International
TAX HIGHLIGHTS

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CTF Director's Note

I am pleased to share with you the inaugural issue of our newest publication, *International Tax Highlights*, developed and produced in collaboration with the Canadian branch of the International Fiscal Association. This newsletter will provide timely updates and insights from domestic and international experts on an important and rapidly evolving area.

Congratulations to the content editor, Angelo Nikolakakis, and to all of the contributors. To our readers, we invite your feedback on this issue, and your ideas for future issues.

Heather L. Evans
Executive Director and CEO
Canadian Tax Foundation

Introducing International Tax Highlights

The COVID-19 pandemic has been a time of reflection and introspection for many of us. The IFA Canadian branch is no exception. A recurring point of discussion for the IFA Canada executive has been how to offer more value to our membership. On several occasions in the past, IFA Canada has considered the possibility of providing our members with a regular publication focused on international taxation. Early in the pandemic, this idea was brought back on the table—particularly following the 2019 retirement of the Canadian Tax Foundation's *Canadian Tax Highlights* (CTH), a newsletter beloved by many in the Canadian tax community. The IFA Canada executive enthusiastically supported the idea of creating an international publication, in partnership with the Foundation, that would be inspired by CTH, with its crisp, easy-to-read text and on-point format. When, in 2020, Patrick Marley and I brought the idea to Heather Evans (the Foundation's executive director and CEO) and Michael Gaughan (the Foundation's managing editor), they were very excited, and immediately put the wheels in motion within the CTF to make this project a reality. That this new project—a co-branded IFA-CTF publication titled *International Tax Highlights*—has come to fruition only two years later is testament to the seamless collaboration between our two sister organizations, the CTF and IFA Canada.

We are tremendously grateful to Angelo Nikolakakis for agreeing to be our first content editor. Angelo hardly needs an introduction to an international tax audience, but here is an introduction nonetheless. Angelo has made many significant contributions to the CTF and IFA, including as a member of the IFA Canada Council. A partner in the International Tax Services practice of EY Law LLP, he has been repeatedly recognized by the Canadian Legal Lexpert Directory in the area of corporate tax. He has also been recognized in the Chambers and Partners global directory of the world's leading lawyers, and in International Tax Review's World Tax guides in the areas of mergers, acquisitions, and cross-border structuring. He is the author of *Taxation of Foreign Affiliates*, the leading publication on the Canadian federal income tax implications of foreign direct investments of Canadian multinationals. He also serves on the executive of the Joint Committee on Taxation of the Canadian Bar Association and Chartered Professional Accountants of Canada, and as a member of the Permanent Scientific Committee of Central IFA.

Michael N. Kandev
International Fiscal Association (Canadian Branch)

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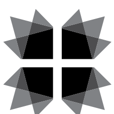

In This Issue

I remember the federal budget of February 22, 1994, as a young stagiaire at Stikeman Elliott in Montreal. This budget caused a great deal of excitement and some panic at the office, even prompting one senior tax partner to contemplate switching

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to the practice of corporate law. Some felt that the sky was falling on the tax practice. This was the budget that proposed the introduction of significant changes to the foreign affiliate rules and the butterfly rules. Some 28 years later, notwithstanding these and many other changes since that day, the practice of tax law is thriving.

For my part, as a young practitioner, I saw such developments as opportunities—as great levellers. They allowed newcomers such as myself to catch up quickly to more seasoned practitioners by knowing as much as they did about the new measures—more, perhaps, given the energy, enthusiasm, and fresh perspective of the young practitioner.

So here we go again. The last few months have seen watershed developments in the field of international taxation; we could not have picked a better time to launch this newsletter. In this inaugural issue, we bring together various highlights and various perspectives on some key developments.

Perhaps the most fundamental changes to international tax principles and international tax practice are reflected in the OECD initiatives relating to BEPS and, more generally, to the digitalization of the global economy. Thus, a significant portion of this issue is devoted to these topics. Patrick Marley and Penelope Woolford take us through the OECD's two-pillar solution, which is aimed at allocating new taxing rights to market jurisdictions (pillar 1) and the introduction of a 15 percent global minimum tax (pillar 2). Michael Colborne shines a more focused light on the continuing work to exclude so-called extractives from the scope of pillar 1. Sue Wooles and Carl Irvine, living in the real world, remind us that there is no "easy button" when it comes to the ever-increasing compliance and administrative burdens that arise with each new initiative.

There have also been important developments in Canada's implementation of other BEPS-related initiatives. Ken Buttenham and Alex Cook provide a useful summary of the proposed "excessive interest and financing expenses limitation" (EIFEL) rules—a new regime to limit the deduction of excessive interest and financing expenses, inspired by BEPS action 4. Nik Diksic does likewise with respect to the proposed hybrid mismatch arrangement rules, inspired by BEPS action 2.

On the jurisprudence side, the Supreme Court of Canada has favoured us with two very important decisions, one in the inbound context (*Loblaw Financial*) and one in the outbound context (*Alta Energy Luxembourg SARL*). David Duff, in his article, and Michael Kandev and John Lennard, in their co-authored article, share their different perspectives on the *Alta Energy* decision and its implications both for the application of GAAR (in general and, more specifically, in the context of treaty shopping) and for the new principal purpose test (PPT) now applicable in relation to many of our tax treaties as a result of Canada's implementation of elements of the MLI, which reflects yet another cluster of BEPS initiatives. David Bunn provides a remarkably straightforward summary of the *Loblaw* decision, which reflects a number of principles that are fundamental to tax practice—taxpayers' rights to arrange their affairs, and the role of the courts both in general and in the interpretation of the law, in the context of the FAPI rules.

Finally, Shiraj Keshvani and Amanda Heale highlight the growing need for effective and efficient dispute prevention and resolution mechanisms in the transfer-pricing context—an area of tremendous importance in international tax practice.

Some of the articles are much longer than we will want in future issues, but exceptions have been made for this inaugural offering, given the breadth and importance of some of the developments covered in these articles.

We have a very strong community of international tax practitioners, academics, and tax administration officials in Canada, at all stages of their careers, and we have very highly regarded public-interest institutions, two of which have graciously joined forces to host this new publication. We hope that readers will enjoy this newsletter, and will be inspired to submit their contributions from time to time as we all enter this new era of international taxation.

Angelo Nikokakakis
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International Tax Reform: Canada Looks To Advance Two-Pillar Solution

The OECD/G20 Inclusive Framework on BEPS (which currently includes 141 countries) continues to work toward a two-pillar solution to international tax reform. This approach is summarized in the October 8, 2021 Statement on a Two-Pillar Solution To Address the Tax Challenges Arising from the Digitalisation of the Economy.

Pillar 1

Pillar 1 is focused on shifting more taxing rights from residence countries to market countries (that is, the countries where goods or services are used or consumed). This regime is intended to reallocate more than US$125 billion of profits from approximately 100 of the world's largest and most profitable multinational enterprises (MNEs) to countries worldwide. In particular, under so-called amount A, 25 percent of "residual profits" (that is, profits exceeding a threshold of 10 percent of revenues) would be allocated to market countries, to be attributed in accordance with a revenue-based allocation key, and subject to certain de minimis exceptions. Profits would be computed by reference to financial accounting income, with some adjustments.

Initially, this regime would apply only to MNEs with global revenues above €20 billion. However, contingent on "successful implementation," this threshold is to be reviewed in seven years and could be reduced to €10 billion. So-called extractives and "regulated financial services" would be excluded from the regime.

Under a "marketing and distribution profits safe harbour," the residual profits allocated to a market jurisdiction under amount A could be capped if they are already taxed in that jurisdiction (for example, if they are attributable to a permanent establishment in that jurisdiction). However, further work is under way on the design of this safe harbour and on various other definitional and implementation matters, including mechanisms to address double taxation and tax certainty (that is, dispute prevention and resolution mechanisms).

In addition, under so-called amount B, the application of the arm's-length principle (that is, transfer-pricing rules) to in-country "baseline marketing and distribution activities" will be "simplified and streamlined," with a particular focus on "low capacity countries." Here, too, additional work is being undertaken and is expected to be completed by the end of 2022.

There remains considerable uncertainty as to whether pillar 1 will be adopted in the United States (and other countries). Canada is moving ahead with its alternative digital services tax (which will come into effect for 2022 and subsequent taxation years if pillar 1 is not successfully adopted by the end of 2023). The United States has indicated that it may impose retaliatory tariffs against countries (such as Canada) that impose digital services taxes—on the basis that such taxes unfairly discriminate against US-based MNEs.

Pillar 2

Pillar 2 proposes a 15 percent global minimum tax. This regime is intended not to eliminate tax competition but to put multilaterally agreed limitations on it. Through these limitations, this regime is intended to raise around US$150 billion in new revenues annually, from a broader range of MNEs than those affected by pillar 1 (though qualifying international shipping income is excluded), and these revenues are to be allocated among countries through a complex set of interlocking and alternative charging provisions.

The global minimum tax is also designed to operate on the basis of adjusted financial accounting income and adjusted accounting tax expense, with a view to calculating an "effective tax rate." A form of minimum tax would arise if the effective tax rate is lower than 15 percent on a jurisdiction-by-jurisdiction basis. Because there are various differences in many countries between financial accounting income and taxable income, even a country with a much higher nominal tax rate can have an effective tax rate for financial accounting purposes that is below the minimum rate. Examples of factors that give rise to such differences include the impact of accelerated tax depreciation, bonus depreciation, certain tax credits, and other items. A limited substance-based income exclusion provides that the minimum tax does not apply on income of up to 5 percent of the aggregate of payroll costs and tangible asset costs. (During a 10-year transitional period, the exclusion will be based on higher percentages—beginning at 10 percent of payroll costs and 8 percent of tangible asset costs, and declining over the period.) Companies that incur losses for tax purposes may nevertheless be taxable under the global minimum tax.

The global minimum tax comprises two main rules: an income inclusion rule (IIR) and an undertaxed payments (or profits) rule (UTPR)—together, the global anti-base erosion (GloBE) rules. A separate, treaty-based "subject to tax rule" (STTR) may also apply to deny reduced withholding taxes on certain payments that are not subject to tax at a rate of at least 9 percent. (The 2022 budget notes that the STTR is not expected to affect Canada.) Primary taxing rights will generally remain with a source country (that is, the country where underlying income is earned), under its normal tax rules or under a permitted "qualified domestic minimum top-up tax" (QDMTT). However, if that source country does not tax the relevant income at a sufficiently high rate, the country in which the ultimate parent company of the group is resident (or an intermediate parent country) will generally be permitted to impose a top-up tax (TUT) under the IIR. (There is also a priority rule for countries in which a "partially owned parent entity" is located.) While the IIR is generally not applied to earnings in the jurisdiction of the ultimate parent entity, that jurisdiction may choose to apply a domestic IIR. To the extent that any portion of the TUT is not paid under the IIR in a relevant parent country, the UTPR would then apply on a residual basis. Any residual TUT is allocated among residual countries that have implemented a qualified UTPR and in which an MNE has operations (including a parent country) according to the relative proportion of the MNE group's employees (by number rather than payroll costs) and the value of tangible assets in the jurisdiction.

The UTPR represents a significant departure from current international tax principles: the proposed regime could allow Canada (and other countries) to tax the income of a sister company or parent company regardless of the country's lack of nexus to that income. It remains to be seen whether this approach is contrary to existing treaty obligations. For example, saving clauses, such as article 27(3) of the Canada-UK tax treaty, that allow Canada to tax a Canadian resident on its share of the income of a controlled foreign affiliate in which it has an interest do not appear to apply to income of a non-resident sister company or parent company.

The GloBE rules are intended to apply consistently, such that the amount of TUT in respect of a constituent entity is generally the same regardless of which GloBE rule is being applied or which jurisdiction is applying it (though see below for comments on the US GILTI regime).

As has been noted, the GloBE rules also contemplate that the source country may impose a QDMTT. By imposing a QDMTT, the source country could ensure that it (rather than a parent country or another country in which the group has operations) has priority to collect any TUT, although this is not entirely clear: the rules also contemplate that taxes imposed

under a controlled foreign corporation (CFC) regime (such as Canada's FAPI rules) are included in the covered taxes of the jurisdiction to which GloBE income is allocated—thus potentially reducing TUT. The mechanism for doing this is unresolved, especially where the CFC taxes are paid in an intermediary jurisdiction.

Although the global minimum rate is 15 percent, several countries have chosen to maintain lower tax rates in light of the substance-based income exclusion. In addition, countries may choose to impose lower tax rates on MNE groups that are not subject to the GloBE rules—for example, if these groups have consolidated income below the €750 million threshold. Paying taxes locally may also be preferable to many MNEs, given that this is more consistent with the location of their real economic activity.

Many countries, including Canada, use tax incentives or government grants to attract and promote investment. Pillar 2 may effectively claw back these incentives. This may compromise a country's ability to promote domestic investment and to attract foreign investment through income tax measures, or it may result in countries shifting toward non-income tax incentives that are less heavily affected by pillar 2.

At present, countries with tax rates close to 15 percent may seek to attract foreign investment through their relatively favourable tax rates coupled with other factors (for example, a favourable regulatory environment). The introduction of the GloBE rules may render these jurisdictions even more competitive, by eliminating the current tax advantage of jurisdictions with lower rates and non-taxing jurisdictions.

It is anticipated that many high-tax countries will adopt a comprehensive version of the GloBE rules, although it remains to be seen how far these countries will benefit from doing so. Given their existing high tax rates, it is unlikely that these countries will collect significant TUT in respect of domestic entities through a QDMTT, except in sectors that enjoy significant tax incentives (which may be restructured). Furthermore, it is unlikely that high-tax countries will have much TUT to collect in respect of subsidiaries in low-tax countries if most of those low-tax countries enact a QDMTT (or otherwise modify their domestic tax rules), especially if the low-tax countries also introduce non-income tax incentives. As a result, taxpayers may still have an incentive to shift income (and underlying economic activity) from high-tax countries to lower-tax countries, though the tax benefits of doing so may decrease. The result could then be (1) no collection of materially new taxes by the high-tax countries; (2) an increase in taxes collected by low-tax countries; and (3) a decline in economic returns repatriated to the ultimate parent company and its shareholders.

All countries (including Canada) should re-evaluate the tax incentives they offer in the context of the GloBE rules. Unless they are redesigned, the GloBE rules may negate the benefits that these tax incentives were intended to offer. Consider, for example, a country that offers an R & D tax credit that does not meet the definition of a qualified refundable tax credit (QRTC) under the GloBE rules. A QRTC is considered income under the GloBE rules, while a non-QRTC is treated as a reduction to tax expense. Thus, a QRTC has a smaller impact on the reduction of the effective tax rate, and thus on triggering TUT. A country's R & D tax credit might be redesigned to qualify under the definition of QRTC. Moreover, high-tax countries such as Canada could consider attracting new investment through special low-taxed regimes (such as a patent box regime—the implementation of which, according to the 2022 budget, is being considered by Canada), given that the jurisdictional blending of low-taxed income in a high-tax country may prevent the TUT from arising.

A shift to non-tax incentives may also occur, which will make it difficult to compare different jurisdictions in terms of the attractiveness of investing in them, because non-tax incentives can be fragmented and less transparent and their benefits can be difficult to compare across MNEs.

The Canadian government has indicated a clear desire to proceed with pillar 2. However, it is not entirely clear what benefits Canada will obtain from doing so. First, Canada initially anticipated a significant increase in tax revenues, though it recognized in the 2022 budget that this increase is currently difficult to estimate (particularly because most financial modelling is static—without taking into account the anticipated responses of other countries and MNEs). As noted above, to the extent that source countries enact a QDMTT (or otherwise modify their income tax regimes), there may be very little TUT to collect in Canada under an IIR (or UTPR). Regardless, the economic returns to Canadian-based MNEs will likely decrease to the extent that additional taxes are paid to other jurisdictions.

Second, incentives to locate economic activities abroad (rather than in Canada) will likely remain—particularly for (1) MNEs to which pillar 2 does not apply, (2) MNEs that may realize a material benefit from the substance-based income exclusion, or (3) corporations that otherwise find the 15 percent minimum tax rate sufficiently attractive compared with the domestic Canadian tax rate.

Third, as Canada and other countries adopt pillar 2, the relative competitiveness of US-based MNEs will likely improve. It is anticipated that the US GILTI regime will be permitted to co-exist with the GloBE rules (assuming that proposed amendments to apply GILTI on a country-by-country basis are enacted)—possibly in a manner that provides a comparative benefit to US-based MNEs. In addition, as a result of the enactment of the GloBE rules, competitors to US MNEs (such as MNEs based in Canada) will now be subject to a new global minimum tax.

Fourth, the collection of any QDMTT (or new income taxes) by traditional low-tax jurisdictions could allow those countries more funding and flexibility to potentially attract investment

through other incentives (such as reduced personal taxes; reduced VAT or other indirect taxes; subsidized education; and health care)—which could continue to attract investment to those jurisdictions (and away from Canada). Countries will need to ensure that any new non-income tax incentives are not closely linked to the taxes collected under the GloBE rules, or else they could potentially taint the "qualified" status of those taxes.

Fifth, the GloBE rules may encourage the segmentation of businesses that are seeking to fall below the €750 million consolidated revenue threshold so as to avoid the application of the rules. The "cliff" effect disadvantages those businesses that exceed that threshold by even $1.

Additional work on the GloBE rules remains to be done as part of the implementation framework.

Finally, the Canadian government indicated in the 2022 budget that Canada intends to implement the GloBE rules in 2023 (together with a QDMTT), with a UTPR to follow in or after 2024. Canada has also launched a consultation on pillar 2. Interested parties are invited to send written representations by July 7, 2022. Industry associations and MNEs affected by pillar 2 should consider making submissions before this deadline in order to ensure that their voices are heard, especially because these rules may significantly affect Canada's competitiveness globally and because of the current challenging economic environment.

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Pillar 1: Amount A—Extractives Exclusion

In October 2021, 137 members of the OECD/G20 Inclusive Framework on BEPS signed on to the Statement on a Two-Pillar Solution To Address the Tax Challenges Arising from the Digitalisation of the Economy. This constituted a political agreement on the key components of pillar 1 and pillar 2 of BEPS 2.0.

While the main targets of pillar 1 are the tech giants, amount A is not limited to these enterprises. That said, the OECD recognized that amount A could give rise to inappropriate results in the case of extractive companies (that is, mining companies and oil and gas companies) by shifting tax from the country where the resource is located to countries where the resource is consumed. Consequently, profits from extractive activities are intended to be excluded from amount A.

On April 14, 2022, the OECD released a public consultation document: *Pillar 1—Amount A: Extractives Exclusion*. The consultation document (the substantive part of which is schedule F to amount A) provides a description and explanation of the proposed rules. In light of the work-in-progress nature of other aspects of amount A, schedule F outlines the relevant principles in narrative format except for certain specific definitions delineating the scope of the extractives exclusion. The public was invited to provide comments by April 29, 2022.

This article is intended to provide a summary of schedule F. For a more detailed consideration of the proposals, readers are referred to the International Council on Mining and Metals' recent submission to the OECD in response to the proposals.

Extractive Activities Exclusion

Profits from "extractive activities," as defined, will be excluded from amount A. In very general terms, the intended result is to exclude revenue from the sale of "extractive products," as defined, in respect of which the corporate group has carried out "exploration, development, or extraction," as defined. The two-pronged aspect of the test draws a very deliberate line between integrated producers and pure trading and tolling operations. This means that revenue from commodity trading alone (without engagement in the relevant extractive activity), or revenue from performing extraction services alone (with no ownership of the extractive product), will not qualify for the exclusion (consultation document, at 5).

Schedule F outlines the process for determining whether the extractives exclusion excludes profits from amount A. This process has two key components: the redetermination of (1) in-scope revenue *ex*-extraction activities and (2) the extraction activities' profit margin.

Revenue from Extractive Activities

Amount A in-scope revenue is the difference between consolidated corporate group revenue and third-party revenue (more on this below) from extractive activities. For this purpose, the definition of "extractive activities" has two tests that must be satisfied: (1) a product test (that is, the activity must involve the sale of an "extractive product," as defined) and (2) an activities test (that is, the activity must involve "exploration," "development," or "extraction," as defined).

While schedule F refers to "third-party revenue" in its general description of the principles, the definition of "extractive activities" and the definition of these activities' key components ("extractive product" and "exploration, development, or extraction") contemplate that in some circumstances, the revenue base for the extractives exclusion may be narrower than third-party sales of extractive product. In this regard, the definitions of "extractive product," "exploration," and "development" are self-explanatory and do not contain any surprises. However, the definition of "extraction" merits specific comment.

Extraction is defined to mean "the removal of an Extractive Product from its natural site or from mine tailings and includes the Qualifying Processing and Transportation of such

Extractive Products." "Transportation" is defined in a straightforward manner to mean the physical movement to the delivery location and incidental storage of an extractive product in fulfillment of delivery terms set out in a sales contract. Of more interest is the term "qualifying processing," which is defined to mean

> processing undertaken to concentrate, isolate, purify, refine or liberate an Extractive Product [as defined] from its natural state to produce a basic commodity.
>
> a) Qualifying Processing includes transformation and processing of hydrocarbons into a liquefied state, including liquefied natural gas (LNG) and liquefied petroleum gas (LPG); processing of bitumen from oil sands, oil shale and heavy oil to a stage that is not beyond the crude oil stage or its equivalent;
>
> b) Qualifying Processing for mining and metals includes activities which result in the production of minerals, mineraloids and metals including the casting of metals;
>
> c) Qualifying Processing does not include extrusion, fabrication or activities to produce alloys, steel, jewellery, petrol, gasoline, diesel, kerosene and similar refined hydrocarbons, lubricants, chemicals, plastics and plastic polymers;
>
> d) For all other cases, Qualifying Processing is deemed to include processing activities up to and including, but not beyond, the Delineation Point.

Paragraphs (a) to (c) are largely self-explanatory. Paragraph (d), however, is intended to provide a cutoff point (the "delineation point") in the value chain, a point that may occur before extractive products are sold to third parties and may involve not a sale but, instead, the processing of extractive product to a point where there is a recognized market price for it.

To this end, the delineation point is defined as "the deemed end point of excluded Extractive Activities." The definition goes on to state that the delineation point is the earliest of the following:

1) The point where there is a sale of the extractive product to a third party (the revenue would be the sales price).
2) The point where there is an intragroup transaction transferring extractive product from the country where extraction occurs to another country (the revenue would be the sales price).
3) Where applicable, the point where the extractive product meets the specifications established by the "internationally recognised reference price," as defined (for example, the pricing of Brent crude at the London Metal Exchange), that is used for pricing extractive product. (If this rule applies, the deemed revenue amount for the purposes of identifying the excluded revenue and for applying the profitability test is calculated as follows: revenue = internationally recognized reference price × quantity of extractive product.)

The definition also provides three interpretation rules. The first states that when none of the three delineation points is reached (that is, no sale or transfer occurs, and the extractive product is not refined sufficiently to meet the specification for an internationally recognized reference price), the deemed revenue amount for the purposes of identifying the excluded revenue and for applying the profitability test is calculated as market value (whatever that might be) of extractive product × quantity of extractive product.

The second interpretation rule provides that if there is a conflict between the tests set out under the definition, they are to be applied in the following order: (1) third-party sale, (2) intragroup transfer, and (3) internationally recognized reference price. The third interpretation rule simply provides that if there is an intragroup transfer of the extractive product from one state to another, it is deemed not to have taken place if further processing is done within [X] kilometres of the border of the first state.

It is noteworthy that intragroup transfers trigger a delineation point. This not only presumes that the transfer price for the sale is correct but also, potentially, subjects amounts in excess of this amount to amount A redistribution among countries where sales are made (for example, China and the United States) as opposed to countries where resources are extracted and processed. It is questionable whether this is a desirable result; why not shift back to the source state?

Another noteworthy point is that, in some circumstances, these rules could result in a delineation point that is earlier in the value chain than may have been intended. For example, it is not uncommon for some metals to be processed to a certain stage in a particular country, with the resulting product sold to a related company in another country for further processing and on-sale to either an intragroup marketing entity or a third party. In this scenario, the delineation point would be the first intragroup sale. Is it intended that the further value added by that processing be subject to amount A redistribution?

Profit Margin of Extractive Activities

If a corporate group meets the general scope provisions and also has more than €20 billion of in-scope revenues after redetermining the revenue to exclude revenue from extractive activities, the group must identify the profits from extractive activities in order to exclude them from amount A. This will also require the group to determine the remaining profits from in-scope activities in order to assess whether they exceed the 10 percent profitability threshold.

Schedule F notes that this exercise is expected to be "a more complex part of the Extractives Exclusion" because it may require identifying intragroup revenue and performing cost allocations. The objective of the exercise is to ensure that no residual profits from extractive activities are redistributed under amount A, and thus effectively to treat the in-scope part

of the group as a stand-alone business on an equal footing with a similar downstream business (for example, manufacturing).

Schedule F describes two approaches for calculating the profit margin for in-scope revenue: the "disclosed operating segment" approach and the "entity-level" approach (the latter is relevant only if the disclosed-operating-segment approach is unavailable). The first approach applies if two conditions are met:

1) The corporate group's disclosed segments "predominantly" generate revenue that is excluded. To ascertain whether this condition is met, the "predominance test" is applied to determine whether any of the group's segments made up at least 75 to 85 percent (precise amount to be determined) of excluded revenues (determined on the basis of the delineation point, discussed above). If this condition is satisfied and the in-scope revenues do not exceed a (€1 billion) cap, the entire segment qualifies for the extractives exclusion.
2) Costs are appropriately and reliably allocated between the segments. Schedule F provides some additional commentary on how this is expected to be done in a number of circumstances. A brief reading over of even the broad principles outlined in the schedule suggests that this will likely be a very complex exercise.

If these conditions are met, the resulting profit computation is then tested against the 10 percent profitability threshold, with the excess subject to amount A redistribution.

Corporate groups that do not qualify for the disclosed-operating-segment approach must use the entity-level approach, which is essentially the disclosed-operating-segment approach applied on an entity level instead of a segment level. In other words, each entity in the corporate group applies the predominance test—that is, a percentage (75 to 85 percent) of excluded revenue and the (€1 billion) cap on in-scope revenue. If these conditions are met, the entity is excluded under the extractives exclusion. If the conditions are not met, the entity will be required to determine its in-scope revenue by subtracting the excluded revenue (determined by using the delineation point) from the total revenue of the entity.

Having determined its in-scope revenue for each particular entity, the corporate group would combine the in-scope entities into a "consolidated bespoke segment" for amount A purposes. The group would then need to apportion its expenses, including indirect and unallocated costs, using the segment-accounting or management-accounting principles that would have applied had the entity published the remaining in-scope portion of those entities as one combined disclosed operating segment. The result would then be tested against the 10 percent profitability threshold, with the excess subject to amount A.

At first sight, it appears that the extractives-exclusion analysis will be a very complex exercise for corporate groups that are subject to amount A. Whether the end result provides a better policy result than exempting resource companies from amount A altogether is questionable, particularly when one considers that income will be redistributed, in many cases, from countries where resources are located to wealthy, industrialized countries.

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Pillar 2 and the Myth of the "Easy Button"

Readers may recall the clever ad campaign for Staples Inc., which marketed the company as an "easy button": one push, and your problems are solved. One of the great frustrations for in-house tax professionals is the (implicit) assumption among tax policy makers (and tax authorities) that the information necessary to comply with new tax-reporting obligations is readily available to large multinational enterprises (MNEs) in the requisite form; we need only press the "easy button" to produce it. This is not the case, however. Taxpayers take their compliance obligations seriously and must build complicated systems to identify, collect, and process the relevant information in order to comply with those reporting obligations. Often, that information can be readily identified and processed only where such systems already exist. It can take years and tremendous expense to build out new systems in large MNEs. And yet tax policy makers continue to enact increasingly complex proposals without (1) providing taxpayers with adequate time to build and modify reporting systems to comply with those enactments or (2) adequately minimizing the incremental compliance burden such proposals impose.

The OECD's pillar 2 initiative is a prime example of this practice. This initiative, intended to ensure that MNEs are subject to a minimum 15 percent effective tax rate in all jurisdictions in which they operate, is proposed to come into effect in 2023. Yet Canada's federal government has only now (as of April 2022) commenced consultation on implementing this proposal for Canadian MNEs, with a view to enacting these rules at some (as yet unknown) date in 2023. In fairness to the Canadian government, the OECD released the model rules only in December 2021 and the commentary thereon in March 2022, and consultations on the implementation framework, including safe harbours and simplifications, are ongoing. This puts Canadian MNEs in the difficult position of having to try to develop systems to comply with pillar 2 without clear guidance on what they actually have to comply with.

Consider the requirement under pillar 2 for corporate groups to compute global anti-base erosion (GloBE) income/loss by "constituent entity," aggregated on a jurisdiction-by-

jurisdiction basis. To meet this requirement, taxpayers must start with their financial accounting net income, and then make a variety of adjustments to recompute income at both the constituent entity and the jurisdiction levels. The details of those adjustments are beyond the scope of this article, but suffice it to say that they are significant and complex. Thus, to comply with pillar 2, MNEs will have to create reporting systems to identify, collect, and process information about the transactions, circumstances, and events that might give rise to such adjustments.

This, in turn, requires that the adjustments be well defined: you can't develop a system to identify transactions giving rise to an adjustment without a clear understanding of what that adjustment is and what facts and circumstances have given rise to it. Many such details under the pillar 2 model rules—and what they mean in practice—are still being worked out, and thus taxpayers cannot yet develop systems to comply with them.

Pillar 2 overlaps with country-by-country reporting (CbCR)—another OECD/G20 initiative—and other existing Canadian reporting obligations for foreign affiliates (FAs); each is intended to provide tax authorities with information on the income, expenses, and tax payable by multinational corporate groups. Frustratingly, however, each reporting regime imposes different reporting requirements, requires different reporting of income, and is subject to different timelines. MNEs devoted significant resources to putting systems in place to gather CbCR data—systems that were implemented just a few years ago. Now, yet another OECD/G20 BEPS initiative will further increase the compliance burden on MNEs without allowing them adequate time to leverage the CbCR data.

Instead of layering a third level of FA reporting over existing obligations, the government should seek to build on existing requirements and to eliminate duplicative reporting where possible. For example, if pillar 2 were implemented in a way that allowed MNEs to make use of the systems put in place for CbCR (for example, by allowing taxpayers to use CbCR income for the purposes of computing GloBE income), the incremental compliance burden arising from pillar 2 for MNEs could be significantly reduced. Similarly, given the existence of pillar 2 and CbCR, the government might consider simplifying the current reporting obligations for FAs. It is sound tax policy to seek information about the foreign activities of Canadian MNEs, but so is doing so in the most efficient and cost-effective manner possible.

The Canadian government had previously estimated that it would generate $4.5 billion of tax revenue through pillar 1 and pillar 2; in the 2022 federal budget, however, no estimates were provided. If jurisdictions with tax rates below 15 percent decide to increase their rates as a result of pillar 2, the revenue provided to the Canadian government could be negligible (or, indeed, negative). Compliance costs to MNEs, however, will not be. Whether or not pillar 2 represents well-designed substantive tax policy, it clearly imposes significant tax-reporting and compliance obligations on Canadian MNEs. In the rush to implement pillar 2 in 2023, it is unclear whether policy makers have fully considered the compliance burden that these rules will impose on taxpayers (and, it should be noted, on tax authorities). In implementing pillar 2, governments must recognize the compliance burdens MNEs are facing and work to simplify the implementation and determination of GloBE income. More broadly, in light of pillar 2, consideration should also be given to reducing complexity both in the tax system and in reporting obligations.

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The Future for Interest Deductibility in Canada: The New EIFEL Regime

On February 4, 2022, draft legislative proposals were released regarding the new excessive interest and financing expenses limitation (EIFEL) rules; these proposals were open for consultation until May 5, 2022.

The rules limit the deduction of a taxpayer's interest and financing expenses (IFE), net of interest and financing revenues (IFR) (together, "net IFE"), to a fixed percentage of the taxpayer's adjusted taxable income (ATI), which is based on a tax version of the accounting concept of earnings before interest, taxes, depreciation, and amortization (EBITDA). The fixed percentage starts at 40 percent of ATI for taxation years beginning in 2023, decreasing to 30 percent for taxation years beginning thereafter. There is also a "group ratio" rule applicable in certain cases, allowing a higher ratio.

The rules apply to all corporations and trusts, except for (1) Canadian-controlled private corporations with less than $15 million of capital employed in Canada; (2) groups with Canadian net IFE of $250,000 or less; and (3) certain groups that operate almost entirely in Canada. The de minimis exclusion for group net interest expense is notably lower in Canada than in other countries that have adopted interest limitations based on OECD BEPS action 4. The rules will indirectly apply to partnerships, owing to the inclusion of partnership interest expenses and other amounts within the calculations of corporations and trusts that hold partnership interests.

ATI is used to determine a taxpayer's capacity to deduct net IFE in a year, and it uses "taxable income" (TI) as the starting point. ATI adjusts TI for various items, including (1) IFE and IFR; (2) non-capital losses and net capital losses for the year; (3) deductions for part VI.1 tax; (4) capital cost allowance (CCA) deductions; (5) foreign-source income sheltered by Canadian foreign tax credits; and (6) other adjustments specific to partnerships and trusts.

The IFE and IFR that are covered by the rules are broadly defined. Both definitions include a catch-all provision for interest expense/revenue amounts and specifically include other

financing-related amounts, such as financing expenses that are otherwise deductible under the Act and more general amounts related to the "cost of funding." These amounts specifically include (1) financing components of leases; (2) interest expense and revenues that are recognized in a partnership (prorated on the basis of the corporation's or trust's share of partnership income); and (3) CCA or resource pool deductions that specifically relate to financing.

"Excluded interest"—that is (broadly speaking), interest on a debt between two taxable Canadian corporations that are in a group relationship—may be excluded from the rules through a joint election. The explanatory notes comment that this exclusion is intended to prevent the EIFEL rules from having a negative impact on transactions that Canadian corporate groups commonly undertake in order to allow the losses of one group member to be offset against the income of another group member.

When a group's external interest expense is high compared with its group EBITDA, it may be beneficial for the group to elect into the "group ratio" rules. An electing group may deduct IFE on the basis of a higher percentage of ATI; this percentage is based on group net interest expense (GNIE) over group adjusted net book income (GANBI) (subject to formulaic restrictions on the resulting percentage). The formulaic restrictions mean that the ratio of GNIE/GANBI would need to be 260 percent before a deduction equal to 100 percent of ATI could be achieved. When groups elect into these rules, they are required to allocate the group's total capacity for deductions among group members. These rules use consolidated financial statements as their basis, requiring IFRS-compliant financial statements or a number of "acceptable" local GAAPs, which exclude any European GAAPs.

The EIFEL rules allow taxpayers to carry forward to later taxation years certain amounts arising in a particular taxation year. Specifically, taxpayers can carry forward

- excess capacity (EC) to deduct IFE (that is, where permissible IFE deductions exceed actual net IFE for the year) for 3 years as cumulative unused excess capacity (CUEC); and
- restricted interest and financing expenses (RIFE) (that is, IFE that is not deductible in the year) for 20 years.

In addition, a corporation can generally elect to transfer EC to other corporations within the same group. This rule does not apply to trusts.

Transitional provisions enable taxpayers to jointly elect to determine EC for the three "pre-regime years" immediately prior to the first year for which EIFEL applies to the taxpayer, thereby enabling the calculation of a carried-forward CUEC amount that would otherwise be nil.

Groups need to pay attention to any future loss-restriction events under section 111 of the Act, because (1) RIFE is deductible in future years only if it relates to interest from a business, and that business has continued after the loss-restriction event; and (2) CUEC expires after a loss-restriction event, meaning that it can no longer be utilized, which appears particularly restrictive.

As currently drafted, the proposed EIFEL rules have several features that need to be addressed, including the following:

- The proposals do not clearly indicate whether the rules should be applied when the income of a foreign affiliate is being computed.
- If the current-year losses (capital losses and non-capital losses) that are adjusted in a taxpayer's determination of ATI are applied in a future taxation year to reduce the taxpayer's taxable income for that year, there is no subsequent adjustment to the ATI calculation in that later period, which results in a double reduction in ATI (except for any partial addback of the portion of a non-capital loss that reasonably relates to the net IFE of the taxpayer).
- The rules include several very broadly drafted anti-avoidance rules that could arguably produce inappropriate results in some circumstances. In particular, a rule designed to ensure "symmetrical treatment" of interest paid between non-arm's-length parties appears to be overly restrictive in respect of loans to foreign affiliates (or other non-arm's-length non-residents), particularly when these loans are funded by the Canadian taxpayer's borrowings.
- The rules apply industry-specific restrictions to prevent financial institutions from transferring excess capacity or applying the group ratio rule. The current proposals could significantly impair some financial institutions' ability to effectively conduct business, given the regulatory restrictions and other restrictions faced by these companies.

The EIFEL rules add additional complexity to the obtaining of an interest deduction in Canada, and there are no plans to simplify the current rules restricting interest deductibility—for example, the thin capitalization rules. Although the rules are formula-driven, groups have some informed choices to make because of the elections available to them. Canadian groups subject to the rules should undertake financial modelling prior to the introduction of the EIFEL rules so as to be in a position both to apply the rules as advantageously as possible and to consider the impact of these rules, because there is no grandfathering for existing financing arrangements.

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Canada's New Hybrid Mismatch Rules

On April 29, 2022, the Department of Finance released the long-awaited Legislative Proposals Relating to the Income Tax Act—Hybrid Mismatch Arrangements, together with explanatory notes (collectively, "the proposals"). The proposals generally target transactions and series of transactions that give rise to a "deduction/non-inclusion mismatch," as contemplated by proposed subsection 18.4(6). Stakeholders are invited to provide feedback on the proposals by June 30, 2022. However, the proposals would apply to payments arising on or after July 1, 2022, including payments arising from arrangements entered into before that date (that is, the proposals do not provide for any form of grandfathering for existing arrangements). This article provides a broad overview of the proposals.

General

The proposals relate to the implementation of *Neutralising the Effects of Hybrid Mismatch Arrangements, Action 2—2015 Final Report* ("the hybrids report"), published by the OECD on October 5, 2015. This relation is specifically stated in proposed subsection 18.4(2), which also provides that, unless the context otherwise requires, the rules "are to be interpreted consistently with that report, as amended from time to time." This is a very novel approach to Canadian tax legislation; it effectively contemplates a legislative delegation to the OECD, which may be questionable from a Canadian constitutional perspective.

It should be noted that the proposals do not purport to implement all of the chapters of the hybrids report. In keeping with the announcement on this matter in the 2021 federal budget, the proposals are focused only on deduction/non-inclusion outcomes, not double deduction outcomes, and they mainly focus on hybrid financial instruments rather than a broader range of scenarios. At the same time, they depart from the hybrids report in targeting not only actual payments but also certain notional interest deductions in the absence of any payment.

Scope

There are three categories of arrangements to which the proposals would apply. In the definition of "hybrid mismatch arrangement" in proposed subsection 18.4(1), these categories are identified as

- hybrid financial instrument arrangements,
- hybrid transfer arrangements, and
- substitute payment arrangements.

In all cases, a "payment" must "arise," but there is a special rule in proposed subsection 18.4(9) that relates to "notional interest expense" on a debt that would be, or could reasonably be expected to be, in the absence of any "foreign expense restriction rule," deductible in computing the "relevant foreign income or profits for a foreign taxation year" of a debtor. When this rule applies, the debtor is deemed to make a payment under the debt to the creditor in respect of the debt, in an amount equal to the deductible amount, and the creditor is deemed to be a recipient of such payment. The mismatch condition in proposed paragraph 18.4(10)(d) is also deemed to be satisfied.

Hybrid Financial Instrument Arrangement

A hybrid financial instrument arrangement is addressed mainly in proposed subsections 18.4(10) and (11). This category comprises situations where the payment (other than a payment under a substitute payment arrangement) arises under, or in connection with, a financial instrument. For the purposes of these rules, a "financial instrument" is broadly defined to mean a debt, an equity interest, or any right that may reasonably be considered to replicate a right to participate in profits or gain of any entity, or any other arrangement that gives rise to an equity or financing return.

The payment arising from such an arrangement must give rise to a deduction/non-inclusion mismatch, which in general is the key element of the proposed rules. Whether such a mismatch exists is determined under proposed subsection 18.4(6), which has an inbound category and an outbound category. In the inbound category, a payment gives rise to a deduction/non-inclusion mismatch if A exceeds B, where

> A is the total of all amounts, each of which would, in the absence of this section, subsection 18(4) and subsection 18.2(2), be deductible in respect of the payment, in computing the income of a taxpayer . . . under [part I] for a taxation year (referred to in this paragraph as the "relevant year"), and
>
> B is the total of all amounts each of which, in respect of the payment,
>
> (i) can reasonably be expected to be—and actually is—foreign ordinary income of an entity for a foreign taxation year that begins on or before the day that is 12 months after the end of the relevant year, or
>
> (ii) is Canadian ordinary income of a taxpayer for a taxation year that begins on or before the day that is 12 months after the end of the relevant year.

The outbound category is similar, but inverted, such that a payment gives rise to a deduction/non-inclusion mismatch if C exceeds D, where

> C is the total of all amounts, each of which, in the absence of any foreign expense restriction rule, would be—or would reasonably be expected to be—deductible, in respect of the payment, in computing relevant foreign income or profits of an entity for a foreign taxation year (referred to in this paragraph as the "relevant foreign year"), and
>
> D is the total of all amounts, each of which, in respect of the payment,
>
> (i) would, in the absence of section 12.7, be Canadian ordinary income of a taxpayer for a taxation year that begins

on or before the day that is 12 months after the end of the relevant foreign year, or

(ii) can reasonably be expected to be—and actually is—foreign ordinary income of another entity for a foreign taxation year that begins on or before the day that is 12 months after the end of the relevant foreign year.

The terms "Canadian ordinary income" and "foreign ordinary income" are defined in proposed subsection 18.4(1). Of particular note is the fact that "foreign ordinary income" is subject to a number of downward adjustments, including an adjustment whereby the income is subject to tax at a nil rate (or even a rate that is lower than the highest rate imposed by the relevant foreign country on such income), or is included in income because of a foreign hybrid mismatch rule—the latter reflecting the ordering rule in the hybrids report, which gives priority to a country's deduction-denial rule (except for a rule that is substantially similar in effect to proposed subsection 113(5)).

The payer of the payment must not deal at arm's length with, or must be a specified entity in respect of, a recipient of the payment, or the payment must arise under, or in connection with, a structured arrangement (discussed below). A specified entity is defined, essentially, by reference to a relationship that involves an ownership interest representing at least 25 percent of votes or value.

The final set of conditions in proposed subsection 18.4(10) are (1) that it can reasonably be considered that the deduction/non-inclusion mismatch arises in whole or in part because of a difference in the treatment of the financial instrument (or in the treatment of one or more transactions, either alone or together, where the transaction or transactions are part of a transaction or series of transactions that includes the payment or relates to the financial instrument) for tax purposes under the laws of more than one country that is attributable to the terms or conditions of the financial instrument (or transaction or transactions); or (2) that it can reasonably be considered that the deduction/non-inclusion mismatch would arise in whole or in part because of such a difference if any other reason for the deduction/non-inclusion mismatch were disregarded.

Hybrid Transfer Arrangement

A hybrid transfer arrangement is addressed mainly in proposed subsections 18.4(12) and (13). Similar conditions apply in this regard—including, in particular, the condition that the payment under the hybrid transfer arrangement must give rise to a deduction/non-inclusion mismatch under proposed subsection 18.4(6)—although the targeted scenario is a bit different.

A payment is considered to arise under a hybrid transfer arrangement if the payment arises under, or in connection with, a transaction or series of transactions (referred to as the "transfer arrangement") that includes a disposition, loan, or other transfer by an entity to another entity (the "transferor" and "transferee," respectively) of all or a portion of a financial instrument (referred to as the "transferred instrument"); or arises under, or in connection with, the transferred instrument.

An additional condition is that it must be reasonable to consider that the deduction/non-inclusion mismatch arises (or would arise, if other reasons for the mismatch were disregarded), in whole or in part, for the reasons specified. If the payment arises as compensation for a particular payment under the transferred instrument, the reasons must be that (1) the tax laws of one country treat all or a portion of the payment as though it has the same character as, or represents, the particular payment, in determining the tax consequences to an entity that is a recipient of the payment but not of the particular payment; and (2) the tax laws of another country treat the payment as a deductible expense of another entity. In any other case, it must be reasonable to consider that the mismatch arises because

- the tax laws of one country treat one or more transactions included in the transfer arrangement, either alone or together, as or as equivalent to a borrowing or other indebtedness, or treat all or a portion of the payment as arising under, or in connection with, a borrowing or other indebtedness, and the tax laws of another country do not treat the transaction or transactions, or the payment, as the case may be, in that manner; or
- the tax laws of one country treat the payment, or any other payment arising under or in connection with the transfer arrangement or transferred instrument, as though the payment or other payment was derived by one entity, and the tax laws of another country treat the payment or other payment, as the case may be, as though it was derived by another entity, because of a difference in how the countries treat one or more transactions included in the transfer arrangement, either alone or together.

Substitute Payment Arrangement

A substitute payment arrangement is addressed mainly in proposed subsections 18.4(14) and (15). Again, many of the conditions are similar in spirit to those for the arrangements described above, although they are extensively described in a page and a half of detailed drafting. It should also be noted that this category is not conditional on hybridity as such (that is, the mismatch need not be attributable to a difference in how two countries treat the arrangement—a difference based on the terms and conditions of the arrangement or a financial instrument).

The core descriptive conditions (in simplified form) for this kind of arrangement appear to be that

- the payment must arise under, or in connection with, an arrangement under which all or a portion of a

financial instrument is disposed of, loaned, or otherwise transferred by an entity to another entity (referred to as the "transferor" and "transferee," respectively);
- all or a portion of the payment can reasonably be considered to represent or otherwise reflect, or be determined by reference to, another payment (referred to as the "underlying return") that arises under, or in connection with, the financial instrument, or revenue, profit, cash flow, commodity price, or any other similar criterion;
- the substitute payment would give rise to a deduction/non-inclusion mismatch if any Canadian ordinary income and any foreign ordinary income, in respect of the substitute payment, were limited to the portion of those amounts that can reasonably be considered to relate to the portion of the substitute payment that represents, or otherwise reflects, or is determined by reference to, an underlying return. This condition can also be met in certain circumstances where a substitute payment does not in fact give rise to a deduction/non-inclusion mismatch, but an amount is deductible to the transferee in respect of the underlying return on the transferred instrument; and
- either the transferee or an entity that does not deal at arm's length with the transferee is a recipient of the underlying return—or, if the reference is (for example) cash flow, a distribution under the financial instrument—and the amount of the underlying return or the distribution, as the case may be, exceeds the total of all amounts, in respect of the underlying return or the distribution, as the case may be, each of which can reasonably be expected to be—and actually is—foreign ordinary income for a foreign taxation year or Canadian ordinary income for a taxation year, as the case may be, of the recipient; or, alternatively, the transfer results in an avoidance of an ordinary income inclusion or in an avoidance of a hybrid mismatch arrangement regime that would be relevant if the transferor were the recipient of the underlying return or a distribution under the financial instrument.

In brief, this seems to target situations where the amount of the underlying return or distribution from a transferred instrument received by a transferee exceeds the amount of ordinary income resulting from that receipt, or where the transfer would result in an avoidance of an ordinary income inclusion or of a hybrid mismatch arrangement regime.

Structured Arrangement

Proposed subsection 18.4(5) provides an exception to the deduction-denial rule in proposed subsection 18.4(4) and the income-inclusion rule in proposed subsection 12.7(3) for payments under a structured arrangement. A "structured arrangement" is any transaction or series of transactions that meets the following criteria: the transaction or series includes a payment that gives rise to a deduction/non-inclusion mismatch, and it can reasonably be considered, having regard to all the facts and circumstances, including the terms or conditions of the transaction or series, that any economic benefit arising from the deduction/non-inclusion mismatch is reflected in the pricing of the transaction or series, or the transaction or series was otherwise designed to, directly or indirectly, give rise to the deduction/non-inclusion mismatch. The exception applies if, at the time the taxpayer entered into, or acquired an interest in, any part of a transaction that is, or is part of, the structured arrangement, it was not reasonable to expect that the taxpayer, a non-arm's-length entity, or a specific entity in respect of the taxpayer was aware of the deduction/non-inclusion mismatch, and none of those entities shares in the value of any economic benefit resulting from that mismatch. The explanatory notes suggest that this exception is expected to be available only to the holder of a financial instrument; the issuer, on the other hand, is expected to be "aware" of the structuring and the related tax consequences, such that it (the issuer) would not be able to rely on the exception.

Substantially Similar Arrangements

In addition, under a relatively broad anti-avoidance rule in proposed subsection 18.4(20), it is proposed that the tax consequences to a person be determined in order to deny a tax benefit "to the extent necessary to eliminate any deduction/non-inclusion mismatch, or other outcome that is substantially similar to a deduction/non-inclusion mismatch, arising from a payment" if certain conditions are met. Among these conditions is that one of the main purposes of a transaction or series of transactions that includes the payment is to avoid or limit the application of subsection 12.7(3), 18.4(4), or 113(5) in respect of the payment, and that the mismatch be caused by certain specific factors—namely, the payment of a deductible dividend, or a mismatch that results from differences in the income tax treatment of arrangements under the laws of two or more countries that are grounded in the terms or conditions of the arrangement (although the explanatory notes suggest that this requirement, in the context of the anti-avoidance rule, should be interpreted more broadly than the causal test in proposed paragraph 18.4(10)(d)).

Consequences

The consequences of the application of this regime in respect of the payment are produced under subsection 12.7(3), 18.4(4), or 113(5), depending on the circumstances. Subsection 12.7(3) results in an income inclusion; subsection 18.4(4) results in the denial of an income deduction; and subsection 113(5) results in the denial of a deduction in computing taxable income that would otherwise be available in respect

of a dividend received on the shares of a foreign affiliate. In addition, under proposed subsection 214(18), interest paid or credited by a corporation resident in Canada, which is not deductible because of the hybrid mismatch rule in proposed subsection 18.4(4), is deemed to be a dividend, not interest, for the purposes of part XIII of the Act. This rule, in effect, is intended to align the treatment of these interest payments for the purposes of withholding tax under part XIII with the tax treatment for the purposes of part I and the tax treatment under the relevant foreign tax law, and it prevents taxpayers from using hybrid mismatch arrangements as equity substitutes to inappropriately avoid dividend withholding tax.

While it is too soon to have fully digested all of the potential implications of these new rules, taxpayers would be well advised to begin to review their arrangements in light of these developments. As noted above, the proposals would apply in respect of payments arising on or after July 1, 2022.

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Comment on Alta Energy

When the SCC granted leave (on August 6, 2020) for the Crown to appeal in *Alta Energy* (2018 TCC 152; aff'd 2020 FCA 43; aff'd 2021 SCC 49), I wondered why. After all, the Crown had lost at trial and on appeal, continuing a string of losses on tax treaty-shopping cases running from *MIL (Investments)* (2006 TCC 460; aff'd 2007 FCA 236) to *Prévost Car* (2008 TCC 231; aff'd 2009 FCA 57) and *Velcro* (2012 TCC 57). Did anyone seriously expect that the SCC would come to a different conclusion?

More importantly, the whole issue seemed moot going forward, given the amended preamble in article 6 of the multilateral instrument (MLI), which expressly states that "covered" tax treaties (which include Canada's treaty with Luxembourg) are not intended to create "opportunities for non-taxation or reduced taxation through tax . . . avoidance (including through treaty-shopping arrangements aimed at obtaining reliefs provided in this agreement for the indirect benefit of residents of third jurisdictions)." Does anyone seriously believe that a similar arrangement should not now be caught by GAAR or the principal purpose test (PPT) in article 7(1) of the MLI?

As a result, I figured that the court's decision to grant leave must have been less about tax treaty shopping itself than about the method of reasoning in GAAR cases. Indeed, the textual approach that the FCA applied to the misuse and abuse test in subsection 245(4) seemed like a clear invitation to the SCC to set the record straight on the appropriate interpretive exercise under GAAR—which, as the SCC emphasized in *Copthorne* (2011 SCC 63), requires the court to "[go] behind the words" of legislation or treaty provisions to determine if the transactions at issue are "in accord with their object, spirit or purpose."

From this perspective, I prefer the minority decision, which rightly emphasizes (at paragraph 117) that "[t]he GAAR directs courts to go behind" the ordinary meaning of the text "to identify the rationale underlying the relevant provision of the treaty." In contrast, the majority decision misconstrues the interpretive exercise under GAAR by declaring (at paragraph 47) that its goal is "to ensure the relevant provisions are properly interpreted in light of their context and purpose" and limits the scope of the GAAR analysis to the "specific provisions" at issue on the basis (at paragraph 49) that broader objectives such as avoiding double taxation "cannot be invoked to override the wording of the provisions in issue."

While ordinary interpretation under a textual, contextual, and purposive approach construes the text of provisions *in light of* their context and purpose, GAAR requires courts to determine the object, spirit, or purpose of the relevant provisions in order to deny tax benefits that would otherwise result from the ordinary interpretation of these provisions. It also contemplates separate inquiries into "a misuse of . . . provisions" of the ITA and other relevant enactments, including tax treaties, and "an abuse having regard to those provisions . . . read as a whole"—notwithstanding the erroneous conclusion in *Canada Trustco* (2005 SCC 54) (based partly on the original version of subsection 245(4), which was retroactively repealed in 2005) that subsection 245(4) contemplates a "unified, textual, contextual, and purposive approach to interpreting the specific provisions that give rise to the tax benefit."

Notwithstanding my preference for the minority's approach to GAAR, I find the majority's conclusion that GAAR should not apply more persuasive for three reasons.

First, to the extent that the allocation of tax jurisdiction under bilateral tax treaties is based on a concept of economic allegiance, it seems more reasonable to conclude (as does the majority) that the "business property exemption" in article 13(4) is an exception to this approach that operates as an incentive to cross-border investment, not (as the minority concludes) an expression of economic allegiance based on the idea that value in this circumstance is created in the state of which the investor is a resident.

Second, regardless of the majority's argument (at paragraph 66) that the treaty would have included a limitation-on-benefits provision if the parties had intended to deny treaty benefits to corporations with minimal economic connections to a state, it is not clear that Canada had identified treaty shopping as a concern when the treaty was signed in 1999, and it is indisputable that OECD commentaries and initiatives addressing treaty abuses were adopted only after the treaty was signed. As a result, although the *Copthorne* decision rightly observed that implied exclusion arguments could render GAAR meaningless, it is difficult to conclude that GAAR should apply to deny benefits under a tax treaty that was signed before international norms against tax treaty shopping were clear—

though it is arguable that these norms had changed by the time the transactions in *Alta Energy* were carried out.

Finally, while the title of the treaty states that it is "for the Avoidance of Double Taxation," it does not follow that its purpose is also to prevent "double non-taxation." On the contrary, as the majority decision rightly notes (at paragraph 54), the requirement that a treaty resident is "liable to tax" does not require that the person be actually subject to tax. While the modified preamble language in the MLI makes clear that tax treaties are not intended to create opportunities for non-taxation through tax treaty shopping, this language does not apply to the transactions at issue in *Alta Energy*.

Given the MLI and the amended preamble, the majority's conclusions on tax treaty shopping should not matter going forward—which leaves us only with their problematic approach to GAAR.

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Treaty Shopping After Alta Energy Luxembourg

On November 26, 2021, the SCC rendered its decision in *Alta Energy Luxembourg SARL* (2021 SCC 49). Six of the nine justices held that the Canadian statutory general anti-avoidance rule (GAAR) did not deny treaty benefits under the Canada-Luxembourg tax treaty ("the treaty") in an apparent treaty-shopping scenario. The decision will likely become a leading authority on this controversial issue both in Canada and internationally, and it may influence the interpretation of the OECD-sponsored Multilateral Convention To Implement Tax Treaty Related Measures To Prevent Base Erosion and Profit Shifting (MLI).

The facts of the case are straightforward. A group of American investors set up a Canadian oil and gas exploration company (Alta Canada), using a Delaware LLC as the direct parent. Realizing that they would not be able to benefit from a treaty exemption on an ultimate sale of Alta Canada, the American group transferred the shares of Alta Canada to a newly formed Luxembourg company (Alta Luxco) at a time when those shares had not appreciated in value. Alta Luxco ultimately sold the Alta Canada shares at a significant capital gain, and claimed an exemption from tax in Canada under articles 13(4) and (5) of the treaty, which exempt from Canadian taxation gains on the sale of shares if the value of the shares disposed of is derived principally from immovable property situated in Canada in which the business of the company was carried on (known as the "business property exemption").

The minister reassessed Alta Luxco on the basis that the property did not satisfy the business property exemption and, in the alternative, that GAAR applied to deny the exemption. Alta Luxco objected and ultimately appealed to the TCC, which sided with Alta Luxco. The GAAR issue was appealed to the FCA, which also ruled in favour of Alta Luxco. The Crown successfully sought leave to appeal to the SCC, but Côté J, writing for a six-person majority, rejected the government's GAAR arguments.

The majority held that the purpose of articles 1 and 4 of the treaty is to allow all persons that are residents under the laws of one or both of the contracting states to claim benefits under the treaty if their residence status could expose them to comprehensive tax liability in that contracting state. Luxembourg's domestic law is consistent with the international norm of treating corporations as being resident in the country in which they have their legal seat or central management. Had the parties to the treaty intended to deviate from this well-established notion, the drafters of the treaty would have explicitly signalled this intention. In fact, the inclusion of article 28(3) in the treaty, which denies treaty benefits to certain Luxembourg holding companies, suggests that when negotiating the treaty, Canada and Luxembourg specifically considered the question of what categories of Luxembourg-resident corporations should be denied access to treaty benefits. The majority thus concluded that the purpose of articles 1 and 4 is not to reserve the benefits of the treaty to residents that have "sufficient substantive economic connections" to their country of residence.

With respect to the business property exemption, the majority indicated that the treaty's purpose is to foster international investment in Canada by exempting residents of Luxembourg from Canadian capital gains tax on shares that principally derive their value from immovable property used in carrying on the residents' business. In enacting article 13(4), the drafters intended to deviate from the OECD model treaty, with Canada in effect giving up its right to tax certain transactions by Luxembourg residents in exchange for the economic opportunities that the business property exemption would provide to Canada. The majority noted that the use of Luxembourg conduit corporations was well known and foreseen at the time the treaty was signed. Canada could have limited access to the business property exemption by negotiating a subject-to-tax clause or including a beneficial owner requirement in the treaty, but it made a deliberate choice not to do so. Indeed, the majority left open the possibility that Canada may have intended the exemption to apply even in conduit scenarios.

In conclusion, the majority stated that a broad assertion of "treaty shopping" does not conform to a proper GAAR analysis; the application of GAAR must not be premised on a value judgment of what is right or wrong or on theories about what tax law ought to be or ought to do.

The three-person minority judgment, co-authored by Rowe and Martin JJ, forcefully endorsed the government's view that the purpose of the relevant provisions of the treaty was to

assign taxing rights to the state with the closest economic connection to the taxpayer's income. That purpose had clearly been frustrated by Alta Luxco, since it had no genuine economic connection to Luxembourg and was "a mere conduit interposed in Luxembourg for residents of third-party states to avail themselves of a tax exemption under the Treaty." The minority criticized the majority's view that the government of Canada would deliberately agree to a treaty that created "the conditions for unlimited tax avoidance" by means of Luxembourg conduit corporations.

An important outstanding question is how *Alta Energy* will affect the application of the MLI and, more specifically, whether the outcome in this case would have been different under the MLI. The main feature of the MLI is the principal purpose test (PPT), which operates to deny treaty benefits when one of the principal purposes of an arrangement or transaction is to obtain treaty benefits in a way that is not in accordance with the object and purpose of the relevant treaty provisions. The PPT bears substantial resemblance to GAAR, especially in respect of the abuse analysis. Accordingly, the SCC's holding in *Alta Energy* may strongly influence the analysis of when the PPT may apply to deny treaty benefits. Although the MLI contains a new preamble stating that the treaty is intended to eliminate double taxation without creating opportunities for non-taxation or reduced taxation (including through treaty-shopping arrangements), it is not clear that a court would apply such a broad statement of purpose to deny a treaty benefit that may very well have been intended to extend to conduit corporations—especially given that the MLI negotiators do not appear to have identified *Alta Energy*-like planning as a concern in their final report on BEPS action 6 or otherwise to have suggested that the business property exemption should be circumscribed. Put another way, OECD countries may notionally agree that treaty shopping is bad, but where a specific provision in a specific treaty was designed to foster treaty shopping for a specific purpose, GAAR and the PPT should arguably not apply to deny the resulting benefit.

It remains to be seen whether, as a result of *Alta Energy*, the Canadian government will actively pursue the inclusion of a limitation-on-benefits provision in key treaties.

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Loblaw Financial: A "Remarkably Straightforward" End to a Long Judicial Journey

On December 3, 2021, the SCC released its highly anticipated decision in *Canada v. Loblaw Financial Holdings Inc.* (2021 SCC 51), thereby bringing much-needed closure to a case that has been closely observed by many in the tax community. The key question addressed in the decision was one of statutory interpretation. Specifically at issue was the meaning of a particular phrase used in the "investment business" definition within the "foreign accrual property income" (FAPI) regime, set out in subsection 95(1) of the Act. The question was whether the business of a foreign banking subsidiary of Loblaw Financial Holdings Inc. ("Loblaw Financial") was "conducted principally with" arm's-length persons. In a unanimous decision, the SCC ruled that the arm's-length test was met and that therefore the business was not an investment business, and the income from it was not FAPI.

Much has been written on the factual background of the case and the decisions of the lower courts. In brief, Loblaw Financial owned all of the shares of a Barbados corporation (Glenhuron) that carried on a banking business regulated by the Central Bank of Barbados. In connection with its banking business, Glenhuron undertook a number of financial activities, including investing in short-term debt securities, making and acquiring loans, and entering into swaps and forward contracts. For Glenhuron to have fallen outside the definition of "investment business" during the relevant taxation years (2001 to 2010), it would have needed to (1) carry on its business as a foreign bank, (2) be regulated under foreign law, (3) employ more than five full-time employees (or the equivalent thereof) in the active conduct of its business, and (4) conduct its business principally with persons with whom it dealt at arm's length. (Following an amendment in 2014, the foreign banking exception is now generally available only to foreign affiliates of significant Canadian financial institutions.)

The TCC ruled in favour of the Crown on the basis that Glenhuron, while meeting the first three tests, did not conduct its business principally with arm's-length persons. In the court's view, the business of Glenhuron was conducted principally with non-arm's-length persons since it was funded with related-party capital and received significant direction, support, and oversight from its parent corporation. On appeal to the FCA, the decision was reversed on the basis that the lower court had erred in determining how to apply the arm's-length test in the context of foreign banks. It was held that the determination of whether a business is conducted principally with arm's-length persons should be based on the income-earning activities of the business, and that neither activities relating to capitalization nor the presence of corporate oversight is relevant for these purposes.

On appeal to the SCC, the sole issue under consideration was whether Glenhuron conducted its business principally with arm's-length persons. More specifically, the court considered whether a parent corporation is conducting business with its foreign subsidiary when it provides capital and exercises corporate oversight. The question was described by the court as "remarkably straightforward," with the answer being an equally straightforward "no."

In rendering its decision, the SCC reaffirmed a number of fundamental principles of tax law. In particular, it noted that legislation is to be interpreted by applying a unified textual, contextual, and purposive approach, and that when the words of a statute are precise and unequivocal, their ordinary meaning should play a dominant role, especially when the provision in question is part of a highly detailed and precise regime, such as the FAPI regime. It was also noted that taxpayers are entitled to arrange their affairs so as to minimize the amount of tax payable (the *Duke of Westminster* principle).

Within this framework, the court concluded that neither the source of capital nor the presence of corporate oversight is relevant to a determination of whether a business is conducted principally with arm's-length persons. In dismissing the relevance of capital funding, the court made a number of observations. An observation of particular note was the following: although raising capital is a necessary part of any business and enables the business to be conducted, activities relating to capitalization are not part of the actual conduct of the business, and a bank is no different from any other business in this respect. Moreover, when the overall context of the FAPI regime is considered, it is intuitively clear that the determination of whether an investment business exists should focus on income-earning activities, not capitalization. Also, there is no basis for reading anti-avoidance or international competitiveness considerations into the arm's-length test, because doing so would be tantamount to rewriting the legislation. Rather, full effect should be given to Parliament's precise and unequivocal words, so that taxpayers can act with a degree of certainty.

Similarly, in dismissing the relevance of corporate oversight, the SCC noted that there is no basis in the text, context, or purpose of the arm's-length requirement to support the position that a parent corporation's direction, support, and oversight is to be taken into account in an analysis of whether the requirement is met. A corporation is separate from its shareholders, and although a corporation's business may be conducted with money provided by shareholders or in accordance with policies adopted by the board of directors in the interests of the shareholders, it is the corporation, nevertheless, that remains the party conducting the business.

Once the source of capital and presence of corporate oversight were removed from the analysis, the court held that the investment activities of Glenhuron were the only part of the business that was relevant for the application of the arm's-length test, and since the vast majority of these activities were conducted with arm's-length persons, the test was met during the relevant taxation years.

Loblaw Financial is a welcome decision for taxpayers. In addition to confirming that the *Duke of Westminster* principle lives on, the case reaffirms the basic principles governing statutory interpretation and emphasizes that courts should be reluctant to interpret complex tax provisions in a way that departs from their clear text. As noted by the court, if taxpayers are to act with any degree of certainty under the highly intricate and defined FAPI regime, then full effect should be given to Parliament's precise and unequivocal words.

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Transfer-Pricing Dispute Prevention and Resolution

Over the last decade, tax authorities around the world have been increasingly focused on raising revenues through transfer-pricing audits and assessments (see BEPS actions 8-10). Canada has been no exception, as the federal budgets from 2016 through 2022 demonstrate: the current Liberal government, since it was elected in 2015, has committed over $3 billion in additional funding to audit and enforcement activities, with much of that funding dedicated to combatting international tax avoidance and evasion and auditing large multinational groups. It's clear that transfer-pricing practices are seen by the CRA and other tax authorities as a source of base erosion and therefore as a rightful target of audit resources.

Heightened levels of audit activity in the transfer-pricing arena necessarily mean greater potential for transfer-pricing controversies. The corollary of the BEPS project's focus on transfer pricing as a source of tax revenues was its commitment to making dispute resolution mechanisms more effective (BEPS action 14—2015 final report). Implicitly recognizing that BEPS measures could lead to "unnecessary uncertainty for compliant taxpayers and to unintended double taxation," the OECD made "[i]mproving dispute resolution mechanisms . . . an integral component of the work on BEPS issues." The Forum on Tax Administration, an organization of more than 50 tax administrations, including those of the G20—chaired by the CRA's own Bob Hamilton and aimed at strengthening tax administrations around the world—makes tax certainty the central pillar of their work.

From a tax adviser's perspective, however, it is not clear that the bright promise of ensuring effective, timely resolution of disputes has come to fruition in practice, and it does not appear—at least in Canada—that tax authorities' enthusiasm for transfer-pricing audits and assessments has been matched by a genuine commitment to safeguarding dispute resolution processes.

A Canadian taxpayer that is a member of a multinational group faced with a transfer-pricing assessment with which it disagrees can generally consider three options for resolving the controversy. First, it can file an objection and pursue the administrative appeals process within the CRA. Second, if the transfer-pricing dispute involves a jurisdiction that is a treaty partner of Canada, it can pursue relief bilaterally, through the mutual agreement procedure (MAP) under the relevant treaty. Third, once CRA Appeals has confirmed the audit assessment (or once at least 90 days have elapsed since the filing of an objection), the taxpayer can seek relief through the TCC—and, from there, through the FCA and (with leave) the SCC. (There is, of course, flexibility in practice for a taxpayer to pivot among these three options—for example, by filing an objection and then seeking competent authority relief; or, having found the MAP to be ineffective, by proceeding with its administrative appeal or proceeding to file an appeal with the TCC.) A taxpayer may also proactively pursue an advance pricing arrangement (APA) under one of Canada's tax treaties prior to a reassessment.

Historically, the CRA objections process has led to the resolution of a very large majority of tax disputes. However, lead times at CRA Appeals are notoriously long; taxpayers frequently wait 12 to 18 months before an Appeals officer is assigned and engaged in the consideration of an objection, and it is some months longer before these taxpayers receive an indication of the officer's decision. Moreover, while the Appeals Branch has made efforts to operate independently of the audit function, CRA Appeals has no true statutory independence from the Audit Branch. With respect to larger-dollar-value transfer-pricing assessments, the authors' experience has been that these assessments have frequently been "signed off on" by the International and Large Business Directorate at CRA Head Office, with the result that a contrary decision by Appeals is unlikely, and a taxpayer confident in its position must resort to the MAP or the courts.

With respect to the MAP, Canada was an early signatory of the multilateral instrument (MLI) that arose from BEPS action 15, and it opted in to mandatory binding arbitration as part of its commitment to effective (bilateral) dispute resolution. As a result, a large number of Canada's treaties were modified to introduce binding arbitration in circumstances where the two jurisdictions are unable to come to an agreement within a specified period. Experience with binding arbitration under the treaty between Canada and the United States has been that it materially improved the effectiveness of the MAP—with no need to resort to arbitration, in many cases. Despite the optimism implied by this commitment to effective bilateral dispute resolution, more than two years after the MLI entered into force for Canada, it has yet (as far as we are aware) to enter into a single mode of application (MOA) with respect to procedures for the actual implementation of arbitration. (Paragraph 10 of article 19 of the MLI provides that the competent authorities must settle the MOA prior to the first case's eligibility for submission to arbitration.) Moreover, Canada and Japan, although covered under the MLI, have not selected the same type of arbitration process, and thus arbitration will not be available until a process can be agreed on. Nor has Canada's treaty with Mexico—although it, too, is a covered agreement under the MLI—been modified to include binding arbitration. Other key jurisdictions, such as Germany and Switzerland, are not covered by the MLI; these treaties have been under renegotiation since 2017. When we consider that Canada reported these two countries as among the main jurisdictions for MAP transfer-pricing disputes, binding arbitration does not appear to be, at least in the near term, the beacon of hope it once seemed. (In 2020, the CRA reported that Austria, France, Germany, Mexico, Switzerland, and the United States are the main jurisdictions with which the CRA started MAP transfer-pricing cases.)

APAs, based on cooperation and collaboration, are often seen as the best solution for both taxpayers and tax authorities, resulting in certainty and avoiding assessments altogether. To some observers, however, the extensive timelines and resources required for APAs make them a less viable alternative. In addition, APAs may not cover the most controversial issues, such as business restructurings.

The judicial process offers an alternative for multinational groups that seek certainty in transfer-pricing assessments. In the *Cameco* case (2018 TCC 195; aff'd 2020 FCA 112), the TCC and the FCA offered decisive guidance on the interpretation and application of the "recharacterization" provisions in paragraphs 247(2)(b) and (d)—and they vindicated the taxpayer's position in full. But the outcome in *Cameco*, despite its clarity, came after a full decade of hard-fought litigation. Moreover, since *Cameco*, the CRA has continued to apply the transfer-pricing recharacterization provisions with at least the same enthusiasm as it did before the decision, and the 2020 federal budget announced a review of Canada's transfer-pricing rules in the wake of the courts' decisions.

Although some funding has been allocated to the courts in recent federal budgets, this funding (1) is not necessarily allocated to the Department of Justice and the TCC; (2) does not match the level of funding injections for CRA audit and assessment; and (3) appears to be inadequate for facilitating, through technology, a more expeditious dispute resolution system that would bring the Canadian judicial process truly into the modern era. When one considers, as well, that the TCC, after more than two years of recurrent pandemic lockdowns and an unrelenting level of assessment activity, now faces an unprecedented backlog, it is clear that taxpayers seeking to resolve their transfer-pricing controversies face a long haul.

This lengthy dispute-resolution process—as we consider the path to recovery in today's post-COVID (we hope) environment—poses a significant issue for policy makers looking to

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ensure that Canada remains an attractive and viable place for investment and growth. Although one obvious solution may be to direct more resources to dispute resolution, we suggest that it may be time for a more creative approach. Consider the following possibilities, for example:

- a statutory framework supporting a truly independent Appeals function that is bound by timelines and has the authority to create precedent for auditors;
- investment in published MAP guidance that builds on the hundreds of successful resolutions achieved by Canada's competent authority, and the redirection of resources to the proactive resolution of complex issues such as business restructurings—particularly as businesses transform themselves in order to meet new realities; and
- investment in the efficiency of the judicial process, building on the digital changes made during the pandemic as well as on the pre-pandemic efforts to encourage early and effective settlement; and
- consideration of new approaches to managing and streamlining the docket (for example, through case categorization).

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