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Recent Developments in International Taxation
Canada

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In the past two years, Canada has demonstrated a commitment to international tax reform and confronting aggressive tax planning. Canada's Department of Finance ("**Finance**") released the most recent Canadian Federal Budget on March 28, 2023 ("**Budget 2023**"), which contained various proposals to amend the *Income Tax Act* (Canada) (the "**ITA**") that are significant in a business tax context. While Budget 2023 did not contain any new measures aimed at international tax reform, it provided an update on previously announced measures aimed at implementing and building upon the objectives outlined in the two pillars of the Organization for Economic Cooperation and Development ("**OECD**")/G20 Inclusive Framework on Base Erosion and Profit Shifting ("**BEPS**").

Further to Budget 2023 and subsequent public consultations, on August 4, 2023, Finance released a significant draft legislation package ("**August Draft Legislation**"), which includes new measures that were previously announced in Budget 2023, and changes to previously released draft legislation. The proposals in the August Draft Legislation include (among others):

- amendments to expand the scope of the general anti-avoidance rule;
- a share buyback tax of 2% on repurchases of equity by most publicly listed Canadian corporations, trusts and partnerships;
- updates to draft proposals on intergenerational business transfers;
- an increase to the alternative minimum tax ("**AMT**") from 15% to 20.5% and changes to the tax base for the AMT to better target high income individuals;
- changes to the recently introduced interest barrier rule;
- updates to the draft *Digital Services Tax Act*; and
- the draft *Global Minimum Tax Act*, which will implement the second pillar of the OECD's Inclusive Framework on BEPS.

The August Draft Legislation is subject to change following feedback from the public due September 8, 2023.

In addition to the foregoing proposals, on March 28, 2023, Finance released the final draft legislation for the new and expanded mandatory disclosure rules, which became law on June 22, 2023.

From the abundance of new legislation released in the last year, this note will provide an update on select recent developments in Canadian income tax, with a focus on aggressive tax planning and international taxation.

The General Anti-Avoidance Rule

Section 245 of the ITA, known as the general anti-avoidance rule ("**GAAR**") is a tool used to prevent abusive tax avoidance by denying tax benefits flowing from transactions that are technically compliant with the provisions of the ITA, but are nevertheless found to frustrate the object, spirit and purpose of those provisions. The following three conditions must be met for the GAAR to apply:

1. there must be a tax benefit;

2. the transaction must be an avoidance transaction (meaning a transaction not undertaken for a *bona fide* non-tax purpose); and

3. the avoidance transaction giving rise to the tax benefit must result in a misuse or abuse of the ITA or related enactment (for example, a tax treaty).

This framework was established by the Supreme Court of Canada in *Canada Trustco Mortgage Co. v. Canada*, 2005 SCC 54 ("***Canada Trustco***"). In the years since that decision, Courts have upheld GAAR assessments issued by the Canadian tax authority, the Canada Revenue Agency ("**CRA**"), in approximately 30 cases. Conversely, Courts have overturned GAAR assessments in approximately 24 cases for not meeting one or more of the above-mentioned conditions. This mixed success led Finance to formally launch a consultation on the GAAR in 2020.

Two years later, in August 2022, Finance released a detailed consultation paper, which listed their perceived shortcomings of the GAAR, including that it does not sufficiently take into consideration the economic substance of transactions and that it does not have a sufficient deterrent effect on abusive tax planning. The consultation paper was met with criticism and skepticism from practitioners, as the proposals to amend the GAAR threatened the certainty, predictability and fairness of the well-established three-part test from *Canada Trustco.*

Several months after the release of the consultation paper, Finance announced in Budget 2023 draft amendments to the GAAR that incorporated some of the proposals in the consultation paper. The draft amendments included:

- a preamble intended to provide a statutory interpretative guide;

- a lowered threshold of what constitutes an "avoidance transaction" (this will change the definition of avoidance transaction from a transaction not undertaken for a *bona fide* non-tax purpose, to a transaction where one of the main purposes was to obtain a tax benefit);

- the introduction of the concept of economic substance in the "misuse or abuse" analysis;

- a 25% penalty on the amount of any tax benefit assessed under the GAAR; and

- an extended limitation period within which the CRA may assess or reassess under the GAAR in certain circumstances.

These amendments were revised in the August Draft Legislation to be broader in scope and more punitive. In particular, the version of the GAAR amendments announced in Budget 2023 provided that an avoidance transaction that is significantly lacking in economic substance "tends to" indicate misuse or abuse; whereas, the revised draft amendments go further to create a presumption that a transaction is a misuse or abuse where it significantly lacks economic substance. The August Draft Legislation also includes the following list of factors that establish a transaction significantly lacks economic substance:

a) where all or substantially all of the opportunity for gain or profit and risk of loss remains unchanged in a group of non-arm's length taxpayers (for example, through a circular flow of funds);

b) where it is reasonable to conclude that at the time of entering into the transaction, the expected value of a tax benefit exceeded the expected non-tax economic return (notably, as per the explanatory notes, foreign tax savings are <u>not</u> to be included as a commercial, non-tax return); and

c) where the entire (or almost entire) purpose for undertaking or arranging the transaction or series was to obtain the tax benefit.

The introduction of the concept of economic substance in the GAAR is a significant new development in Canadian taxation, as there is a longstanding principle in Canadian jurisprudence that the economic realities of a situation cannot be used to recharacterize a taxpayer's *bona fide* legal relationships, absent a specific provision in the ITA to the contrary or a finding that they are a sham. The draft amendments very specifically require a consideration of economic substance in applying the GAAR.

The August Draft Legislation also modified the formula for the penalty where the GAAR applies, which is now 25% of the difference between the tax payable by the person in the year and the tax that would have been payable if the GAAR did not apply. There is a reduction to the penalty where additional penalties are levied on account of the taxpayer's gross negligence. An exception to the 25% penalty has been added where a transaction is "identical or almost identical" to a transaction that was the subject of administrative guidance from the CRA or a court case. As set out in the explanatory notes, this exception is intended to forgive taxpayers who reasonably rely on the current state of the law in planning their affairs. The penalty will also not apply where the taxpayer discloses the transaction in accordance with the mandatory disclosure rules under the ITA.

If these draft amendments are made law, they will apply to transactions entered into on or after January 1, 2024. It is possible that the effective date will be pushed back after public consultation. Regardless of what happens next, it is clear that Finance is committed to upending the existing GAAR framework, putting creative tax planning in Canada in a state of uncertainty.

<u>Excessive Interest and Financing Expense Limitations</u>

In the 2021 Canadian Federal Budget ("**Budget 2021**"), Finance announced that it would be introducing an interest barrier and earnings-stripping regime to be consistent with the recommended best practices in the OECD's BEPS Action 4 Report and with interest deductibility limits introduced by other members of the G-7 and European Union. The original draft legislation

and explanatory notes were released in February 2022, revised proposals were released on November 3, 2022, and further revisions were released in the August Draft Legislation.

At a high-level, the proposed Excessive Interest and Financing Expense Limitations ("**EIFEL**") rules limit deductible net interest expense to a fixed ratio of "tax EBITDA" (taxable income before interest expense, interest income, income tax, and deductions for depreciation and amortization). The interest barrier will be phased in, with the limit being 40% of tax EBITDA for taxation years beginning on or after October 1, 2023 and 30% of tax EBITDA for taxation years beginning on or after January 1, 2024.

There are some general exceptions to the EIFEL rules, including exemptions for Canadian-controlled private corporations with taxable capital employed in Canada of less than C$50 million and corporations or trusts that are part of a group where the Canadian members have total interest and financing expenses (net of interest and financing revenues) of less than C$1 million.

There are no sectoral-specific exemptions, which distinguishes Canada's rule from interest barriers in other jurisdictions; however, taxpayers that are highly leveraged by virtue of their industry may get relief by electing to use a "group ratio" as an alternative to the fixed ratio. In the original draft legislation, Finance included a number of practical impediments to the group ratio, including requirements that all group entities have the same reporting currency and taxation year as the ultimate parent, which were eventually removed in later versions. The August Draft Legislation also includes a 10% "up-lift" to the group ratio, which Finance explains in the explanatory notes is intended to account for book-tax timing differences between group members. The up-lift is consistent with recommendations in the BEPS Action 4 Report.

Several other changes to the EIFEL rules are included in the August Draft Legislation, including changes to the calculation of a taxpayer's adjusted taxable income and interest and financing revenues, as well as new measures that apply in respect of interest paid between controlled foreign affiliates.

Alternative Minimum Tax

Canada's alternative minimum tax ("**AMT**") is an alternative tax applied to a taxpayer's "adjusted taxable income" ("**ATI**"), which includes fewer deductions, exemptions and tax credits than the normal income tax rules. In its current form, the AMT applies at a rate of 15% if the amount of tax calculated using the AMT is higher than ordinary Part I income tax. In Budget 2023, Finance proposed a number of changes to the existing AMT regime to better target high income individuals. The August Draft Legislation includes draft measures to implement these changes, including an increase to the AMT rate from 15% to 20.5%, and changes to the calculation of a taxpayer's ATI. Some of these changes are:

- an increase in the AMT capital gains inclusion rate from 80% to 100%;
- a decrease in the AMT capital loss carryforwards inclusion rate from 80% to 50%;
- the inclusion of 100% of the benefit associated with employee stock options; and

- the disallowance of 50% of certain deductions, including the following: employment expenses (other than to earn commission income), deductions for CPP, QPP and PPIP contributions, moving expenses, childcare expenses, interest and carrying charges incurred to earn income from property, and non-capital loss carryovers.

The August Draft Legislation also increases the AMT exemption amount (which is a deduction available to all individuals) from $40,000 to approximately $173,000. The AMT exemption amount will also be indexed for inflation.

Certain trusts including mutual fund trusts and segregated trusts are exempt from AMT. The August Draft Legislation proposes to add to that list trusts that have units traded on a designated stock exchange and trusts that are investment funds.

These amendments will apply to taxation years that begin after 2023.

Digital Services Tax and Global Minimum Tax

In Budget 2023, Canada restated its commitment to move forward with the BEPS two-pillar plan for international tax reform agreed to by OECD/G20 members in October 2021.

The first pillar of the BEPS plan ("**Pillar One**") is the development of a multilateral agreement and model rules for a digital services tax ("**DST**"). In the 2021 Canadian Federal Budget, Canada announced plans to implement a domestic DST as an interim measure, while negotiations between OECD members on a multilateral agreement are ongoing. In December 2021, Finance released draft legislation for Canada's DST; according to the draft *Digital Services Tax Act* ("**DSTA**"), Canada's DST would apply at a rate of 3% on revenue from specified digital services that rely on user participation to create value. Assuming that a multilateral agreement on Pillar One is not reached by the end of 2023, the DST is proposed to apply on January 1, 2024, with retroactive effect to January 1, 2022.

On July 12, 2023, the OECD announced that 138 members agreed to postpone the implementation of any domestic DSTs until December 31, 2024. On the same day, Canada refused this moratorium, announcing that it will move forward with the DSTA starting January 1, 2024.

The August Draft Legislation contains the first revisions to the draft DSTA. These revisions were relatively minor and notably did not address concerns that Canada's DST will be retroactive and will not be deductible against income taxes payable in Canada.

The second pillar of the BEPS plan is a global minimum tax for large multinational enterprises ("**MNEs**") with annual revenues of €750 million or more. In February 2023, the OECD released the "global anti-base erosion" ("**GloBE**") model rules. The August Draft Legislation includes the draft *Global Minimum Tax Act* ("**GMTA**") and a Table of Concordance that cross references the proposed GMTA provisions with source documents from the GloBE model rules. The GMTA is set to apply to fiscal years of qualifying MNEs beginning on or after December 31, 2023.

At a high-level, the draft GMTA imposes a 15% global minimum tax on the income of qualifying MNE groups. A qualifying MNE group must meet two conditions: (i) have an entity or permanent establishment in more than one jurisdiction; and (ii) have consolidated revenues of €750 million

or more in at least two of the four fiscal years immediately preceding the particular fiscal year. There are exclusions for government entities, international organizations, non-profit organizations, pension funds and certain investment and real estate entities, as well as for entities that are owned by the foregoing excluded entities, where certain ownership thresholds are met. The draft GMTA borrows specific measures from the GloBE model rules and OECD guidance, including an income inclusion rule, a qualified domestic minimum top-up tax, and safe harbours to provide relief where certain conditions for MNEs are met. These rules are subject to consultation in fall 2023.

Mandatory Disclosure Rules

In Budget 2021, Finance announced public consultations on a proposed expansion of the existing mandatory disclosure rules in the ITA. On February 4, 2022, Canada released draft legislation to implement the new rules, which was revised on August 9, 2022 and again on March 28, 2023. The final version of the mandatory disclosure rules became law on June 22, 2023. The new rules are designed to implement best practices from the OECD BEPS project and action plan on mandatory disclosure, and include the following:

(1) an expansion of the reportable transaction regime to require disclosure where one (as opposed to two) of the three generic hallmarks is present (the hallmarks are a contingent fee arrangement, confidential protection or contractual protection);

(2) the introduction of a notifiable transaction regime that requires disclosure of certain transactions and substantially similar transactions that the CRA (with the concurrence of Finance) designates as objectionable or offensive (sample notifiable transactions were provided with the draft legislation, however, the CRA has yet to officially designate any transactions as “notifiable”); and

(3) new rules that require the disclosure of uncertain tax treatments, which are applicable to large corporations that have audited financial statements prepared in accordance with international financial reporting standards, assets of greater than or equal to C$50 million at the end of the year and that are required to file an income tax return in Canada.

Where taxpayers do not comply with the new rules, penalties and extended limitation periods will apply. In addition to these new and expanded rules applicable to taxpayers, Finance also introduced new and expanded reporting requirements for advisors and promoters.

The rules went through several revisions following consultations as Finance worked to find an appropriate balance between the desire for transparency, the need for clarity for taxpayers and their advisors, and the rules’ effectiveness in identifying truly objectionable schemes. Shortly after the rules became law, the CRA released administrative guidance on the application and administration of the new and expanded regimes, which provides some comfort and assistance in determining their scope.

The reportable and notifiable transaction regimes apply to transactions entered into after June 22, 2023, and the uncertain tax treatments regime applies to tax years beginning after 2022 (though penalties for late-filing will not apply until tax years beginning after June 22, 2023).

Conclusion

In the last twelve months, Finance has released a significant amount of draft legislation. In the context of targeting aggressive tax planning and international tax reform, the select measures discussed in this report will change the Canadian landscape of tax planning and tax administration. The practical impact of these changes will become clear in the months and years to come.