International TAX HIGHLIGHTS

Editor: Angelo Nikolakakis, EY Law LLP, Montreal (angelo.nikolakakis@ca.ey.com)

Volume 3, Number 1, February 2024

In This Issue

We are back with you again, looking forward to another good year of *International Tax Highlights*.

As expected, there have been numerous developments since the last issue of this newsletter. In this issue, we highlight certain Canadian legislative developments, some international developments, and some jurisprudence.

On November 30, 2023, the Fall Economic Statement Implementation Act, 2023 (Bill C-59) was tabled in the House of Commons, and it is now working its way through the legislative process. This bill contains a number of important Canadian legislative developments, including the implementation of many legislative proposals previously released on August 4, 2023. Among these are revised proposals to address hybrid mismatch arrangements (HMAs). Ian Bradley and Seth Lim, in this issue's first article, take us through these proposals, and they discuss the concerns that have arisen in relation to the extension of subsection 113(5) of the ITA to dividends received by foreign affiliates. Staying with this theme, we then have an article by Simon Townsend and Silvia Wang; they consider the implications of these proposals regarding the HMA rules, along with the pending second package of proposals, with respect to some typical situations involving Canadian unlimited liability companies.

With respect to pillar 2, we have an important update from David Bunn and Megan Seto on uncertainties that arise in determining the identity of the ultimate parent entity in situations involving public corporations that may be controlled by private holding companies, which are subject to Canadian accounting standards for private enterprises (ASPE), and similar issues. We also have an update by Patrick Marley and Oleg Chayka on the third round of agreed administrative guidance released on December 18, 2023, which is not yet reflected in the proposed Global Minimum Tax Act. We then have Nathan Boidman's interesting comparison of legislative developments in Barbados and Bermuda—two of the many jurisdictions reacting to the onset of pillar 2.

A related but singular development concerns the Canadian treatment of income from the operation of ships in international traffic. On December 20, 2023, the Department of Finance released legislative proposals to exempt such income in the hands of Canadian-resident corporations. Audrey Dubois and Karl Degré explain how these proposals are intended to update the Canadian approach to the treatment of such operations, both in general and so as to better align the Canadian approach with pillar 2.

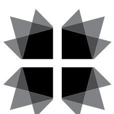
On the jurisprudence front, we are grateful to Tim Hughes, Oleg Chayka (once again), and Okanga Okanga for their coverage of the recent TCC decision in *Husky Energy Inc.*, involving the impact of a securities lending arrangement on the determination of "beneficial ownership" for tax treaty withholding tax relief on dividends. This will be a case to follow closely.

Also on the jurisprudence front, Sebastien Rheault, Jing Yu Wang, and Julien Tremblay-Gravel take us through the recent decision from Australia in the *PepsiCo* case, where the court upheld the bifurcation of arm's-length payments, as between consideration for tangible concentrates and consideration for intangible trademarks, resulting in the imposition of withholding tax on the imputed royalties. This will also be a case to follow closely, and not just for transfer-pricing practitioners: contractual purchase price allocations are common and can be very important, even in purely domestic transactions.

For transfer-pricing practitioners, and especially those in the mining sector, we have an interesting contribution from Kevin Chan, Steve Marshall, and Paul Hildebrandt, who review the recent "practice note" issued by the OECD and the Intergovernmental Forum on Mining, Minerals, Metals and Sustainable Development (IGF) regarding their proposed

In This Issue

In This Issue 1
The Updated Hybrid Mismatch Rules 2
Can the Hybrid Mismatch Rules Affect Canadian ULCs? 5
Pillar Two: Pubcos Controlled by Family Offices 7
OECD Releases Third Round of Pillar 2 Administrative Guidance 9
How Will Pillar 2-Inflected Barbados and Bermuda Law Play in Canada? 11
Proposed Change to the Canadian International Shipping Regime 14
Beneficial Ownership and "Legal Reality": Insights from Husky Energy Inc. v. Canada 15
The Australian PepsiCo Case: Withholding Tax on Embedded Royalties—A Canadian Perspective 17
A Transfer-Pricing Framework for the Mining Sector 20
Subsection 212.1(1): Is a Non-Resident Beneficiary Six Feet Under? 22



CANADIAN TAX FOUNDATION
FONDATION CANADIENNE DE FISCALITÉ

©2024, Canadian Tax Foundation and IFA Canada

framework for identifying the primary economic factors that should influence the transfer price of minerals. This will be relevant not only to the context of applying Canadian transfer-pricing rules and principles but also to the many Canadian-based companies that have foreign mining operations.

Last but not least (as is fitting for the topic), we have the contribution by Balaji (Bal) Katlai, Henry Korenblum, and Hugh Neilson, who review continuing concerns under the surplus-stripping rules in section 212.1 in the context of post mortem pipeline planning.

Many thanks to all.

We hope you enjoy this issue.

Angelo Nikolakakis
EY Law LLP, Montreal

The Updated Hybrid Mismatch Rules

On November 30, 2023, the federal government tabled the Fall Economic Statement Implementation Act, 2023 (Bill C-59), which includes updated legislation for the hybrid mismatch rules. These rules address hybrid mismatch arrangements, which are cross-border arrangements that are characterized differently under the tax laws of different countries. The rules in Bill C-59 are the first of two legislative packages that will amend the ITA to implement the recommendations of the action 2 report, which was prepared as part of the OECD/G20 base erosion and profit shifting (BEPS) project. This first legislative package deals with "deduction/non-inclusion" (D/NI) mismatches relating to hybrid financial instruments (including mismatches that involve hybrid transfers of financial instruments and substitute payments relating to these instruments). These rules apply to payments arising after June 30, 2022 (except where otherwise noted). The second legislative package has not yet been released and is expected to address the remaining recommendations from the action 2 report. In this article, we provide a brief overview of the hybrid mismatch rules, summarize Bill C-59's key updates to those rules, and discuss related policy concerns.

Scope of the Rules

The hybrid mismatch rules generally apply to payments arising under a "hybrid mismatch arrangement" that produces a D/NI mismatch. A D/NI mismatch generally arises where a payment is deductible in Canada or a foreign country but is not included in ordinary income in either country.

The rules address three types of hybrid mismatch arrangements:

- *Hybrid financial instrument arrangements*. These are arrangements in which financial instruments are treated differently under the tax laws of different countries (for example, as debt in one country and equity in another country).
- *Hybrid transfer arrangements*. These are arrangements, involving the transfer of a financial instrument, that are treated differently under different countries' tax laws. (For example, one country treats the arrangement as a sale of the transferred instrument, while another country treats it as a loan that is secured by the transferred instrument.)
- *Substitute payment arrangements*. In these arrangements, which involve the transfer of a financial instrument, payments are made that substitute for returns on the transferred instrument.

Each type of arrangement is defined through complex tests, which generally involve the following requirements:

- The parties to the arrangement must be connected in a certain way: either they do not deal at arm's length or they satisfy the "specified entity" test (which generally requires having at least 25 percent common ownership). If the parties are not sufficiently connected, the rules can still apply if the arrangement is a "structured arrangement" (generally, an arrangement that is designed to produce a D/NI mismatch or is priced to reflect the economic benefit of the mismatch).
- The arrangement must include a payment that produces a D/NI mismatch.
- The D/NI mismatch must reasonably be considered to arise because of the hybrid tax treatment of the arrangement (that is, because the tax treatment of the arrangement varies by country).

The substitute payments rule is somewhat different, because its application does not require that a D/NI mismatch arise from the hybrid tax treatment. This rule generally applies to transfer arrangements that produce D/NI mismatches (or similar results) involving substitute payments, which could undermine the integrity of the other hybrid mismatch rules.

The rules also apply to notional interest deductions, which are allowed in some foreign jurisdictions on interest-free (or low-interest) debts. These debts are essentially deemed to be hybrid financial instruments under subsection 18.4(9). Notably, this rule was not included in the action 2 report.

Where a hybrid mismatch arrangement exists, the D/NI mismatch that results from the hybrid tax treatment is called the "hybrid mismatch amount" and is subject to the operative rules, which aim to neutralize the D/NI mismatch.

Operative Rules

Primary Rule

The primary operative rule (found in subsections 18.4(3) and (4)) generally applies to "inbound" arrangements (that is, arrangements in which a Canadian taxpayer makes a payment to a foreign entity under a hybrid mismatch arrangement). This rule denies a deduction for the payment to the extent of the hybrid

mismatch amount. Any denied interest deduction is deemed to be a dividend for the purposes of non-resident withholding tax (as set out in subsection 214(18)). This deemed dividend treatment is another departure from the action 2 report. This primary rule takes precedence over any foreign hybrid mismatch rules, which might otherwise include the payment in foreign income.

If a deduction for a payment is denied under the primary rule, an adjustment mechanism (set out in paragraph 20(1)(yy)) allows a deduction to be claimed in the future, to the extent that an amount is subsequently included in foreign ordinary income. This rule provides relief for hybrid mismatch amounts that involve timing differences rather than permanent mismatches.

Secondary Rule

The secondary operative rule (set out in subsections 12.7(2) and (3)) generally applies to "outbound" arrangements (that is, arrangements in which a payment is received by a Canadian taxpayer from a foreign entity under a hybrid mismatch arrangement). Under this rule, an amount equal to the hybrid mismatch amount for the payment is included in the taxpayer's income. This rule does not apply to a payment that is non-deductible in the foreign country because of a foreign hybrid mismatch rule; the foreign rule therefore takes precedence over the Canadian secondary rule.

Denial of Foreign Affiliate Dividend Deduction

Subsection 113(5) denies a section 113 deduction for a dividend received from a foreign affiliate (FA) to the extent that the dividend is deductible for foreign tax purposes by the dividend payer (or by other entities that directly or indirectly own the dividend payer, or that pick up the dividend payer's income for foreign tax purposes). Unlike the application of the main operative rules, the application of this rule does not require a hybrid mismatch arrangement. This rule takes precedence, however, over any foreign hybrid mismatch rules that would otherwise deny the foreign tax deduction for the dividend.

Bill C-59: Key Updates to the Hybrid Mismatch Rules

Rules for FAs

The most significant changes in Bill C-59 are new rules addressing how the hybrid mismatch rules apply in the computation of the foreign accrual property income (FAPI) and surplus of FAs:

- The primary rule (subsection 18.4(4)) does not apply in computing the FAPI of an FA.
- The secondary rule (subsection 12.7(3)) can apply in computing the FAPI of an FA, in respect of payments received by the FA (or by a partnership of which the FA is a member). However, this rule does not apply if subparagraph 95(2)(a)(ii) applies to include the income or loss of the FA derived from the payment in its active business income or loss (or if, in the case of notional interest expenses, subparagraph 95(2)(a)(ii) would have applied to an actual interest payment on the debt).
- Dividends received by an FA from another FA (including dividends received through partnerships) are included in the recipient FA's FAPI, to the extent that subsection 113(5) would have applied had the recipient FA been a Canadian corporation (that is, to the extent that the dividend payment is deductible under foreign tax laws).
- Where one FA receives from another FA a dividend to which subsection 12.7(3) applies, or to which subsection 113(5) would have applied had the recipient been a Canadian corporation, the dividend is not included in the recipient's surplus balances under the normal rules applicable to interaffiliate dividends (it is included instead, presumably, in "taxable earnings," as part of the recipient's FAPI).

These rules apply to payments arising after June 30, 2024.

The new rules for FAs significantly expand the scope of the hybrid mismatch rules. We have some policy concerns regarding the scope and effects of these rules, and these concerns are as follows:

- The exemption for payments covered by subparagraph 95(2)(a)(ii) is welcome. However, the scope of the exemption could be somewhat limited in practice, because many hybrid investments that fund active business operations produce payments (for example, dividends from other FAs) that are not typically covered by subparagraph 95(2)(a)(ii). Furthermore, this exemption does not apply to the new rule targeting deductible interaffiliate dividends.
- Double taxation can arise when the new rules apply to an investment that funds the FAPI-generating activities of another FA. This is because the rules include a payment in the recipient's FAPI, without providing a deduction from FAPI for the payer. Consider an example in which one FA receives a dividend from a second FA, which earns FAPI. If the dividend is deductible by the second FA under foreign tax laws, the dividend will be included in the first FA's FAPI, even though no deduction is available from the second FA's FAPI. This reflects the fact that such arrangements do not receive hybrid tax treatment from a FAPI perspective, because the payer and recipient FAs both compute FAPI under Canadian tax rules.
- The foreign tax credit generator rules (set out in subsections 91(4.1) to (4.7) and in regulations 5907(1.03) to (1.07)) apply in many of the same situations as the

hybrid mismatch rules, denying deductions for foreign tax paid in connection with these arrangements (which would otherwise be available under subsection 91(4) to offset FAPI, and under paragraph 113(1)(b) to offset income from taxable surplus dividends). Where the hybrid mismatch rules include a payment in an FA's FAPI or taxable surplus, the foreign tax credit generator rules will often deny relief for foreign tax on that payment, even where relief would be provided in comparable scenarios involving a Canadian recipient (for example, in a situation where a dividend received by a Canadian corporation from an FA would benefit from the new subsection 113(6) deduction, described below).

Deduction for Foreign Withholding Tax on Subsection 113(5) Dividends

New subsection 113(6) provides a deduction for foreign withholding tax paid by a Canadian corporation on a dividend to which subsection 113(5) applies (the deduction is equal to the non-business income tax paid on the dividend, multiplied by the corporation's relevant tax factor). This change addresses a concern that double taxation could arise where subsection 113(5) dividends were subject to foreign withholding tax (since foreign tax credits are generally not available for dividends received from FAs).

Notional Interest Expense

The deeming rule in subsection 18.4(9) now applies where *any* entity, not just the debtor, claims a notional interest deduction on a debt. However, the updated explanatory notes (November 2023) confirm that the deeming rule would not apply to deductions in respect of equity (for example, an allowance for corporate equity regimes).

There is also a change to the effective date: the secondary rule will not apply to notional interest expense computed in respect of a period before January 1, 2023.

Exempt Dealer Compensation Payments

The rule for hybrid transfer arrangements now provides an exemption for dealer compensation payments received in certain circumstances. This exemption will apply to certain dealer compensation payments for underlying dividends on public corporation shares. To qualify for the exemption, these payments must be received by a Canadian registered securities dealer from a controlled FA that carries on a regulated securities-trading business principally with arm's-length persons (the FA must also have substantial market presence in a foreign country and face competition in that country).

Timing Mismatches

As noted above, when an interest deduction is denied under the primary rule, subsection 214(18) deems the interest to be a dividend for withholding tax purposes. When a deduction is subsequently provided under paragraph 20(1)(yy) (for example, because a timing mismatch is resolved), new subsection 227(6.3) allows the taxpayer to apply for a refund of withholding tax. The refund is based on the difference between the withholding tax applicable to the deemed dividend and the withholding tax that would have applied to an interest payment.

The updated explanatory notes acknowledge that no equivalent to paragraph 20(1)(yy) exists to address timing mismatches under the secondary rule (that is, situations where a payment is included in income under this rule, but the D/NI mismatch resolves in the future). However, the explanatory notes suggest that subsections 12(3) and 248(28) should generally prevent a timing mismatch from producing a double income inclusion. Although these provisions may provide relief in some circumstances, they may not be effective in others (for example, in situations where the future income inclusion arises for a different Canadian taxpayer, or under foreign tax laws).

Other Changes

Bill C-59 also includes the following changes:

- The rule for substitute payment arrangements now requires that at least one of certain parties linked to the arrangement be a non-resident.
- The rules for specified entities now provide that two parties are not specified entities in respect of each other in certain circumstances involving rights granted to secure a debt.
- Taxpayers must file prescribed forms where the hybrid mismatch rules apply. These filing requirements generally apply to payments arising after June 30, 2023. The details of these new forms are not yet available.

Conclusion

The updated hybrid mismatch rules in Bill C-59 address some of the concerns previously raised by the tax community. Other concerns persist, however, and the rules for FAs raise new policy concerns. The hybrid mismatch rules remain complex and have a potentially broad scope. Taxpayers should carefully review these rules to determine whether they apply to the taxpayers' existing cross-border arrangements. The rules will necessitate that taxpayers take a coordinated global approach so as to properly understand how these cross-border arrangements will be treated in foreign tax systems, including how the rules interact with any foreign hybrid mismatch rules.

Ian Bradley and Seth Lim
PwC Law LLP, Toronto

Can the Hybrid Mismatch Rules Affect Canadian ULCs?

On November 21, 2023, Canada signalled its intention to proceed with proposed hybrid mismatch arrangement (HMA) rules. More recently, on November 28, 2023, Canada released the notice of ways and means motion that includes the first package of the revised HMA legislation. This now forms Bill C-59, tabled before the House of Commons. The first package of the proposed legislation implements the recommendations included in chapter 1 of the OECD BEPS action 2 final report, addressing deduction/non-inclusion (D/NI) mismatches that arise from payments under (1) hybrid financial instrument arrangements, (2) hybrid transfer arrangements, and (3) substitute payment arrangements. The first package also implements some of the recommendations in chapter 2 of the action 2 final report, addressing dividend deductions under section 113 to the extent that they are deductible under foreign law. A retroactive date of July 1, 2022 is provided for most elements of the first package. Other recommendations of the BEPS action 2 report will be included in the second package of the proposed legislation, which has not been released as of this writing.

In this article, we address whether the first package of legislative proposals related to the HMA rules will, along with the pending second package, have an impact on the use of the unlimited liability company (ULC) structure for conducting business in Canada from the United States. We use three examples to help illustrate our consideration of whether certain deductible expenses would be disallowed in Canada under the HMA rules.

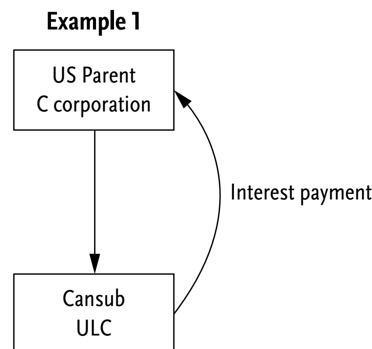
Use of Canadian ULCs for Carrying On Business in Canada from the United States

Generally, Canadian ULCs are created by provincial statute in Canada. They may yield certain benefits when they are used for carrying on business in Canada. A ULC is treated as a flowthrough entity by default for US tax purposes (unless an election is made to treat the ULC as a corporation), and it is treated as a corporation in Canada, subject to regular Canadian corporate tax. From a US perspective, the benefits of Canadian ULCs may include the ability to operate in a branch form for US tax purposes while maintaining the legal protection of two distinct corporations, and the ability to apply Canadian operating losses against a US parent's taxable income.

Example 1

In example 1, a US C corporation ("US Parent") has a wholly owned subsidiary in Canada ("Cansub"). Cansub is a ULC that is treated as an opaque entity in Canada but as a disregarded entity in the United States. Cansub received an interest-bearing loan from US Parent. The interest payments are deductible in Canada by Cansub. However, since Cansub is a disregarded

Example 1



entity in the United States, there would be no corresponding income inclusion in that country. This structure is already affected by the denial of withholding tax relief under the Canada-US tax treaty ("the treaty") because of article IV(7)(b), but, for the moment, let us just consider the additional implications.

First Package of the Proposed Legislation

Under proposed subsection 18.4(10), a payment will arise from a hybrid financial instrument arrangement if the following four conditions are met:

1) the payment arises under, or in connection with, a financial instrument;
2) the payer and the recipient are either non-arm's-length or specified entities, or the arrangement is a structured arrangement;
3) the payment gives rise to a D/NI mismatch; and
4) it can reasonably be considered that (a) the D/NI arises (in whole or in part) because of a difference between two or more countries in their tax treatment of either the financial instrument or transactions that are related to the financial instrument, and (b) this difference is attributable to the terms or conditions of the financial instrument or other relevant transactions.

If a payment arises from a hybrid financial instrument arrangement (one of three HMAs), the primary operative rule in subsection 18.4(4) will restrict a deduction in Canada that results in a D/NI mismatch.

In example 1, there is a deduction in Canada but no recognition of income in the United States, resulting in a D/NI mismatch.

However, several arguments may be advanced to alleviate concerns that an overly broad reading of this first HMA legislative package applies to structures with a hybrid entity. First, the D/NI mismatch in example 1 arises primarily because of the difference between the countries in their tax treatment of Cansub (that is, regarded/disregarded), not because of a difference in the tax treatment of the financial instrument as such. Second, under the interpretation rule in proposed subsection 18.4(2), the Canadian rules are to be interpreted in accordance with the

OECD's action 2 report. In that report, in the overview section of chapter 1 (on which Canada's first package of legislation is partly based), it is stated that "[a] payment cannot be attributed to the terms of the instrument where the mismatch is solely attributable to the status of the taxpayer or the circumstances in which the instrument is held." Third, the explanatory notes provided by Finance for the proposed legislation include several examples—including examples of (1) structures with notional interest expenses on non-interest-bearing loans, (2) forward subscription agreements paired with loans, and (3) sale and repurchase agreements, or REPO transactions—and the OECD's action 2 report provides 37 examples, and none of these examples, with respect to hybrid financial instruments, detail a mismatch arising solely because the entity is classified differently in two countries.

Second Package of the Proposed Legislation

The second package of the proposed legislation has not been released. It is expected to include other recommendations of the BEPS action 2 report. Chapter 3 of the report ("Disregarded Hybrid Payments Rule") targets a deductible payment, made by a hybrid entity, that is disregarded under the laws of the payee jurisdiction and is therefore not treated as income under the laws of the payee jurisdiction. The purpose of this rule is to prevent a taxpayer from exploiting differences between jurisdictions in the tax treatment of the payer entity. The primary recommendation in chapter 3 of the report is that the payer jurisdiction should restrict the amount of the deduction, and the defensive rule requires that the payee jurisdiction include an equivalent amount in ordinary income.

Furthermore, chapter 3 provides that no mismatch will arise to the extent that the payer's deduction is set off against dual-inclusion income. "Dual-inclusion income" is generally defined in the BEPS action 2 report as an income item that is included in income under the laws of both the payer and payee jurisdictions. In addition, double taxation relief, such as a foreign tax credit granted by the payee jurisdiction, "should not prevent an item from being treated as dual inclusion income where the effect of such relief is simply to avoid subjecting the income to an additional layer of taxation in either jurisdiction" (at paragraph 126). Significantly, implementation techniques may vary by country; however, the BEPS action 2 report recommends (at paragraph 126) that when a determination is being made as to whether to treat as dual-inclusion income an item of income that benefits from double taxation relief, an approach should be taken that balances rules that "minimise compliance costs, preserve the intended effect of such double taxation relief and prevent taxpayers [from undermining] the integrity of the rules."

If Finance were to implement, in the legislation's second package, the recommendations in chapter 3 of the action 2 report, the arrangement described in example 1 (above) might be affected, and the deduction for interest expense might be disallowed in Canada to the extent that Cansub is in a net loss position. A deeming rule could be introduced to deem the interest payment to be a dividend paid to US Parent (a rule similar to proposed subsection 214(18) in the first package). The deemed dividend might be subject to a withholding tax of 25 percent because of the anti-hybrid provision in article IV(7)(b) of the treaty.

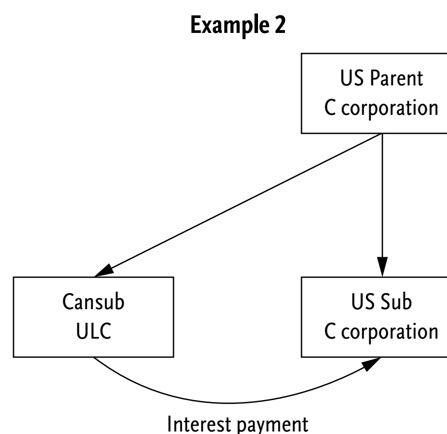
Remedial Steps

If the second package of the proposed legislation indeed has an impact on the ULC structure, a remedy might be to convert the ULC to a regarded entity for US tax purposes.

Example 2

In example 2, which is a variation on example 1, the loan is made by a US subsidiary of US Parent ("US Sub"), and US Sub is a C corportion. The interest payments are deductible both by Cansub in Canada and by the US Parent in the United States. US Sub will have an income inclusion in the United States from the interest income. In this example, we have assumed that the indebtedness originates from US Sub. In particular, the US Parent did not loan the funds to US Sub in order to further the loan to Cansub.

Example 2



Variations on the intercompany loan structure shown above are commonly employed to avoid the application of article IV(7)(b) of the treaty and to access treaty benefits on the interest payment, on the basis that the treatment of the interest for US tax purposes is the same as the treatment that would result if the ULC were not a fiscally transparent entity. (In CRA document no. 2010-0376751E5, May 24, 2011, the CRA compared the two treatments, considering, in both scenarios, the quantum, character, and timing of the item of income under US tax laws.)

First Package of the Proposed Legislation

For the same reasons that applied with respect to example 1, it is arguable that the first package of the proposed legislation may not apply.

Second Package of the Proposed Legislation

As discussed above, the second package of the proposed legislation, which has not yet been released, will include other recommendations of the BEPS action 2 report. In particular, chapter 6 of the report ("Deductible Hybrid Payments Rule") would apply to a "hybrid payer" that makes a payment that (1) is deductible under the laws of the payer jurisdiction and (2) triggers in the parent jurisdiction a duplicate deduction that results in a hybrid mismatch. A "hybrid mismatch" will occur if a deduction may offset income that is not dual-inclusion income. A person will be a "hybrid payer," according to chapter 6, where

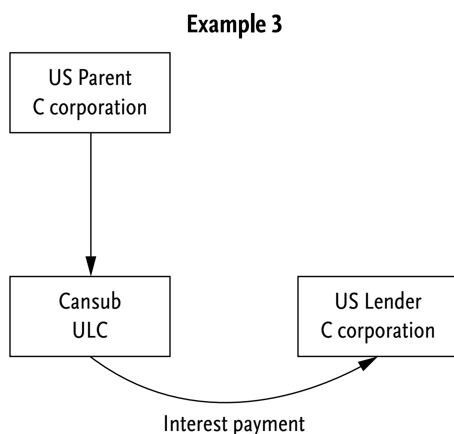
1) a payment is deductible under the laws of the payer jurisdiction,
2) the payer is resident in the payer jurisdiction, and
3) the payment triggers a duplicate deduction for an investor in that payer (or in a related person) under the laws of the other jurisdiction (the parent jurisdiction).

Importantly, chapter 6 provides that the rule will not apply if a deduction can be offset against an amount that will be included in income in both jurisdictions. This means, in the case of example 2, that if the interest expense can be offset against income of Cansub (which will be taxed in both Canada and the United States), the rule may not apply. If Cansub is in a loss position, however, chapter 6 may apply.

Example 3

Example 3 is the same as example 2, except that Cansub now receives a loan from a third party. The interest payments are deductible both by Cansub in Canada and by the US Parent in the United States.

Example 3



First Package of the Proposed Legislation

One of the conditions that must be met, in order for the arrangement to be considered a hybrid financial instrument arrangement, is that the payer and the recipient are either non-arm's-length entities or specified entities, or that the arrangement is a structured arrangement. Since the lender in example 3 is a third party, the payer and the recipient would not be either specified entities or non-arm's-length entities. A structured arrangement is defined, in general terms, as a transaction that gives rise to a D/NI mismatch, in a situation where it can reasonably be considered that a portion of the economic benefit arising from the D/NI mismatch is reflected in the pricing of the transaction that gives rises to a D/NI mismatch, or the transaction or series was otherwise designed to give rise to the D/NI mismatch.

Assuming that the loan is not a structured arrangement, it would not be considered a hybrid financial instrument arrangement and would not be caught by the first package of the proposed legislation.

Second Package of the Proposed Legislation

Chapter 6 of the BEPS action 2 report is relevant for this example, and the chapter 6 recommendations may be implemented by Finance in the second package of the legislation; therefore, it is important to understand whether chapter 6 applies to arrangements between arm's-length parties. The overview for chapter 6 of the action 2 report includes a proposed scoping rule that enforces, notably, only the defensive aspect of the rule: it denies a deduction in the payer jurisdiction (that is, in Canada). According to the action 2 report, the scoping rule restricts the application of the deduction denial to situations where parties are in the same control group or are part of a structured arrangement. Therefore, if the loan in example 3 is not a structured arrangement, chapter 6 may not apply to it, and the interest deduction may not be disallowed in Canada.

Next Steps

Further analysis will have to be undertaken once Finance releases the second package of HMA rules. In the meantime, this article has proposed that the structures herein described, along with similar structures, may be safe from the application of the first package of proposed legislation.

Simon Townsend and Silvia Wang
RSM Canada LLP, Toronto

Pillar Two: Pubcos Controlled by Family Offices

For accounting periods beginning on or after December 31, 2023, multinational groups with consolidated annual revenues of over €750 million in at least two of the four preceding years are subject to new minimum tax rules under the Global Minimum Tax Act (GMTA), Canada's implementing legislation for pillar 2. These rules determine the effective tax rate (ETR) for each jurisdiction in which the multinational group

operates. If the ETR is below 15 percent in a given jurisdiction, additional top-up taxes may be imposed under the GMTA.

Identifying the ultimate parent entity (UPE) of a multinational group is crucial for assessing the impact of pillar 2. Such identification is the starting point for, among other things, determining all of the entities that compose a particular multinational group. This knowledge is relevant, in turn, to a determination of whether the consolidated revenue threshold is met. Although the identification of the UPE is straightforward in many cases, it can sometimes become complex. This complexity arises, for example, when a private investment entity (PIE), such as a family office, controls a public company ("Pubco"), often through tiers of entities that reflect the different ownership and control exercised by various family members over group assets.

Under the GMTA, the UPE of a multinational group refers to an entity that has, directly or indirectly, a controlling interest in any other entity and no other entity has a controlling interest in the tested entity. A controlling interest is an ownership interest where the interest holder is required, or would have been required, to consolidate the assets, liabilities, income, expenses, and cash flows of another entity on a line-by-line basis in accordance with an acceptable financial accounting standard. Therefore, given the definition of a "controlling interest," pillar 2 requires consideration of the accounting principles applicable in the consolidated financial statements of an entity.

The GMTA defines "consolidated financial statements" as the financial statements of a UPE that are prepared in accordance with an acceptable financial accounting standard (that is, actual consolidated financial statements) or, in the absence of such financial statements, as the financial statements that would have been prepared in accordance with an acceptable financial accounting standard (that is, a notional consolidation test).

The specific ambiguity under the GMTA arises in cases where a PIE holds a controlling interest in a Pubco, and the PIE prepares financial statements under Canada's accounting standards for private enterprises (ASPE). ASPE permit but do not require the consolidation of subsidiaries, and in practice many private companies do not consolidate subsidiaries that would otherwise be consolidated under other accounting standards, including international financial reporting standards (IFRS). This reflects the simplified approach of the ASPE accounting framework in comparison with the principles imposed under IFRS.

In this Canadian context, the key interpretive issue that gives rise to the UPE question centres on the definition of "consolidated financial statements" in situations where the PIE prepares financial statements under ASPE and opts not to consolidate the Pubco. As noted above, the notional consolidation test, in the absence of actual consolidated financial statements, looks to the financial statements that would have been prepared in accordance with an acceptable financial accounting standard. ASPE and IFRS are both acceptable financial accounting standards under the GMTA. Adding further confusion is the fact that the definition of "consolidated financial statements" in the GMTA includes a parenthetical reference to "other than entities that are not required or permitted to be consolidated"—a qualification that does not exist under the OECD model rules.

The question, then, is whether the notional consolidation test causes the PIE to be the UPE of a multinational group that includes the Pubco, notwithstanding that ASPE, an acceptable financial accounting standard, offer the choice not to consolidate.

It is relevant to note that the openness of the relationship between family offices and the public companies they control can vary from business to business. It is common, however, for there to be operational independence and separate corporate governance structures for each of the family office and the public company. Therefore, the potential outcome of treating the PIE and the Pubco as a single economic unit for pillar 2 purposes creates complexities, including significant coordination requirements and compliance costs, that would not otherwise exist. Such treatment can also lead to distortive effects, since other investments of the PIE over which the Pubco has no influence will be combined with the Pubco group when jurisdictional blending is applied.

The concept of a UPE, and the interaction of the UPE with ASPE, is not new in the Canadian context: a UPE is defined for the purposes of country-by-country reporting (CbCR), which has existed since 2016. However, the definition of a UPE under the GMTA is worded differently than it is in the context of CbCR, and the Department of Finance accepts that, in certain cases, the UPE for pillar 2 purposes can be different from the UPE for CbCR purposes.

In recent months, the Department of Finance has received comments regarding the differing views on whether the PIE or the Pubco should be the UPE under the GMTA, when the statute is interpreted in accordance with the OECD's guidance. The department and its representatives have confirmed that the GMTA has been drafted so as to align with the OECD model rules and the accompanying guidance. The Department of Finance has also indicated that the parenthetical exception was not intended to deviate from the OECD model rules and may be removed from the next draft of the GMTA to avoid confusion.

During the consultation period, the Department of Finance stated that its view under the pillar 2 rules, as currently drafted, is that the PIE is generally the UPE of a multinational group that includes the Pubco, unless a specific exception under the relevant accounting standard excludes the Pubco from being consolidated on a line-by-line basis by the PIE (that is, by satisfying the investment entity carve-out under IFRS or ASPE, as the case may be). The fact that ASPE permit but do

not require consolidation is not relevant, in and of itself. The concern about the alternative outcome, in which the Pubco is the UPE, is that it could lead to pillar 2 avoidance opportunities by allowing a group to be fragmented into two or more smaller groups that are below the consolidated revenue threshold.

In December, however, the Department of Finance advised various stakeholders that (1) additional discussions (based on feedback from other countries that are part of the pillar 2 Inclusive Framework) have occurred at the OECD level regarding the appropriate outcome, and (2) further discussions are expected in 2024. Therefore, in the coming months, it is possible that the OECD will consider the issue further and return with additional clarification. That said, the expectation is that any changes to the notional consolidation test would need to include objective thresholds and guardrails to protect the integrity of the pillar 2 rules. Whether this could be done to the satisfaction of the pillar 2 Inclusive Framework remains an open question.

David Bunn and Megan Seto
Deloitte LLP, Toronto

OECD Releases Third Round of Pillar 2 Administrative Guidance

On December 18, 2023, the OECD released its third set of administrative guidance on pillar 2 ("the third administrative guidance"). The two previous sets of administrative guidance were published on February 2, 2023 and July 17, 2023.

The OECD's press release accompanying the third administrative guidance makes it clear that additional administrative guidance will follow, including guidance intended to address aggressive tax-planning schemes and to simplify the operation of, and compliance with, the pillar 2 rules, especially with respect to the application of deferred tax rules. In addition, the Inclusive Framework plans to launch the pillar 2 peer review process and to enhance the pillar 2 administration rules and dispute resolution mechanisms. Unfortunately, taxpayers currently have no effective mechanism for obtaining tax rulings or bespoke guidance on how the pillar 2 rules may apply to their particular facts and circumstances. As a result, many unresolved issues have arisen where the OECD's guidance to date is simply not adequate to provide certainty on how various pillar 2 rules—and the corresponding rules in Canada's Global Minimum Tax Act (GMTA)—are to be interpreted.

Canada has committed to introducing a global minimum tax under pillar 2, and on August 4, 2023 it took the first step toward complying with this commitment by releasing a draft of the GMTA. The new tax regime is set to apply to fiscal years beginning on or after December 31, 2023. In essence, the GMTA, instead of simply incorporating the global anti-base erosion (GloBE) model rules by reference, adopts them with modifications that reflect Canadian legal conventions and practices. The resulting need to "Canadianize" the third administrative guidance will likely add more complexity to the next draft of the GMTA, which is expected to come out in 2024 (notwithstanding its proposed retroactivity). Somewhat surprisingly, the Department of Finance has not yet released any draft legislation or guidance on legislative changes to the ITA, with a view to synchronizing that statute with the GMTA. In particular, it is very unusual for legislative amendments to apply retroactively with no previous announcement (in a press release or elsewhere) regarding their intended effect.

The third administrative guidance primarily clarifies the application of the transitional country-by-country reporting (CbCR) safe harbour and the permanent simplified calculations safe harbour for non-material constituent entities (NMCEs) that were part of the Safe Harbours and Penalty Relief document released by the OECD in December 2022 ("the 2022 SH document"). In particular, the third administrative guidance summarizes the pillar 2 policies on

- purchase price accounting (PPA) adjustments,
- tested jurisdictions,
- qualified financial statements and CbC reports,
- consolidated revenue computations and hybrid arbitrage arrangements for the transitional CbCR safe harbour, and
- the revised simplified calculations safe-harbour rules for NMCEs.

In addition, the third administrative guidance addresses fiscal year mismatches, the allocation of blended controlled foreign corporation (CFC) taxes, and transitional filing deadlines for MNEs with short fiscal years. The new guiding rules also contain useful examples that demonstrate the rules' intended operation.

Transitional CbCR Safe Harbour

PPA Adjustments

Financial statements or accounts reflecting the effect of PPA adjustments are generally acceptable and can be used for computing the pre-tax profit or loss for transitional CbCR safe-harbour purposes without any further adjustments, except

- where the MNE group files a CbC report for a fiscal year beginning after December 31, 2022, and that report is based on the constituent entity's reporting package or separate financial statements without the PPA adjustments (subject to some exceptions); and
- where a goodwill impairment adjustment reduces income and relates to transactions entered into after November 30, 2021.

Tested Jurisdictions

If constituent entities of the MNE group, joint ventures, and joint venture groups are located in the same jurisdiction,

separate tested jurisdictions will be deemed to exist and to include only constituent entities of the MNE group, only joint ventures, and only joint venture groups, as the case may be, located in that jurisdiction.

Qualified Financial Statements and CbC Reports

Consistent sources of financial data must be used at the constituent-entity level for transitional CbCR safe-harbour computations. This entails using either the financial accounts used to prepare the consolidated financial statements of the ultimate parent entity (UPE) or the distinct financial statements of the constituent entities. Also, the same consistent source of financial data must be used for all entities located in the same tested jurisdiction, except for permanent establishments and NMCEs. Failure to comply with the consistency requirements for financial data will leave the tested jurisdiction ineligible for the transitional CbCR safe harbour.

The qualified CbC report requirement applies on a tested-jurisdiction-by-tested-jurisdiction basis. In other words, failure to have a qualified CbC report for one tested jurisdiction does not disqualify the MNE group from relying on the transitional CbCR safe harbour in another tested jurisdiction for which the qualified CbC report is available.

When an MNE group is not required to prepare and file a CbC report, it can still qualify for the transitional CbCR safe harbour if it fills in section 2.2.1.3(a) of the GloBE information return, using information from the qualified financial source as if the MNE group were required to prepare and file a CbC report.

SBIE Rates

When an MNE group calculates the substance-based income exclusion (SBIE) amount for transitional CbCR safe-harbour purposes, it must use the same SBIE rates as are prescribed under the GloBE model rules, including the increased transitional SBIE rates.

Hybrid Arbitrage Arrangements

The third administrative guidance introduces a set of anti-avoidance rules that prevent constituent entities from accessing the transitional CbCR safe harbour if they become party to a hybrid arbitrage arrangement after December 15, 2022. Hybrid arbitrage arrangements include deduction/non-inclusion arrangements, duplicate loss arrangements, and duplicate tax recognition arrangements.

Although the anti-avoidance rules introduced in the third guidance apply only to the transitional CbCR safe harbour, the guidance also announced plans by the Inclusive Framework to develop a new set of anti-avoidance rules addressing a wider range of hybrid arbitrage arrangements in the broader pillar 2 context. These plans demonstrate an ongoing administrative challenge—namely, the fact that guidance on pillar 2 will slowly evolve. It is hoped that the further release of administrative guidance will be done on a prospective, not retroactive, basis—unless it is guidance for the relief of taxpayers. The need to reach a global consensus on all aspects of the pillar 2 framework (including anti-avoidance measures) will almost certainly create further delays, particularly when countries may disagree on the desired approach.

Revised Simplified Calculations Safe-Harbour Rules for NMCEs

The third administrative guidance redesigns and amends the "simplified calculations safe harbour" rules for NMCEs—rules that were part of the 2022 SH document. It does so in order that these rules can be coherently incorporated into the revised GloBE commentary. In addition, the guidance clarifies that the simplified calculations safe harbour for NMCEs is subject to an annual election, made for each NMCE rather than for the jurisdiction.

Consolidated Revenue Threshold

To determine whether an MNE group meets the €750 million consolidated revenue threshold, the revenue amounts can be netted to account for discounts, returns, and allowances, as long as such netting is in line with the relevant accounting standard and is done before the cost of sales and other operating expenses is deducted.

Revenue encompasses both (1) the net realized or unrealized gains from investments that are recorded in the profit-and-loss statement of the consolidated financial statements, and (2) income or gains that are presented separately as extraordinary or non-recurring items.

When an MNE group presents its gross gains and losses from investments separately rather than as a net amount, the gross losses can reduce the group's revenues only by an amount no greater than the amount of the gross gains from investments included in the group's revenues.

Fiscal Year Mismatches

The accounting period used by the UPE to prepare the consolidated financial statements is usually the fiscal year for GloBE purposes.

If some constituent entities have accounting periods that are different from the UPE's accounting period, the unadjusted or adjusted financial results of the constituent entity's fiscal year that are included in the group's consolidated financial statements, as the case may be, should be used for GloBE computations.

If the financial accounts are prepared for an accounting year that is different from the UPE's fiscal year, and these accounts are not included in the group's consolidated financial statements because of considerations related to entity materiality or joint venture status, the GloBE computations should be prepared with reference to the accounting period that ends during the UPE's fiscal year.

Where a constituent entity has different year-ends for financial accounting and tax purposes, the calculation of adjusted covered taxes should align with the tax allocation methodology used in the consolidated financial statements (or in other relevant financial statements, if applicable).

Allocation of Blended CFC Taxes

The first administrative guidance introduced a simplified methodology for the allocation of US global intangible low-taxed income (GILTI) tax and similar taxes within blended CFC tax regimes—a methodology applicable to constituent entities located in low-tax jurisdictions where the GloBE jurisdictional effective tax rate (ETR) is below 15 percent. The simplified methodology involves the determination of a special blended CFC allocation key and is applicable to fiscal years that end on or before June 30, 2027.

The third administrative guidance provides additional rules on determining the GloBE jurisdictional ETR, which is relevant for computing the blended CFC allocation key under three scenarios.

The first scenario involves situations where different blending groups of entities (for example, regular constituent entities, investment entities, and members of the JV group) are located in the same jurisdiction, and it is necessary to compute multiple GloBE jurisdictional ETRs for the same jurisdiction. If this is the case, the blended CFC allocation key of the relevant entity is computed by using the GloBE jurisdictional ETR determined for the blending group to which that entity belongs.

The second scenario includes situations where an MNE is not required, by virtue of a safe harbour or a de minimis exclusion, to compute a GloBE jurisdictional ETR. In this case, a GloBE jurisdictional ETR is equal to a simplified ETR or a qualified domestic minimum top-up tax (QDMTT) ETR, as the case may be. In the computation of the QDMTT ETR, a QDMTT payable in the jurisdiction must be added to the jurisdiction's taxes. If an investment (or another) entity is not eligible for a safe harbour, the GloBE jurisdictional ETR with respect to that entity is calculated under the regular GloBE rules.

The third scenario involves non-GloBE entities (that is, entities that are different from constituent entities, joint ventures, and members of JV groups) in which constituent entities have a direct or indirect ownership interest, and that are located in a jurisdiction for which multiple GloBE jurisdictional ETRs are determined. In the computation of a non-GloBE entity's blended CFC allocation key, it is necessary to apply the GloBE jurisdictional ETR for the blending group that has the largest aggregate amount of attributable income.

Transitional Filing Deadlines for MNEs with Short Reporting Years

An MNE group with a short reporting year that ends before March 31, 2025 will not be required to file a GloBE information return or notification for that short year before June 30, 2026—the transitional 18-month extended filing deadline for the first (regular) fiscal year that an MNE group becomes subject to the GloBE rules in 2024.

Conclusions

The release of the third administrative guidance in December 2023 prompted the OECD to reconsider its initial timeline for publishing the revised GloBE commentary, which incorporates all sets of administrative guidance and the 2022 SH document; the timeline was changed from 2023 to 2024. Also, the OECD disclosed its plans to publish additional sets of administrative guidance in 2024. These recent developments mean that the ultimate shape of the pillar 2 framework will remain unclear at least until later in 2024. Therefore, Canada should consider following the pragmatic approach of Hong Kong, Singapore, and Thailand, along with certain other jurisdictions, which have deferred the introduction of the global minimum tax to 2025.

Patrick Marley and Oleg Chayka
Osler Hoskin & Harcourt LLP, Toronto

How Will Pillar 2-Inflected Barbados and Bermuda Law Play in Canada?

Overview

This article examines how two jurisdictions well known to Canadians—one a pure tax haven (Bermuda), the other a quasi-tax haven (Barbados)—are in the process of hitching their future tax law policy and legislation to the October 8, 2021 (pillar 2) agreement among 137 countries ("the Inclusive Framework") to institute and impose a global minimum tax of 15 percent on the financial statement income of multinationals whose annual revenue is at least €750 million.

For Bermuda and Barbados (and for all other countries currently in the tax categories of these two jurisdictions), the decision to follow the example of the Inclusive Framework involves three main elements or considerations.

1) The first consideration is a question: Is the country satisfied with its current tax situation, with no particular desire to change that situation so as to start taxing (or increasing tax on) foreign-based (for example, Canadian) multinationals that do business in or from the country?
2) The second consideration is the fact that the current context is going to be fundamentally changed by pillar 2. To this point, foreign-based groups (for example, Canadian groups) have often been able to retain, under the laws of their home or base country (say, Canada), the tax saved in the tax haven or quasi-tax haven. Under pillar 2, Canada will impose a tax on the

Canadian parent of (for example) a Bermuda subsidiary if the latter has paid less than 15 percent tax on its profits. Pillar 2 will specify that the tax be the excess of 15 percent of the Bermuda profits over the tax paid in Bermuda (which, under current law, would be zero). That result would arise under the income inclusion rule (IIR) of pillar 2, which will be enacted in Canada by provisions of the Global Minimum Tax Act (GMTA), released in draft form on August 4, 2023.

3) The third consideration is that, owing to the circumstances described in item 2, countries such as Bermuda and Barbados will naturally want to preempt the country of the foreign parent (that is, Canada, in the illustration above) by changing their laws to impose a 15 percent tax on the profits of the local subsidiary, thus leaving no room for the IIR to operate in Canada.

In what follows, I will examine these three considerations in relation to Canadian groups carrying on activities in Bermuda and Barbados.

The evolution of the format and content of this article has been somewhat unusual. The first three phases (in August, October, and November) of the four-phase Bermuda development included a proposal respecting foreign tax credits that was sufficiently unusual to prompt an intention in me to write a piece titled "The Unique Relationship Between FAPI, the ITA, the Draft Global Minimum Tax Act, and a Draft Bermuda Corporation Tax Act." That unusual proposal was dropped, however, in the Bermuda development's fourth phase—namely, the release, on December 8, of draft legislation for the Corporate Income Tax Act 2023. A week later, however, the release by Barbados of a tax reform proposal provided me with the basis for fashioning a comparative commentary on the pillar 2-related proposals in the two countries.

Bermuda

As noted above, Bermuda announced on December 8, following three consultations over several months, a proposal to enact a corporate tax statute aimed primarily at groups that are subject to pillar 2. (The December 8 draft was enacted on December 28; Corporate Income Tax Act, 2023 [Act No. 35/2023], published in *Bermuda Official Gazette*, December 28, 2023.) The statute will feature a 15 percent tax on financial statement income. This tax is intended to comply with the December 20, 2021 OECD pillar 2 model rules for determining adjusted income and adjusted taxes; the result will be an effective tax rate (ETR) of no less than 15 percent on the Bermuda profits and therefore no "top-up tax" for the purposes of, for example, Canada's GMTA in respect of a Canadian parent of a Bermuda subsidiary. In terms of the technical model rules and the GMTA, the Bermuda approach does not involve an attempt to avoid top-up tax in the parent country by using a qualified domestic minimum top-up tax (QDMTT); it involves an attempt to adopt a "covered tax" format.

In general terms, what this means for the active business profits of a Canadian-owned Bermuda subsidiary is that, regardless of whether Canada adopts pillar 2, the overall taxes on the Canada-Bermuda group will go from 0 percent to 15 percent, with that 15 percent going to the Bermuda government—whereas it would go to Canada if Bermuda does not adopt its planned corporate tax act but Canada adopts pillar 2 (as it clearly intends to do).

The current rate of 0 percent stems from (1) the absence of corporate taxes in Bermuda and (2) the foreign affiliate rules under the ITA, pursuant to which no tax is imposed either when a foreign affiliate earns active business income (ABI)—including deemed ABI under paragraph 95(2)(a) of the ITA—or when that income is distributed by the foreign affiliate to a Canadian parent and the affiliate is resident in a country, such as Bermuda, that has a tax information exchange agreement (TIEA) with Canada and the income has been earned in that country or in another country with which Canada has either a TIEA or an income tax treaty.

Either the new Bermuda law or the adoption of pillar 2 in Canada will result in the new 15 percent tax burden.

In general terms, what the basic taxing format being adopted by Bermuda means for the FAPI of a Bermuda subsidiary of a non-CCPC Canadian corporation is that the current total tax on the group (slightly above 25 percent) will remain the same, but that, instead of all of the tax revenue going to Canada, it will be divided between the two countries. To illustrate, consider the following fact situation:

- Assume that the Bermuda CFA earns $1,000 of net FAPI.
- The CFA calculates Bermuda tax of $150.
- Absent any other pertinent rule, the results in Canada would be as follows:
  - Under the ITA, Canco would add $1,000 to income under subsection 91(1) and deduct $150 times 4 (that is, the foreign accrual tax [FAT] multiplied by the "relevant tax factor") under subsection 91(4), resulting in $100 of tax (25 percent × $400).
  - Under the GMTA, the Bermuda CFA's effective tax rate would be 15 percent; therefore, Canco has no IIR top-up tax to pay, and the overall tax is $250—the same as before, but now with $150 going to Bermuda and $100 to Canada.

What would have been the results if the December 8 draft had retained the unusual tax-credit rule included in section 18(1)(a)(v) of the third (November) draft? This would have involved, for the purposes of the IIR, a need to qualify under the GMTA for the full or partial pushdown of covered tax credits under the GMTA equivalent of article 4.3.23 of the December 2021 model rules.

Section 18(1)(a)(v) would have reduced the $150 Bermuda tax liability of the CFA by reason of (and by reference to) tax paid in Canada by Canco. The provision read as follows:

> [T]o the extent that the constituent entity-owners of the Bermuda Constituent Entity are subject to a controlled foreign company tax regime, the adjusted creditable foreign taxes of the Bermuda Constituent Entity's direct or indirect constituent entity-owners under a controlled foreign company tax regime on their share of the Bermuda Constituent Entity's income are allocated to the Bermuda Constituent Entity.

Would this have meant, then, that the Bermuda CFA's tax would be reduced by $100 to $50? Almost, but not quite. By reducing the net Bermuda tax to $50, would we not also have been reducing the subsection 91(4) deduction to $50 times 4 (or $200), leaving $800 of taxable income in Canada and increasing the Canadian tax to $200? If that had been correct, would we then have totally eliminated the Bermuda tax under the special credit? And would we, in that case, have ended up with no FAT for subsection 91(4) and Canadian tax of $250?

Then, turning to the GMTA, would we arrive at no Bermuda covered tax and thus no ETR—and thus IIR tax of $150? Perhaps not. In calculating the covered tax of the Bermuda CFA for the purposes of determining its ETR, the CFA may have been able to add in the $250 (or at least $150, which would have been enough) if the income were "passive income" (as defined in the model rules) paid by Canco. This should be the result under sections 24(4)(a) and (c) of the GMTA. Thus, more detail and a definition of "passive income" for section 24 would have been required in order to make firm determinations. However, the dropping of proposed section 18(1)(a)(v) renders this academic (although a definition of "passive income" for the purposes of the GMTA is still needed).

Finally, let us consider a few other points of interest. Bermuda's Corporate Income Tax Act is supposed to come into effect by 2025. It will provide investment tax credits as a means of softening the blow of the new tax, and these credits, in order to be as effective as possible, will be designed to align with the model rule concept of qualified refundable tax credits, which are generally provided to a taxpayer regardless of whether it has any tax otherwise payable. When they are so provided, they do not reduce covered taxes in the numerator in the ETR equation; instead, they are added to income in the denominator. That provides a better result than where the credits are not qualified and refundable and then are deducted from the covered tax amount in the numerator.

Assume, for example, that before credits are taken into account, a Canadian-owned Bermuda subsidiary has, for ETR purposes, income of $1,000 for the denominator and taxes of $150 for the numerator. Therefore, the Bermuda subsidiary has an ETR of 15 percent, and there is no top-up tax for the Canadian parent to pay to Canada under the IIR of the GMTA. Then assume, however, that the subsidiary has earned $150 of Bermuda credits that are qualified and refundable. Those credits would be added to the income in the denominator of the ETR equation and would reduce the ETR to 150 divided by 1,150 (or 13 percent), giving rise to a top-up tax of $1,150 × (15 percent − 13 percent) or $23.50, payable by the Canadian parent to Canada.

The results would be much worse, however, if the $150 of credits were non-refundable or otherwise not qualified refundable credits. In that case, the $150 would be deducted from the numerator, reducing it to $0 and reducing the ETR to 0 percent, and raising a top-up tax liability of 15 percent of $1,000 (or $150) for the Canadian parent under the GMTA.

Barbados

On November 7, 2023, Barbados announced that it would be amending its already complex corporate tax system (a system reflected in its tax treaty network, which includes Canada) both to change the basic system and, as in the case of Bermuda, to incorporate pillar 2 features into the system. The incorporation of pillar 2 features was intended, as in the case of Bermuda, to enable Barbados to capture tax increases (to bring taxes up to 15 percent) related to local activities instead of seeing them go to parent-country tax coffers under pillar 2 law in the parent country (Canada, for example, in the case of a Canadian-owned Barbados subsidiary). Barbados followed up on December 15, releasing two draft bills.

Although, with respect to ABI and FAPI, the bottom-line results for Barbados subsidiaries of Canadian-based groups subject to pillar 2 will, in principle, be no different from the results in the "Canada-parent/Bermuda-subsidiary" context (15 percent and 25 percent, respectively, in both cases), the details of the narrative will be quite different.

For starters, Bermuda plans to increase taxes from 0 percent to 15 percent for in-scope groups, but the Barbados increase is slightly smaller: under current law, the average tax rate on the first $30 million is just under 3 percent, and on income over $30 million it is 1 percent, which means an increase of 12 percent in the first case and 14 percent in the second case.

The basic scheme for in-scope groups will involve two factors that differentiate the two countries. First, Barbados is planning a tax system with multiple tax rates. There will be a new standard corporate tax rate of 9 percent, with four exceptions. This rate will not apply to certain small groups, to insurance, to international shipping, or to in-scope groups based in countries that do not adopt pillar 2. Thus, the 9 percent rate will apply to in-scope Canadian-owned Barbados subsidiaries. Sections 8 to 11 will be added to section 43 of the existing legislation by the Income Tax (Amendment) (No.) Act, 2023. The current rates would apply if Canada were not enacting pillar 2.

Next, so as to bring overall Barbados taxes up to 15 percent in accordance with the model rules (which will then connect with Canada's GMTA), Barbados is enacting (in the Corporation

Top-Up Tax Act, 2023) a top-up tax by way of the QDMTT, as prescribed by the model rules. This tax, if compliant with certain safe-harbour procedures, guarantees that no top-up tax will exist in Canada under the GMTA, because a full 15 percent will have been paid in Barbados under a combination of the standard 9 percent tax and the supplementary QDMTT. The top-up tax in Barbados distinguishes that country's approach from Bermuda's covered tax approach, which does not guarantee that top-up tax will not arise in Canada.

The second key way in which Barbados differs from Bermuda—a difference that is relevant in a situation where the in-scope foreign parent is based in Canada—is that the Barbadian QDMTT applies only where the foreign parent is subject to pillar 2 laws. This reflects an obvious Barbadian desire not to increase the taxation of foreign-owned Barbados subsidiaries except where doing so is necessary to pre-empt the taxation by a foreign country of Barbados profits under pillar 2.

The QDMTT Act in Barbados will not apply to an "excluded entity" (section 6(3)), which is defined in section 6(4)(d) as including a

> constituent entity (say a Barbados subsidiary) which is part of a MNE Group (1) the ultimate parent entity or intermediate parent entity of which is located in a jurisdiction that has not implemented an IIR or an UTPR in the year; or (2) the members of which are not subject to an UTPR.

This means, according to current expectations, that a Canadian-owned Barbados subsidiary would not be an excluded entity and therefore would be subject to the Barbados QDMTT. This would be the case regardless of whether Canco is (1) the ultimate parent entity or (2) an intermediate parent entity (meaning that Canco itself is a subsidiary of, say, a US corporation). In the second case, the Barbados QDMTT would apply whether or not the United States has instituted pillar 2, but the QDMTT would not apply if the United States owned the Barbados subsidiary directly (and if the United States has not adopted pillar 2).

Finally, it may be noted that Barbados, like Bermuda, intends to rely on qualified refundable tax credits to soften the blow of adopting pillar 2, and in Barbados, as in Bermuda, there will be further relief for international shipping and insurance.

Nathan Boidman
Davies Ward Phillips & Vineberg LLP, Montreal

Proposed Change to the Canadian International Shipping Regime

On December 20, 2023, the Department of Finance released legislative proposals intended to make available to Canadian-resident corporations the existing exemption for international shipping income. These proposals are in line with an announcement made in the 2023 fall economic statement, and they acknowledge that the 15 percent global minimum tax should generally not capture international shipping income. Explanatory notes to the legislative proposals were also published on January 29, 2024.

As reflected in paragraph 81(1)(c) of the ITA, Canada's longstanding policy on the taxation of international shipping income, a policy based on a reciprocity regime, has been not to tax the international shipping income of non-resident persons provided that the non-resident's country of residence grants a similar exemption to Canadian taxpayers.

To maintain competitiveness, Canadian-based international shipping groups have structured their operations to fall within the ambit of paragraph 81(1)(c) while maintaining operations in Canada using the Canadian foreign affiliates regime. In addition, Canada enacted subsection 250(6) of the Act so as to deem a non-Canadian corporation not to be a tax resident of Canada and to be a tax resident of its country of incorporation, if certain conditions related to international shipping were met.

Canada's policy rationale has been consistent with the principle that, under article 8 in most double tax treaties signed by Canada, the taxing right is reserved solely for the country of residence. This ensures that income is taxed in only one country. The policy rationale is also in line with the global consensus on offering alternative tax regimes, such as tonnage tax, to international shipping groups—an approach that takes into account specific industry considerations and the high volatility of the shipping market.

International Shipping in the Context of GloBE

In August 2023, Canada released the Global Minimum Tax Act (GMTA), effective for fiscal years starting on or after December 31, 2023, to implement the global minimum tax. As noted above, Finance announced in November, and reiterated in the technical notes, its intention of introducing certain amendments to domestic legislation to ensure that Canadian shipping companies with management in Canada can continue their operations in Canada.

Canada replicated, in the GMTA, the international shipping exemption in article 3.3 of the global anti-base erosion (GloBE) model rules. Pursuant to section 19 of the GMTA, a constituent entity's income from its core or ancillary international shipping activities is excluded from the calculation of its GloBE income. To benefit from that exemption, the constituent entity's "strategic or commercial management" that is related to the performance of these qualifying activities needs (under section 19(6) of the GMTA) to be effectively carried on within the jurisdiction in which the constituent entity is located.

This exemption is based on tonnage tax regimes and substance-based regimes that are common in Europe and Asia. These regimes generally exempt international shipping income

from taxation (or reduce the applicable tax to a fixed amount per tonnage) if substance-based requirements are met.

However, the formulation of section 19 of the GMTA may create challenges for Canadian-based international shipping groups that are subject to pillar 2, given that the strategic or commercial management of international shipping operations might not be located in the jurisdiction in which the international shipping income is booked.

Proposed Legislative Changes

The December release provides the possibility of realigning the location of the strategic and commercial management with the location of the entity for GMTA purposes, by moving the entity's tax residence to Canada.

The longstanding regime, under paragraph 81(1)(c) and subsection 250(6) of the Act, remains available to taxpayers, but with the addition of new paragraph 81(1)(c.1) and other minor adjustments. Paragraph 81(1)(c.1) would exempt from tax under the Act "the income for the year of a corporation resident in Canada (if this Act were read without reference to subsection 250(4)) earned in Canada from international shipping, if that corporation satisfies the conditions in paragraphs 250(6)(a) and (b)." The residence requirement for paragraph 81(1)(c.1) is based on the common-law mind-and-management test. Subsection 250(6) becomes an elective regime in respect of each taxation year. These amendments will preserve and enhance the desirability of locating the strategic and commercial management of international shipping operations in Canada in light of the GloBE regime.

Audrey Dubois and Karl Degré
KPMG LLP, Montreal

Beneficial Ownership and "Legal Reality": Insights from Husky Energy Inc. v. Canada

Introduction

On December 13, 2023, the TCC released its decision in *Husky Energy Inc. v. The King* (2023 TCC 167). The judgment focuses on beneficial ownership and related principles in the context of a stock loan transaction. The decision has tax implications for three areas: (1) Canadian corporations ("Cancos") and their non-resident shareholders; (2) the CRA's approach to the reassessment of non-resident withholding tax (WHT) under part XIII of the ITA; and (3) the interpretation of beneficial ownership and enjoyment of benefits under tax treaties (outside the context of stock loan transactions).

Facts

In 2003, Husky Energy Inc. ("Husky"), a Canadian-resident corporation, paid dividends to its shareholders, including two major shareholders resident in Luxembourg ("the Luxcos"). The Luxcos had obtained Husky shares from two Barbados-resident corporations ("the Barbcos") under "overseas securities lender's agreements" (OSLAs), a form of industry-standard documentation published by the International Securities Lending Association (ISLA) and widely in use at the time of the transactions. Although such transactions are referred to colloquially as "loans," the form of OSLA used by the Luxcos and Barbcos provides for the absolute transfer of securities. Such absolute transfer is necessary to permit the transferee under an OSLA to subsequently deliver the securities with good title under a short sale or other transaction independent of the OSLA. The OSLA also contemplates the subsequent title transfer of securities by contractually obligating the transferee to return, upon the termination of the transaction, securities that are *equivalent* to those transferred. These do not have to be the same securities as those transferred in the first instance. It is therefore clear that the securities transferred under an OSLA are not held by the transferee for the benefit of the transferor.

In exchange for the transferor giving up its proprietary interest to the transferee, the transferee is obligated by the OSLA to maintain the transferor's *economic* position during the term of the agreement. Of particular relevance to the *Husky Energy* decision is the transferee's contractual obligation under the OSLA to compensate the transferor for the amount of any dividends paid by the issuer of the securities during the term of the agreement. This obligation is not dependent on the receipt of dividends by the transferee and is not determined by reference to the receipt of dividends by the transferee. It exists whether or not the transferee continues to hold the securities. The amount of any dividend compensation payment is calculated by reference to the gross amount of dividends paid by the issuer. It is not reduced by the WHT obligations of any person.

Canada imposes 25 percent WHT on dividends paid or credited to non-residents, subject to reduction under an applicable tax treaty. The tax rate is reduced to 5 percent and 15 percent under the Canada-Luxembourg treaty and the Canada-Barbados treaty, respectively, provided that certain requirements are met by the dividends' recipient. The requirements relate to residence, beneficial ownership of the dividends, and (in the case of the Canada-Luxembourg treaty) voting rights.

When paying the dividends to the Luxcos, Husky withheld and remitted 5 percent of the gross dividend amount as WHT on the basis that the requirements under the Canada-Luxembourg treaty were satisfied. Upon receipt, the Luxcos reinvested the dividends for their own account. To satisfy their contractual obligations under the OSLAs, the Luxcos made compensation payments to the Barbcos in amounts determined by reference to the gross dividends paid by Husky. This required the Luxcos to borrow in order to fund a portion of the compensation payments, because they had received dividends from Husky net of WHT.

The CRA disagreed that the Luxcos had satisfied the beneficial ownership requirements so as to be eligible for the 5 percent WHT rate under the Canada-Luxembourg treaty. The CRA viewed the Barbcos, not the Luxcos, as the beneficial owners of the dividends. On that basis, the CRA took the position that WHT should have been applied at the 15 percent rate stipulated in the Canada-Barbados treaty. Husky and the Barbcos were reassessed for the shortfall. The trio appealed.

The main issue was the beneficial ownership of the Husky dividends and, consequently, whether the appropriate WHT rate was applied to those dividends. The Crown also pursued alternative arguments based on the general anti-avoidance rule (GAAR), contending that the transactions misused or abused the Canada-Barbados and Canada-Luxembourg treaties.

Decision

The court held that although the Luxcos were residents of Luxembourg, they fell short of meeting the beneficial ownership requirements of the Canada-Luxembourg treaty that would have entitled them to claim the favourable 5 percent rate.

The court proceeded to hold that, because the Luxcos were the recipients of the dividends but not their beneficial owners, the WHT rate applicable to those payments was 25 percent, as stipulated in part XIII of the ITA. Accordingly, Husky should have withheld tax at the 25 percent rate and was not entitled to a due diligence defence.

The court dismissed the Crown's GAAR arguments, holding that the arrangements could not be considered abusive of the Canada-Luxembourg or Canada-Barbados treaties.

Key Insights

Key to the TCC's conclusion that the Luxcos were not the beneficial owners of the dividends was a finding that they were obligated to pay dividend compensation payments to the Barbcos under the OSLA. The court claimed that this conclusion was consistent with the framework for analyzing beneficial ownership—a framework established by the FCA in *Prévost Car* (2009 FCA 57) and reaffirmed in *Velcro Canada* (2012 TCC 57).

The court found that the *Husky Energy* facts were distinguishable from those in *Prévost Car*, a case in which the intermediary was found to have legal autonomy, including the authority to decide whether to pay dividends to its shareholder in an amount equal to the dividends received. The court in *Husky Energy* stated (at paragraph 274) that the contractual obligation of the Luxcos under the OSLAs to make compensation payments to the Barbcos made it "certain from the outset . . . that the Barbcos 'will' ultimately benefit from the Dividends as a result of the mandatory compensation payments." The court found (at paragraph 276) this to be an "economic result that is dictated by legal obligations" and that "does not require the application of an economic substance over form approach."

The implication is that *Husky Energy* produced a different outcome—predicated on its own peculiar facts—from *Prévost Car*, and that the outcome does not necessarily signify a shift in the jurisprudence on beneficial ownership. In *Husky Energy*, there was no finding of agency or a nominee relationship, and no piercing of the corporate veil. The TCC analyzed what it called the "legal reality" of the Luxcos' obligations under the OSLA. However, this legal reality included the Luxcos' obligation to make contractual payments calculated by reference to dividends paid by Husky—an obligation that existed independently of whether the Luxcos continued to own the relevant shares. The dividend compensation payments received by the Barbcos would have the same contractual character, whether or not the Luxcos continued to own the shares or sold them to a third party. Furthermore, the Barbcos had no right under the OSLA to compel the delivery of any property. Denuding a dividend recipient of beneficial ownership under these circumstances would appear to be a material deviation from the decision of the FCA in *Prévost Car*.

Also noteworthy is the absence of any direct analysis by the TCC of the *Velcro Canada* decision. Like *Husky Energy*, *Velcro Canada* dealt with the beneficial ownership question in a contractual context. The issue concerned, in particular, the right of an assignor (resident in a non-treaty jurisdiction) to assign to an assignee (resident in a treaty jurisdiction) a right to grant licences to use intellectual property. Under the assignment agreement (unlike under the OSLA), the assignor retained ownership of the intellectual property. The assignee was contractually obligated to pay a percentage of amounts received from a Canadian-resident licensee within 30 days of receipt. The court found that the assignee had beneficial ownership of the royalty payments because it was not an agent, nominee, or conduit. Citing *Prévost Car*, the court said that the assignee would need to have "absolutely no discretion" with respect to the funds received, and that the discretion of the assignee to commingle the funds received from the Canadian payer, and to use them operationally as it saw fit, provided sufficient discretion to override this strict test. The assignee was therefore found to be the beneficial owner of the royalty payments.

References to the *Velcro Canada* case appear in *Husky Energy*, in arguments put forward by the Luxcos. The Luxcos contended that various factors—their commingling of the dividends with other funds, their use of such funds to purchase a term deposit, their exchange of US-dollar dividends into Canadian dollars, and the need to borrow funds to pay compensation payments under the OSLA that were equal to the payments declared by Husky—meant that, on the basis of the tests articulated in *Prévost* and *Velcro Canada*, the Luxcos were beneficial owners of the dividends. The respondent admitted that the Luxcos had "very narrow powers" to use the amounts received as dividends. It seems clear that this discretion, while limited, did not meet the "absolutely no discretion" standard that the TCC described in *Velcro Canada*, citing *Prévost*. The TCC's decision in *Husky Energy* does not explicitly address these arguments with reference to *Velcro*. This is surprising, because the facts

in *Husky Energy* are more persuasive than those in *Velcro Canada* with respect to the ability of the Luxcos to apply discretion in the application of the dividends received.

The decision in *Husky Energy* is also inconsistent with the OECD's 2014 and 2017 commentary on article 10 of the OECD model treaty ("the OECD commentary"), which states:

> In these . . . examples (agent, nominee, conduit company acting as a fiduciary or administrator), the direct recipient of the dividend is not the "beneficial owner" because that recipient's right to use and enjoy the dividend is constrained by a contractual or legal obligation to pass on the payment received to another person. Such an obligation will normally derive from relevant legal documents but may also be found to exist on the basis of facts and circumstances showing that, in substance, the recipient clearly does not have the right to use and enjoy the dividend unconstrained by a contractual or legal obligation to pass on the payment received to another person. *This type of obligation would not include contractual or legal obligations that are not dependent on the receipt of the payment by the direct recipient such as an obligation that is not dependent on the receipt of the payment and which the direct recipient has as a debtor or as a party to financial transactions.* [Emphasis added]

This commentary postdates the drafting of the Canada-Luxembourg treaty that is applicable to the transactions in *Husky Energy*; however, the FCA in *Prévost Car* decided that subsequent OECD model treaty commentaries that expand on or clarify notions already captured by the OECD model treaty are relevant to judicial interpretation, provided that they do not extend the scope of provisions in a manner that could not have been considered by the drafters. In the subsequent *Alta Energy* case (2021 SCC 49), commentary on a new article to the OECD model treaty was found to extend the scope of provisions in this way. The OECD commentary that is quoted above concerns existing article 10, not a new article. It clarifies an existing notion, making it relevant to the process of interpreting article 10 of the Canada-Luxembourg treaty to exclude the impact of the contractual obligations under the OSLA in the course of determining beneficial ownership of the Husky dividends by the Luxcos. In such a case, the proprietary entitlement of the Luxcos to the Husky shares and to the dividends paid thereon would be sufficient to make them the beneficial owners of the Husky dividends for the purposes of article 10 of the Canada-Luxembourg treaty.

Another important aspect of the *Husky Energy* decision was the TCC's declaration that in the determination of liability for withholding tax under the ITA (and therefore under a tax treaty), regard should be had only to the direct payee of dividends. The court found (at paragraphs 242-43) the direct payees to be the Luxcos, such that the liability to pay part XIII tax under the ITA could fall only on those two companies. The court also held that the issue of beneficial ownership did not arise in respect of the Barbcos as argued by the Crown, because they were not the payees of the dividends under the ITA. The court explained (at paragraph 239) that liability for tax under the ITA does not rest on beneficial ownership, and that such a concept could be derived only from the relieving provisions of the tax treaties.

In practice, the TCC's approach to identifying the payee under the ITA excludes the possibility that a situation where A pays (through B) dividends to C could have the same legal consequences as a situation where A pays dividends directly to C. Such a situation would arise when, for example,

- B is the agent of C,
- B is C's nominee, or
- B is the trustee of a trust or other fiduciary arrangement under which C has a beneficial interest in the dividends.

Note that in each of these cases, the legal reality is that, at law, B is acting as C, has the power to bind C, or is a fiduciary for C in respect of the dividends; in other words, C has constructive receipt of the dividend through B. When one adds to this list the extraordinary judicial remedy of piercing the corporate veil to deal with a situation where B is a mere conduit, these situations align both with legal reality under private law and with beneficial ownership as construed by the FCA in *Prévost Car*, by the TCC in *Velcro Canada*, and by the OECD commentary.

Given the potential impact of the *Husky Energy* decision on users of the industry-standard securities-lending documentation produced by ISLA and others, and given the potential impact of the decision on the administration of WHT and, more generally, on the functioning of capital markets, it would be useful if the legal reality of securities lending and similar contractual arrangements in this context were revisited on an appeal.

Timothy Hughes, Oleg Chayka, and Okanga Okanga
Osler Hoskin & Harcourt LLP, Toronto

The Australian PepsiCo Case: Withholding Tax on Embedded Royalties—A Canadian Perspective

On November 30, 2023, in the case of *PepsiCo Inc. v. Commissioner of Taxation* ([2023] FCA 1490), the Federal Court of Australia ruled that a portion of the payments was in fact a royalty for the use of intellectual property (IP) and therefore subject to withholding tax. Are there Mentos in this cola case, or will it fizzle out on appeal? The answer remains unclear, but the court's decision in this Australian case raises interesting questions from a Canadian tax perspective, which are briefly discussed in this article.

Background

The Australian Tax Office (ATO) has presented *PepsiCo* as a "lead case for our strategy to target arrangements where royalty withholding tax should have been paid." The case comes after a 2018 tax alert in which the ATO informed the tax community of its concerns that arrangements between an Australian payer and a non-resident recipient that allocate all consideration to tangible goods may fail to comply with the Australian royalty withholding tax obligations that are associated with consideration for the use of intangible assets.

The *PepsiCo* case involved payments made by an unrelated third party, Schweppes Australia Pty Ltd., to the designated PepsiCo Group supplier in Australia (payments that were then transferred outside Australia) under exclusive bottling appointment agreements (EBAs). Pursuant to these EBAs, Schweppes Australia purchased beverage concentrate to bottle and distribute beverages under PepsiCo's brands in the Australian territory. The EBAs also granted Schweppes Australia an exclusive royalty-free licence to use the brands and other IP to manufacture, bottle, sell, and distribute the finished soft drinks.

While the agreements stated that the licence of rights was royalty-free and that compensation was solely for the purchase of concentrate, the ATO argued that a portion of the payments constituted consideration for the licensed IP rights. The ATO's primary contention was that these alleged embedded royalties should have triggered withholding tax at the treaty rate of 5 percent. In the alternative, the ATO argued that these transactions ought to be subject to Australia's diverted profits tax (DPT) rules.

Justice Moshinsky of the Federal Court of Australia upheld the ATO's position with respect to withholding tax. The court also supported the ATO's alternative argument that the DPT would apply if the embedded royalty argument failed.

The Withholding Tax Issue

The term "royalties" is defined in Australia's Income Tax Assessment Act 1936 (ITAA) as including "any amount paid or credited, however described or computed . . . to the extent to which it is paid or credited . . . as consideration for the use of, or the right to use," various IP items. Similarly, article 12(4) of the Australia-US treaty defines "royalties" as "payments or credits of any kind to the extent to which they are consideration for the use of or the right to use" various IP items.

In *PepsiCo*, the court noted that the two definitions' use of the phrase "to the extent to which" suggests that a payment can be apportioned if it is consideration for more than one thing. The court proceeded to conclude that

- the payments made by Schweppes Australia under the EBAs were, to some extent, *consideration for* the use of, or the right to use, the relevant trademarks and other IP;
- the relevant portions of the payments were income derived by PepsiCo for the purposes of Australia's withholding tax provisions and were amounts to which PepsiCo was *beneficially entitled* within the meaning of the treaty; and
- the relevant portions of the payments are deemed to have been paid by Schweppes Australia to PepsiCo by virtue of Australia's withholding tax provisions.

The court opined that the payments may be for the right to use IP, such as trademarks, even if the payments are not called "royalties."

It is not clear, however, that the issue was merely one of nomenclature in the EBAs. An argument could be made, on the basis of the EBAs and the facts as they are described in the decision, that the amounts were payable only for the purchase of tangible goods. In other words, it appears that the issue was not that the payments were for more than one thing. Rather, the issue was that Schweppes Australia was not paying for licensed rights, because they were granted royalty-free. It is not clear whether expert evidence was introduced on this point. From an economic perspective, however, these two types of transactions have different risk profiles for the parties involved, and it does not automatically follow that the parties intended any royalty or similar payment.

Nevertheless, the fact that the EBAs contained an express, royalty-free licensing of the IP rights to Schweppes Australia was considered by Justice Moshinsky to be of no help in resolving the question of characterization under the applicable Australian tax legislation and the relevant tax treaty provisions. The court, noting the words "of any kind" in the treaty and "however described" in the ITAA, held that the manner in which payments are described by the parties to a transaction is not determinative. The issue in this case was whether the payments made by Schweppes Australia under the EBAs were, to any extent, consideration for the use of, or for the right to use, the relevant trademarks and other IP.

We will have to wait and see how this interpretation plays out on appeal in Australia. This type of analysis would be problematic, however, under Canadian law. It is generally the case in Canada that, in the absence of a sham or the application of an anti-avoidance provision, the taxpayer's legal arrangements must be respected. Paragraph 212(1)(d) of the ITA imposes withholding tax on rent, royalties, or similar payments, and the language of this provision is broad and expansive. It is doubtful, however, that section 212 could be interpreted as containing anti-avoidance language that would (1) deem an amount to be paid for something other than what the parties agreed to or (2) deem that a royalty or similar payment was paid when the parties agreed that none was payable. If the parties agree to a royalty-free licence, these legal arrangements should generally be respected and (at least in our view) the CRA would not be authorized—in the absence

of a sham or the application of an anti-avoidance provision such as GAAR—to recharacterize as a royalty an arm's-length payment for tangible goods.

The TCC's decision in *Entre Computer Centers Inc. v. R* ([1997] 1 CTC 2291) shows that a Canadian court will generally respect the legal arrangements between the parties. In that case, the CRA unsuccessfully tried to apply part XIII withholding tax to amounts that were, as the court found, part of payments that a Canadian distributor had paid to purchase computers for resale. The court stated (at 2303):

> The transaction is essentially a sale and the payment of the amount stated on the invoice is the price paid to become owner of the product. The payment does not exhibit any of the characteristics usually found in a payment of rent, royalty or similar payment for the use of or the right to use property. There is simply no link, other than the one established in the deeming provision, between the applicable mark-up and the actual use of or right to use Entré Proprietary Marks. The mark-up is simply dependent upon the volume of products purchased.

A Canadian analysis of the issue would also need to consider case law regarding the definition of "royalties and similar payments" under part XIII. For example, in *Hasbro Canada Inc. v. The Queen* ([1999] 1 CTC 2512), the TCC concluded that a royalty or similar payment is a payment that is made for the use of property, rights, or information, whereby the payments for such use are *contingent* upon the extent or duration of use, profits, or sales by the user. In the Australian *PepsiCo* case, it appears that Schweppes Australia's payments were calculated on the basis of a price per unit of concentrate under the EBAs, not on the basis of sales made or profits earned by the company. In other words, there does not seem to be an element of contingency based on use, profits, or sales by the IP user.

An analysis of this issue under section 212 of the ITA would include a consideration of, among other things, whether a portion of the payments is made for the use of, or for the right to use, property in Canada. Indeed, on the basis of the reasons advanced by the FCA in *Farmparts Distributing Ltd*. ([1980] 2 FC 205), the TCC found in *Hasbro* that the opening words of paragraph 212(1)(d) were broad enough to include any payment made for the use of property in Canada, even though the payment does not qualify, strictly speaking, as "royalties or similar payments." That said, the EBAs' explicit statement that the licence of, and thus the right to use, the IP was royalty-free seems to exclude the possibility that any part of the payments was made for such rights.

PepsiCo could also cause unforeseen results for customs purposes. Generally, a royalty paid for the use of IP can qualify under Canadian customs regulations to be excluded from the value for duty. This carve-out arises precisely because the royalty payment is in respect of property and rights that are conceptually different from the cost or value of the tangible imported goods. In other words, if the parties in *PepsiCo* were using solely the unit prices paid for concentrate for customs compliance, this could be further evidence that the parties thought that their agreement was solely for tangible goods, not for the use of IP. Accordingly, the court's decision in the case could cause a clear separation between the transaction's treatment for income tax purposes and its treatment for customs purposes.

It is worth noting, as a final comment on this aspect of the case, that although *PepsiCo* is not a transfer-pricing case (that is, the issue in the case is not whether Schweppes Australia's overall payments and distribution margins were arm's length: Schweppes Australia and PepsiCo are not related parties), the court relied on the arm's-length principle and transfer-pricing methods for apportionment purposes. The court relied on expert testimony that used the relief-from-royalty method to quantify the amount of the embedded royalty. However, some commentators on the case have noted that this method was, in essence, a slight variation on the comparable uncontrolled price (CUP) method. Again, we will have to wait and see how this plays out on appeal in Australia.

In Canada, however, this aspect of the case would need to be considered in the light of our domestic law and administrative policies. If the CRA were to rely, like the Australian court, on transfer-pricing concepts to apportion an amount for part XIII purposes in a transaction between related parties, consideration would need to be given to (1) section 247 of the ITA, (2) the applicable treaty, (3) Canadian transfer-pricing case law, and (4) interpretive aids such as the OECD's Transfer Pricing Guidelines and its commentary on its model convention.

In *Canada v. Cameco Corporation* (2020 FCA 112; leave dismissed 2021 CanLII 10731 (SCC)), the FCA found that it was not possible for the CRA to recharacterize a payment unless the requirements of a specific anti-avoidance provision are met (for example, paragraphs 247(2)(b) and (d) of the ITA). Since the recharacterization rule, as the FCA affirmed in *Cameco* (at paragraph 77), "only applies if arm's length persons would not have entered into the particular transaction or series of transactions under any terms and conditions," it seems unlikely that the CRA could successfully rely on transfer-pricing concepts to recharacterize a part of the payment for tangible goods as being a royalty or like payment. Arm's-length parties clearly enter into this type of transaction, as *PepsiCo* demonstrates. That said, this analysis may need to be revisited under amended section 247 of the ITA (as proposed in Bill C-59), in which economic substance becomes the focus of the "non-recognition and replacement" rule, which would replace the recharacterization rule (more on economic substance below).

Similarly, in its *Transfer Pricing Memorandum* (TPM-06), the CRA acknowledges that although a transaction may need to be unbundled for the purposes of non-resident tax and withholding, it may not be possible or desirable to do so when the properties or services are so closely linked or continuous

that they cannot be adequately evaluated on a separate basis. The transfer-pricing policy states that this can be the case "[w]here the synergy or integration between intangible and/or tangible properties is so significant that neither element can be valued separate and apart from the other." In circumstances like those in *PepsiCo*, it may not be possible to use the CUP method to reliably apportion the amount of the alleged embedded royalty if the comparables used in the benchmark (for example, licences in the beverage industry) did not also involve related supply agreements for tangible goods (for example, for the supply of concentrate). The decision in *Canada v. GlaxoSmithKline Inc.* (2012 SCC 52) may also need to be considered. The SCC found that the economically relevant characteristics of the situations being compared may make it necessary to consider other transactions that affect the price under consideration. The court also found that a transaction-by-transaction approach may be ideal, but it is not appropriate in all cases.

The Diverted Profits Tax Issue

Australia introduced the DPT in 2017 as an anti-avoidance measure to help ensure that the tax paid by multinational enterprises "properly reflects the economic substance of their activities in Australia" and to "prevent the diversion of profits offshore through contrived arrangements."

The DPT features a two-part test: (1) the arrangement must involve a tax benefit, and (2) the scheme must have been undertaken for a principal purpose (or for principal purposes) that includes enabling the taxpayer to obtain the tax benefit. On the first part, the court in *PepsiCo* found that there was a tax benefit. Had it not been for the arrangements in question, the taxpayer would (in the court's view) reasonably have been expected to pay withholding tax on the amount of hypothetical royalties. For the second part, the court analyzed eight matters (which are listed in the DPT provision as factors indicative of tax avoidance) to determine whether the requisite purpose was present.

The court found a number of factors indicating that the principal purpose of the scheme was to obtain a tax benefit. The main factor was a discrepancy between form and substance:

> 453 . . . *In form, the payments to be made by [Schweppes Australia] were for the concentrate alone and not for the licence of the trademarks and other intellectual property. However, in substance, the payments to be made by [Schweppes Australia] were for both the concentrate and the licence of the trademarks and other intellectual property.* The trademarks licensed under the EBAs were highly valuable; the brands were among the most valuable brands in the global beverage industry. . . . *This matter strongly supports the Commissioner's position that the requisite purpose did exist.* [Emphasis added.]

The court reached this conclusion despite PepsiCo's argument that the ATO's assumptions represented a departure from the substance of the transactions actually undertaken and would not achieve the same commercial results or consequences as the transacting parties intended. This issue will be interesting to follow at appeals because, from a business and economic perspective (as we mentioned above), valid reasons may exist for parties to agree on a royalty-free licence in the context of broader commercial arrangements. In particular, the existence of a royalty can introduce a different risk profile for the parties, and it may in fact constitute a different transaction. In addition, a buy-sell transaction can be a simpler transaction for arm's-length parties than one involving a royalty that requires them to share confidential in-market sales or profit-level details.

Although Canada has no DPT as such, GAAR is similar to the DPT in some respects. In Canada, the analysis of an issue like the one treated under the DPT in *PepsiCo* would likely need to consider the current GAAR rather than the amendments proposed in the 2023 GAAR reform (Bill C-59). The proposed amendments to GAAR explicitly introduce economic substance under the misuse-or-abuse analysis (rather than under the purpose analysis, as the Australian DPT does). If, under the proposed amendments, an avoidance transaction is found to be significantly lacking in economic substance, this determination becomes "an important consideration" that "tends to indicate" that the transaction results in misuse or abuse (albeit without constituting a presumption). This test is not exactly the same as the one applied by the court in *PepsiCo*, but it does appear to narrow the gap between the threshold for applying the Canadian GAAR and the threshold for applying the Australian DPT.

Conclusion

On January 19, 2024, PepsiCo appealed from the Federal Court of Australia's decision. For the time being, however, the court's ruling supports the ATO's position on both points: that these payments should be characterized as embedded royalties, and that royalty withholding tax should be applied under the Australia-US treaty. The case also sheds some light on the possible use of transfer-pricing principles in quantifying embedded royalties for withholding tax purposes, and on the applicability of the "GAAR-like" Australian DPT in such circumstances.

Sébastien Rheault, Jing Yu Wang, and Julien Tremblay-Gravel
Barsalou Lawson Rheault LLP, Montreal

A Transfer-Pricing Framework for the Mining Sector

Transfer pricing is an important consideration for multinational groups operating in the mining sector, because each of the steps in the process of extracting, refining, and selling minerals may take place in different jurisdictions and lead to different transfer-pricing risks.

The OECD and the Intergovernmental Forum on Mining, Minerals, Metals and Sustainable Development (IGF) recently published a practice note that proposes a framework ("the framework") for determining the transfer price of minerals. The framework states (at 6) that the transfer pricing of sales of mineral products is a high-priority tax issue facing developing countries. The issue is also important, however, in the Canadian context.

The framework states that it does not "replace, alter, or affect the OECD Transfer Pricing Guidelines (TPG) (OECD, 2022) interpretation of Article 9 OECD Model Tax Convention (OECD, 2017) or the application of countries' domestic transfer pricing laws and the interpretation of those laws by the respective tax administration." The framework focuses solely on how to price minerals on an arm's-length basis.

The framework provides background to the mining value chain and identifies risks, presumably in order to help tax authorities evaluate a taxpayer's own transfer-pricing framework. The framework identifies the large scale and the frequency of related-party transactions in the mining industry as a potential risk to tax revenues.

The OECD and IGF Framework

The framework emphasizes (at 16 and 17) the OECD's previously stated view that the comparable uncontrolled price (CUP) method is generally the most appropriate method for determining the transfer price of minerals. The CUP method compares the price of property or services charged in a controlled transaction with the price charged for property or services in an arm's-length, uncontrolled transaction.

To appropriately apply the CUP method to transactions in the mining sector, it is important to consider the characteristics of transactions that are being compared, and to make reasonable adjustments as required. Following are some factors to consider in this regard (at 20):

- the physical features and quality of the minerals;
- the volumes being transacted;
- the economic circumstances at the time of sale;
- the timing, location, and terms of delivery; and
- other factors, such as transportation, insurance costs, foreign exchange rates, and payment terms.

The framework provides a detailed discussion of these factors and their impact on the CUP analysis, cautioning that appropriate adjustments need to be made for differences in the controlled transactions and the conditions of the quoted price.

The framework reiterates that most mining entities are part of a wider group. Transactions should therefore take into account the "full benefit of market intelligence and knowledge that the wider MNE group has access to, and sell at the highest possible price, taking into account its commercial objectives" (at 17). Pricing should take into account the entire group experience, strategy, and economic circumstances.

The framework also recommends administrative strategies that tax authorities could implement to assist in pricing cross-border mineral transactions—strategies that would simplify compliance and increase certainty for taxpayers while reducing the resources required of tax administrators to audit transfer-pricing transactions. As discussed below, each of the OECD's and IGF's suggested approaches needs to be considered carefully by tax administrators to determine whether a particular approach is appropriate for the specific minerals at issue.

The first suggestion (at 29) is that tax authorities publish a transfer-pricing methodology for specific minerals to encourage compliance and limit the administrative resources required to audit compliant taxpayers. For example, if a nation were rich in copper, its tax authority could (1) recommend that taxpayers use the London Metal Exchange's published price for copper as a starting point in the transfer-pricing analysis, and (2) publish additional guidance on how to adjust prices for variations in quality and processing costs. Taxpayers generally welcome guidance from tax authorities when it brings transparency, clarity, and certainty to an otherwise complex analysis.

An alternative suggestion in the framework (at 30) is that tax authorities, particularly those with limited resources, adopt a "safe harbour" approach whereby they publish an acceptable transfer price for a mineral and agree not to challenge the pricing decisions of taxpayers who use the published price. The framework points out that tax authorities that adopt a safe-harbour approach should consider the risk that safe harbours may underprice minerals, and it advises, accordingly, that if safe harbours are used, their outcomes should be monitored.

In the 2022 TPG, the OECD commented on the use of safe-harbour provisions. It stated that safe harbours can be appropriate for simple transactions and small taxpayers, but when they are used in complex and higher-risk transfer-pricing matters, they may be inappropriate and lead to perverse effects on pricing decisions. Jurisdictions will have to consider the unique circumstances of specific mineral transactions when deciding whether to implement a safe-harbour provision.

The framework acknowledges the limitations of safe-harbour provisions and suggests, as an alternative, that safe harbours be used for risk-assessment purposes only.

The OECD's final suggestion (at 31) is that tax authorities implement an advanced pricing arrangement (APA) system wherein a taxpayer and a tax authority negotiate and agree on a transfer price in advance, thereby enhancing the predictability of the transaction's tax treatment.

As has been discussed in previous issues of this newsletter, APAs play an important role in resolving international tax disputes, but they can be difficult to implement. Canada has a robust APA program, but these arrangements may be more difficult to implement in countries without a strong tax authority. The long-term nature of APAs may also be inappro-

priate for some mineral transactions in situations where pricing is volatile or where the quality of the extracted minerals varies over time.

A Canadian Perspective

Canada's transfer-pricing regime is premised on the arm's-length principle and may be engaged at various stages of mineral resource development. It may be engaged, for example, in the valuation of

- intragroup technical services,
- the rental of specialized machinery,
- related-party financing, and
- related-party sales of minerals and associated marketing activities.

The CRA has stated that in the context of Canadian transfer pricing, a "natural hierarchy" of transfer-pricing methodologies continues to exist, with the traditional transaction methods (for example, the CUP method) generally being preferred over transactional profit methods; at the same time, the CRA has emphasized that the determination of the appropriate method should be based primarily on the method that provides the most direct view of arm's-length behaviour and pricing (see *Transfer Pricing Memorandum* TPM-14). The importance of the CUP method has also been recognized in Canadian jurisprudence (see *Canada v. GlaxoSmithKline Inc.*, 2012 SCC 52).

In general, the CRA has endorsed the OECD's TPGs for interpreting and applying the arm's-length principle (TPM-14). Although Canadian courts have found (see *Glaxo*) that the TPGs are not law, the courts have also recognized that the TPGs should inform the interpretation and application of Canadian transfer-pricing rules (*Smithkline Beecham Animal Health Inc. v. Canada*, 2002 FCA 229). In *Marzen Artistic Aluminum Ltd. v. Canada* (2016 FCA 34, at paragraph 50), the FCA stated:

> The [OECD] Guidelines assist the Court in its task of ascertaining the price that would have been paid by parties dealing at arm's length in the same circumstances. They identify and describe a number of pricing methods that can be applied to identify the arm's length price for a given transaction.

The TPGs play an important role in the interpretation and application of the Canadian transfer-pricing rules, and the framework may be considered to provide important guidance on the application of the CUP method in the mining context. The framework explicitly recognizes that certain factors are important when transactions are being compared and the CUP method is being applied—for example, the physical features and quality of minerals; the volumes being transacted; the economic circumstances at the time of sale; the timing, location, and terms of delivery; and certain other factors, such as transportation and insurance costs, foreign exchange rates, and payment terms. This is important guidance, particularly in the context of pricing related-party mineral sales and associated marketing activities.

Although the framework is largely dedicated to providing guidance to tax administrators in resource-rich, developing nations, it also provides valuable insights for Canadian mining companies, which are often engaged in mining activity abroad. In particular, the OECD and IGF's suggestions for the future development of other jurisdictions' transfer-pricing regimes will likely be of interest. Many of the countries in which Canadian mining companies do business are in the process of designing and implementing their transfer-pricing rules, and those rules will need to be thoroughly understood by taxpayers. The framework previews certain features that these jurisdictions may adopt—the safe-harbour approach, for example, which Canadian mining companies should consider as they continue to look at investment and development opportunities abroad.

Kevin Chan, Steve Marshall, and Paul Hildebrandt
Torys LLP

Subsection 212.1(1): Is a Non-Resident Beneficiary Six Feet Under?

The current non-resident anti-surplus-stripping rules in subsection 212.1(1) can deny the conversion of "hard" ACB into shares with high PUC if the shares are held directly or indirectly (for example, through a trust or partnership) by a non-resident individual. The lookthrough rules in subsection 212.1(6) may lead to unintended consequences for post mortem pipeline planning that would otherwise allow such a conversion of the hard ACB resulting from a deemed disposition pursuant to subsection 70(5).

A comfort letter issued by the Department of Finance on December 2, 2019 ("Cross-Border Surplus Stripping and Graduated Rate Estates," available on *Knotia*) indicated that this result is not consistent with current tax policy and that the department would recommend an exception, retroactive to February 26, 2018. To date, no legislative measures have been introduced in this regard. The CRA acknowledged this comfort letter in technical interpretation no. 2019-0824561C6 (December 3, 2019), but it provided no comments on whether it would apply the proposed amendment prior to its being legislated. In addition, the relief outlined in the comfort letter includes numerous limiting conditions. Specifically, it would apply only to "dispositions of shares by a Canadian resident *graduated rate estate* of an individual who was *resident in Canada immediately before the individual's death*, provided that *those shares* were acquired by the estate on and as a consequence of the individual's death [emphasis added]."

In the absence of this amendment, it is likely that gains that are deemed realized on the final tax return of a deceased individual will be subject to double taxation if one or more

beneficiaries are non-residents. Although the flat rate of part XIII tax may mitigate this double taxation, especially if a reduced treaty rate is available, it still seems inequitable. On the evidence of the comfort letter, the Department of Finance appears to agree, but the lack of legislation to implement those proposals is disconcerting. The inequity seems even more pronounced when we consider (1) the position of an estate executor who must make a decision before the estate loses its graduated rate estate status, 36 months after the date of death; and (2) the position of estates now well past this 36-month window, many of which could not reasonably defer administration of the estate indefinitely.

The Provision and Exceptions

Conceptually, section 212.1 is the cross-border equivalent of section 84.1 (that is, it is similarly intended to tax surplus stripping), with two fundamental differences. First, section 212.1 applies to all non-resident persons, whereas section 84.1 applies only to individuals, including trusts. Second, section 212.1 does not afford relief in respect of hard ACB. Specifically, section 212.1 applies where the following four conditions are satisfied:

1) A non-resident person ("vendor") disposes of shares ("subject shares") of a corporation resident in Canada ("subject corporation").
2) The subject shares are acquired by another corporation resident in Canada ("purchaser corporation").
3) The vendor and the purchaser corporation do not deal at arm's length.
4) Immediately after the disposition, the subject corporation is connected (within the meaning of subsection 186(4)) with the purchaser corporation.

Where these four conditions are met, the result may be a reduction in the PUC of any shares received by the vendor, or a deemed dividend (subject to withholding taxes under part XIII of the Act).

Several bona fide scenarios may result in these conditions not being met. They are not met, for example, where

- the non-resident shareholder's shares have restricted or no voting rights, and therefore the subject corporation and purchaser corporation would not be connected (assuming that the purchaser corporation holds no other shares, and that the subject corporation is not controlled by the purchaser corporation, alone or in combination with persons not acting at arm's length);
- the vendor controls the subject corporation only because of contingent rights described in paragraph 251(5)(b) (such rights are disregarded for the purposes of paragraph 186(4)(a));
- the vendor acts at arm's length with the purchaser corporation, which would typically be the case when multiple arm's-length investors hold interests in the purchaser corporation (provided that the vendor is not a member of a group of less than six persons that controls both corporations as described in subsection 212.1(3)); or
- the non-resident's shares could be acquired by a person other than a Canadian corporation (such as an individual).

Where transactions are structured specifically to fall within such exceptions, the possible application of GAAR (including the rule's proposed economic substance test) must be considered. This is necessary even where these structures are motivated primarily by non-tax considerations, such that tax is likely not a "main reason" for them. Because these exceptions carry significant non-tax consequences (such as a lack of voting rights, and a sale to an arm's-length purchaser), it would appear that most situations will not lack economic substance.

Some limited planning opportunities may exist along these lines—for instance, in a situation involving the immigration of a non-resident corporate shareholder of a Canadian corporation. (This was the situation addressed in *Canada v. Collins & Aikman Canada Inc.*, 2010 FCA 251, although the reader should note that section 212.1 was not argued, and that the FCA indicated that the existence of the structure that facilitated the transactions dated back to 1961, long before section 212.1 was even proposed.) Structures that utilize the exception under subsection 212.1(4) are also noteworthy. This exception comes into play when (subject to other requirements) a non-resident transfers shares to a Canadian corporation resident in Canada that controls the non-resident. The scope and application of such exceptions are clearly very narrow and limited.

Partial Disposition by an Estate

In the context of post mortem planning, the circumstances needed to access the exceptions discussed above are unlikely to exist. If legislation implementing the comfort letter is not enacted, or if the requirements of the proposed exception are not met (if, for example, the estate has lost its graduated rate estate status), are any planning alternatives available?

One possibility might be to settle the non-resident beneficiary's interest in the estate before undertaking the pipeline. If the estate has sufficient assets beyond the shares of the subject corporation, these assets could be used to satisfy the non-resident's capital interest. Paragraph 212.1(6)(a) would deem a portion of the shares to be disposed of by the non-resident beneficiary, but the purchaser would be the estate, not a Canadian corporation, and therefore subsection 212.1(1) would not apply.

A second possibility would be to settle the non-resident beneficiary's interest with shares of the Canadian corporation. Because a Canadian corporation would acquire neither the shares nor the non-resident beneficiary's interest in the

estate, subsection 212.1(1) would again not apply. However, this would leave the non-resident with shares of the Canadian corporation that have high ACB but low PUC. Therefore, this strategy would not be useful unless the Canadian corporation is expected to continue operating, and the non-resident beneficiary intends to retain its shares. Part XIII tax would be deferred and could be avoided entirely if the shares are ultimately sold in a transaction to which section 212.1 does not apply.

Note that any assets transferred from the estate would be deemed to be disposed of at fair market value, because assets can only roll out at cost to Canadian-resident beneficiaries. However, any gains would be limited to the increase in value that occurs after the taxpayer's death; therefore, these amounts may be relatively modest in many cases. Similar planning may be useful in other situations involving non-resident beneficiaries of trusts, with the potential for substantially greater inherent gains in their assets.

In summary, various planning options may allow non-resident beneficiaries to avoid the inappropriate results of the anti-surplus-stripping rules in section 212.1, but these options are limited. Even if the comfort letter proposals are ultimately enacted in legislation, problems will remain for situations that fall outside the limited exceptions. Tax practitioners must exercise caution when navigating these complex provisions in cross-border situations. It is easy for practitioners who focus primarily on domestic tax planning, including planning related to section 84.1, to overlook the much broader application of section 212.1.

Balaji (Bal) Katlai
Toronto

Henry Korenblum
Oberon Capital Corporation, Toronto

Hugh Neilson
Video Tax News, and Kingston Ross Pasnak, Edmonton

The editor of *International Tax Highlights* welcomes submissions of ideas or of written material that has not been published or submitted elsewhere. Please write to Angelo Nikolakakis at angelo.nikolakakis@ca.ey.com.

IFA Canada
Canadian Tax Foundation
145 Wellington Street West, Suite 1400
Toronto, Ontario M5J 1H8
Telephone: 416-599-0283
Facsimile: 416-599-9283
Internet: http://www.ctf.ca
ISSN 2816-4415 (Online)

©2024, Canadian Tax Foundation and IFA Canada. All rights reserved. Permission to reproduce or to copy, in any form or by any means, any part of this publication for distribution must be obtained in writing from the Canadian Tax Foundation, 145 Wellington Street West, Suite 1400, Toronto, Ontario M5J 1H8; e-mail: permissions@ctf.ca.

In publishing *International Tax Highlights*, the Canadian Tax Foundation, IFA Canada, and Angelo Nikolakakis are not engaged in rendering any professional service or advice. The comments presented herein represent the opinions of the individual writers and are not necessarily endorsed by the Canadian Tax Foundation, IFA Canada, or their members. Readers are urged to consult their professional advisers before taking any action on the basis of information in this publication.