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Budget 2016: Significant International Tax Proposals Unveiled

BEPS-Related Changes

Over the past several years, Canada, along with many of its G20 counterparts, has been a committed proponent of the "Base Erosion and Profit Shifting" or "BEPS" initiative of the Organisation for Economic Co-operation and Development (the "**OECD**"). The general focus of the BEPS initiative has been the development and implementation of various measures designed to curb (if not eliminate) certain tax planning strategies and practices of multinational enterprises ("**MNEs**") that are perceived to result in an inappropriate shifting of income to low-tax jurisdictions.

On the heels of the final BEPS project reports released on October 5, 2015, and Canada's endorsement of the recommendations developed under the BEPS project in November 2015, Budget 2016 proposes several legislative and administrative measures to respond to certain of the recommendations contained in the final BEPS reports, including: (A) the introduction of country-by-country transfer price reporting rules for certain MNEs, (B) a continuing review and evolution of the audit and assessment practices of the Canada Revenue Agency (the "**CRA**") in the transfer pricing area to ensure their ongoing consistency with the OECD's "Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations" (the "**TP Guidelines**"), (C) the introduction of measures for combating perceived treaty abuse, both on a bilateral and multilateral basis, including participation in the development of a multilateral instrument to streamline (and thus expedite) the implementation of certain treaty-related BEPS recommendations, and (D) the establishment of a spontaneous tax ruling exchange procedure with certain other participating jurisdictions. Each of these proposals is canvassed in further detail below.

Country-by-Country Transfer Price Reporting

The BEPS project report recommendations included the development of new standards for transfer pricing documentation to help better align transfer pricing reporting across jurisdictions and to provide tax administrations with improved information for purposes of conducting risk assessments and enforcement. In this regard, the TP Guidelines are being revised to include a minimum standard for country-by-country reporting, which Budget 2016 proposes to adopt for Canadian purposes.

The country-by-country report will be a form that a large MNE will be required to file with the tax administration of the country in which the MNE’s ultimate parent resides. Each country-by-country report will include the global allocation, by country, of key variables for the MNE, including revenue, profit, tax paid, stated capital, accumulated earnings, number of employees and tangible assets, as well as the main activities of each of its subsidiaries. Where a jurisdiction receives a country-by-country report from a member of an MNE, that jurisdiction is expected to automatically exchange that report with other jurisdictions in which the MNE operates, provided required agreements and protections are in place with the other jurisdictions and the other jurisdictions have implemented country-by-country reporting. Where Canada cannot obtain a country-by-country report in respect of a subsidiary resident in Canada from the jurisdiction in which the ultimate parent of the MNE resides, in certain cases, the CRA may require the subsidiary to file the relevant country-by-country report directly. (MNEs may be able to avoid multiple subsidiary filing requirements by designating one of its subsidiaries to be a “surrogate” for filing purposes, with the surrogate filing the country-by-country report on behalf of the entire MNE.

For Canadian purposes, the new country-by-country reporting requirements, which will be the subject of future draft legislation, will generally apply to MNEs with total annual consolidated group revenue of at least 750 million Euros. Where an MNE has an ultimate parent (or surrogate) that is resident in Canada, it will be required to file a country-by-country report with the CRA within one year of the end of the fiscal year to which the report relates.

Country-by-country reporting will be required for taxation years that begin after 2015, with the first exchanges between Canada and other participating jurisdictions expected to occur by June 2018.

Revised Transfer Pricing Guidance

Although the OECD's TP Guidelines are not explicitly incorporated into Canada's income tax legislation, they are routinely referred to and relied on by taxpayers, the CRA and the courts for purposes of interpreting and applying section 247 of the *Income Tax Act* (the "**Tax Act**"), and, in particular, for the guidance offered with respect to the application of the so-called "arm's length principle".

The recommendations arising from the BEPS project included certain revisions and clarifications to the TP Guidelines that are intended to provide "an improved interpretation of the arm's length principle" for purposes of achieving a higher level of congruence between the profits of MNEs, on the one hand, and the economic activities generating those profits on the other.

In addition to indicating its support for the changes to the TP Guidelines, Budget 2016 confirms the Government's belief that the CRA's current audit and assessing practices are consistent with the revisions and clarifications. It also indicates that revisions to CRA administrative practices may be forthcoming after certain follow-up work by BEPS project participants is completed respecting: (i) the development of a threshold for the proposed simplified approach to low-value added services, and (ii) clarifications to the definitions of "risk-free" and "risk adjusted returns" for minimally functional entities (often referred to as "cash boxes").

Curbing Treaty Abuses

Budget 2016 reaffirms, albeit without a specific implementation timeline, the Government's longstanding commitment to curb perceived treaty abuses, including, most notably, instances of so-called "treaty shopping" in the context of certain transactions involving non-resident parties. "Treaty shopping" is described in Budget 2016 as occurring where a person resident in a third-country creates an intermediary holding company in a treaty jurisdiction for purposes of channeling, through the company, income and gains sourced in Canada to access benefits granted under an applicable tax treaty that would not otherwise have been available to them.

Budget 2016 expresses the Government's intention to implement its treaty abuse objectives in a manner consistent with the mechanics contemplated by the "minimum standard" recommended in the BEPS project reports. Among other things, the BEPS "minimum standard" requires countries to include an express statement in their treaties of a common intention to eliminate double taxation, without creating opportunities for non-taxation or reduced taxation through tax evasion or avoidance. Countries are also required to implement the common intention by way of either (i) a general anti-abuse rule in the treaty using the criterion of whether one of the "principal purposes" of a subject arrangement or transaction was to obtain treaty benefits in a manner that does not accord with the object and purpose of the relevant treaty provisions, or (ii) a specific anti-abuse rule requiring the satisfaction of a series of bright-line tests in order to qualify for treaty benefits (e.g., a rule similar to the limitation on benefits clause contained in the Canada-US Tax Treaty).

Budget 2016 reflects the Government's willingness to consider either of the foregoing approaches in the context of future bilateral treaty negotiations, "depending on the circumstances and discussions with Canada's treaty partners". In addition, and potentially of more immediate and significant impact, Budget 2016 confirms the Government's participation (along with other G20 countries) in the development, later in 2016, of the "multilateral instrument" contemplated by the BEPS project as a means of streamlining and expediting the implementation of the treaty anti-abuse rules described above (the multilateral instrument, as currently conceived, would be a tax treaty that multiple countries would sign modifying certain provisions of the bilateral treaties identified therein).

Spontaneous Exchange of Tax Rulings

In an effort to increase transparency and avoid what the Government describes as "mismatches in tax treatment" and "instances of double non-taxation", Budget 2016 adopts the BEPS project report recommendation to automatically exchange certain tax rulings with the revenue authorities of other jurisdictions which have adopted substantially similar measures and which have appropriate safeguards in place with respect to the protection of taxpayer information. Rulings subject to the automatic exchange regime will, according to Budget 2016, generally be those which could, in the revenue authorities' view, give rise to BEPS-related concerns in the event the exchange were not effected, and will include (but will not be limited to) rulings dealing with the following subject matter: (i) preferential regimes; (ii) cross-border unilateral advance pricing arrangements; (iii) downward adjustments to profits; (iv) permanent establishments; and (v) conduits.

It will be interesting to see what, if any, influence these new measures, scheduled to take effect in 2016, may have on taxpayer decisions going forward with respect to the seeking of advance income tax rulings.

Cross-Border Surplus Stripping

Section 212.1 of the Tax Act contains an anti-avoidance rule aimed at preventing certain non-resident shareholders in a Canadian corporation from (i) extracting (or "stripping") retained earnings (or "surplus") from the corporation in excess of the paid-up capital ("**PUC**") of the corporation's shares, or (ii) engaging in transactions designed to artificially increase the PUC of a corporation's shares. (PUC can generally be returned to non-resident shareholders free of withholding tax and is, thus, viewed as a valuable tax attribute.)

The anti-surplus stripping rule in the Tax Act will generally be engaged in circumstances where a non-resident taxpayer transfers shares in a Canadian corporation (known as the "subject corporation") to another Canadian corporation (known as the "purchaser corporation") with which the non-resident transferor does not deal at "arm's length". Under such circumstances, among other things, a deemed dividend that will be subject to non-resident withholding tax can result in the event the value of any non-share consideration received by the non-resident transferor exceeds the PUC attributable to the transferred shares.

Subsection 212.1(4) of the Tax Act provides an exception to the anti-surplus-stripping rule where (i) a Canadian purchaser corporation acquires shares of a non-resident corporation that itself owns shares of a Canadian corporation, thus creating a so-called "sandwich" structure (with the non-resident corporation being "sandwiched" between the two Canadian corporations), and (ii) the non-resident corporation subsequently disposes of the shares of the lower-tier Canadian corporation to the Canadian purchaser corporation (thus eliminating the "sandwich").

Budget 2016 indicates that the exception in subsection 212.1(4) has, in the Government's view, been inappropriately utilized by certain foreign-based corporate groups in the context of internal reorganization transactions designed to create sandwich structures with the primary purpose of increasing the PUC of a Canadian corporation's shares. While such previously undertaken transactions will, according to Budget 2016, continue to be challenged by the Government (including by way of assessment under the General Anti-Avoidance Rule contained in section 245 of the Tax Act), Budget 2016 proposes to amend subsection 212.1(4) for purposes of "clarifying" that the exception provided for therein will not be available in circumstances where, either at the time of the disposition or as part of a series of transactions that includes the disposition, a non-resident person both (i) owns, directly or indirectly, shares of the Canadian purchaser corporation, and (ii) does not deal at arm's length with the Canadian purchaser corporation.

In addition, Budget 2016 proposes to “clarify” (through new subsection 212.1(1.2) of the Tax Act), the application of the anti-surplus stripping rules in circumstances where it may otherwise be uncertain whether consideration has been received by a non-resident from a Canadian purchaser corporation in respect of the disposition of shares of a lower-tier Canadian corporation (which could include, for example, share transfers effected by way of a dividend in-kind or as part of a return of capital). In such cases, the non-resident will be deemed to have received non-share consideration from the Canadian purchaser corporation with a fair market value equal to the amount, if any, by which the fair market value of the lower-tier corporation’s shares disposed of exceeds the amount of any increase, because of the disposition, in the fair market value of the shares of the Canadian purchaser corporation.

The above-noted amendments are to apply to any subject corporation share disposition occurring on or after March 22, 2016.

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