COVID-19 tax measures and proposed international tax reform

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Two significant tax developments in 2020 were Canada's measures in response to COVID-19 and Canada's participation with the OECD's pursuit of international tax reform.

COVID-19 measures included relief from various tax administration and litigation deadlines and new financial support programs. Canada has used its tax system as an effective means to deliver economic support to various sectors of the economy impacted by the pandemic – with the result that Canada is forecasted to have its largest deficit since WWII. Significant budget deficits from COVID-19 spending will put pressure on Canada to raise additional revenue in the future.

The proposed international tax reform spearheaded by the OECD is one possible avenue for doing so. The OECD proposals would expand the taxing rights of market jurisdictions (Pillar One) and impose a global minimum tax on multinational enterprises (Pillar Two). If adopted, these measures would fundamentally change Canada's existing international tax framework.

Canada's response to COVID-19 – administrative and financial relief

In response to the ongoing COVID-19 pandemic, the Canada Revenue Agency (CRA) provided procedural administrative relief by deferring most deadlines for filing and paying 2019 income taxes and instalments, as well as temporarily extending deadlines for filing notices of objection. Relief from interest and penalties that would normally accrue during the extensions was automatically granted. Deadlines for GST/HST (but not payroll) remittances were also deferred. The CRA suspended collection action on new debts and indicated a willingness to accept flexible payment arrangements for existing debts.

Limited substantive administrative relief was provided. The CRA issued temporary guidance (which expired on September 30 and has not been updated) on residency, permanent establishment and other international issues affected by COVID-19. The relief applied to individuals, corporations resident in countries that have tax treaties with Canada and otherwise on a case-by-case basis. Generally, affected taxpayers would not be considered to be resident in Canada, or to be carrying on business or have a permanent establishment in Canada, solely because of pandemic-related travel and mobility restrictions. The CRA also provided certain relief from cross-border withholding and remittance requirements where a waiver or clearance certificate would have otherwise been required. On the domestic side, the CRA indicated that $500 reimbursements to employees for equipment needed to work from home would not be a taxable benefit.

COVID-19 wreaked havoc with tax litigation. The Tax Court was closed from March until July. Procedural deadlines in Court proceedings, including limitation periods, were extended by federal legislation and Court orders. The resulting backlog of hearings led to increased support from the Court for parties to settle, including a new fast-track settlement conference initiative.

A variety of pandemic-related benefits were established beginning in March. For individuals, the Canada Emergency Response Benefit (CERB) consisted of a $2,000 per month benefit that was generally available to laid-off individuals who earned at least $5,000 in the prior year. CERB has now been replaced by the Canada Recovery Benefit (CRB). Employers were able to apply for the Canada Emergency Wage Subsidy (CEWS), which subsidized up to 75% of wages of businesses experiencing decreased revenues. Employers could also apply for a refund of certain payroll remittances. Eligibility requirements for CEWS are complex and the program was significantly revised in the summer. CERB and CEWS payments are taxable income. Many other targeted benefits were established, including for small businesses, students, caregivers and individuals who are sick or required to self-isolate.

Proposed measures to tax digital and consumer-facing businesses and global minimum tax

Canada has been an active participant in the multi-year OECD/G20 Base Erosion and Profit Shifting (BEPS) project, which targets tax-planning strategies that shift profits to low tax jurisdictions.

The BEPS reports released in 2015 were aimed at improving the coherence, substance and transparency of the international tax system. The BEPS project also created a multilateral instrument (MLI) in 2016 to implement treaty measures. To date, the MLI has been signed by 94 countries (and ratified by 53 of them). The MLI entered into force in Canada at the end of 2019 for most of Canada's treaties – although for some capital gains it will not be effective until January 1, 2021.[1]

As many countries were not satisfied with the results of the BEPS project, the OECD introduced a two-pillar approach to international tax reform in 2019 to address the digital economy and unresolved BEPS issues.

The Pillar One proposals of the BEPS project represent a fundamental change to the international tax system by allocating new taxing rights to market jurisdictions (where customers are located) over automated digital companies and certain consumer-facing businesses. While various outstanding technical and political issues remain, certain industry-specific exemptions are contemplated, as well as a consolidated minimum revenue threshold of €750 million for multinational enterprises (MNEs).

The new taxing right is intentionally unconstrained by existing tax principles requiring a physical presence in the jurisdiction and would reallocate an estimated $100 billion of corporate income tax on residual profits away from residence jurisdictions to source/market jurisdictions.

The proposals face political headwinds from the United States which has suggested that the rules be applied on an opt-in basis – the United States is no doubt concerned about the potential impact on a number of U.S. digital giants. Conversely, the European Union has generally been very supportive of the proposals. A number of E.U. countries have separately introduced stand-alone domestic digital taxes (with more threatening to do so absent a consensus on Pillar One).

The Pillar Two proposals introduce a global minimum tax to MNE groups with total consolidated group revenue of at least €750 million.

If the effective tax rate of an MNE group in a certain jurisdiction is below the agreed minimum rate, a top-up tax will generally be collected from group members in other jurisdictions under either an “income inclusion rule” (IIR) or an “undertaxed payments rule” (UTPR). The calculations use financial accounting results as the starting point and take into account losses incurred in other periods or by other entities in the same jurisdiction, “excess” local taxes paid and a formulaic carveout for substantive activities in the local jurisdiction.

Top-up taxes would be collected under the IIR from parent entities resident in jurisdictions that adopt Pillar Two. The UTPR acts as a backstop by allocating any remaining top-up taxes to other group members based on deductible payments made by them to the low-tax entity and their net intra-group expenditures.

The Pillar Two proposals also include exceptions for tax-exempt entities and investment funds, and a treaty-based “subject to tax rule” which can apply a top-up withholding tax on certain types of payments between connected persons.

For more details on the Pillar One and Two proposals, please see our Osler Update entitled “OECD releases blueprint reports on international tax reform (Pillar One and Pillar Two) and launches public consultation” on osler.com.

Significant progress on the technical details regarding both Pillar One and Pillar Two have been made, but many details remain to be resolved and extensive changes to domestic legislation and treaties will also be required. The OECD hopes that the outstanding political and technical issues will be resolved by mid-2021.

Rather than waiting for global consensus, many countries have introduced unilateral digital tax measures (with the United States imposing or threatening trade tariffs in response). In its 2019 election platform, the Liberal Party advocated a 3% tax on Canadian revenues from certain advertising and digital intermediation services with worldwide revenues of at least $1 billion and Canadian revenues of more than $40 million. Although the 2020 Federal Budget was delayed due to COVID-19, the government’s 2020 Throne Speech signaled that making digital giants pay their fair share of tax was a priority. It remains to be seen whether Canada will move ahead prior to seeing how the current OECD negotiations and threatened tariff wars pan out.

We anticipate that Canada will look to introduce new domestic and international tax measures in 2021 and beyond – particularly since our current Liberal minority government is being supported by the left-leaning NDP party. It will be important to follow these measures closely, as they could have a significant impact on domestic and cross-border investments in Canada.

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[1] The MLI may enter into effect at a later date with countries where the MLI has yet to come into effect. In addition, the MLI will not affect Canada’s tax treaties with the United States (which has not signed the MLI), or Germany and Switzerland (with which Canada has announced bilateral treaty negotiations).