# RECENT CANADIAN AND INTERNATIONAL DEVELOPMENTS


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# OUTLINE

1. Update on OECD/G20 International Tax Proposals
2. Update on International Tax Proposals in the US
3. Examples regarding Application of International Tax Proposals
4. 2022 Budget Potpourri
5. Questions

# UPDATE ON OECD/G20 INTERNATIONAL TAX PROPOSALS

PANELISTS: MARK KAPLAN, PATRICK MARLEY, STEFANIE MORAND, ANDREW SPIRO AND CHRISTOPHER MONTES

# OECD/G20 Tax Proposals - Pillar One

137 of the 141 members of the OECD/G20 Inclusive Framework have agreed on certain key parameters of the two-pillar approach to international tax reform.

Pillar One is intended to shift taxing rights over certain large multinational corporate groups from residence jurisdictions to market jurisdictions

OECD has released public consultation documents on nexus and revenue sourcing (on Feb 4, 2022), tax base determinations (on Feb 18, 2022), scope of Amount A (on Apr 4, 2022), extractives exclusion (on Apr 14, 2022), and the regulated financial services exclusion (on May 6, 2022), all on a "without prejudice" basis. These documents "do not reflect final or consensus views" among members of the Inclusive Framework

- Amount A: 25% of residual profit (i.e. profit in excess of 10% of revenue, based on adjusted financial accounting income) will be allocated to market jurisdictions with nexus, using a revenue-based allocation key.
- Amount B: intended to simplify the application of the arm's length principle to baseline marketing and distribution activities

# OECD/G20 Tax Proposals - Pillar One

Pillar One will apply to about 100 of the world's largest MNEs (generally, groups with global revenues over EUR 20 billion, and pre-tax profit margins over 10% with a prior period test and an average test). Pillar One will include exclusions for Extractives and Regulated Financial Services.

Implementation of Pillar One will require removal of all Digital Services Taxes (DST) and other similar measures, but there is considerable uncertainty as to whether Pillar One will be adopted in the US (and other countries)

Canada is moving ahead with its alternative DST (payable on revenue earned in 2022 and subsequent taxation years) if Pillar One is not successfully adopted by the end of 2023. This may lead to retaliatory tariffs by the U.S.

The Canadian DST would apply to entities/groups with global revenue of at least EUR 750 million in a calendar year not earlier than 2022, and more than $20 million of in-scope revenue from Canadian users.

# OECD/G20 Tax Proposals - Pillar Two

Pillar Two is intended to ensure that large multinational enterprises pay a minimum tax of 15% on income arising in each jurisdiction.

Model Rules were released by the OECD on Dec 20, 2021. Commentary to the Model Rules and illustrative examples were published on March 14, 2022.

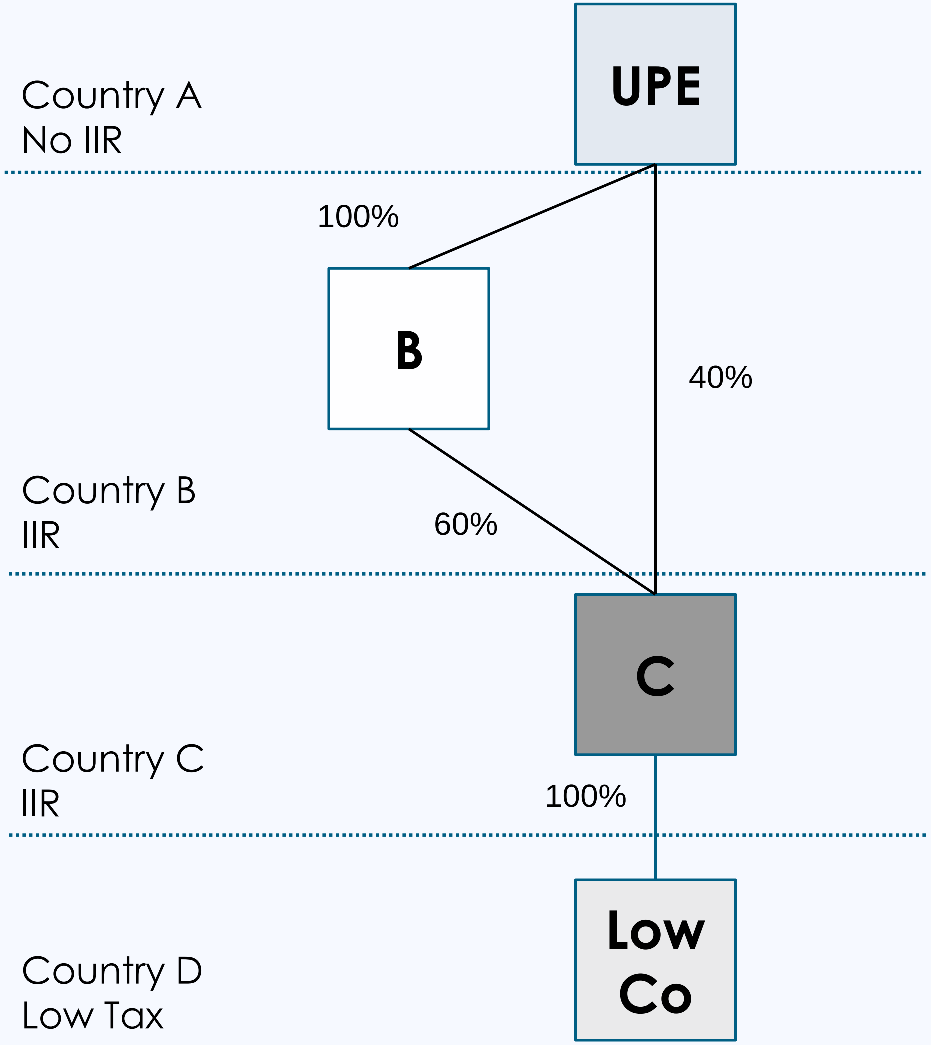
Pillar Two applies to multinational groups with more than EUR 750 million in consolidated revenues (in at least two of the four previous fiscal years), with exclusions for government entities, international and non-profit organizations, and pension, investment or real estate funds

Effective tax rate in each jurisdiction will be calculated based on adjusted financial accounting income and adjusted accounting tax expense (with a recapture mechanism)

The excess of 15% over the effective tax rate in a jurisdiction (i.e. the “top-up tax percentage”) applies to income less a substance-based exclusion equal to 5% of tangible assets and payroll costs in the jurisdiction (with a higher percentage during a transitional period).

# OECD/G20 Tax Proposals - Pillar Two

- "Qualified Domestic Minimum Top-up Taxes" (QDMTT) paid to a local jurisdiction can be credited against minimum tax liability under Pillar Two.
- Otherwise, primary rule is the Income Inclusion Rule (IIR), which is applied on a "top-down" basis (starting from the ultimate parent entity)
- A backstop to the IIR is the UTPR, which applies to low-taxed income not subject to the IIR. UTPR requires an adjustment that increases the tax of an entity in a jurisdiction in an amount sufficient to result in the appropriate top-up tax being paid by the group. The UTPR top-up tax amount is allocated to implementing jurisdictions based on relative percentages of employees and tangible assets.
- Most countries are expected to implement QDMTTs, which will decrease the amount of any additional revenue collected under the IIR and UTPR.




# Pillar Two Example: Top-Down Approach of the IIR

No IIR at the UPE level (since Country A has no IIR).

B Co's allocable share of IIR from Low Co is 60%.

C Co collects no IIR Top-Up Tax because its Intermediate Parent Entity, B Co, owns a Controlling Interest in C Co and applies the IIR.

Remaining 40% of Top-Up Tax to be collected through the UTPR.

<u>**Hierarchy**</u>: Local income tax → [local QDMTTs / CFC taxes in parent jurisdiction] → IIR → UTPR

# OECD/G20 Tax Proposals - Pillar Two

- A proposed EU Directive to implement Pillar Two by December 31, 2023 was vetoed by Poland on April 5, 2022. Poland's stated reason for opposing the directive was that both Pillar One and Pillar Two should be implemented together as a package (which is unlikely to occur). Next meeting is scheduled for May 24, 2022.
- There are proposals in the US (the BBBA and the Biden Administration's Budget for FY2023) to amend its GILTI and BEAT regimes to align with Pillar Two.
- Canada intends to implement Pillar Two, along with a domestic minimum top-up tax that would apply to Canadian members of MNEs that are within the scope of Pillar Two. The IIR and domestic minimum top-up tax would come into effect in 2023, the UTPR would come into effect no earlier than 2024. A public consultation is ongoing (with submissions due July 7, 2022).

# UPDATE ON INTERNATIONAL TAX PROPOSALS IN THE US

PANELISTS: MARK KAPLAN, PATRICK MARLEY, STEFANIE MORAND, ANDREW SPIRO AND CHRISTOPHER MONTES

# The American Jobs Plan: The 2023 Biden Administration's Revenue Proposals

- On March 28, 2022, the Biden Administration released its 2023 Budget as part of the American Jobs Plan.
- The United States Treasury introduced several new international tax proposals that build upon the Build Back Better Act (the "BBBA") which was passed by the US House of Representatives in November 2021 but stalled in the US Senate.
- The Budget treats the BBBA as enacted, with its revenue estimates scored against the BBBA as the baseline.

# The American Jobs Plan: The 2023 Biden Administration's Revenue Proposals (continued)

- The US Congress will return from its spring recess amid speculation that Democrats may make one last attempt to pass pared-down budget reconciliation legislation before the August recess.
- However, there are mixed signals about a post-BBBA reconciliation bill, with some senators suggesting a package would need to come together by Memorial Day. Among the complicating factors are differences between Senators Kyrsten Sinema's (D-AZ) and Joe Manchin's (D-WV) tax positions (e.g., Senator Sinema opposes tax rate increases)and uncertainty over whether both Senators Manchin and Sinema want an agreement.

# From the Fact Sheet - "The American Jobs Plan"

- Increase the corporate tax rate to 28%
- Increase the rate on global intangible low-taxed income ("GILTI") to 21%, calculates it on a country-by-country basis and eliminates the 10% return on tangible assets
- Encourage other countries to adopt strong minimum taxes on corporations
- Deny deductions to foreign corporations on payments that could allow them to strip profits out of the United States if they are based in a country that does not adopt a strong minimum tax
- Replace an ineffective provision in the 2017 tax law that tried to stop foreign corporations from stripping profits out of the United States

# From the Fact Sheet - “The American Jobs Plan” (continued)

- Make it "harder for U.S. corporations to invert"
- Deny companies expense deductions for offshoring jobs and provides a credit for expenses for onshoring
- Eliminate the deduction for foreign-derived intangible income
- Impose a 15% minimum tax on corporations based on "book income"
- Eliminate tax preferences for fossil fuels
- Strengthen business tax enforcement

# A Quick Recap of Various Concepts Introduced as part of the Tax Cuts and Jobs Act of 2017

- The corporate tax rate was changed from a tiered tax rate ranging from 15% to as high as 39% depending on taxable income to a flat 21%.
- The Act also changed the US from a global to a territorial tax system with respect to corporate income tax with the introduction of the provisions of section 245A.
- One-time repatriation tax of profits in overseas subsidiaries is taxed at 8% (15.5% for cash) creating the concept of "previously taxed earnings and profits" or "PTEP".

# A Quick Recap of Various Concepts Introduced as part of the Tax Cuts and Jobs Act of 2017 (continued)

- The introduction of "Global Intangible Low-Taxed Income" or "GILTI" calculated as the total active income earned by a US taxpayer's foreign subsidiaries that exceeds 10% of the taxpayer's depreciable tangible property (referred to as the "Qualified Business Asset Investment" or "QBAI"). A corporation (but not other businesses) can generally deduct 50% of the GILTI and claim a foreign tax credit for 80% of foreign taxes paid or accrued on GILTI.
  - Therefore, if the foreign tax rate were zero, the effective US tax rate on GILTI would be 10.5% (half of the regular 21% corporate rate because of the 50% deduction provided by way of section 250); if the foreign tax rate were 13.125% or higher, there would be no US tax after the 80% credit for foreign taxes.

# A Quick Recap of Various Concepts Introduced as part of the Tax Cuts and Jobs Act of 2017 (continued)

- The introduction of "Base Erosion And Anti-abuse Tax" or "BEAT" which targets large US corporations (i.e., those with gross receipts of more than $500 million, averaged over the prior three years) that make deductible payments, such as interest, royalties, and certain service payments, to related foreign parties.
- The BEAT only applies to a corporation that makes more than 3% of its total deductible payments to related foreign parties
- The BEAT is a minimum tax add-on: A US corporation calculates its regular US tax, at a 21% rate, and then recalculates its tax at a lower BEAT rate after adding back the deductible payments. If the regular tax were lower than the BEAT, then the corporation must pay the regular tax plus the amount by which the BEAT exceeds the regular tax.
- The BEAT rate was 5% in 2018, 10% in 2019 through 2025, and 12.5% in 2026 and beyond.

# A Quick Recap of Various Concepts Introduced as part of the Tax Cuts and Jobs Act of 2017 (continued)

- The introduction of "Foreign-Derived Intangible Income" or "FDII" which is designed to reduce the tax rate on foreign-derived sales and service income to 13.125%, rather than the regular 21% to encourage US corporations to export more goods and services and locate more intangible assets in the United States. The FDII computation is complicated but it is intended to approximate income from the sale of goods and services abroad attributable to US-based intangible assets such as patents, trademarks, and copyrights.
- The reduced tax rate is again facilitated by way of the introduction of section 250 which provides for a 37.5% deduction (which results in a permanent tax benefit and 13.125% effective tax rate as compared to a 21% corporate rate) for tax years beginning after December 31, 2017 and before January 1, 2026 after which the deduction is reduced to 21.875%, resulting in an effective tax rate of 16.406%.

# A Quick Recap of Various Concepts Introduced as part of the Tax Cuts and Jobs Act of 2017 (continued)

- As with the provisions of the new law related to GILTI, the law approximated the income attributable to a US firm's intangible assets by the income that exceeds a 10% deemed return on its depreciable tangible property (again, the QBAI); the share of the excess income allocated to the sale of goods and services abroad is taxed at a reduced rate.

# Increased Corporate and GILTI Rates

- The Budget would raise the corporate tax rate to 28% from the BBBA baseline (and current) rate of 21%.
- Early drafts and policy outlines of the BBBA included a similar rate increase, which was later dropped following opposition from Senator Kyrsten Sinema.
- The House-passed BBBA then included a 15% corporate alternative minimum tax ("CAMT"), largely viewed as a substitute for the corporate rate increase from a revenue perspective. Thus, the FY23 Budget would increase the corporate rate while maintaining the CAMT from the BBBA.

# Increased Corporate and GILTI Rates (continued)

- The Budget would also increase the GILTI rate to 20%. For comparison, the GILTI rate under current law is 10.5%, or 13.125% after the 20% GILTI foreign tax credit ("FTC") haircut, for tax years beginning before December 31, 2025.
- The corporate and GILTI rate increases would apply to tax years beginning after December 31, 2022. For an earlier tax year ending after December 31, 2022, a blended corporate rate would apply equal to 21% plus 7% multiplied by the portion of the tax year that takes place in the 2023 calendar year.

# Replacement of BEAT with UTPR

- The Budget would repeal the BEAT and replace it with a UTPR that is consistent with the Pillar Two Model Rules, which include the Undertaxed Profits Rule ("UTPR") and the Income Inclusion Rule ("IIR").
- The technical aspects of the Budget's UTPR proposal align closely with those in the Pillar Two Model Rules published on December 20, 2021.
- Under the Budget, both domestic corporations that are part of a foreign-parented multinational group and domestic branches of foreign corporations would be denied US tax deductions to the extent necessary to collect the hypothetical top-up tax required for the financial reporting group to pay an effective tax rate of at least 15% in each foreign jurisdiction in which the group has profits (i.e., the UTPR Top-up Tax).

# Replacement of BEAT with UTPR

- As contemplated in the Pillar Two Model Rules, both US-parented and foreign-parented multinationals operating in low-tax jurisdictions (with financial reporting groups' global annual revenue of $850 million or more in at least two of the prior four years) would fall within the UTPR's scope. The Budget explicitly states, however, that the UTPR would not apply to income that is subject to an IIR that is consistent with the Pillar Two Model Rules, including income subject to GILTI; as such, the UTPR would generally not apply to US-parented multinationals.

# Replacement of BEAT with UTPR (continued)

- The Budget also includes a domestic minimum top-up tax that would apply to preclude the imposition of UTPR by other countries. This top-up tax would equal the excess of (a) 15% of the financial reporting group's US profit (determined using the same rules as under the UTPR to determine the group's profit for a jurisdiction), over (b) all the group's income tax paid or accrued with respect to US profits (including federal and state incomes taxes, CAMT, and creditable foreign income taxes incurred with respect to US profits).
- Consistent with the OECD Pillar Two proposal, the Budget's UTPR proposal would take effect in 2024.

# Onshoring and Offshoring Rules

- The Budget would create a new general business credit for onshoring expenses, while disallowing deductions for offshoring expenses. In each case, the relevant expenses are solely those incurred in relocating a trade or business to or from the United States, respectively, and do not include capital expenditures or costs for severance pay and similar assistance to displaced workers.
- The onshoring credit would equal 10% of relevant expenses incurred when onshoring a trade or business to the United States. The Budget states that "onshoring" means reducing or eliminating a trade or business conducted outside the United States and starting, expanding, or otherwise moving the same trade or business within the United States, provided US jobs increase.

# Onshoring and Offshoring Rules (continued)

- The offshoring rule would disallow deductions for relevant expenses incurred when offshoring a trade or business from the United States. "Offshoring" for this purpose means reducing or eliminating a trade or business conducted inside the United States and starting, expanding, or otherwise moving the same trade or business outside the United States, provided US jobs decrease.
- The Budget states that a US shareholder could not deduct an offshoring expense against its subpart F or GILTI inclusion, implying that a CFC or a US person could incur the relevant expense.
- The onshoring and offshoring rules would apply to expenses paid or incurred after the date of enactment.

# Some Observations

- The Budget's proposal to increase the corporate (and thus GILTI) rate would be expected to pose additional tax liabilities on taxpayers on top of increases expected from the BBBA's move toward country-by-country GILTI and FTC regimes, among other BBBA changes.
- These increases are also in addition to the CAMT, which some had viewed as a substitute for the rate increases; a higher corporate rate could, however, reduce the likelihood that some taxpayers are subject to the CAMT.
- Taxpayers looking to restructure their global operations may have significant interest in the Onshoring and Offshoring rules, though the scope of each proposal is uncertain, pending further word from the Administration or draft legislative text.

# Some Observations (continued)

- Because it maintains the BBBA proposals, the Budget does not propose to repeal the deduction for FDII.
  - This contrasts with President Biden's FY2022 Budget, released in May 2021, proposing to repeal FDII in its entirety. This may have implications on the current review of FDII by the OECD's Forum on Harmful Tax Practices (“FHTP”), which is assessing whether FDII is considered a harmful tax practice. The FHTP previously stated in August 2021, based on last year's Budget, that the FDII regime is "in the process of being eliminated" and that "[t]he United States has committed to abolish this regime." The elimination of this from the Budget raises the question of whether the FHTP will look to revisit the review of FDII.

# Some Observations (continued)

- The Budget also does not propose changing the anti-inversion rules of Section 7874, which the House-passed BBBA did not propose to amend. Senate Finance Committee drafts, as well as the Administration's FY22 Budget, proposed expanding the scope of transactions that are "domestic entity acquisitions" and reducing the Section 7874 ownership percentage thresholds, among other changes. The Administration has not communicated that it intends to drop these proposals altogether, so they could re-emerge in later policy outlines or draft texts.
- The Budget proposes to replace BEAT with the UTPR. The proposal would conform the US rules to the Pillar Two agreement, a clear sign of the Administration's support for implementing Pillar Two around the world.

# Some Observations (continued)

- The Budget's proposed adoption of a domestic minimum tax appears to respond to criticism that a foreign government's adoption of the IIR and UTPR would result in foreign countries gaining tax revenue that arises from US profits — a domestic minimum tax would instead tax those profits in the United States first and preclude application of the IIR and UTPR by other countries.

# Some Observations (continued)

- Critics also note that adopting a minimum tax on US profits under Pillar Two would eliminate certain job-creating incentives (particularly those arising from general business credits, which are non-refundable credits and treated less favorably than refundable credits for Pillar Two purposes).
  - Although the Budget alludes to the possibility of rules that would allow US taxpayers to benefit from "US tax credits and other tax incentives that promote US jobs and investment," no further details are provided. The United States would presumably have to balance the desire to preserve certain tax incentives without them triggering the types of low-tax outcomes that the United States is seeking to end under Pillar Two.

# Some Observations (continued)

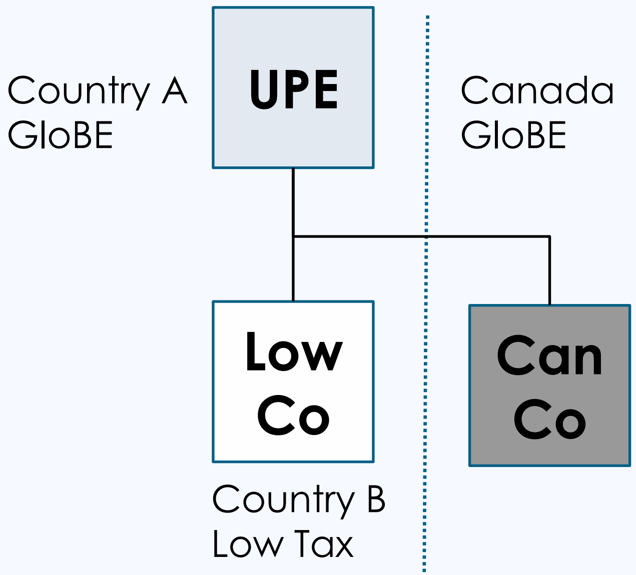
- The US adoption of the Pillar Two Model Rules would require numerous and novel changes to the Code:
  - the proposal would require the use of financial accounting principles (similar to the CAMT, which is presumed adopted as part of the BBBA, although with very different adjustments) to determine the taxable base,
  - the introduction of rules for determining foreign taxes that fundamentally differ from the existing US FTC rules,
  - the Budget would require deferred taxes to be considered in the computation of foreign taxes, and also allow for a broader scope of foreign taxes to be treated as income taxes, and
  - The definition of Cost of Goods Sold may need be modified for purposes of the CAMT (i.e., the UTPR) as it was for purposes of the BEAT.

# EXAMPLES REGARDING APPLICATION OF INTERNATIONAL TAX PROPOSALS

PANELISTS: MARK KAPLAN, PATRICK MARLEY, STEFANIE MORAND, ANDREW SPIRO AND CHRISTOPHER MONTES

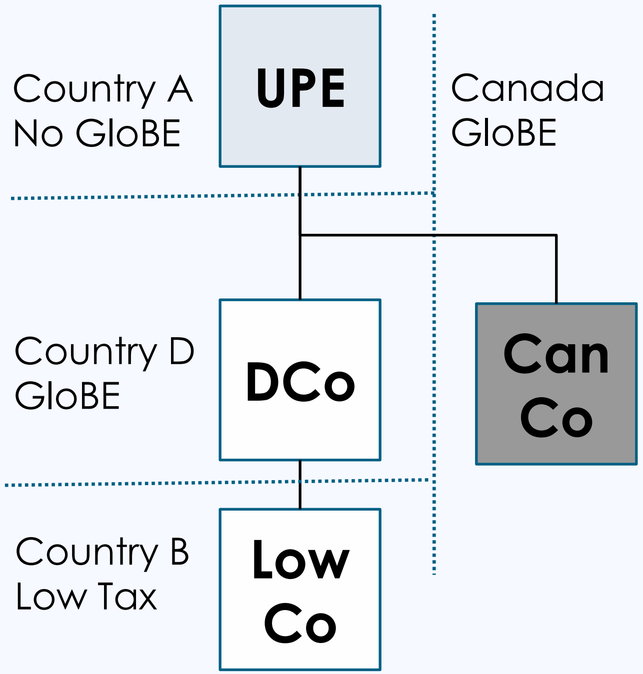
# Pillar Two: Who Needs To Pay? Small Changes – Big Impact – No Nexus Required

**Scenario 1:**



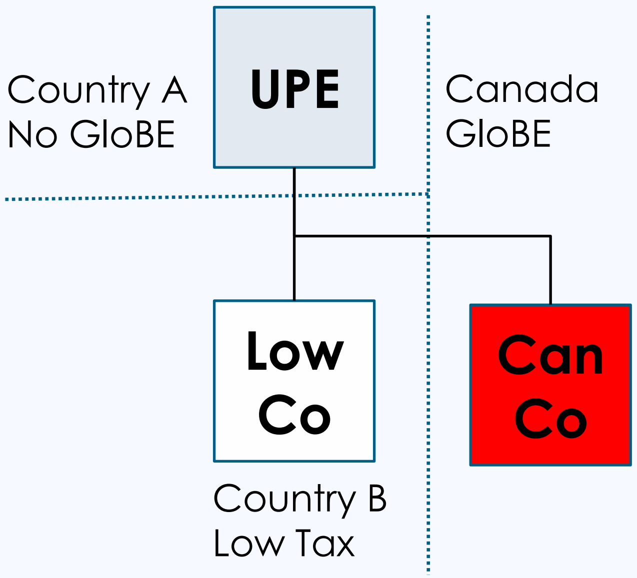

Top-Up Tax attributable to LowCo payable in Country A (UPE) under IIR

**Scenario 2:**




Top-Up Tax attributable to LowCo payable in Country D under IIR

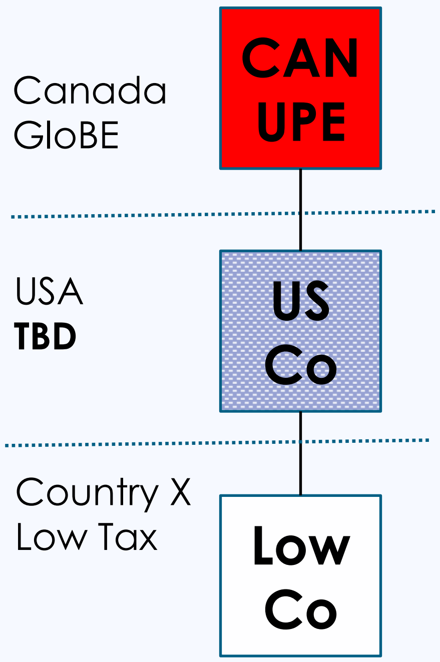
**Scenario 3:**



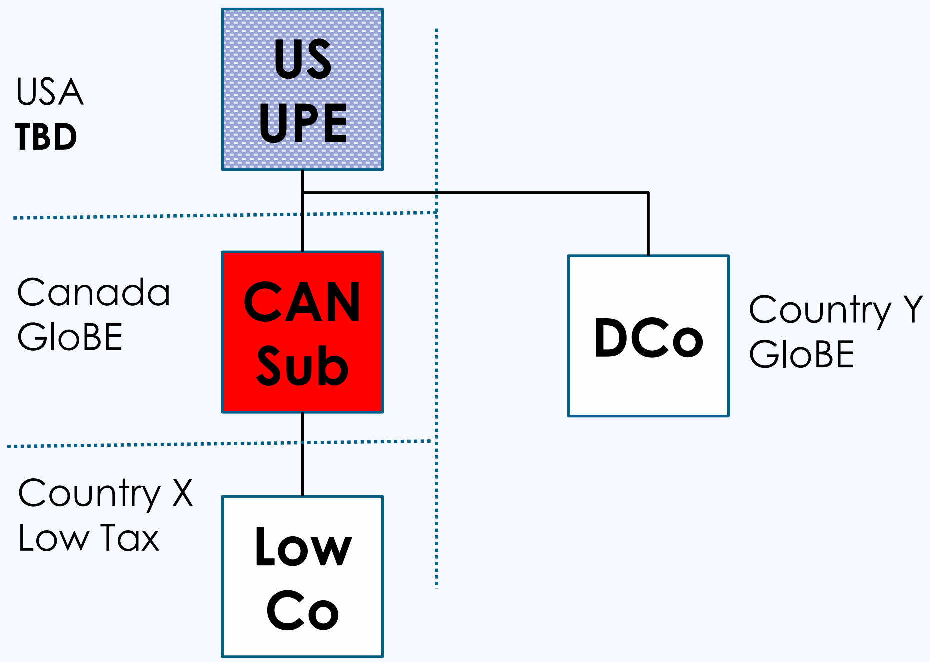

Top-Up Tax attributable to LowCo payable in Canada under UTPR

# Pillar Two: Additional Examples -- Canadian MNE and US MNE with CanSub

**Canadian MNE with US Subsidiary:**




**US MNE with Canadian Subsidiary:**



# Pillar Two: Example 4.1.5-1 – Imposition of Top-up Tax in Loss Year

- Salt in the Wound – March 2022 commentary confirms the possibility of Top-Up Tax if there is a difference between the GloBE tax base and the local tax base, even if there is no net GloBE income for a jurisdiction

- Assume a $20 book to tax difference (e.g., due to a capital gains exemption);
- Company otherwise in a loss position
- Pillar 2 proposes an immediate cash tax of $3 (even if NOLs never get used)!

| Local Tax | | GloBE | |
|---|---|---|---|
| Income | 100 | Income | 100 |
| | | Capital gain excluded under local law | 20 |
| Expenditure | (220) | Expenditure | (220) |
| Total Profit (Loss) | (120) | Total Profit (Loss) | (100) |
| Tax (Tax benefit) | (18) | Expected Adjusted Covered Taxes Amount | (15) |

# Pillar Two: Tax Credits – What the Left Hand Giveth the Right Hand Taketh? (Article 3.2.4)

- "Qualified Refundable Tax Credit" means a refundable tax credit designed in a way such that it must be paid as cash or available as cash equivalents within four years from when a Constituent Entity satisfies the conditions for receiving the credit under the laws of the jurisdiction granting the credit. A tax credit that is refundable in part is a Qualified Refundable Tax Credit to the extent it must be paid as cash or available as cash equivalents within four years from when a Constituent Entity satisfies the conditions for receiving the credit under the laws of the jurisdiction of the credit. A Qualified Refundable Tax Credit does not include any amount of tax creditable or refundable pursuant to a Qualified Imputation Tax or a Disqualified Refundable Imputation Tax.

| Qualified Refundable Tax Credit | Non-Qualified Refundable Tax Credit |
|---|---|
| • Treated as income for purposes of GloBE Rules<br>• Included in ETR denominator and not treated as reducing taxes in the year the refund/credit is claimed | • Excluded from income for purposes of GloBE Rules, but treated as a reduction to Covered Taxes in the period the refund/credit is claimed (i.e., reduction to numerator of ETR computation) |

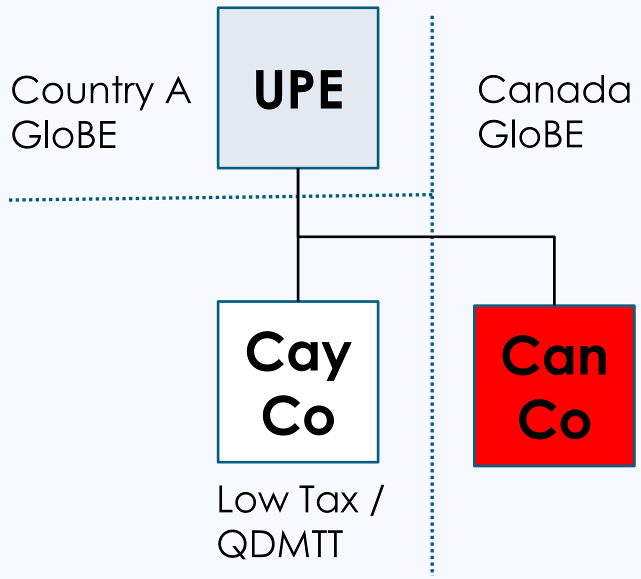
# Pillar Two: Canadian Patent Boxes – An Opportunity for Canada?

- Budget 2022:

**Review of Tax Support to R&D and Intellectual Property**

The Scientific Research and Experimental Development (SR&ED) program provides tax incentives to encourage Canadian businesses of all sizes and in all sectors to conduct R&D. The SR&ED program has been a cornerstone of Canada's innovation strategy. The government intends to undertake a review of the program, first to ensure that it is effective in encouraging R&D that benefits Canada, and second to explore opportunities to modernize and simplify it. Specifically, the review will examine whether changes to eligibility criteria would be warranted to ensure adequacy of support and improve overall program efficiency.

As part of this review, the government will also consider whether the tax system can play a role in encouraging the development and retention of intellectual property stemming from R&D conducted in Canada. In particular, the government will consider, and seek views on, the suitability of adopting a patent box regime in order to meet these objectives.



# 2022 BUDGET POTPOURRI

PANELISTS: MARK KAPLAN, PATRICK MARLEY, STEFANIE MORAND, ANDREW SPIRO AND CHRISTOPHER MONTES

1. Interest Coupon Stripping
2. FAPI Amendments
3. Application of GAAR to unused Tax Attributes
4. Exchange of Information on Digital Economy Sellers
5. Transfer Pricing Proposals

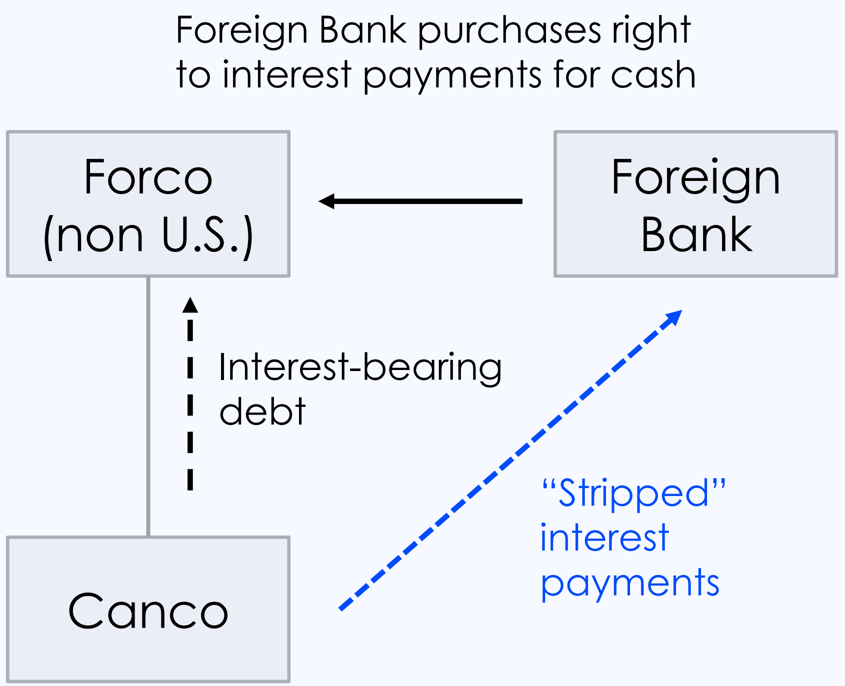
# Interest Coupon Stripping

Budget proposal targets structures designed to eliminate or reduce Canadian withholding tax that would be payable on inter-group financing.

Entitlement to interest/coupons on related party debt is separated from the entitlement to the repayment of principal.  The right to receive the stripped coupons is then sold to an arm's length purchaser.

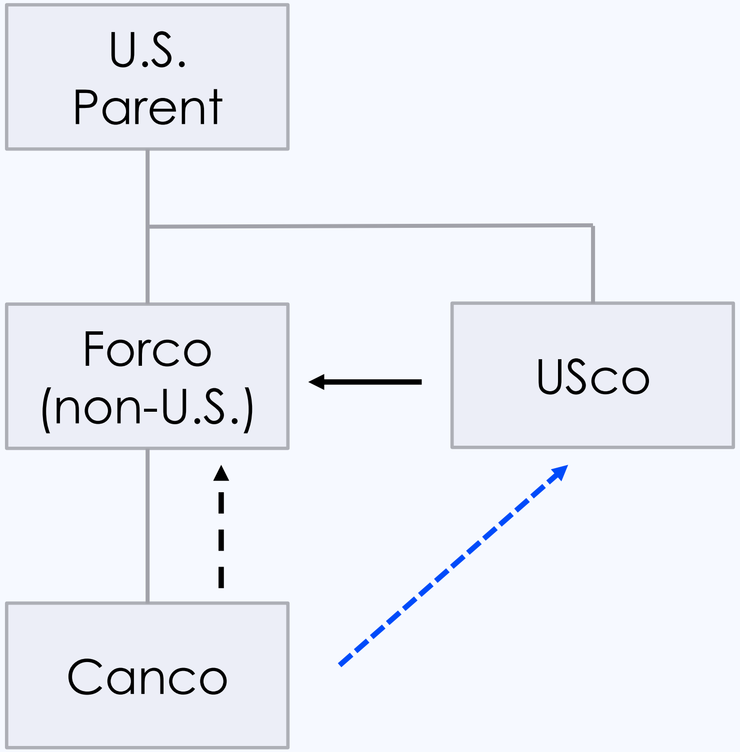
ITA 212(1)(b)(i)(B) was introduced in the 2011 Budget to defeat coupon strip planning as a means to avoid the application of Part XIII altogether, but certain coupon stripping structures are not caught.

# Coupon Strip Example – ITA 212(1)(b)(i)(B)

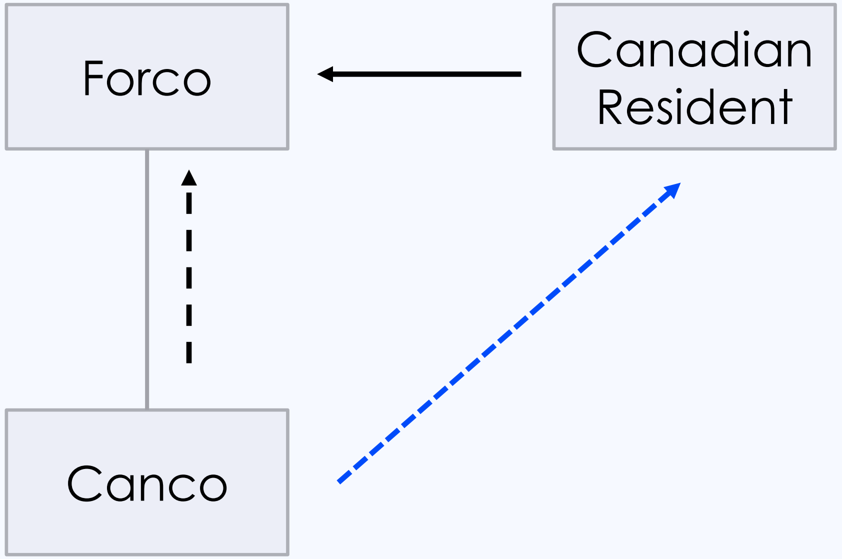



ITA 212(1)(b)(i)(B) imposes withholding tax on interest paid "in respect of a debt or other obligation to pay an amount to a person with whom the payer is not dealing at arm's length".

# Coupon Strip Examples – 2022 Budget




Interest payments to USco are exempt from Canadian withholding tax under Article XI of the *Canada-U.S. Treaty.*




Interest payments to Canadian Resident are not subject to Canadian withholding tax.

# Budget Proposal – Interest Coupon Stripping Arrangements

New ITA 212(21) and 212(22) introduce a new specific anti-avoidance rule applicable where a taxpayer pays interest to a person in respect of a debt or other obligation owed to another person where:

(a) the other person (the "**non-arm's length creditor**") is either a non-resident with whom the payer is not dealing at arm's length or a partnership that is not a Canadian partnership; and

(b) the Part XIII tax payable in respect of the payment is less than the amount of Part XIII tax that would have applied if the payment had been made to the non-arm's length creditor.

Exception for certain publicly offered debt obligations.

# Budget Proposal - Consequences

If the rule applies, the payer is deemed to make an interest payment to the non-arm's length creditor.

The amount of deemed interest is A x (B-C)/B where:

A = the amount of the actual interest payment

B = the Part XIII tax rate that would apply to an interest payment to the non-arm's length creditor

C = the Part XIII tax rate applicable to the actual interest payment

# Effective Date

Proposal to apply to interest accrued on or after April 7, 2022 (Budget day).

One-year grandfathering available to payments in respect of debts incurred before Budget day if (i) the coupon holder and the non-arm's length creditor deal at arm's length <u>and</u> (ii) the right to the coupons was acquired under an agreement or arrangement entered into before Budget day.

For grandfathered arrangements, rule will apply to interest that accrues on or after April 7, 2023.

# Tax Deferral Using Foreign Corporations

"Foreign accrual property income" (FAPI) earned in a controlled foreign affiliate (CFA) is included in a taxpayer's income in the year earned by the affiliate.

The FAPI regime includes provisions to avoid double taxation by allowing for a deduction against FAPI inclusions in respect of "foreign accrual tax" (FAT) applicable to the FAPI in question multiplied by the taxpayer's "relevant tax factor" (RTF).

Foreign affiliate dividends-received deduction in ITA 113 is also based in-part on the dividend recipient's RTF.

# Tax Deferral Using Foreign Corporations

RTF is intended to calibrate to the rate that would have applied had the income been earned in Canada.

- For corporations, RTF is 4 (reflecting an assumed tax rate of 25%)
- For all other taxpayers RTF is 1.9 (reflecting an assumed tax rate of 52.63%)

CCPCs are subject to a substantially higher corporate tax rate on undistributed investment income than non-CCPCs. However, corporate RTF does not differentiate between tax rates applicable to CCPCs and other corporations, leading to a potential deferral benefit for CCPCs.

Deductible FA dividends can give rise to GRIP, allowing for ultimate distribution as eligible dividends.

# CFA Deferral Example

Ontario CCPC earning $100 undistributed investment income directly is subject to $50.17 (50.17%) corporate tax.

Ontario CCPC earning the same $100 investment income through a CFA, assuming 20% foreign tax rate, achieves deferral under existing rules as follows:

FAPI inclusion = $100

FAT deduction = $20 x 4 = $80

Net FAPI inclusion = $20

Total tax = $30.34 ($20 foreign tax plus $10.34 Canadian tax on net FAPI).

# Budget Proposal – Tax Deferral Using Foreign Corporations

Budget proposes to eliminate potential deferral advantage associated with CCPCs earning investment income through CFAs and FAs by applying the RTF currently applicable to individuals to CCPCs (and "substantive CCPCs").

To preserve integration, Budget proposes accompanying amendments to add an amount to the CCPC (or substantive CCPC)'s capital dividend account (CDA). New CDA inclusion will replace GRIP inclusion of amounts in respect of inter-corporate dividend deductions for hybrid surplus and taxable surplus dividends.

# Budget Proposal – Application of GAAR to Tax Attributes

Legislative override of 2018 FCA decision in *1245989 Alberta Ltd* (a.k.a. *Wild*).

*Wild* involved a corporate reorganization designed to achieve a step-up on the PUC of shares held by an individual; step-up was achieved without triggering ITA 84.1 by relying on automatic PUC averaging under corporate law.

TCC held that the transaction amounted to a misuse or abuse of section 84.1.

FCA overturned TCC decision on the basis that there could not be a misuse or abuse of section 84.1 before the increased PUC was used to realize an unintended tax benefit – in this case the tax-free extraction of corporate surplus.

# Budget Proposal – Application of GAAR to Tax Attributes

Budget concern that *Wild* decision with respect to unused tax attributes runs counter to the policy of the rule in ITA 152(1.11) that allows the CRA to determine the amounts of tax attributes where the GAAR applies to a transaction.

Budget proposes to amend the GAAR to allow it to apply to transactions that affect tax attributes that have not yet become relevant to the computation of tax.

Corresponding amendments to notice of determination rule apply to any notice of determination issued after Budget day, <u>even in respect of pre-Budget transactions</u>.

# Budget Proposal – Application of GAAR to Tax Attributes

Budget proposes to amend the definition of "tax benefit" to include a reduction, increase or preservation of an amount that could at a subsequent time (i) be relevant for the purpose of computing an amount payable under the ITA or a refund of an amount under the ITA, and (ii) result in a tax benefit (as defined before the Budget change).

Corresponding change to the definition of "tax consequences".

Amendment to ITA 152(1.11) provides for determination of any amount that is, or could at a subsequent time be, relevant for purposes of computing income, taxable income…

# Exchange of Information - Digital Economy Platform Sellers

On July 3, 2020 OECD published *Model Rules for Reporting by Platform Operators in the Sharing and Gig Economy* (the "**Model Rules**"). The Model Rules impose reporting obligations on operators of digital platforms that provide accommodation, transport and other personal services ("**Basic Scope**").

On June 22, 2021 OECD published the *Multilateral Competent Authority Agreement on Automatic Exchange of Information on Income Derived through Digital Platforms ("**DPI MCAA**")*, together with an optional extension to the Model Rules to cover digital platforms providing for the sale of goods and rental of means of transportation ("**Extended Scope**").

# Exchange of Information - Digital Economy Platform Sellers

The DPI MCAA provides a framework for automatic exchange of information collected from digital platform operators by competent authorities based on three options:

- Exchange of information collected under the Basic Scope
- Exchange of information collected under the Extended Scope
- Decline to exchange information, but express interest in receiving information from other jurisdictions.

Other jurisdictions, including the EU, UK and Australia have announced intention to implement the Model Rules or a similar framework.

# Exchange of Information - Digital Economy Platform Sellers

Budget 2022 announces that Canada also proposes to implement the Model Rules.

Canada intends to implement Extended Scope (including reporting in respect of sales of goods and rental of means of transportation).

Automatic exchange of information proposed in the Budget to be limited to exchange with jurisdictions with reciprocal exchange rules in place.

# Exchange of Information - Digital Economy Platform Sellers

Reporting rules will apply to platform operators (“**reporting platform operators**”) who are:

- Resident in Canada
- Not resident in Canada or a partner jurisdiction that facilitate relevant activities by sellers resident in Canada or with respect to rental of immovable property located in Canada

“Partner jurisdiction” means a jurisdiction that has implemented similar reporting requirements on platform operators and has agreed to exchange information with the CRA.

# Exchange of Information - Digital Economy Platform Sellers

Platform is broadly defined in the Model Rules; includes software, websites, apps.

Exclusions for software that exclusively facilitates:

- processing of compensation (e.g. payment processors)
- mere listing or advertising (e.g. classified ads boards)
- transfer of users to another platform (e.g. online aggregators)

A platform operator is defined in the Model Rules as an entity that contracts with sellers to make all or part of a platform available.

# Exchange of Information - Digital Economy Platform Sellers

Reporting Platform Operators:

- Entities engaged in contracting, directly or indirectly, with sellers to make the software that runs a platform available for sellers to be connected to other users; or
- Entities collecting compensation for the relevant activities facilitated though the platform.

Exemptions

- Platform operators that demonstrate that their business model does not allow sellers to profit
- Platform operators that demonstrate that the platform does not have reportable sellers
- Platform operators for which the total prior year compensation for relevant activities is less than €1 million, and that elect to be excluded

# Exchange of Information - Digital Economy Platform Sellers

Reportable sellers are active users registered on the platform to provide services or sell goods.

Exclusion for certain sellers who represent low compliance risk:

- Governmental entities
- Public companies
- Large hotel accommodation providers
- Very small sellers

# Exchange of Information - Digital Economy Platform Sellers

Reporting platform operators required to complete due diligence procedures to identify reportable sellers and jurisdictions of residence.

Proposed to apply to calendar years beginning after 2023, with the first reporting and exchange of information to take place in early 2025 with respect to the 2024 calendar year.

# Budget Proposals – Transfer Pricing Consultation

Budget confirms the Department of Finance's continuing intention to proceed with the transfer pricing consultation announced in Budget 2021.

Budget 2021 had announced a consultation on Canada's transfer pricing rules in light of the FCA decision in *Cameco*. (SCC denied leave to appeal in February of 2021.)

Consultation materials indicating how Finance proposes to address concerns with *Cameco* expected in the coming months.

# QUESTIONS?