New PPT rule in the OECD's Multilateral Instrument to displace Canadian GAAR?

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Canada signed the OECD's Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting (the MLI) on June 7, 2017. Once in effect, the MLI will modify up to 75 of Canada's bilateral tax treaties (referred to as Covered Tax Agreements; a full list is available here). The most significant modification will be to add a broad anti-avoidance rule into these tax treaties, referred to as the principal purpose test or PPT. The ambiguity and uncertainty surrounding the application of the PPT is of significant concern to taxpayers – since it could apply to deny a variety of benefits under many of Canada's tax treaties. This note provides (a) an update on the status of the MLI and the CRA's administration of the PPT stemming from comments made by government officials at the recent Canadian Tax Foundation Conference (CTF Conference), (b) our analysis of the interaction of the PPT and Canada's domestic general anti-avoidance rule (GAAR), and (c) a discussion of an optional provision of the MLI which could increase fairness and provide needed flexibility in the application of the PPT.

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) and optional provisions of the MLI – see our Osler Updates "International Tax Reform 2015 – BEPS Final Report," "Significant tax treaty changes proposed in multilateral convention," and "Canada signs the multilateral tax agreement."

Current status of the MLI

At the CTF Conference, a Department of Finance official noted that the MLI will likely not come into effect for any of Canada's Covered Tax Agreements with respect to withholding taxes until 2019, and for other taxes 2020. The actual coming into effect date will depend on

the timing for completing domestic procedures in both Canada and the jurisdiction of each treaty counterparty. The Canadian implementation procedures are as follows:

(i) the MLI must be tabled for 21 sitting days of Parliament (which has not yet commenced);

(ii) a bill must then be introduced to implement the MLI into Canadian domestic law (the Implementation Bill), which will need to be debated in both the House of Commons and the Senate, with both houses likely sending the Implementation Bill to committee for study;

(iii) the Implementation Bill must be approved by Parliament and receive Royal Assent; and

(iv) an Order in Council is then needed to notify the OECD that the ratification procedures in Canada are complete.

For Covered Tax Agreements, the MLI will enter into *force* on the first day of the month beginning three months after Canada and the relevant treaty partner complete their notifications to the OECD and, it will enter into *effect* 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. To date, only Austria and the Isle of Man have notified the OECD that their ratification procedures are complete.

PPT

The PPT is contained in the MLI's Article 7, "Prevention of Treaty Abuse," which states that a treaty benefit may be denied where it is reasonable to conclude that one of the principal purposes of the arrangement or transaction in question was to gain the benefit unless it is established that granting that benefit would be in accordance with the object and purposes of the relevant provisions of the treaty.

The broad wording of the PPT, together with limited interpretive guidance to date, results in uncertainty as to whether treaty benefits will continue to apply in a variety of situations. To partially address these concerns, the CRA indicated at the CTF Conference that it is considering establishing a centralized committee (similar to the GAAR Committee) which would handle the application of the PPT to transactions undertaken by taxpayers. As with the application of the GAAR, it is helpful for the CRA to administer the PPT in a consistent manner, and with some restraint, particularly following the surge of spending recently on international audits, and the broad manner in which the ambiguous wording of the PPT is potentially capable of being construed.

PPT and GAAR – complementary or mutually exclusive anti-abuse provisions?

The CRA also indicated at the CTF Conference that it may look to apply the PPT and the GAAR (section 245 of the *Income Tax Act* (Canada) (ITA)), as alternative assessing positions. This is an unhelpful position, as alternative assessments based on separate broad anti-avoidance rules could substantially, and unnecessarily, increase uncertainty and litigation costs. Moreover, it is particularly concerning given the judicial update delivered by Chief Justice Rossiter at the CTF Conference on the significant lack of resources available to the Tax Court of Canada.

Despite the CRA's comments, it appears unnecessary for the CRA to ever assess a taxpayer under both the PPT and GAAR (where the GAAR challenge is based on a misuse or abuse of a treaty provision). For any transaction undertaken by a taxpayer, the Canadian tax

consequences must first be determined under the ITA. For example, where a Canadian corporation pays a dividend to a non-resident the ITA generally applies withholding tax at a rate of 25%. Next, the taxpayer must determine whether any benefit applies under an applicable tax treaty (such as whether the withholding tax rate on dividends is reduced). If the PPT applies, then the taxpayer would not be entitled to a treaty benefit (e.g., the withholding tax rate would remain at 25%).

The GAAR may apply to any tax benefit provided under a tax treaty, as per section 4.1 of the *Income Tax Conventions Interpretation Act.* However, if the PPT applies to a transaction then there would be no benefit provided under the relevant tax treaty and GAAR would not apply. On the other hand, GAAR could potentially apply if the PPT does not apply. However, GAAR should not apply in such a situation. If the PPT does not apply on the basis that none of the principal purposes of the transaction were to obtain the tax benefit then GAAR should not apply on the basis that there is no "avoidance transaction" (i.e., that the transaction was undertaken primarily for *bona fide* purposes other than to obtain the benefit). Similarly, if the PPT does not apply on the basis that obtaining the tax benefit was within the object and purpose of the relevant tax treaty then GAAR should not apply on the basis that there was no misuse or abuse. As a result, if the CRA were to reassess a taxpayer based on the potential application of the PPT, there would not appear to be any reason for the CRA to also reassess the taxpayer under GAAR.

Mitigating the impact of the PPT's all-or-nothing approach

If the PPT applies to a treaty benefit, it will deny the benefit in its entirety; there is no mechanism for denying benefits only to the extent reasonable in the circumstances, or based on some other limiting factor. There is, however, a mechanism in the MLI that Canada could adopt to provide an alternative to this all-or-nothing approach.

Each signatory to the MLI has agreed to implement the PPT as part of its compliance with the BEPS minimum standards. The MLI also contains various optional provisions that are not minimum standards. Canada has provisionally reserved on all optional provisions – other than with respect to arbitration (a full list of Canada's provisional positions on the MLI is available here) – and is currently assessing which reservations it may reverse prior to ratification. We strongly recommend that Canada reverse its reservation on Article 7(4) of the MLI. Under Article 7(4) a taxpayer may be entitled to a treaty benefit (or another treaty benefit) that would otherwise be denied under the PPT if the relevant competent authority determines that the particular treaty benefit would have arisen in the absence of the relevant transaction (after consulting with the competent authority of the other jurisdiction).

Article 7(4) is important because it allows a taxpayer to receive full or partial treaty benefits in circumstances where the competent authority agrees that it would be inappropriate to fully deny benefits under the PPT. This is particularly important for treaty benefits sought in respect of investments made by or through collective investment vehicles (such as private equity funds) – which the OECD has noted are not adequately addressed through the PPT. For example, assume residents of various treaty countries invest into Canada through a holding company established in a treaty country by a private equity fund. Under the applicable treaty between that country and Canada, a 5% rate of Canadian withholding tax would apply to dividends paid by a Canadian corporation to the holding company. If the PPT were to otherwise apply to deny all treaty benefits to the holding company, such dividends would generally be subject to a 25% withholding tax rate. However, Article 7(4) would allow the applicable withholding tax rate to be reduced to 5% or 15% if the CRA determines that such a reduced withholding tax rate would have applied if the relevant investors had invested into the Canadian corporation directly.

The result under Article 7(4) appears to be more consistent with the result that would have

applied under GAAR. Specifically, if GAAR had applied, rather than the PPT, the resulting tax consequences are determined in a manner that is reasonable in the circumstances – which includes a consideration of the tax consequences that would have arisen in the absence of the relevant avoidance transaction. In the example above, if the reasonable alternative transaction would have been for the investors to invest directly into the Canadian corporation, then a reduced rate of withholding may nevertheless have applied. While it may well be that the PPT would not apply in such a circumstance, Article 7(4) would allow more flexibility to ensure a fair tax result in which full or partial treaty benefits are allowed – particularly in circumstances where such a result would have arisen based on an application of GAAR. Reversing Canada's reservation on Article 7(4) would make possible a more fair and proportionate result, and should assist in resolving tax disputes before they reach the limited resources of the judiciary.

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