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Canada tables NWMM to ratify MLI; Updates MLI reservations

MAY 29, 2018 9 MIN READ

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- Canada intends to remove some of its initial reservations on optional MLI provisions
- Timeline and required procedure for the MLI to enter into effect

On May 28, 2018, Canada tabled a Notice of Ways and Means Motion (NWMM) [PDF] in the House of Commons, formalizing Canada's intention to introduce legislation to enact the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting [PDF] —also known as the Multilateral Instrument or MLI—into Canadian law. This is the next step in the process for Canada to ratify the MLI, which it signed in June 2017 (Canada indicated in its 2018 Federal Budget that it intends to ratify the MLI in 2018).

Background on the MLI

The MLI has been signed by more than 75 jurisdictions (including Canada). Once in effect, the MLI will modify a significant number of existing bilateral tax treaties, including up to 75 of Canada's bilateral tax treaties (referred to as Covered Tax Agreements – view a full list [PDF]). The most significant treaty modifications implemented through the MLI will be to adopt the OECD agreed minimum standards on treaty abuse and improving dispute resolution.

The minimum standard to address treaty abuse consists of two parts: (i) an amended preamble, suggesting that covered tax treaties are intended to eliminate double taxation without creating opportunities for non-taxation or reduced taxation through tax evasion or avoidance; and (ii) a broad anti-avoidance rule, referred to as the principal purpose test or PPT. Under the PPT, a treaty benefit may be denied where it is reasonable to conclude that one of the principal purposes of an arrangement or transaction is to gain the benefit unless it is established that granting the benefit would be in accordance with the object and purposes of the relevant provisions of the treaty.

Canada has agreed under the MLI to implement the minimum standard with respect to dispute resolution features of its tax treaties, and has also agreed to adopt mandatory binding arbitration to assist in resolving treaty-based disputes in a timely manner.

Canada alters initial reservations

Canada has announced its intention to remove some of its initial reservations on optional MLI provisions (noting that reservations can be removed at any time – but new reservations are not permitted). The first change is to add a one-year holding period to access treaty-based withholding tax reductions on dividends under a Covered Tax Agreement. These reductions generally apply where the beneficial owner or recipient of a dividend is a company that owns, holds or controls more than a certain amount of the shares or voting power of the dividend paying company. However, Article 8 of the MLI denies such special relief if those ownership conditions are not met throughout a 365-day period that includes the day of the payment of the dividends. For this purpose, changes of ownership resulting from certain corporate reorganizations are ignored.

The second change is to add a one-year lookback testing period in determining whether a Covered Tax Agreement exempts capital gains on a sale of equity interests (including shares) that do not derive their value principally from immovable property. Canada's domestic "taxable Canadian property" rules impose a five-year lookback period for determining whether shares derive their value principally from certain types of Canadian properties (such as real property and resource properties). By contrast, many of Canada's tax treaties exempt gains from being taxed in Canada where the shares sold by a resident of the other state do not derive their value principally from immovable property in Canada *at the time of disposition*. Article 9(1) of the MLI, which Canada proposes to adopt, will allow the source country to tax such gains if the relevant value threshold is met at any time during the 365 days preceding the disposition.

The new provision on capital gains will also extend the application of existing provisions in Covered Tax Agreements that do not already provide for such taxation to allow taxation of gains from both shares and other equity interests (such as interests in partnerships and trusts), in each case provided the relevant immovable property threshold is met during the 365-day testing period.

The third change is to adopt a provision for resolving dual resident entity cases. Many of Canada's tax treaties provide that the dual residence of persons other than individuals (such as corporations) is to be resolved, if agreement can be reached, by the competent authorities of the two treaty partner countries in which the entity is resident. Article 4 of the MLI adds certain factors that the competent authorities should take into account when determining residency status: place of effective management, place where the entity is incorporated or otherwise constituted, "and any other relevant factors."

The new article on dual resident entities does not provide for a clear result where the entity is a dual resident by virtue of a corporate continuance. Some such entities may be governed by the laws of both the jurisdiction under which they are created and the one to which they are continued. The U.S.-Canada treaty contains a tie-breaker rule that provides that such an entity would be resident only in the jurisdiction where the entity was created. By referring to the place where the entity is incorporated or otherwise constituted as a relevant factor, the new MLI provision may be signalling that a similar approach should be applied, although without treating any one particular factor as a mechanical bright-line rule.

Finally, Canada intends to adopt a provision of the MLI that will allow certain treaty partners to move from an exemption system as their method of relieving double taxation, to a foreign tax credit system. This change appears consistent with Canada's general treaty policy over the past two decades – which has generally removed treaty-based guarantees of an exemption system. We note that Article 5 of the MLI allows countries to adopt one of three different options when removing such treaty-based guarantees, and at this point, it is uncertain which of the three options Canada intends to adopt. In any case, the removal of a treaty-based guarantee of an exemption system would allow Canada's treaty partners to change their domestic laws to adopt a foreign tax credit system as an alternative. However, the general trend for many years has been for countries (including Canada) to provide an exemption system – and any change to a foreign tax credit system by Canada's treaty partners may have a significant adverse impact on cross-border investments. Unfortunately, Canada did not announce an intention to remove its reservation on Article

7(4) of the MLI – which would specifically allow treaty benefits that would otherwise be denied under the PPT to be granted in full or in part by the competent authorities in appropriate circumstances. For example, assume that an investor would be entitled to a 15% withholding tax rate on dividends had it made a direct investment into Canada, but instead invests into Canada through an intermediary that would have been entitled to a 10% withholding tax rate. A denial of treaty benefits under the PPT could lead to a 25% withholding tax rate on dividends to the investor. However, Article 7(4) would provide a specific mechanism to allow the investor to access the 15% rate notwithstanding the application of the PPT – if the CRA determines that the 15% rate would have applied had the investor invested into Canada directly. This is particularly important, for example, for private equity and other collective investors that may be resident in multiple jurisdictions. Canada has also not provided any additional guidance on when or how the PPT is intended to apply to private equity and other collective investment vehicles – despite many suggestions that further guidance is needed (either on a unilateral or bilateral basis). In particular, the PPT is very broadly worded, and the current OECD guidance is ambiguous and open to different interpretations.

Timeline for MLI coming into effect

The MLI will enter into force on July 1, 2018, following the ratification of the MLI by at least five countries (Austria, Isle of Man, Jersey, Poland, and Slovenia).

The MLI will enter into *force* for Canada on the first day of the month beginning three months after Canada deposits its instrument of ratification with the OECD. Where the MLI is already in *force* for a counterparty to a Covered Tax Agreement, the MLI will then enter into *effect* for that Covered Tax Agreement for (a) withholding taxes, on the first day of the next calendar year, and (b) for other taxes, for tax years beginning six months after the MLI enters into *force* for Canada. Where the MLI is not yet in *force* for a counterparty, the timeline for entry into *effect* for that Covered Tax Agreement will depend on the date on which the MLI enters into *force* for that counterparty.

The Canadian ratification procedures are as follows:

i. the NWMM must be tabled as a bill – an Implementation Bill – which will be debated in both the House of Commons and the Senate, with both houses likely sending the Implementation Bill to committee for study;
ii. the Implementation Bill must be approved by Parliament and receive Royal Assent (as Parliament is scheduled to break for the summer on June 22, 2018, and to reconvene on September 17, 2018, Royal Assent is unlikely to be received before the fall of 2018);
iii. an Order in Council is then needed to notify the OECD that the ratification procedures in Canada are complete.

By way of example, if Canada notifies the OECD in September of 2018 that its domestic ratification procedures are complete, the MLI would enter into force for Canada on January 1, 2019. The MLI would then enter into effect for those Covered Tax Agreements where the MLI had also entered into force for a counterparty (a) for withholding taxes, on January 1, 2019, and (b) for other taxes, for tax years beginning on or after July 1, 2019.

Following ratification, Canada will be unable to add any further reservations; however, signatories may withdraw or narrow a reservation following ratification. Given that the NWMM refers to the implementation of the MLI in full, and is not subject to any particular reservations, removing a reservation appears to be a function of the executive branch of government – likely requiring an Order-in-Council – rather than a function of Parliament.

Certain removals of reservations could have a significant impact on the Canadian fisc (such as if Canada were to agree to the MLI's changes to the "permanent establishment" threshold – potentially allowing other countries an increased ability to tax certain Canadian resource profits). As a result, it is hoped that Parliament will carefully consider the MLI, together with the potential consequences of removing Canada's current reservations, prior to approving the MLI's ratification.

For further background on the MLI – including a discussion of the OECD's BEPS Final Report (which includes recommendations on the MLI and 14 other Action Items), optional provisions of the MLI and prior discussions of Canada's implementation procedures – see our Osler Updates "Canada begins ratification process for multilateral tax convention to implement BEPS," "International Tax Reform 2015 – BEPS Final Report," "Significant tax treaty changes proposed in multilateral convention," "Canada signs the multilateral tax agreement," and "New PPT rule in the OECD's Multilateral Instrument to displace Canadian GAAR?"

For further information on the MLI, the PPT, or other tax matters, please contact any member of our National Tax Group.