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Impact of recent international tax developments on Canada

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Recent international tax changes proposed by the OECD could significantly impact the cross-border activities of Canadians – particularly with respect to tax planning strategies that shift profits to low or no-tax jurisdictions. First, Canada recently ratified the OECD's Multilateral Instrument [PDF], which will introduce certain tax measures contained in the OECD/G20 Base Erosion and Profit Shifting (BEPS) Project into many of Canada's tax treaties. Second, the OECD recently released its *Programme of Work* [PDF] *to Develop a Consensus Solution to the Tax Challenges Arising from the Digitalization of the Economy* (Program of Work). These proposals are intended to (i) allocate additional taxing rights to market jurisdictions (such as by revising the "permanent establishment" nexus for establishing source country taxing rights and revising "arm's length" standard for allocating profits), and (ii) introduce a global minimum tax to prevent shifting profits to low-tax jurisdictions.

Update on the MLI – Introducing BEPS changes into Canada's tax treaties

Canada signed the *Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting* [PDF] — also known as the Multilateral Instrument or MLI in June 2017, listing 75 of its 93 tax treaties as being potentially revised by the MLI (Covered Tax Agreements). The federal legislation to ratify the MLI in Canada is contained in Bill C-82, *An Act to implement a multilateral convention to implement tax treaty related measures to prevent base erosion and profit shifting*, which received Royal Assent on June 21, 2019. As a result, Canada's domestic process to ratify the MLI is complete.

MLI – Next steps

Canada must now approve an Order in Council to notify the OECD that the ratification

procedures in Canada are complete. The MLI will enter into force for Canada on the first day of the month beginning three months after Canada deposits its instrument of ratification with the OECD. Where the MLI is already in force for a counterparty to a Covered Tax Agreement, the MLI will then enter into effect for that Covered Tax Agreement for (a) withholding taxes, on the first day of the next calendar year that begins on or after the date of entry into force for Canada, and (b) for other taxes, for tax years beginning six months after the MLI enters into force for Canada. Where the MLI is not yet in force for a counterparty, the timeline for entry into effect for that Covered Tax Agreement will depend on the date on which the MLI enters into force for that counterparty. By way of example, if Canada deposits its instrument of ratification with the OECD in September 2019 and the MLI is already in force for a counterparty to a Covered Tax Agreement, the MLI will enter into effect for that Covered Tax Agreement (a) on January 1, 2020 for withholding taxes, and (b) for other taxes, for tax years beginning on or after July 1, 2020 (which for calendar year taxpayers would be January 1, 2021 (i.e., the "next" calendar year)).

The number of Covered Tax Agreements could increase further, as additional treaties could be listed as Covered Tax Agreements in Canada's final notification to the OECD. Based on the hearings at the Standing Committee on Finance, Canada may include as additional Covered Tax Agreements its treaties with Algeria, Armenia, Ivory Coast, Kuwait, Oman, Papua New Guinea, Peru, Trinidad and Tobago and the United Arab Emirates (although not all of these jurisdictions have signed the MLI). Tax treaties that will not be covered include Canada's tax treaty with the United States, which did not sign the MLI, and Canada's tax treaties with Switzerland and Germany, with which Canada has separately announced bilateral treaty negotiations.

Canada initially adopted the minimum standards agreed to in the BEPS Project when it signed the MLI, including the principle purposes test (which is a broad anti-avoidance rule), an amended treaty preamble and modified dispute resolution procedures, including potential binding arbitration. Canada subsequently announced its intention to remove some of its initial reservations on optional MLI provisions at the time of ratification, including provisions which (i) provide for the use of certain factors by competent authorities when resolving dual resident entity cases (Article 4); (ii) add a one-year holding period test to access treaty-based withholding tax reductions on dividends (Article 8); (iii) add a one-year lookback test when determining whether capital gains from alienation of shares or other equity interests derive their value principally from immovable property (Article 9); and (iv) allow treaty partners to move from an exemption system to a foreign tax credit system (Article 5). For more information, see our previous post on updates to Canada's MLI reservations (May 29, 2018 Canada tables NWMM to ratify MLI; Updates MLI reservations).

Canada has left open the possibility of adopting additional measures at a later date. This includes changes to the permanent establishment (PE) rules reflected in (i) Article 10 in respect of anti-abuse rule for PEs situated in third jurisdictions; (ii) Article 12 in respect of artificial avoidance of PE status through commissionaire arrangements or similar strategies; and (iii) Article 13 in respect of artificial avoidance of PE status through the specific activity exemptions of the MLI. These changes in the PE rules trend towards the expansion of taxing rights of source jurisdictions, which means that the resident jurisdiction would need to provide relief from double taxation.

At the Committee stage for Bill C-82, we stressed that Bill C-82 should be amended to ensure that any future removal of Canada's reservation on the PE changes be made with Parliament's consent, rather than just an Order in Council. However, because Bill C-82 received Royal Assent without amendment, the PE changes in the MLI can be adopted with respect to Covered Tax Agreements at a subsequent time without Parliamentary debate. We further note that Canada did not register any reservations with respect to similar expansions of the PE concept in the OECD Model Treaty. Nevertheless, it is hoped that Canada will be reluctant to remove its PE-related reservations – particularly since it could result in Canada

permanently ceding certain taxing rights (as the removal of a reservation under the MLI is intended to be permanent).

New OECD work program

On May 31, 2019, the OECD published its *Programme of Work* [PDF] *to Develop a Consensus Solution to the Tax Challenges Arising from the Digitalization of the Economy* (Program of Work). This Program of Work was endorsed by Canada and other G-20 countries, noting that they will "redouble our efforts for a consensus-based solution with a final report by 2020." The Program of Work will follow the "two-pillar" approach set out in the OECD's Policy Note [PDF] published in January 2019 and the Public Consultation Document [PDF] published in February 2019. The concepts in either pillar, if adopted, will lead to significant changes in Canada's international tax system.

We note that the proposals under both pillars are not restricted to taxpayers in the digital or technological space, despite the reference to "digitalization" in the Program of Work. Indeed, in the 2015 BEPS Final Report on Action 1, the OECD acknowledged that the digital economy is increasingly the economy itself, concluding that "it would be difficult, if not impossible, to ring-fence the digital economy from the rest of the economy for tax purposes."

Osler made a submission [PDF] to the OECD in response to the Public Consultation Document. Our comments were principally directed to the impact of the proposals on the international tax framework, including fundamental changes to the existing PE and profit allocation rules. In our submission, we stressed that the OECD should not proceed with such significant revisions without a strong consensus from a clear majority of stakeholders, as well as specific proposals for dispute resolution. In our view, the Program of Work sets an appropriately high bar of reaching a consensus-based solution to be agreed among the 129 members of the Inclusive Framework by the end of 2020. If the 129 jurisdictions of the Inclusive Framework agree to those principles by the end of 2020, this could then start a years-long process of adopting new rules through domestic legislation and changes to tax treaties.

Pillar One – Revising PE threshold and arm's length standard

The first pillar focuses on the allocation of taxing rights, including nexus (PE) and profit allocation (transfer pricing) rules. As previously acknowledged by the OECD in the Policy Note and the Public Consultation Document, the proposals under this pillar would potentially expand the taxing rights of source or market jurisdictions even where there is no physical presence in such jurisdiction, and would go beyond the arm's length principle. The Program of Work renewed the Inclusive Framework's commitment to exploring the three separate proposals in this regard identified in the Public Consultation Document:

1. **The "user participation" proposal**, which would require revisions to the existing profit allocation and nexus rules based on active user participation. This proposal focuses on the value created by highly digitalized businesses through developing an active and engaged user base and would target social media platforms, search engines and businesses operating in the gig economy.
2. **The "marketing intangibles" proposal**, which would allocate marketing intangibles to market jurisdictions, together with a proportionate share of income. This proposal would require changes to the existing nexus rules and go beyond the requirement of having a physical presence in the jurisdiction, would have a broader scope of application than the

user participation model, and would target all industries and not only highly digitalized business models.

3. **"Significant economic presence,"** which effectively establishes a taxable presence or a virtual permanent establishment where revenues are generated in a jurisdiction on a sustained basis combined with other factors suggesting a significant economic presence, such as a large user base and billing and collection in local currency, among others. The significant economic presence proposal is premised on the idea that the existing international tax framework is not fit for purpose.

The Program of Work recognizes that expanding the taxing rights of source jurisdictions could give rise to potential double taxation, and suggests that these concerns could be addressed through certain simplifying mechanisms, such as using accounting results as a proxy for overall profit, and the use of fractional apportionment. While Canada uses an apportionment method based on revenue and salaries for allocating income among provinces – the OECD's proposal will be significantly more complex – since it would include jurisdictions with significantly different tax systems, different currencies, and different levels of tax administration capabilities.

Since Canada's domestic tax laws and tax treaties are largely dependent on the arm's length standard for transfer pricing, and the thresholds of "carrying on business" and "permanent establishment" (in the case of tax treaties) for determining Canada's jurisdiction to tax non-residents, the implementation of any of these "pillar one" proposals will require significant changes to both the *Income Tax Act* (the ITA) and Canada's tax treaties.

Pillar Two – Global minimum tax

The second pillar will seek to address unresolved BEPS issues through the development of two inter-related rules to ensure that all multinational enterprises – regardless of whether they operate in the digital economy – pay a minimum level of tax. The current articulation of the proposal under this pillar includes an income inclusion rule that would tax the income of a foreign branch or a controlled entity if that income is subject to an effective rate that is below a minimum rate, in conjunction with either the denial of a deduction or the imposition of possible withholding tax on base eroding payments unless that payment was subject to tax at or above a specified minimum rate. In the press release that accompanied the Program of Work, the OECD described this pillar as providing countries with a new tool to protect their tax base from profit shifting to low or no-tax jurisdictions.

Under current rules in the *Income Tax Act* (ITA), income earned by a "controlled foreign affiliate" of a Canadian taxpayer from an active business carried on in a treaty jurisdiction is generally exempt from current Canadian taxation at the shareholder level regardless of the applicable tax rate in the local country. In addition, the applicability of withholding tax under Part XIII of the ITA (and the availability of exemptions under both the ITA and Canada's tax treaties) generally do not depend on the rate at which a payment is taxed in the recipient jurisdiction. Therefore, the implementation of these proposals under "pillar two" will require significant changes to the ITA and Canada's tax treaties. Various administrative challenges could also arise – such as the potential inability of a payer to determine the level of tax paid by the recipient of the payment.

OECD work program – Next steps

The OECD intends to develop recommendations on the core elements of both pillars at the beginning of 2020, and plans to deliver a final report by the end of 2020 (which is consistent

with the timeline endorsed by the G20). We understand that a compromise solution will also be sought at the G7 meeting in France in July 2019, at the G20 meeting of Finance Ministers scheduled for October 2019, and finally at a meeting of the 129 jurisdictions of the Inclusive Framework at the end of January 2020.

Assuming a consensus is reached, it will then take time for each country to make the requisite changes to its domestic law and tax treaty network to adopt the consensus solution. The OECD has noted the possibility of countries adopting tax treaty-related changes through an addendum to the MLI – which could be then ratified through procedures similar to those followed in ratifying the MLI – although the OECD has also noted that separate treaty negotiations may be required for countries (such as the United States) that have not signed the MLI.

We will continue to monitor the progress of the OECD Program of Work and other international tax developments that may be of interest to Canadians. For any questions on international or other tax matters contact any member of our National Tax Group.