules; and

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[7] On 16 December 2022, the Swiss Parliament approved the constitutional amendment to implement Pillar Two by incorporating the OECD Model Rules. Switzerland has triggered a process for amending the constitution to enable its implementation of Pillar Two and the constitutional amendment will be subject to a mandatory public referendum scheduled for June 2023. See Sarah Paez, "Switzerland Seeks Input on Temporary Pillar 2 Regulation", *Tax Notes Int'l,* Aug. 22, 2022, p.953.
[8] UK, Draft Legislation on Multinational Top-Up Tax, Explanatory Note are available at https://www.gov.uk/government/publications/introduction-of-the-new-multinational-top-up-tax.
[9] The Treasury, Australia, "Global Agreement on Corporate Taxation: Addressing the tax challenges arising from the digitalisation of the economy: Consultation Paper, October 2022; New Zealand Inland, "OECD Pillar Two: GloBE Rules for New Zealand: An Officials' Issues Paper", May 2022.
[10] Japan's Liberal Democratic Party and Komeito Party released 2023 tax reform proposals on December 16, 2022 to include the the IIR based on the Model Rules.
[11] Singapore Budget 2022, February 18, 2022 says that Singapore was to explore the implementation of Pillar Two.
[12] Nana Ama Sarfo, "Indonesia, India, the G-20, and the Direction of Tax Multilateralism," *Tax Notes Int'l,* Sept. 26, 2022, p.1466.
[13] ATAF Suggested Approach to Drafting Domestic Minimum Top-Up Tax Legislation, December 2022.
[14] For further, see Jinyan Li, Angelo Nikolakakis and Jean-Pierre Vidal, "Canadian QDMTT Challenges" in this issue of *CTJ;* Lyne Latulippe, Christine Ally and Julie S. Gosselin, "The Revised Case for IP Regimes under the Globe Rules – A Canadian Perspective", *(2023) CTJ* [**]. Catherine Brown and Elizabeth Whitsitt, "Implementing Pillar Two: Potential Conflicts with Investment Treaties", (*2023) CTJ* [**].
[15] Robin Boadway and Jean-Francois Tremblay, "The Implications of Pillar Two for Corporate Tax Reform", forthcoming in the CTJ; Mintz, xx, in the following issue of *CTJ on* Pillar 2 ("Mintz Pillar Two"); and Amin Mawani, "Tax Planning …".
[15] Freeland's interview on CBC, Oct.16, 2021.

- Introducing a qualified DMTT while revising the design of corporate tax incentives.

The paper builds on a vast body of literature on Pillar Two and draws insights from discussions at a symposium hosted by the Canadian Tax Foundation on July 27, 2022[16] and an academic round table organized by the author and Jean-Pierre Vidal on October 14, 2022.[17]

For ease of reference, this paper uses the following key terms: "GMT" refers to the top-up tax chargeable under the IIR or UTPR; "IIR" refers to rules in Articles 2.1 to 2.3 of the Model Rules and is a misnomer as it not an income inclusion rule; "UTPR" refers to the rules in Article 2.4-2.6 of the Model Rules and is also a misnomer as it is not connected to any under-taxed payments or profits of the taxpayer; UPE stands for "Ultimate Parent Entity"; "UPE Jurisdiction" refers to the jurisdiction in which an UPE is located; CE stands for Constituent Entity which is a member of an in-scope MNE group; "CE Jurisdiction" refers to the jurisdiction in which a CE is located.

II. PILLAR TWO's FOUNDATION, FUNCTION AND "FUNNY" CHARACTER

A. An Unprecedented Tax

The GMT is an unprecedented tax. It is created in a top-down manner: a global political agreement gives the blessing; the OECD Model Rules create the prototype; and participating countries give it life through legislation. The Pillar Two framework sees each MNE group as a single entity as opposed to a constellation of connected separate legal entities. It measures the acceptable level of taxation of the group's profits by a global standard that transcends national tax systems. It expects countries to self-regulate by adopting the standard. Comparing to existing corporate income taxes, the GMT has a different foundation, function and character.

B. Global Political Agreement

The October 2021 Statement is a historical political agreement. For the first time in history of international taxation, close to 140 jurisdictions agreed on how to coordinate the taxation of global profits of MNEs through national tax laws. Through taxing MNEs' profits at the minimum global level, the agreement reallocates taxing rights and regulates countries' fiscal choices.

However, since the Inclusive Framework has no legal authority to impose taxes, the agreement has no legal force. The agreement provides the political backing for adding two global tax regimes (Pillar One and Pillar Two) to the existing system of international taxation that is dominated by national tax laws, many of which are connected through bilateral tax treaties based on model tax conventions.[18] The legal

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[16] Slides and papers were available at https://www.ctf.ca/CTFWEB/EN/Conferences_Events/2022/Programs/22PTWO/22PTWO_Program.aspx.

[17] Participants include: Vincent Arel-Bundock (Montreal), Robin Boadway (Queen's), Catherine Brown (Calgary), Allison Christians (McGill), Raphael Clement (HEC Montreal), Wei Cui (UBC), Carl Deslongchamps (CTF), David Duff (UBC), Heather Evans (CTF), Amin Mawani (York), Sylvia Masiye (Osgoode Hall Law School), Jack Mintz (Calgary), Lyne Latulippe (Sherbrooke), Jinyan Li (Osgoode Hall Law School), Angelo Nikolakakis (EY Law), Jeremy Shnaider (EY), Geoffrey Turner (Davis), Jean-Pierre Vidal (HEC Montreal).

[18] Organization for Economic Co-operation and Development, *OECD Model Tax Convention on Income and on Capital* (2017) and *United Nations Model Double Taxation Convention between Developed and Developing Countries* 2021. *The Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting* ("Multilateral Instrument" or "BEPS MLI") was signed on June 7, 2017 and has been ratified by

pathway for erecting the pillars is different. Pillar One creates a new taxing right for market jurisdictions, the enforcement of which requires a multilateral tax convention to overrule the limitations under bilateral treaties. With respect to the GMT in Pillar Two,[19] however, there is no perceived tax treaty limitations and thus no new multilateral tax convention is necessary.

Since tax liability can only be created by law, not political agreement, even if such agreement can be regarded as soft law or customary international law,[20] the GMT must be created through domestic legislation. The "global" feature is reflected in the common approach that must be adopted by domestic legislation. This common approach is prescribed by the OECD, sanctioned by the Inclusive Framework, and expressed in a new tax language – the language of international financial accounting, global formulary allocation of income and taxes, new terminology such as IIR, UTPR, GloBE Income, and Top-up Tax.[21] In effect, the OECD is the *de facto* creator, interpreter and facilitator (or even enforcer) of the common approach.

As a matter of international tax governance, the common approach is, in effect, global because it affects every country in which an in-scope MNE group earns profits, whether or not that country is part of the political agreement.

C. Creating a Floor for Global Tax Competition

Pillar Two "will help end the race to the bottom in corporate taxation."[22] That is an over-statement. Pillar Two does not "end", but only "raises" the bottom for tax competition from 0 to 15% of ETR.

Race to the bottom refers to the phenomenon where countries compete with one another to attract investment, including footloose investment, by offering lower corporate taxation. Such global tax competition is not unlawful and is not universally viewed as a problem.[23] Almost every country, including Canada, uses tax policy to promote economic development. The problem lies in "harmful" tax competition" practices that aim to attract mobile income and lack transparency. The "harm" on other countries includes loss of tax revenue, undermining the effectiveness in using income taxation to redistribute social income and finance welfare programs, and causing unfair tax disadvantages to small and medium-sized firms.[24]

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about 80 countries, including Canada. The BEPS MLI provides a speedy and standard way of amending existing treaties. Treaty law remains, in substance, bilateral.

[19] A multilateral tax convention is being developed to implement Pillar One and the STTR element of Pillar Two, but not the GloBE rules.

[20] In this respect, the political agreement may be viewed as "soft law" or even "customary international tax law". See Reuven Avi-Yonah, "UTPR's Dynamic Connection to Customary International Tax Law", letter to the editor, *Tax Notes Int'l,* Nov. 21, 2022, p.951.

[21] The OECD Model Rules, supra n. 2, define these and many other terms in chapter 10.

[22] Canada, Budget 2022, supra n. 3, at 210.

[23] For a review and critique of the literature on tax competition, see John Prebble, "Tax Competition's Terminological and Factitious Lure", *Bulletin for Int'l Taxation,* 2021 (vol.75), No. 11/12 xx.

[24] See Reuven Avi-Yonah, "Globalization, Tax Competition, and the Fiscal Crisis of the Welfare State," *Harv. L. Rev.* 113, No. 7 (2000) 1573-676; and Tsilly Dagan, *International Tax Policy: Between Competition and* Cooperation (Cambridge, Cambridge University Press 2018), 12-42.

Directionally, Pillar Two builds on initiatives in BEPS 1.0 project through Action 1 – Tax Challenges Arising from Digitalisation, Action 3 –Controlled Foreign Company, and Action 5 –Harmful Tax Practices.[25] Substantively, Pillar Two is similar to the US Global Intangible Low-Taxed Income (GILTI) and Base Eason Anti-Abuse Tax (BEAT) introduced in 2017.[26]

The floor of ETR 15% is propped up by one of three building blocks: QDMTT, IIR, and UTPR.[27] Once the "missing tax" (or "Top-Up Tax") is identified, the gap is first filled by an QDMTT charged by the low-tax jurisdiction itself. If tax is still missing, the UPE Jurisdiction or CE Jurisdictions can charge a GMT. The QDMTT-IIR-UTPR rule order is baked in the design of Pillar Two.[28]

C. Nature of the GMT

Is the GMT an income tax or a Pigouvian tax? The answer depends on whether the GMT is charged under the IIR or UTPR. The IIR tax is in the nature of an income tax. Even though the nominal tax base is another country's missing tax, the ultimate base is the under-taxed profits of a CE, albeit computed under accounting standards as opposed to tax law. In essence, the IIR is akin to the GILTI, which is akin to the traditional controlled foreign company (CFC) or Canadian FAPI rules.

The UTPR tax is different. It shifts taxing rights and is, in effect, a Pigouvian tax designed to induce behavior change through an economic sanction:[29]

> The UTPR purports to create a new taxing right that hinges on the non-exercise of a taxing right under the IIR by a parent entity jurisdiction, which hinges on the non-exercise of a traditional taxing right over business profits earned by a CE of an in-scope MNE group in its jurisdiction. What is taxed under the UTPR is not the income of the CE located in the UTPR jurisdiction, but the foreign source income of a foreign company that is a member of the same MNE group. The UTPR is thus unprecedented.
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> While the UTPR is described as a tax measure, as part of a supposedly "global" tax agreement, it is arguably more of an economic sanction, to coerce jurisdictions into adopting an IIR or a QDMTT, and there are many jurisdictions that have not subscribed to Pillar Two, even at a political level. Realistically, the UTPR would only affect jurisdictions

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[25] See OECD, BEPS – Inclusive Framework on Base Erosion and Profit Shifting, https://www.oecd.org/tax/beps/beps-actions/. However, Action 1 generated no concrete recommendations. Action 3 recommendations did not lead to reforms of CFC rules. Action 5 was focused on preferential regimes and improving transparency.

[26] GILTI, supra n.4 and BEAT were introduced in the *Tax Cut and Jobs Act of 2017*.

[27] While the IIR and UTPR were inspired by the US GILTI and BEAT, the QDMTT was mentioned in the Model Rules like "an afterthought." Mindy Herzfeld, "How Does the Qualified Domestic Minimum Top-Up Tax Fit Into Pillar 2?" *Tax Notes Int'l,* April 18, 2022, p. 315. It is reasonable to assume that it was demanded by source countries that have nominal high corporate tax rates but provide tax incentives which may reduce the ETR to below 15%. Without a QDMTT, these countries would need to either abandon their tax incentives or see the tax revenue foregone get picked up by the resident country of parent entities. For further, see Jinyan Li, Angelo Nikolakakis and Jean-Pierre Vidal, "Canadian QDMTT Challenges" in this issue of *CTJ*.

[28] See heading "Computation of Top-Up Tax" below.

[29] Angelo Nikolakakis and Jinyan Li, "UTPR: Unprecedented (or Unprincipled) Tax Policy Response in Need of an MLI", *Tax Notes Int'l*, Jan. xx, 2023, p. xx.

that choose to not adopt an IIR and a QDMTT. It is the income of their CEs that would be taxed by a jurisdiction that has no nexus to that income, being the UTPR jurisdiction(s).

III. TECHNICAL DESIGN

A. "Diabolical"[30]

In terms of system design, the Model Rules prescribe who is taxable, what is the tax base, how much tax is payable, and how to administer, but in a language that is "global", largely divorced from the domestic tax law language of any country. It covers only large MNEs on a group basis. The tax base is the Top-Up Tax (TUT) computed by using accounting income and covered taxes on a jurisdictional basis. The amount of tax payable is determined by the interlocking mechanism of TUT, IIR and UTPR. Administration of the GMT is national, but highly coordinated through the OECD implementation framework.

From the viewpoint of Pillar Two, national corporate income tax base is like a fungible commodity and transferrable across countries in order to achieve the global floor. To encourage countries to adopt the GMT, money talks:

- high-tax UPE Jurisdictions whose tax base is shifted by MNEs (lawfully through taking advantage of deficiencies in the existing law or tax incentives offered by governments) to low-tax countries can get their tax base back by applying the IIR;
- high-tax CE Jurisdictions whose tax base is not eroded by MNEs but want to support the global floor can apply the UTPR and obtain tax revenue that belongs to another country;
- low-tax jurisdictions may wish to keep their tax revenue by raising normal corporate tax to ETR 15% or introducing a QDMTT.

Gaining additional tax revenue from the GMT has been one of the common justifications for implementing Pillar Two.[31]

Interlocking the IIR and UTPR provides a redundancy or fail-safe mechanism. An UPE Jurisdiction would be motivated to apply the IIR if charging the tax would not affect its taxpayers' overall tax burden because the tax would otherwise be charged by other countries through the UTPR. A CE Jurisdiction would gain tax revenue that is not otherwise available. Allowing the QDMTT to displace the IIR and UTPR gives capital-importing countries the opportunity to continue using tax incentives in general without losing tax revenue in respect of in-scope MNEs. Such design potentially offers fiscal incentives to as many countries as possible and neutralizes the attraction of tax haven jurisdictions.

B. Taxpayers

The taxpayers of the GMT are CEs of an MNE group "that has annual revenue of EUR 750 million or more in the Consolidated Financial Statements of the UPE in at least two of the four Fiscal Years Immediately

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[30] Ruth Mason, "A Wrench in GLOBE's Diabolical Machinery," *Tax Notes Int'l*, Sept. 19, 2022, p. 1391.
[31] OECD, Tax *Challenges Arising from Digitalisation – Economic Impact Assessment* (2020) (USD 27-33 billion in 2020 and USD 150 billion in 2021, at 95). This estimate excluded MNEs with an ultimate parent in the United States because they would be subject to US GILTI.

preceding the tested Fiscal Year.[32] A CE can be a corporation, a partnership, or a permanent establishment.[33]

Some entities that are not generally engaged in profit-shifting and benefit from the race-to-the-bottom tax competition are excluded. Examples are pension funds, investment funds or real estate investment vehicles qualifying as UPE, nonprofit organizations and government entities and international organizations.[34] The Model Rules do not prohibit a jurisdiction from adopting a broader scope. The EU Directive includes domestic groups.

C. Computation of Top-Up Tax of Low-Taxed CEs

The amount of TUT in a low-taxed jurisdiction is the base for the GMT in another jurisdiction. It is computed by the following steps: (1) determining the jurisdictional ETR, which is, in turn, determined by the ratio of covered taxes and adjusted GloBE income; (2) determining the jurisdictional TUT percentage by subtracting the jurisdictional ETR from 15%; (3) determining the amount of jurisdictional TUT by multiplying excess profits by the TUT percentage; and (4) allocating jurisdictional TUT to each CE in the jurisdiction.

Jurisdictional ETR

A country's ETR applicable to an MNE determines if the GMT is applicable.[35] ETR is computed at a jurisdictional level on a group basis. Expressed as a formula, ETR = Adjusted Covered Taxes/Net GloBE Income.

The GloBE income or loss of each CE of an MNE group is generally the accounting profit or loss.[36] It is generally taken from the financial accounting net income or loss of the CE used in preparing the consolidated financial statements of the UPE. If an MNE group has two CEs in a jurisdiction, CE-1 has income of $100 million and CE-2 has loss of $80 million, the aggregate Net GloBE Income will be $20 million. If CE-1's Covered Tax is $10 million, the ETR would be $10 million/$20 million, or 50%. Qualified Refundable Tax Credits are treated as income in the computation of GloBE Income or Loss of a CE.[37] Certain adjustments are required to account for certain permanent differences between the measurement of accounting and tax income.[38] These adjustments include removing dividends and capital gains or losses from the disposition of shares, with the except of certain portfolio shareholdings. International shipping profits are excluded so that such profits remain taxable according to Article 8 of the OECD Model Tax Convention. Income or loss is allocated between a PE and head office or to owners of a flow-through entity, such as a partnership according to local tax rules.

Covered taxes generally include taxes on income or profits, taxes in lieu of income taxes, certain taxes on corporate distributions and taxes on equity.[39] The amount of Covered Taxes of a CE is determined based on the same accounts used to calculate the GloBE income or loss, that is, the "current tax

[32] OECD Model Rules, supra n.2, Article 1.1.1.
[33] OECD Model Rules, supra n.2, Article 1.3.1.
[34] OECD Model Rules, supra n.2, Article 1.5.
[35] OECD Model Rules, supra n.2, Article 5.1.
[36] OECD Model Rules, supra n.2, Chapter 3.
[37] OECD Model Rules, supra n.2, Art.3.2.4.
[38] OECD Model Rules, supra n.2, Article 3.2.
[39] OECD Model Rules, supra n.2, Chapter 4.

expenses accrued for Financial Accounting Net Income or Loss". There are some adjustments to the amount of Covered Taxes, such as[40] excluding any taxes associated with income that has been excluded from the calculation of GloBE Income or Loss; taking deferred tax into account to prevent additional taxes arising solely from timing differences between the recognition of income and expenses for tax and accounting purposes; and allocating cross-border taxes (e.g., taxes imposed by the residence country on profits derived in a source country, such as CFC taxes and tax on PE profits) to the jurisdiction where the profit is recognized.

Top-up Tax Percentage

A TUT percentage is calculated by subtracting the jurisdictional ETR from 15% minimum rate. So, if the jurisdictional ETR is 0% or 9%, the top-up tax percentage will be 15% or 6%, respectively.

Top-Up Tax

The jurisdiction TUT is computed according to the following formula:[41]

Jurisdictional Top-up Tax = (Top-up Tax Percentage × Excess profit) + Additional Top-up Tax - QDMTT

The amount of excess profits of a jurisdiction is the Net GloBE Income minus a Substance-based Income Exclusion (SIBE).[42] The SIBE is the sum of 5% of the eligible payroll costs in relation to group activities in the jurisdiction, plus 5% of the carrying value of eligible tangible assets located in the jurisdiction.[43] The effect of SIBE is to kick out routine profits from the scope of the GMT so that the GMT applies only to excessive or residual profit that is more mobile and susceptible for shifting. As such, even if a jurisdictional top-up tax percentage is high, the amount of top-up tax may be low where the GloBE income is derived from substantive activities. For example, if CE has GloBE income of $100 million and Covered Tax of $5 million, the ETR is 5% and Top-Up Tax Percentage is 10%. If the SIBE is $100 million or $60 million, respectively, the Top-Up Tax would be 0 or $4 million (10% x (100 – 60)), respectively.

Top-Up Tax of each CE

If there are two or more CEs in a jurisdiction, the jurisdictional TUT is allocated to each CE according to the following formula:[44]

Top-Up Tax of a CE = Jurisdictional Top-Up Tax x GloBe Income of the CE/Aggregate GloBE income of all CEs in the jurisdiction

Allocation of jurisdictional TUT to each CE is important because the IIR tax is charged in respect of the parent entity's allocable share in each low-taxed CE. The low-taxed CE may have other shareholders.

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[40] OECD Model Rules, supra n.2, Articles 4.1.2. and 4.1.3.
[41] OECD Model Rues, supra n.2, Article 5.2.3. There is also a *de minimis* exclusion. It allows an annual election for any top-up tax to be treated as nil where the MNE group's average revenue and income in the jurisdiction is less than 10 million and 1 million euros, respectively, for the year and the two preceding years.
[42] OECD Model Rules, supra n.2, Article 5.2.2.
[43] There is a transitional rule. For 2023, the Substance-based Income Exclusion will exclude from the application of Top-up Tax an amount of income equal to 8 per cent of the carrying value of Eligible Tangible Assets and 10 per cent of payroll expenditures; these percentages will decline annually over the course of a 10-year transition period to end at 5 per cent for both tangible assets and payroll as of 2032.
[44] OECD Model Rules, supra n.2, Article 5.2.4.

D. Charging Rules

The IIR as the Main Rule

Under the IIR, a GMT is a separate tax charged to the Parent Entity that is equal to the amount of a low-taxed CE's TUT attributed to the Parent Entity in proportion to its allocable share. The allocable share is determined on the basis of the Parent Entity's inclusion ratio, that is, the share of the profits of the Low-Taxed CE attributable to that Parent Entity on the basis of accounting standards.[45] If the UPE owns 100% of a low-taxed CE, 100% of that low-taxed CE's TUT will be allocated to UPE.

The Parent Entity can be an UPE, IPE (Intermediate Parent Entity) or POPE (Partially-Owned Parent Entity). The UPE of an MNE group is the entity that directly or indirectly owns a controlling interest in all the other CEs of the group.[46] The UPE is normally required to consolidate the financial accounts of all the entities of the group. An IPE is situated below the UPE in the ownership chain.[47] A POPE is an IPE that is more than 20% owned by interest holders outside the MNE group.[48]

The top-down ordering of applying the IIR is UPE first, and if UPE is not charged the GMT, the IPE will be. If more than one parent entity in a group applies IIR with respect to the same TUT, to prevent double allocation of the TUT, adjustments are made. POPEs have the priority rights to apply the IIR notwithstanding the general top-down approach. This is to ensure the TUT of a low-taxed CE is fully soaked up by a GMT where there are substantial minority interests in the POPE. For example, the TUT of a low-taxed CE is $1,000. The UPE indirectly owns the CE through POPE. UPE owns 60% of POPE and POPE owns 100% of CE. POPE will charged a GMT of $1,000. As a result, the GMT is effectively borne 60% by the UPE and 40% by the minority shareholders of POPE.[49] If UPE is charged the GMT, its allocable share is only $600, with the remaining $400 TUT free from the GMT.

Because of the concentration of UPEs in a small number of high-tax states,[50] if these states apply the IIR, the global tax competition problem could be addressed. In the event that one or more of these UPE countries choose not to apply the IIR, other countries can apply the UTPR.

The UTPR as a backstop

To ensure the priority of the IIR, the TUT of a low-taxed CE is, in effect, deemed to be zero for UTPR purposes when the IIR is charged. If the IIR is not applied, the UTPR applies to any TUT of a low-taxed CE, including one located in the UPE Jurisdiction.

Unlike the IIR, the UTPR is available to potentially multiple CE Jurisdictions (UPTR Jurisdictions). As such, the targeted TUT needs to be allocated among these jurisdictions in accordance with a "UTPR Percentage" computed as follows:[51]

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[45] OECD Model Rules, supra n.2, Article 2.2.
[46] OECD Model Rules, supra n.2, Article 1.4.
[47] OECD Model Rules, supra n.2, Article 10.1.1.
[48] Ibid.
[49] This aspect of the IIR distinguishes the IIR from traditional CFC rules, which apply only to the shareholder's own share of the passive income.
[50] *OECD Economic Impact Report*, supra n. xx; Suranjali Tandon and Chetan Rao, Evaluating the Impact of Pillars One and Two, October 4, 2022, South Centre, 165 Research Paper, at 14.
[51] OECD Model Rules, Article 2.6.

$$50\% \times \frac{\textit{number of employees in the jurisdiction}}{\textit{number of employees in all UTPR jurisdictions}} + 50\% \times \frac{\textit{total value of Tangible Assets in the Jurisdiction}}{\textit{total value of Tangible Assets in all UTPR jurisdictions}}$$

Also unlike the IIR, the GMT under the UTPR can be charged as a separate tax or a denial of otherwise deductible expenses, which is referred to as "UTPR Adjustment" in the Model Rules.[52]

E. QDMTT

The Model Rules set forth some parameters for a DMTT to be "qualified" for Pillar Two purposes. These include: It applies to domestic excess profit of CEs located in the jurisdictions; Domestic excess profit is determined in a manner that is equivalent to the GloBE rules;[53] It operates to increase domestic tax liability with respect to domestic excess profits to ETR 15%; It is implemented and administered in a way that is consistent with the outcomes provided for under the GloBE rules and the Commentary, provided that the jurisdiction provides no collateral benefits.

F. Administration

Because the GMT must be introduced via domestic legislation based on the Model Rules, an internationally coordinated approach to administration is critical to ensure consistency, certainty and minimization of double taxation and compliance burdens. This approach includes a standardized information return, safe harbours, and tax certainty. An Implementation Framework will to facilitate coordinated implementation, including a peer review process for determining if the domestic law of a country is "qualified" for Pillar Two purposes.

IV. IMPLEMENTING PILLAR TWO IN CANADA

A. Transposing Model Rules into Domestic Law

How?

According to the global political agreement, Canada is not required to implement Pillar Two. However, if Canada chooses to do so, the best method of implementation is transposing through either (a) rewriting the Model Rules with adaptations in limited areas to fit the local context or (b) incorporating by reference to the Model Rules. The former is preferrable as it is more consistent with the Canadian way of incorporating earlier OECD recommended rules, such as the hybrid rules and EIFEL (excessive interest and financing expense limitation). Under the latter approach, domestic law merely provides "the legal scaffolding necessary to support the OECD rules but gives effect to them by reference to the rules themselves."[54]

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[52] The OECD Model Rules do not prescribe the mechanism by which the adjustment must be made and leave the design matter to domestic law implementation.

[53] The Model Rules further state: "A Qualified Domestic Minimum Top-Up Tax may compute domestic Excess Profits based on an Acceptable Financial Accounting Standard permitted by the Authorised Accounting Body or an Authorised Financial Accounting Standard adjusted to prevent any Material Competitive Distortions, rather than the financial Accounting Standard used in the Consolidated Financial Statements."

[54] New Zealand Consultation Paper, supra n. xx, para.10.6.

Inside the Act?

Given the potential interaction between the GMT rules and the general corporate tax rules, it would make sense to house the GMT rules in the Act, but in a separate part so that the GMT can operate as independently as possible.[55] Furthermore, it might be better to have the part in the Act to contain essential rules and leave technical details to the Regulations. This would be similar to the current foreign affiliate rules. It offers two main advantages: "weight control"—the Act does not gain unnecessary wording; "agility" –whenever the OECD commentary or guidance is updated, the updates can be incorporated into Canadian law through amending the regulations by the Governor in Council as opposed to Parliament.

B. Translation and Adaptation

Rewriting the Model Rules through translation and adaptation involves understanding the intent and meaning of the Model Rules and articulating the rules in Canadian tax law language. Canada can consider at least three samples, ranging from the more "liberal", to the more "respectful", and the more "simplified".

The UK approach is the most liberal. The Draft Legislation was intended "to closely follow the intent of the Model Rules but to adapt the structure and drafting in places in an attempt to ensure the rules are as clear and understandable to readers as possible."[56] It uses different terminology and different processes for computation. For example, the Draft Legislation refers the GMT as a "Multinational Top-up Tax" and charges the IIR in respect of low-taxed profits of a "responsible member". It creates a 4-step process for calculating the amount charged. Step 1: Determine which of the MNE group's members have top-up amounts; Step 2: Determine how much of each those amounts is to be attributed to the responsible member; Step 3: Add together the amounts so attributed; Step 4: If the result of Step 3 is not expressed in sterling, convert the result of that Step to sterling.[57]

The EU Directive adopts the Model Rules and terminology almost in their entirety but opts for a slightly different structure. For example, definitions were placed at the beginning. The Directive also contains additional provisions, such as Article 4 - "location of a constituent entity", broadens the scope to include domestic groups, and modifies the IIR model rules to ensure that an UPE located in a low-taxed jurisdiction is subject to the IIR Top-up Tax in respect of itself and of all low-taxed CEs located in the same Member State (Article 5(2)). The EU Directive takes out the word "minimum" in the name of "domestic minimum top-up tax" used in the Model Rules.

The Korean legislation covers both the IIR and UTPR but simplifies the Model Rules by keeping the essential provisions and leaving many details to be determined by Presidential Decree.

In terms of substantive rules, the extent of adaptation is limited in general. For example, any translation and adaptation of the Model Rules on Scope and computation of ETR and TUT will likely be stylistic. Canada may consider the UK approach by giving the GMT a different name and calling a low-taxed CE a

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[55] This is the approach taken in Korea and the UK. The Korean rules are added by amending the International Tax Adjustment Act. The UK Draft Legislation appears to be a standalone act, which is consistent with the UK style of writing taxing statutes.
[56] UK, HM Revenue & Customs, Policy Paper: Multinational top-up tax: UK Adoption of Organization for Economic Cooperation and Development Pillar 2", July 20, 2022, para.1.21.
[57] UK Draft Legislation, supra n.8, Clause 11.

“responsible member”. Any substantive modification may risk the Canadian IIR or UTPR as “qualified”. Similarly, there appears to be little discretion for Canada to modify the IIR charging mechanism as stipulated in the Model Rules.

With respect the UTPR, however, the Model Rules allow choices for domestic legislation: a country can implement the UTPR by denying deduction on otherwise deductible expenses or making an adjustment that is equivalent to a deduction denial, including grinding tax attributes. The UK Draft Legislation and Japan proposed legislation do not even cover the UTPR. The Korean UTPR tax is not charged through a disallowance mechanism, but a separate tax. The UTPR tax must be paid by Korean CEs even if they have sufficient tax losses to offset any UTPR tax liability that would have been calculated through a disallowance mechanism.

The UTPR has no similarity, conceptually or technically, to any existing rules in the Act. To minimize interactions between the UTPR and deduction rules in Part I of the Act, Canada should seriously consider the Korean approach. The amount of GMT payable by each Canadian CE could be allocated by tracing or pro rata. As a method of tax payment, however, an election could be considered to allow taxpayers to satisfy the GMT by grinding loss carryforwards and other tax attributes sufficient to create equivalent tax expense in the manner consistent with the Commentary.[58] The Canadian GMT legislation may need to address the issue of whether UTPR GMT should be joint and several among Canadian CEs.

C. Transplantation and Interaction with Other Rules

The process of transposing the Model Rules would be more akin to a transplantation. The transplants must be compatible with the existing system and be able to change with it because tax law is dynamic and ever-changing. The GMT rules need to thrive in the Canadian context. Some areas of interaction are canvassed below.

ETR and Part I of the Act

The ETR computation will interact with general rules on computing income, taxable income and tax payable. Even though GloBE income is accounting income, covered taxes are determined by Canadian tax law. When capital gains are half-exempt from tax or a Division C deduction reduces taxable income, the covered tax will be reduced, but not GloBE. In such cases, the ETR may fall below 15%. For example, when a taxpayer’s $100 income (which is GloBE income) is tax exempt, its taxable income is nil and covered tax is also nil. The ETR would be nil, giving rise to a TUT.

Transfer pricing rules affect the computation of GloBE income. The Model Rules require cross-border intra-group transactions be valued in accordance with the arm’s length principle, where this is different to the transfer price used for accounting.

ETR and Allocation of Parts I, XIII and XIV Taxes

Part I tax attributable to the “passive income” portion of FAPI[59] of a CFC (“FAPI Tax”) or business income of a Canadian permanent establishment of a foreign CE is deducted in computing Canadian covered

[58] As suggested by Ken Buttenham and Geoffrey Turner at the Pillar Two Symposium, supra n.13, the mechanism could be similar to debt forgiveness attribute grinds in s.80(3)-(13) of the Income Tax Act.
[59] The Canadian FAPI regime will mostly likely be a qualified CFC regime, which is defined in Article 10.1.1 of the OECD Model Rules: “a set of tax rules (other than an IIR) under which a direct or indirect shareholder of a foreign

taxes because it is assigned to CFC's jurisdiction or foreign CE's jurisdiction.[60] The push-down of Canadian FAPI Tax to the CFC is limited to the tax charged in respect of "passive income" as defined in the Model Rules.[61] This requires some allocation rules, such as:

- FAPI Tax must be segregated from total Part I tax when FAPI is not the sole source of income.
- FAPI Tax must be further allocated to "passive income" as defined for Pillar Two purposes because the scope of Canadian FAPI is much broader than "passive income".
- If a Canadian parent has multiple CFCs in different jurisdictions, a jurisdictional allocation needs to be made.

In the absence of any model rules, Canada may introduce its own rules based on sourcing, tracing or pro-rata.[62]

Part XIII taxes on interest, rent and royalty are also deducted in computing Canadian covered taxes as they are assigned to the non-resident CE that recognizes the income in its financial accounts rather than the entity that deducts the tax on payment. In contrast, dividend withholding tax is assigned to Canada as the Model Rules regard this tax as an additional tax on the profit of the distributing CE.[63]

The Part XIV branch profits tax is not specifically mentioned in the OECD Model Rules. It may be treated as withholding tax on dividends. If so, it is not assigned away. If it is treated like a Part I tax on permanent establishments, it would be assigned away.

Canadian Top-Up Tax: Blend before Bifurcate and the Role of QDMTT

The Canadian TUT amount is first computed on a national (blended) basis and then allocated to each CE in Canada. The amount of TUT is the basis for a foreign GMT. It can also be the base for a Canadian QDMTT. As such, the computation is important, but without any no counterpart in existing rules. Canada may put these computation rules in the Regulations.

Below is an example of the computation and the role of the QDMTT.

> ParentCo is located in Country A. It has two CEs in Canada: Canco 1 and Canco 2. In the current fiscal year, they have the following amounts:
>
> Canco 1:
>
> - covered taxes, $2 million
> - net GloBE income, $80 million
> - payroll costs for activities performed in Canada, nil
> - the average accounting carrying value of tangible assets located in Canada, nil
>
> Canco 2:

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entity (the controlled foreign company or CFC) is subject to current taxation on its share of part or all of the income earned by the CFC, irrespective of whether that income is distributed currently to the shareholder."

[60] OECD Model Rules, supra n.2, Article 4.3.

[61] OECD Model Rules, supra n.2, Article 4.3.3.

[62] I acknowledge the insights shared by Ken Buttenham and Geoffrey Turner at the Pillar Two Symposium, supra n.13.

[63] Ibid.

- covered taxes, $4 million
- net GloBE income, $20 million.
- payroll costs for activities performed in Canada, $30 million
- the average accounting carrying value of tangible assets located in Canada, $170 million

ETR computation:

- On a standalone basis, the ETR would be 2.5% ($2 million/$80 million) for Canco 1 and 20% for Canco 2 ($4 million / $20 million).
- But under the Model Rules, it is the group total covered taxes ($2 million + $4 million) divided by the Net GloBE Income ($80 million + $20 million). So, ETR would be 6% ($6 million/$100 million), blending the ETR of the two entities.

TUT computation

- Canadian ETR of 6% means the Canadian TUT percentage to be 9% (15% - 6%).
- Canadian excess profit will be GloBE income – SIBE. The SIBE for Canada is 5% of (payroll cost of $30 million and tangible assets of $170 million) = $10 million. As such, Canadian excess profit would be $90 million ($100 million of GloBE - $10 million of SIBE).
- Canadian TUT would be 9% x $90 million = $8.1 million.

Allocation of TUT

The TUT will be allocated between Canco 1 and Canco 2. This allocation can be pro rata, based on the proportion of the GloBE income of each entity. Canco 1 will be allocated 80% ($80 million / $100 million) of $8.1 million, or $6.48 million. Canco 2 will be allocated the remaining portion.

Canadian QDMTT

Under a Canadian QDMTT, the tax can be allocated between the two entities: Canco 1 would pay an additional tax of $6.48 million, and Canco 2 would pay $1.62 million.

The combined Canadian tax liability for the group would thus be $14.1 million: covered taxes of $6 million and QDMTT of $8.1 million. The ETR is thus 14.1% (not 15% because of SIBE).

If Canada does not have a QDMTT, the $8.1 million will be collected by the foreign parent's jurisdiction under the IIR.

The FAPI and Foreign Affiliate Rules

The IIR is conceptually similar to, but technically different from, the FAPI regime. The table below compares the two regimes.

	IIR	FAPI
Taxpayer	UPE or IPE of large MNE group	Parent that owns the CFCs, regardless of the size of the group
Taxable amount	-Top-up tax of a CFC in respect of business profits	Net FAPI: - FAPI (income from property and income from investment business or inactive business)

	computed under accounting standards	*less* - grossed up foreign accrual tax
Tax rate	Determined by CFC jurisdiction's ETR	Part I of the Act
Offset by tax credits?	No	Yes
Policy rationale	Encouraging taxation at ETR 15% by the CFC jurisdiction	Preserving Canadian tax jurisdiction over Canadian income that is shifted offshore through using a corporate form

In form, the GMT charged under the IIR is a tax on the Canadian UPE. But it is not supplemental to FAPI tax. It may be payable when Part I tax is nil. In effect, the GMT is in lieu of foreign corporate tax that should have been paid by the CFC in the foreign country. As such, it could be accounted for as part of underlying foreign taxes in respect of the CFC's income. Viewed in this light, two intersection questions regarding the FAPI regime and the foreign affiliate regime arise:[64]

- Should the GMT be treated like underlying foreign tax in terms of basis step up under subsection 92(1) of the Income Tax Act? Even though the GMT is based on accounting income and the FAPI is based on tax income, there may be sufficient similarity to deem the GMT as a capital contribution to the CFA for the purpose of preventing double taxation when the CFC shares are disposed of.[65]
- Should dividends paid by the low-taxed CFC be treated as "exempt dividends" under s.113(1) because the income is subject to tax at the ETR 15% (albeit part of the tax was paid to Canada)? Given the policy decision to cede Canadian taxing rights over foreign business income earned through a CFC that is taxed at a level comparable to that of Canada (using a "designated treaty country" as a proxy), it would make sense for Canada to treat the CFC's income as qualifying for "exempt earnings", even if the foreign jurisdiction is not a designated treaty country.

If the answer to the above questions is positive, then amendments to the relevant provisions of the Act and Regulations are necessary.

If the CFC jurisdiction introduces a QDMTT that takes priority over the Canadian GMT, the QDMTT should not be creditable against Part I tax on FAPI or trigger a basis step-up but should qualify the CFC's dividends as exempt under s.113(1) for the reasons explained above.

The GAAR

Should the GAAR apply to the GMT rules?[66] The answer should be a clear yes. There seems to be no good reasons to exclude the GMT rules from the reach of the GAAR. As such, the GMT rules do not need to include a GAAR.

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[64] I acknowledge the insights shared by Geoffrey Turner and Ken Buttenham on this issue at the Pillar Two Symposium, supra n.13.

[65] Such basis step-up is unlikely treated as a "benefit" to disqualify the IIR as a qualifying IIR.

[66] I acknowledge insights gained from discussions with fellow panelists (Catherine Brown, Peter Repetto, Jeffrey Shafer, Steven Suarez) in preparation for the Pillar Two Symposium presentation on Legal Implementation in Canada.

However, applying to the GAAR to transactions designed to minimize the GMT will likely be more challenging. Will tax benefit include avoiding another country's tax? If ETR and TUT are computed by reference to group accounting income, how to identify a specific transaction or series of transactions as an avoidance transaction? How to apply the misuse and abuse test when the GMT legislation is a mere transposition of global rules set by the OECD? What constitute a contextual and purposive interpretation? If Canadian courts apply the GAAR, what recourse is available to the taxpayer to prevent double taxation?

Amending Mechanism

Can Parliament amend the GMT rules unilaterally? Should the domestic legislation incorporate an automatic amendment rule to incorporate any updates to the Model Rules and Commentary and Administrative Guidance or Implementation Framework into Canadian law? If that approach would cede too much Canadian autonomy, should there be a requirement that Canadian amendment be made within a specified period of time following the updates approved by the Inclusive Framework?

Once the GMT is implemented in a number of countries, it will be difficult for Canada to exit from the Pillar Two regime. It is very likely that Pillar Two countries will be "locked in" together, by design[67] and need to exit together.

D. Canadian QDMTT

Should Canada decide to implement Pillar Two, it would be desirable to introduce a QDMTT to preserve Canadian tax revenue that would otherwise be shifted to an IIR or UTPR jurisdiction.[68] Some unique Canadian design issues may arise owing to fiscal federalism and lack of corporate consolidation rules. If Canadian lower ETR is resulted from provincial tax incentives, the revenue from the QDMTT should be transferred to the province whose tax incentives generated the top-up tax amount. This would involve allocating the QDMTT to the relevant provinces in a manner different from the formulary allocation method in the Model Rules.

V. SOME UNKNOWNS

A. Impact Assessment

Revenue gain and net economic loss?

There are some significant known unkonwns about Pillar Two's impact on the Canadian fisc, economy and tax system.[69] There are no published official data on such impact. It is indeed very difficult to estimate such impact when there are so many unknowns.

Jack Mintz's research shows that the revenue gain is likely in the range of $530 million to $830 million depending on whether host countries adopt Pillar Two.[70] This is much lower than the $3.5 billion per

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[67] Mason, supra n. 28.
[68] See Li, Nikolakakis and Vidal, supra n. [**].
[69] For a general overview of the known unknowns, see Tommaso Di Tanno, "The Global Minimum Tax: Some Known Unknowns," *International Tax Studies* 5-2022, 2.
[70] Jack Mintz, "The Global Minimum Corporate Tax: A Cure or Not?" in (2022) vol. xx, *Canadian Tax Journal*, xx (Bird Symposium paper); and Mintz, xx, in the following issue of *CTJ on* Pillar 2 ("Mintz Pillar Two").

year estimated by the Deputy Prime Minister Freeland.[71] Meanwhile, the net loss to the Canadian economy may vary from $1.1 billion to $1.2 billion.[72] There are also concerns about the adverse effect of Pillar Two on Canadian MNEs and their Canadian equity holders and the Canadian economy.[73]

"Globalization" of Canadian tax law?

As a transplanted regime, the GMT will be an obvious addition to the Canadian income tax system with potential non-obvious effect. In terms of law-making, by transposing the OECD Model Rules that were based on the global political agreement, Canadian lawmakers will be put in a "take it or leave it" situation and have no meaningful opportunities to remake the GMT in Canada's own image. In terms of statutory interpretation, Canadian courts may have to treat the Model Rules and other OECD materials pertinent to Pillar Two as more than interpretive aids in order to ensure the Canadian GMT is compliant with the common approach. This will represent a departure from the jurisprudence regarding the relevance of OECD Transfer Pricing Guidelines and Commentaries on the Model Tax Convention in interpreting domestic law and tax treaties.[74]

Legality of the UTPR?

The legality of the UTPR is controversial.[75] The UTPR gives Canada the right to tax a Canadian corporation on income that it does not own or control, in a legal or economic sense. The general logic of the Act is to tax a resident corporation on its income from a source, such as a business or property as well as taxable capital gains. Such income may include the income of a related, but not controlled, non-resident corporation that is reallocated to the Canadian corporation under transfer pricing or other anti-avoidance rules. When income is legally owned by a CFC, this income is imputed to the Canadian parent only to the extent that the income is FAPI. Foreign active business income of CFC is "exempt" from Canadian tax when earned. Therefore, the UTPR departs from this basic logic of the Act. It is the

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[71] Freeland's interview on CBC, Oct.16, 2021.

[72] Mintz Pillar Two, supra n.68.

[73] Angelo Nikolakakis, "Global Tax Deal: Who Wins and Who Loses?", July 13, 2022, CD Howe Institute, Intelligence Memos; Angelo Nikolakakis, "Fiscal and Tax Policy: High Stakes Ahead: Canada and the Global Minimum Tax for Multinationals", May 31, 2022, CD Howe E-brief; Nathan Boidman, "OECD Minimum Tax Deal Will See Canada Reduce or Cannibalize Its Own GDP", *Tax Notes Int'l,* Vol. 104, November 15, 2021, 775.

[74] E.g., *Canada v. GlaxoSmithKline Inc.*, 2012 SCC 52 states in para. 20 states: "However, the [OECD Transfer Pricing] *Guidelines* are not controlling as if they were a Canadian statute and the test of any set of transactions or prices ultimately must be determined according to s. 69(2) rather than any particular methodology or commentary set out in the *Guidelines*." See also *Canada v. Alta Energy Luxembourg SARL*, 2021 SCC 49, para.38.

[75] There has been a lively debate in Tax Notes International since Marcy 2022 on this issue. E.g., Jinyan Li, "The Pillar 2 Undertaxed Payments Rule Departs From the International Consensus and Tax Treaties," *Tax Notes Int'l*, Mar. 21, 2022, p. 1401; Casey Plunket, "What's in a Name? The Undertaxed Profits Rule," *Tax Notes Int'l*, Mar. 28, 2022, p. 1507; Angelo Nikolakakis, "Bait and Switch – A Reply to Casey Plunket", Tax Notes Int'l, April 11, 2022, p.191; Nathan Boidman, "Two More Weak Links in the Pillar 2 Project," *Tax Notes Int'l*, Sept. 26, 2022, p. 1485; Jefferson VanderWolk, "Tax Treaties Pose Problems for the UTPR," *Tax Notes Int'l*, Oct. 3, 2022, p. 29; Allison Christians and Magalhaes, "Undertaxed Profits and the Use-it-or-lose-it Principle," *Tax Notes Int'l,* Nov. 7, 2022, p.705; Reuven Avi-Yonah, "The UTPR and the Treaties", *Tax Notes Int'l,* Jan.2, 2023, p.45; Magalhães, "Give Us the Law: Responses and Challenges to UTPR Resisters," *Tax Notes Int'l,* Dec. 5, 2022, p. 1257; Angelo Nikolakakis and Jinyan Li, "UTPR -Unprecedented (Unprincipled) Tax Policy Response in need of an MLI," *Tax Notes Int'l*, forthcoming. It would be folly to assume away a successful court challenge on ground of treaty violations that could potentially upend the enforcement of a Pillar Two regime.

equivalent of taxing Canadian Peter on the income of his foreign cousin, Paul on the ground that Paul did not pay tax because his government chooses not to tax him.

It is true that there is no public international law that prohibits Canada from asserting the taxing right through the UTPR. In fact, Canada may have a political obligation to adopt the UTPR as part of the global consensus. But legal uncertainty remains if the low-taxed income is derived in a country that has a tax treaty with Canada. Under existing tax treaties, business profits of a company resident in a treaty partner country are not taxable in Canada if the profits have no nexus with Canada, such as attributable to a Canadian permanent establishment, or imputable as FAPI. Some of Canada's treaties have a saving clause that permit Canada to tax Canadian residents (e.g., Article XXIX(2) of the Canada-US treaty). However, it is debatable if such saving clause can save the UTPR tax as it different from the traditional CFC tax or the IIR tax. The UTPR can be a reverse CFC tax as a Canadian CE could be taxed on the income of its foreign parent.

Canada's Obligation under trade and investment agreements?

Charging a GMT or QDMTT may infringe upon Canada's obligations under an international trade or investment agreement.[76]

Tax Reform Initiatives?

The GMT is not expected to hinder Canadian corporate tax reforms in general and the reform of tax incentive policies, including the introduction of a patent box regime.[77] It may even offer an opportunity for Canada to reform the complex foreign affiliate rules by moving to a territorial system.[78] However, in tax law, the devil is always in the detail. It is likely too early to tell at this point about the specific impact of the GMT on specific corporate tax reform measures.

B. US Exceptionalism and Unpredictability

A Canadian GMT will interact with US tax rules. The outcome of such interaction may depends, to a large extent, on the characterization of a US tax as a "covered tax", qualified IIR tax, qualified CFC tax, or QDMTT:

- As a covered tax, the US GILTI or CAMT would have minimal impact on the application of the Canadian GMT beyond the determination of US ETR.
- As a qualified IIR, the GILTI or CAMT would soak-up the top-up tax of CEs located in Canada and other countries and preclude Canada's ability to charge a GMT under the UTPR.
- As a qualified CFC tax, to the extent that the CFC tax is allocated to passive income of a Canadian CFC of a US parent corporation, the US tax will be assigned to Canada and ultimately offset a Canadian QDMTT in cases where the Canadian CFC is otherwise low-taxed.

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[76] Catherine Brown and Elizabeth Whitsitt, "Implementing Pillar Two: Potential Conflicts with Investment Treaties", (*2023) CTJ* [**].
[77] Robin Boadway and Jean-Francois Tremblay, "The Implications of Pillar Two for Corporate Tax Reform", forthcoming in the CTJ; Lyne Latulippe, Christine Ally and Julie S. Gosselin, "The Revised Case for IP Regimes under the Globe Rules – A Canadian Perspective", *(2023) CTJ* [**].
[78] See Buttenham and Turner presentation at Pillar Two Symposium, supra n. 13.

- As a QDMTT, the CAMT would prevent Canada from charging an IIR GMT on Canadian-parented low-taxed CEs in the U.S.

The GILTI has not been accepted by the Inclusive Framework as a qualifying IIR. The October 2021 Statement recognizes the possibility of co-existence between the IIR and GILTI under certain conditions because the regimes are directionally consistent, but technically different. The main technical differences are: GILTI is not based on financial accounting income; GILTI tax rate is lower than 15%; the computation of low-taxed income is not determined on a country-by-country basis; GILTI does not cover the entire lowed-taxed income of the CFC-CE.[79] The Biden Administration tried to make the necessary reforms through the failed Build Back Better Act. Following EU's unanimous approval of the Directive in December 2022, the US Treasury officials indicate that GILTI needs to be changed for the US to implement Pillar Two,[80] but Republican lawmakers continued to oppose it. According to a letter dated December 14, 2022, "Congress's hand will not be forced" even if other countries adopt Pillar 2 rules" and that the UTPR could violate U.S. tax treaties".[81]

The GILTI may be a qualified CFC regime as it applies to the low-taxed intangible income of CFCs. The blended approach to determining if foreign income is low-taxed makes it different from the jurisdictional approach under a qualified CFC.[82]

The CAMT differs from GILTI by using financial accounting income, as opposed to tax income and tax rate of 15%. It is more similar to the IIR in these respects. The worldwide approach makes the CAMT different from the IIR or QDMTT as defined in the Model Rules. It may be possible that a further compromise is reached between the US and other OECD countries and the CAMT become a "bridge" to a global tax deal.[83]

The above qualification issues and the uncertainty in US Congress' support of Pillar Two cannot be ignored by Canada or other countries implementing Pillar Two. However, the reality is that Canada, alone, cannot do much, if anything at all, about this. As recognized by the UK, the solution "will be dependent on the outcome of the US legislative process".[84] Once the outcomes of the US legislative

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[79] For further discussion, see New York State Bar Association, ReportNo.1456 – Report on the OECD Global Anti-Base Erosion Model Rules (Pillar Two), July 21, 2022 (the "NYSTB Report").

[80] Stephanie Soong, "U.S. Must Reform GILTI in Line With OECD Pillar 2, Grinberg Says", *Tax Notes Int'l,* Dec.19, 2022. Avi-Yonah argues that "U.S. tax law is substantively compatible with pillar 2 even though the GILTI rate is too low and neither it nor the corporate AMT is applied country by country"; see Reuven Avi-Yonah, "Is the United States Already Compliant with Pillar 2?" Letter to the Editor, *Tax Notes Int'l*, Nov. 14, 2022, 825-6.

[81] Republican lawmakers' letter to Secretary Yellen, Dec.14, 2022, NTI, Dec.19, 2022, available at https://www.taxnotes.com/research/federal/legislative-documents/congressional-tax-correspondence/gop-lawmakers-demand-treasury-work-with-them-on-oecd-agreement/7fgtk

[82] For further discussion, see Mindy Herzfeld, "How to Allocate CFC Taxes under GloBE", *Tax Notes Int'l*, Dec. 19, 2022, p.1513-18.

[83] Mindy Herzfeld, "The Remade Corporate AMT Walks and Talks like a Duck", *Tax Notes Int'l,* Aug.22, 2022, p. 1194. However, others had a different view; see Elodie Lamer, "Corporate Alternative Minimum Tax Is Not a Pillar 2 Substitute," *Tax Notes Int'l,* p. 75.

[84] UK Consultation Paper, clauses 11.6-11.13 raise some important questions. New Zealand Consultation Paper remarks the following: "There are some issues which have the potential to either defeat or substantially delay the implementation of the GloBE rules, for instance resolving the interaction of Pillar Two with the US global intangible low-taxed income (GILTI) rules. The GILTI rules are similar in their intent to the IIR rule, and the US is expected to continue to apply them rather than adopting an IIR."

process are clear, other countries will have to coordinate and coexist with the US.[85] Canada's close economic interactions and trade agreement with the US may add some special reasons for Canada to be more cautious in implementing Pillar Two.

C. Behavioral Responses

States

Not every member of the Inclusive Framework is equal in terms of shaping or benefiting from Pillar Two.[86] It is the OECD countries that stand to gain the most from Pillar Two and have the necessary technical expertise and resources to implement Pillar Two. The EU has its own interests in using Pillar Two to address the internal race-to-the-bottom problem. UK has been at the forefront of the BEPS project with its Diverted Profits Tax and active participation in designing Pillar Two Framework. It is unclear why Korea was the first country to actually pass implementation legislation. Some other OECD countries are expected to implement Pillar Two as part of the first movers.[87]

Members of the G20, a group that has given the political clout to OECD's technical prowess in the BEPS project, may also be interested in implementing Pillar Two. Indonesia and India (rotating presidency of the G20 in 2022 and 2023, respectively) strongly supported Pillar Two and consider implementation.[88] China, Russia and other major non-OECD countries of the G20 have not publicly announced intention of implementation.

Developing countries are capital importers and have no need for CFC rules in general. As such, the IIR is irrelevant. The UTPR is unlikely meaningful if capital-exporting countries apply the IIR. The treaty-based subject-to-tax rule comes with many restrictions, with limited revenue implications.[89] Meanwhile, Pillar Two implementation will likely constrain the use of tax incentives that lower ETR to below 15%, thereby having "potential to do harm".[90] "And again, the complexity of the administration, lack of data, [and] lack of administration and information systems and competent human resources are also challenges

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[85] This has been the pattern of international tax development in respect of transfer pricing, FACTA and other major areas. However, since the G20/OECD BEPS 1.0, the role of the EU has changed by leading, as opposed to challenging and then following the US position. EU's role in developing the two-pillar solution has also been critical. It appears that the EU and other OECD countries are positioned to have a dialogue with the U.S. in developing a global tax regime. For further discussion on the role of US in international tax governance, see Reuven Avi-Yonah, "The Interaction between Unilateralism and Multilateralism in International Tax", https://ssrn.com/abstract=4219786; Jinyan Li, "China's Rising (and the United States' Declining) Influence in Global Tax Governance? Some Observations" *Bulletin for Int'l Taxation,* November/December 2021, 1.

[86] For discussions on the legitimacy and inclusiveness of the Inclusive Framework, see I. J. Mosquera Valderrama, "Output Legitimacy Deficits and the Inclusive Framework of the OECD/G20 Base Erosion and Profit Shifting Initiative", (2018) 72:3 *Bulletin for Int'l Taxation*, [**]; and Shu-Yi Oei, "World Tax Policy in the World Tax Polity? An Event History Analysis of OECD/G20 BEPS Inclusive Framework Membership", (2022) 47 *Yale J. of Int'l Law,* 199-307.

[87] For further discussion, see Wei Cui, "Strategic Incentives for Pillar Two Adoption", http://ssrn.com/abstract=4161375; and Heydon Wardell-Burrus, "State Strategic Responses to the GloBE Rules", http://ssrn.com/abstract=4291190.

[88] Nana Ama Sarfo, "Indonesia, India, the G-20, and The Direction of Tax Multilateralism", *Tax Notes Int'l,* Sept. 26, 2022, p.1466.

[89] Because some developing countries already have domestic minimum taxes (based on turnovers or assets), the QDMTT will not generate additional revenue. See Tandon and Rao, supra n. [**], at 36-7.

[90] Ibid.

that have to be faced by developing countries."[91] At the end of the day, what most developing countries can do is to introduce a QDMTT.

The United Nations

The United Nations has played no formal role in creating Pillar Two.[92] The UN General Assembly adopted a resolution on November 16, 2022,[93] calling for more inclusive and effective international tax cooperation and urging member states to commence negotiations on a global tax treaty led by the UN. The resolution gives the UN a mandate to monitor, evaluate and determine global tax rules and support the establishment of a global tax body. The goal is to put global South countries on an equal footing to navigate and negotiate global tax rules."[94] The UN Secretary General, who is expected to write a report on the problems on the global tax system and suggest potential solutions, reportedly said: "Tax norms need strengthening to address digitalization and globalization in ways that meet the needs and capacities of developing countries. A global convention on tax with universal participation may help this effort".[95]

The UN's decision to take a leadership role in global tax reform could be a turning point although it is too early to tell if it can succeed. The United States and other OECD countries initially fought against the resolution.[96] The fact that such historic resolution was adopted suggests the widespread dissatisfaction with the two-pillar solution among developing countries, which does not bode well for the implementation of Pillar Two.

MNEs

MNEs are expected to adopt strategies to minimize the GMT through locating GloBE income to high-tax countries and taxes (including withholding taxes and CFC taxes) to low-tax countries as well as taking advantage of SIBE and various adjustments permitted by the Model Rules. New planning opportunities may arise from using financial accounting standards from computing the GMT while tax law

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[91] Sarah Paez, "Developing Countries Face Obstacles to OECD Tax Deal", quoting Melani Astuti, official of Indonesian Ministry of Finance, *Tax Notes Int'*, Sept. 12, 2022, p. 1283.

[92] Article 12B of the UN Model Convention offers an alternative to Pillar One of the Inclusive Framework. No alternative has been suggested by the UN for Pillar Two.

[93] United Nations General Assembly, seventy-seventh session, second committee, agenda item 16, Macroeconomic policy questions, "Promotion of inclusive and effective international tax cooperation at the United Nations", 16 November 2022, A/c.2/77/L.11/Rev.1.

[94] United Nations, "Human Rights Experts Support Call for UN Tax Treaty", 29 November 2022. The linkage between international tax governance and human rights is considered important. According to a human rights excerpt report, A/77/169: Towards a global fiscal architecture using a human rights lens- Report by Independent Expert on Foreign Debt and Human Rights, Ms. Attiya Waris, 12 September 2022, the international taxation system is in urgent need of reform to combat illicit financial flows in line with human rights law and standards, including extraterritorial obligations. Tax-related illicit financial flows involving cross-border tax evasion and avoidance divert crucial resources necessary for States to fulfil their human rights commitments and undermine their ability to mitigate global shocks.

[95] Anna Isaac, "UN agrees global tax rules resolution giving developing nations greater say", *The Guardian*, Nov.23, 2022, at https://www.theguardian.com/world/2022/nov/23/un-agrees-global-tax-rules-resolution-giving-developing-nations-greater-say#:~:text=Developing%20nations%20could%20have%20a,kickstart%20intergovernmental%20talks%20on%20tax.

[96] Isaac, ibid.

computations remain relevant in some areas and interactions between the GMT and existing tax rules are inevitable.[97]

VI. SOME OBSERVATIONS

In light of the knowns and unknowns about Pillar Two, we offer some observations about some key implementation questions.

Should Canada implement Pillar Two? If so, when?

The answer may turn on broader geopolitical considerations than fiscal and economic ones. Canada has been an active participant in developing international tax norms through the OECD and played a somewhat leading role in forging the global political agreement in 2021 as part of G7 and G20. Given the recent apparent momentum in implementing Pillar Two, Canada may wish to join the UK, EU, Korea and other OECD countries who are trading partners, in spite of the unknowns. The price of inaction is also unknown.

However, there seems to be no apparent advantage for Canada to jump onto the bandwagon just for the sake of being on it. Reversing Canada's tax policy on outbound investment by taxing active business income of foreign affiliates is a significant shift in how Canada uses the tax system to advance Canadian interests through the activities of Canadian-based MNEs. The impact on federal-provincial tax/fiscal relations and the degree of spillover effect on the Act as a whole need to be examined and analyzed. Taxpayers need time to prepare for the new tax system. There is likely little tax revenue to be lost to other countries that implement Pillar Two ahead of Canada.

Peeling UTPR off Pillar Two

Canada should take the Pillar Two into three parts – IIR, UTPR and QDMTT and consider enacting the charging rules at different times. The IIR and QDMTT can be introduced and take effect first. The UTPR can and should wait. If most UPE jurisdictions adopt the IIR, the need for the UTPR backstop diminishes. The legal challenges in charging a UTPR tax appear to be serious enough to warrant caution and more analysis.

Making FAPI GILTI-sh

The scope of FAPI has been expanded from the inception, but it is not as broad as the GILTI. Should Canada consider making FAPI more GILTI-like by covering "intangible income" of CFCs but retain the country-by-country determination? Several reasons support such reform.

First, by teasing out intangible income as a different category from traditional passive property income and active business income, a GILTI-sh FAPI would treat intangible income more like passive income in a manner that is consistent with Canadian tax policy towards foreign active business income.

More importantly, a broader FAPI regime will help Canada secure tax revenue from Canadian-parented MNEs in a manner that is tax-neutral to them under Pillar Two. In cases where a CFC's intangible income is low-taxed in the CFC (CE) Jurisdiction, the CE Jurisdiction can charge a QDMTT to prevent Canada from

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[97] See Amin Mawani paper, CJT, forthcoming. See also Heydon Wardell-Burrus, "Tax Planning under the GloBE Rules," *British Tax Review* (forthcoming).

charging a GMT under the IIR. If Canada's GILTI-sh FAPI applies to the intangible income, Canadian FAPI tax will jump the queue in the rule ordering prescribed by the Model Rules, that is: value-creation jurisdiction charges QDMTT first; then UPE jurisdiction charges the IIR GMT; and then CE Jurisdictions charges the UTPR tax. The reason for that is the push-down rule for FAPI Tax –Canadian tax is accounted for as part of CFC Jurisdiction's covered tax for purpose of computing that jurisdiction's TUT. As far as the low-taxed intangible income is concerned, Canada, the UPE Jurisdiction, not the CFC jurisdiction where income is reported, gets to tax such income. This can be explained with the following example.

> Canco, a Canadian resident, owns 100% of Forco, a resident of Country X. Forco earns $1,000 intangible income that is outside the current scope of FAPI (say interest or royalty income received from a foreign affiliate that deducts the payments in computing its active business income). Forco pays no income tax in Country X. Forco has no substantive activities and its SIBE is nil. Forco's Top-Up Tax will be $150 (ETR % of 15% x excess profit of S1,000).
>
> Country X imposes a QDMTT of $150. If so, the QDMTT will reduce the Top-Up Tax to zero. There is nothing from Canada to tax under the IIR.
>
> If Canada's GILTI-sh FAPI applies to Forco's intangible income and collects $150 tax, this Canadian tax is pushed down to Country X to raise its ETR to 15%. As such, Country X's QDMTT is not triggered. The key is the intangible income is qualified "passive income" as defined in the Model Rules.

If Canada were to reform the FAPI, it would be important to define taxable intangible income in a manner that exclude income from substantive activities that qualifies for SIBE. Otherwise, active business income will be swept in, and that would increase the tax burden of Canadian-parented MNEs.

Simplifying the foreign affiliate regime

The combination of a GILTI-sh FAPI regime taxing CFC's passive income and intangible income on a current basis, a GMT regime taxing CFC's excess profits and a broad scope of the existing exemption system owing to an extensive list of designated treaty countries (including tax haven jurisdictions that have a Tax Information Exchange Agreement with Canada), the policy rationale for retaining "taxable surplus" and taxable dividends is arguably much weakened. The associated legislative and administrative complexity to support such system would become unnecessary. It may be time to simplify the foreign affiliate regime.[98]

Revisiting the design of corporate tax incentives

Not all tax incentives are treated the same under Pillar Two. Refundable tax credits and timing benefits (e.g., accelerated depreciation) are "safe" under Pillar Two as they do not generally reduce the ETR or

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[98] Geoffrey Turner advocated for this type of simplification at the Pillar Two Symposium, supra n.14. For further discussion, see Geoffrey S. Turner, "Easing Foreign Affiliate Compliance Burdens in a Full Exemption System for Foreign-Source Active Business Income" 2020 Conference Report, (Toronto: Canadian Tax Foundation, 2020), 11: 1-41; Brian Mustard, Nick Pantaleo, and Scott Wilkie, "Why Not Kenora? Reflections on What Canada's Approach to Taxing Foreign Business Income Is and Could Be,' 2009 Conference Report (Toronto: Canadian Tax Foundation, 2010), 6:1-42; and Nick Pantaleo and Scott Wilkie, "Are the Surplus Rules Surplus?" 2007 IFA (Canadian Branch) Travelling Lectureship.

give rise to a top-up tax liability.[99] Tax incentives for substantive activities that generate SIBE will not give rise to top-up tax liability.[100] Tax incentives targeting a specific type of income (e.g., intangible property income under a patent box regime) are less affected than those tax incentives broadly application (such as a permanent reduced tax rate for certain corporations). Obviously, tax incentives targeted at corporations that are out-of-scope for Pillar Two, such as CCPS, shipping or investment funds, are unaffected. It is unclear how transferred tax attributes, such as flow-through shares regimes, will be affected when they apply to in-scope MNEs.

Instead of revisiting the design of tax incentives, Canada can adopt a QDMTT to allow the continued use of tax incentives without giving rise to a top-up tax liability. The advantage of the QDMTT is that it affects only in-scope MNEs.

In conclusion, adding the GMT to a century-old corporate tax system is an exciting challenge. While it is important to "skate to where the puck is going",[101] it would be folly to proceed without the requisite appreciation of the end goal.

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[99] See, for example, Belisa Ferreira Liotti, et al, "The Treatment of Tax Incentives under Pillar Two", *Transnational Corporations*, vol.29, 2022, No.2, p.25; Mindy Herzfeld, "Tax Credits and Incentives under a Global Minimum Tax Regime," *Tax Notes Int'l*, June 27, 2022, p. 1607; OECD, "Tax Incentives and the Global Minimum Corporate Tax: Reconsidering Tax Incentives after the GloBE Rules", October 6, 2022.

[100] See Michael Devereux, John Vella and Heydon Wardell-Burrus, "Pillar 2's Impact on Tax Competition," *World Tax J.* (forthcoming).

[101] These are purportedly the words of Walter Gretzky made famous by his son Wayne.