Changes to Canada’s International Tax Treaty Landscape: Enactment of the Multilateral Instrument in Canada

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On June 21, 2019, Bill C-82, *An Act to implement a multilateral convention to implement tax treaty related measures to prevent base erosion and profit shifting*, received royal assent in Canada. Bill C-82 ratifies the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting (the “MLI”), which was developed as part of an initiative of the Organisation for Economic Co-operation and Development (the “OECD”). Canada signed onto the MLI two years earlier, on June 7, 2017. Canada is one of nearly 100 countries that are signatories to the MLI.

Following royal assent, all that remains for the MLI to be incorporated into Canadian law is for Canada to issue an Order in Council notifying the OECD of Canada’s completion of its ratification procedures. The MLI will enter into force in Canada on the first day of the month commencing three months after Canada deposits its notification of ratification with the OECD. For withholding taxes, the MLI will come into effect for applicable tax treaties on the first day of the next calendar year after the MLI enters into force (*i.e.*, January 1, 2020). In terms of all other taxes, the MLI comes into effect for applicable tax treaties for taxable periods beginning on or after a six-month period after the MLI enters into force (*i.e.*, January 1, 2021 for taxpayers with a December 31 year end).

The MLI does not amend Canada’s bilateral tax treaties. Instead, the MLI alters the effect and interpretation of the preamble and certain provisions in those treaties which Canada chooses to “cover” (*i.e.*, subject to the MLI), on a treaty-by-treaty basis. Upon signing the MLI, Canada gave notice that 75 out of 94 bilateral tax treaties would be covered treaties ("Covered Tax Agreements") and open to modification by the MLI, although Canada indicated that bilateral treaties with certain additional countries may potentially be covered by the MLI at a future date. Although the large majority of Canada’s treaties will be open to becoming Covered Tax Agreements, the MLI will not come into effect for a particular treaty until Canada’s treaty partner has also deposited its instrument of ratification, acceptance or approval with the OECD. The impact of the MLI on Covered Tax Agreements will depend on which articles are reserved by Canada and its treaty partners. Only those articles that both treaty partners do not reserve against will apply to the Covered Tax Agreement. Where either Canada or its treaty partner reserves against a particular optional provision, that article will not alter the effect of the underlying tax treaty.

Mandatory and Optional Provisions

Certain provisions of the MLI are mandatory, whereas others are optional. The mandatory provisions include certain preamble language, as well as provisions dealing with the prevention of treaty abuse and the mutual agreement procedure ("MAP"). The preamble consists of a declaration against the creation of opportunities for non-taxation and reduced taxation, including treaty-shopping arrangements, and will apply to all treaties where substantially similar language is not already present.

Addressing perceived treaty abuse was one of the focuses of the OECD initiative that gave rise to the OECD. All signatories to the MLI will be required to adopt a principal purpose test (“PPT”) intended to curb perceived treaty abuse, with the possible addition of a simplified Limitation on Benefits (“LOB”) provision. Alternatively, such jurisdictions will be required to indicate an intent to bilaterally negotiate a detailed LOB test into their bilateral tax treaty.

The PPT reflects a contextual approach influenced by the mandatory preamble language. Canada has chosen to adopt the PPT without the simplified LOB test, rather than negotiate detailed LOBs. However, Canada also indicated that it may negotiate detailed LOBs in the future. The PPT states:

> Notwithstanding any provisions of a Covered Tax Agreement, a benefit under the Covered Tax Agreement shall not be granted in respect of an item of income or capital if it is reasonable to conclude, having regard to all relevant facts and circumstances, that obtaining that benefit was one of the principal purposes of any arrangement or transaction that resulted directly or indirectly in that benefit, unless it is established that granting that benefit in these circumstances would be in accordance with the object and purpose of the relevant provisions of the Covered Tax Agreement.[1]

Canada has also chosen to allow a saving provision whereby its competent authority may determine whether a benefit should be granted despite its denial under the PPT, in consultation with the competent authority of Canada’s treaty partner.

The MAP requires contracting jurisdictions to ensure that persons may present their case to the appropriate tax authority where they believe they have been taxed in a manner not reflected by the Covered Tax Agreement. There is also an optional provision for mandatory binding arbitration which will be applied to approximately 20 of Canada’s treaties.

The remaining provisions of the MLI are optional. At the time of royal assent of Bill C-82, Canada has broadly reserved against most of the MLI’s articles, except for four optional articles. The four optional provisions of the MLI that Canada has indicated it will adopt include:

- A tie-breaker rule for dual-resident entities;
- A minimum one-year holding period test to access treaty-based withholding tax reductions on dividends received by corporations in which a significant interest is held;
- A one-year lookback test to determine whether capital gains on a sale of equity interests derive their value principally from immovable property for purposes of a Covered Tax Agreement; and
- A double tax relief provision.

Additional reservations may be withdrawn as further analysis is undertaken.

The Interaction of the GAAR and the PPT

The PPT represents a noteworthy change to the Canadian tax treaty landscape. This may significantly impact the use of international holding and investment entities for investments into and out of Canada.

While substantial uncertainty remains regarding the interaction and application of the PPT and Canada's domestic general anti-avoidance rule (the "GAAR"), the Canada Revenue Agency has recently indicated that it will apply the PPT first, followed by the GAAR. Concerns remain whether the PPT and the GAAR will lead to differing conclusions. While similar in certain respects, there are certain key differences in the language of both tests.

Impact of the MLI on International Tax Structures

There have been ongoing concerns that the MLI may deter investment into Canada due to resulting uncertainty and risk of additional tax. Private equity firms and global organizations investing in the Canadian natural resource and real estate industries may face difficulties with the PPT, particularly where they seek to employ international structures which utilize the exemptions and benefits contained in Canada's bilateral tax treaties. While these structures have been found to be non-abusive by Canadian courts under the GAAR, the language of the preamble together with the PPT creates uncertainty with such structures and may constraint future planning. Also, there are no grandfathering provisions to relieve structures created before the MLI comes into effect.

Conclusion

Although the MLI is just now coming into force, its effect will continue to expand and reverberate throughout the international tax community for many years to come. The PPT should be considered in respect of existing structures, as well as future planning. Multinational organizations and private equity firms should consider the effects that the MLI may have on their investments.

For further information about any of the foregoing, or any related matters, please contact Julie D'Avignon, Kevin Guenther or another member of the Stikeman Elliott Tax Group.

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[1] "Multilateral Convention To Implement Tax Treaty Related Measures To Prevent Base Erosion And Profit Shifting" (2016) at 8, online (pdf): *Organisation for Economic Co-operation and Development* <www.oecd.org/tax/treaties/multilateral-convention-to-implement-tax-treaty-related-measures-to-prevent-BEPS.pdf >.