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Recent Developments in International Taxation

Canada

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Overview

In recent years, Canada has demonstrated a commitment to international tax reform, targeting high-net-worth individuals and large corporations, and confronting aggressive tax planning. Canada's Department of Finance ('Finance') continued this trend with the most recent Federal Budget, released on 16 April 2024 ('Budget 2024'), which introduced significant changes to Canada's Income Tax Act (the 'Tax Act'). The highlights of Budget 2024 include:

- a proposed increase to the capital gains inclusion rate from one-half to two-thirds;
- proposed measures to implement the new Crypto-Asset Reporting Framework developed by the Organisation for Economic Co-operation and Development's (OECD);
- a proposed expansion of the waiver regime for eligible non-resident service providers;
- further changes to the alternative minimum tax (AMT) for high-income individuals, following significant changes that were proposed in the 2023 Canadian Federal Budget ('Budget 2023'); and
- proposed amendments to the Tax Act to ensure compliance with requests for information by Canada's tax authority, the Canada Revenue Agency (CRA).

In addition to these newly announced changes, in Budget 2024, Finance confirmed Canada's intention to proceed with previously announced measures, including (among others) the digital services tax, the global minimum tax (Pillar Two), the excessive interest and financing expenses limitation rules (EIFEL), and the 'modernisation' of the General Anti-Avoidance Rule (GAAR).

On 2 May 2024, draft legislation to implement certain provisions of Budget 2024 was tabled by the Canadian government ('Bill C-69'). These new measures follow the implementation of best practices for mandatory disclosure from the OECD/G20 Inclusive Framework on Base Erosion and Profit Shifting (BEPS) in 2023.

From the abundance of new legislation that has been proposed and enacted in Canada in the last few years, this report will provide an update on select recent developments in Canadian income tax, with a focus on international taxation and aggressive tax planning.

Capital gains inclusion rate

The announcement in Budget 2024 that has generated the most discussion among tax professionals and the Canadian media is the proposed increase to the capital gains inclusion rate from one-half to two-thirds. Individuals would still benefit from the one-half inclusion rate in respect of the first CAD$250,000 of capital gain realised in any given year, while corporations and trusts will be subject to the two-thirds rate in respect of an entire capital gain. The proposed increase applies to capital gains realised on or after 25 June 2024.

Capital gains on the sale of principal residences will remain tax-free; however, capital gains on other capital properties (eg, secondary personal-use properties and marketable securities) would be subject to the increased rate. There are no special rules for capital gains deemed to be realised on an individual's death or departure from Canada.

Finance's position in Budget 2024 was that the increased rate will only affect 0.13 per cent of Canadians; however, the general consensus among the tax community is that it will have a much wider and more profound impact. At the time of writing, Finance has not released draft legislation to implement the change and it is possible that the 25 June 2024 date will be postponed.

Crypto-Asset Reporting Framework and the Common Reporting Standard

In 2022, the OECD approved a new Crypto-Asset Reporting Framework (CARF). Because crypto-assets can be transferred or held without interacting with traditional financial intermediaries, they can escape the reporting obligations imposed on financial institutions under the Common Reporting Standard (CRS). To ensure appropriate reporting, the CARF provides for the automatic exchange of tax information in relation to transactions in crypto-assets. In November 2023, Canada released a joint statement with several other jurisdictions to integrate CARF into domestic law and activate exchange of information agreements in time for exchanges to commence by 2027.

Accordingly, Budget 2024 proposed the implementation of the CARF by imposing an annual reporting requirement on Canadian resident entities and individuals, or those that carry on business in Canada, and that provide business services effectuating exchange transactions in crypto-assets (each a Crypto Asset Service Provider or CASP). CASPs would be required to report to the CRA, in respect of each customer and crypto-asset, the annual value of exchanges between crypto-assets and fiat currencies, exchanges for other crypto-assets, and transfers of crypto-assets (including where a CASP processes payments on behalf of a merchant in transactions with a value in excess of US$50,000).

CASPs will also be required to obtain and report personal information on each of their customers, including the customer's name, address, date of birth, residence and taxpayer identification number. If a customer is a corporation or other legal entity, the same information would need to be collected and reported in respect of the natural person or persons who exercise control over the entity.

Budget 2024 also proposed the broadening of the scope of the CRS to include specified electronic money products and central bank digital currencies not covered by the CARF, and require additional information reporting for financial accounts and account holders. Additional changes to the CRS include the removal of labour-sponsored venture capital corporations from the list of non-reporting financial institutions and an amendment to the anti-avoidance provision to clarify that it applies when it can reasonably be considered that the primary purpose of a person entering into an arrangement or practice is to avoid an obligation of any person under the CRS.

These measures would come into effect in 2026, with the first exchange of information expected to take place in 2027.

Withholding for non-resident service providers

In a welcome change, Budget 2024 proposed to expand the waiver regime for the withholding tax required on payments made to non-residents for services rendered in Canada. Under the current regime, any person in Canada is required to withhold and remit to the CRA 15 per cent of a payment made to a non-resident for services rendered in Canada, representing a prepayment of tax

on behalf of the non-resident. Many such non-residents do not ultimately owe Canadian tax either because they are exempt from tax on the income under an applicable tax treaty or the income is exempt income domestically. Currently, eligible non-resident service providers may apply to the CRA for an advance waiver of the 15 per cent withholding for a *specific* planned transaction or seek a refund of overpaid tax by filing an income tax return. Finance has proposed a new measure that would give the CRA the ability to waive withholding on *multiple* transactions with a single waiver if, inter alia, the non-resident is not subject to tax in Canada in respect of the payments pursuant to the terms of an applicable income tax treaty, or the income is exempt income from international shipping or from operating an aircraft in international traffic. This measure would come into force on Royal Assent of the enacting legislation.

AMT

Canada's AMT is an alternative tax intended to target high-income individuals in Canada. It applies to a taxpayer's adjusted taxable income (ATI), which is computed with fewer deductions, exemptions and tax credits than the ordinary income tax rules provide. In its current form, the AMT applies at a rate of 15 per cent if the amount of tax calculated using the AMT is higher than ordinary income tax. In Budget 2023, Finance proposed a number of changes to the existing AMT regime to better target high-net-worth individuals, including an increase to the AMT rate from 15 per cent to 20.5 per cent, and changes to the calculation of a taxpayer's ATI. Some of these changes include:

- an increase in the AMT capital gains inclusion rate from 80 per cent to 100 per cent;
- a decrease in the AMT capital loss carry-forwards inclusion rate from 80 per cent to 50 per cent;
- the inclusion of 100 per cent of the benefit associated with employee stock options;
- the disallowance of 50 per cent of certain deductions, including the following: employment expenses (other than to earn commission income); deductions for Canada Pension Plan (CPP), Quebec Pension Plan (QPP) and provincial parental insurance plan (PPIP) contributions; moving expenses; childcare expenses; interest and carrying charges incurred to earn income from property; and non-capital loss carry-overs; and
- an increase to the AMT exemption amount (which is a deduction available to all individuals) from CAD$40,000 to approximately CAD$173,000 (indexed for inflation).

Further changes to the AMT were proposed in Budget 2024, including allowing individuals to claim 80 per cent (instead of the previously proposed 50 per cent under Budget 2023) of the charitable donation tax credit when calculating the AMT and allowing certain disallowed credits under the AMT to be eligible for the AMT carry-forward.

Ensuring compliance with CRA requests

The CRA has broad powers to request information and documents related to the administration or enforcement of the Tax Act (subject to certain rules, including those applicable to information

accessible outside Canada). Where requests for certain information are not complied with, the CRA can initiate proceedings in the Federal Court of Canada to force compliance. If the Court grants a compliance order and that order is not complied with, the violation is a contempt of court, which can be punished by jail time.

Finance perceives the use of requests for information and court-ordered compliance orders as ineffective because, in its view, there is generally no material cost to the non-compliant taxpayer. In response, Budget 2024 proposed amendments to allow the CRA to issue a 'notice of non-compliance' where a person fails to comply with a CRA request or requirement to provide information or documents. This notice would be accompanied by a penalty of CAD$50 for each day it remains outstanding (to a maximum of CAD$25,000). Where the CRA obtains a compliance order, a new penalty would apply equal to ten per cent of the aggregate tax payable by the taxpayer in respect of the taxation years to which the compliance order relates if the amount of such tax owing exceeds CAD$50,000. Budget 2024 also proposed the expansion of these rules to apply in respect of requirements to provide foreign-based information or documents.

Digital services tax and global minimum tax

In Budget 2024, 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 December 2021, Finance released the draft Digital Services Tax Act (DSTA), pursuant to which Canada's DST would apply at a rate of three per cent on revenue from specified digital services that rely on user participation to create value.

On 12 July 2023, the OECD announced that 138 members agreed to postpone the implementation of any domestic DSTs until 31 December 2024. On the same day, Canada refused this moratorium, announcing that it will move forward with the DSTA starting 1 January 2024. At the time of writing, the DSTA has not come into force, though Canada's intention to proceed with the legislation was reaffirmed in Budget 2024. Once enacted, the DST will retroactively apply to revenue earned as of 1 January 2022.

The second pillar of the BEPS plan is a global minimum tax for large multinational enterprises (MNEs) with annual revenue of €750m or more. In February 2023, the OECD released the global anti-base erosion ('GloBE') model rules. In August 2023, Finance released a draft of the Global Minimum Tax Act (GMTA) and a Table of Concordance to cross reference the proposed GMTA provisions with source documents from the GloBE model rules. Following consultations with stakeholders in autumn 2023, Finance introduced a revised version of the GMTA as part of Bill C-69.

At a high-level, the GMTA imposes a 15 per cent global minimum tax on the income of qualifying MNE groups. A qualifying MNE group must meet two conditions: (1) have an entity or permanent establishment in more than one jurisdiction; and (2) have consolidated revenue of €750m or more in at least two of the four fiscal years immediately preceding the particular fiscal year. There are exclusions for government entities, international organisations, non-profit organisations, 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 GMTA is set to apply to fiscal years of qualifying MNEs beginning on or after 31 December 2023.

The GMTA borrows two key measures from the GloBE model rules: an income inclusion rule and a qualified domestic minimum top-up tax. Canada has not yet introduced draft legislation relating to the undertaxed profits rule from the GloBE model rules, and did not provide any specific update on this in Budget 2024.

EIFEL

In the 2021 Canadian Federal Budget, 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 G7 and European Union. The original draft legislation and explanatory notes were released in February 2022 and have undergone several revisions since. The latest revised draft legislation was included in the Fall Economic Statement Implementation Act, 2023 ('Bill C-59') tabled by Parliament on 30 November 2023.

At a high-level, the proposed EIFEL rules limit deductible net interest expense to a fixed ratio of 'tax earnings before interest, tax, depreciation and amortisation (EBITDA)' (taxable income before interest expense, interest income, income tax, and deductions for depreciation and amortisation). The interest barrier will be phased in, with the limit being 40 per cent of tax EBITDA for taxation years beginning on or after 1 October 2023 and 30 per cent of tax EBITDA for taxation years beginning on or after 1 January 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 CA$50m and taxpayers or a group of taxpayers where the Canadian members have total interest and financing expenses (net of interest and financing revenue) of CA$1m or less. There is also a *de minimis* exemption for Canadian-resident corporations and trusts provided that such entities and their groups' foreign affiliate holdings do not exceed CA$5m (in addition to other criteria). The version of the EIFEL rules in Bill C-59 provide that the only amount to be considered in applying the *de minimis* threshold is the proportionate share of the value of a foreign affiliate of a particular taxpayer or its group.

Budget 2024 proposed the inclusion of a new elective exemption from the EIFEL rules for interest and financing expenses in respect of arm's-length financing used to build or acquire eligible purpose-built rental housing in Canada that are incurred before 1 January 2036. This remedial measure accompanied other incentives in Budget 2024 for the rental-housing market including a temporary enhancement to the Goods and Services Tax New Residential Rental Property Rebate and accelerated capital cost allowance for purpose-built rental housing.

There are otherwise limited sector-specific exceptions from the EIFEL rules, though taxpayers that are highly leveraged by virtue of their industry may have 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. In the version of the draft legislation released in August 2023, Finance also introduced a ten per cent 'uplift' to the group ratio, which Finance stated in the explanatory notes is intended to account for book-tax timing differences between group members and is consistent with recommendations in the BEPS Action 4 Report.

GAAR

The Tax Act includes a GAAR as a tool to prevent abusive tax avoidance. The GAAR denies tax benefits flowing from transactions that are technically compliant with the provisions of the Tax Act (or related enactment, including a tax treaty), 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 act or related enactment.

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, the CRA has had mixed success in having GAAR assessments upheld by Canadian courts, which 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 its 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 scepticism 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.*

In Budget 2023, Finance announced 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 would change the 'avoidance transaction' definition from a transaction not undertaken primarily 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;

- the introduction of a penalty where the GAAR applies; and

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

Since Budget 2023, draft legislation to implement the new GAAR has been revised, with the most recent version included in Bill C-59. This version includes the foregoing amendments.

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 recharacterise a taxpayer's bona fide legal relationships, absent a specific provision in the Tax Act to the contrary or a finding that they are a sham. Prior proposed language for the new GAAR included a *presumption* of misuse where a transaction lacked economic substance. The version in Bill C-59 provides that: 'If an avoidance transaction – or a series of transactions that includes the avoidance transaction – is significantly lacking in economic substance, this is an important consideration that tends to indicate that the transaction results in a misuse.'

While preferable to a presumption, this still very specifically requires a consideration of economic substance when applying the GAAR, which is likely to upend existing jurisprudence. Bill C-59 includes a non-exhaustive list of factors that will 'establish' a transaction or series is significantly lacking in economic substance:

- where all or substantially all of the opportunity for gain or profit and risk of loss remains unchanged for the taxpayer or in a group of non-arm's length taxpayers (eg, through a circular flow of funds, offsetting financial positions, the timing between steps in a series or an accommodation party);

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

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

Where the new GAAR applies, a taxpayer may be subject to a penalty equal to 25 per cent 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, and the reassessment period will be extended by three years. The penalty will not apply where the transaction was disclosed under the mandatory disclosure rules discussed below or where it was reasonable to conclude at the time of entering into the transaction that the GAAR would not apply to the transaction or series because it was 'identical or almost identical' to a transaction or series that was the subject of published administrative guidance from the Minister of National Revenue (the 'Minister') or one or more court decisions.

Once the new GAAR becomes law (ie, receives Royal Assent), it will apply retroactively to transactions occurring on or after 1 January 2024. The new preamble and penalty, however, will apply to transactions occurring on or after the date of Royal Assent.

Mandatory disclosure rules

Following several public consultations and revisions to draft legislation, on 22 June 2023, Canada's new mandatory disclosure rules became law. The new rules are designed to implement best practices from the OECD BEPS Project and Action Plan on mandatory disclosure, and went through several revisions as Finance worked to find an appropriate balance between the desire for transparency, the need for clarity and the effectiveness of the rules in identifying truly objectionable schemes. The new mandatory disclosure rules include the following three regimes.

Reportable Transaction Rules

The new rules expand the existing regime for 'reportable transactions' to lower the threshold for when reporting will be required, applicable to transactions entered into after 22 June 2023. Where a transaction is an 'avoidance transaction' and one of three generic hallmarks is present, an information return to report the transaction must be filed (under the previous regime, two generic hallmarks were required and the definition of 'avoidance transaction' was narrower). An avoidance transaction exists where it can reasonably be considered that one of the main purposes of the transaction (or of a series of transactions of which the transaction is a part) is to obtain a tax benefit. The three generic hallmarks are:

- where a promoter or adviser (or any person that does not deal at arm's length with the promoter or adviser) is entitled to a contingent fee based on or contingent on the amount of the tax benefit that results from the transaction or attributable to the number of participants;

- where an adviser or promoter (or any person that does not deal at arm's length with the promoter or adviser) obtains confidential protection; that is, where there is an agreement to prohibit disclosure of the details of the structure that gives rise to tax benefits to any person or the tax authorities; and

- where the taxpayer or transaction participant, or an adviser or promoter, obtains contractual protection that is:

    - a form of insurance, protection, indemnity, compensation or guarantee that protects against the failure to achieve tax benefits or pays or reimburses fees, expenses, taxes, interest and penalties in the course of a dispute of the tax benefit; and

    - any form of undertaking provided by a promoter (or any person that does not deal at arm's length with the promoter or adviser) to assist a person in the course of a dispute in respect of a tax benefit from the transaction or series.

As the mandatory disclosure rules went through rounds of consultation and revision, there was much discussion and concern in the tax community and among corporate counsel about their scope. The CRA has since published guidance in which it describes certain transactions that should not be subject to mandatory disclosure rules, including transactions that involve standard tax indemnities, which has provided some comfort to practitioners.

Notifiable transaction rules

The new rules introduce a new regime for 'notifiable transactions'. An information return must be filed in respect of certain transactions and substantially similar transactions that the Minister (with the concurrence of Finance) designates as objectionable or offensive. The following transactions and series of transactions have been designated to date:

- straddle loss transactions using a partnership;
- transactions to avoid Canada's 21-year deemed realisation rule for a trust;
- the manipulation of bankrupt status to reduce a forgiven amount in respect of a commercial obligation;
- transactions undertaken to avoid a deemed acquisition of control; and
- back-to-back arrangements intended to circumvent the thin capitalisation rules or part XIII tax.

The scope of the notifiable transaction regime is significantly broad, as a notifiable transaction includes a transaction that is 'substantially similar' to one that is designated.

Reporting for both reportable and notifiable transactions

There is a prescribed information return to report a reportable or notifiable transaction (or series). The return requests a detailed description of the transaction or series; the parties to the transaction or series; information related to the promoters or advisers of the transaction or series; and information related to the nature and quantum of the tax benefit that arises. The return must be filed by every person for whom a tax benefit results, every person who entered into the transaction or series for the benefit of that person, and every adviser or promoter (or non-arm's length person thereto) who is or was entitled to a contingent fee or a fee in respect of contractual protection. Filing by one person does not relieve the filing obligation of others.

Rules for uncertain tax treatments

New rules were introduced to require certain corporations to disclose tax treatments in respect of which uncertainty is reflected in their financial statements for the year. These rules only apply to corporations that meet the following criteria:

- the corporation has audited financial statements prepared in accordance with International Financial Reporting Standards (IFRS) or other country-specific generally accepted accounting principles (GAAP) relevant for corporations that are listed on a stock exchange outside Canada;
- the carrying value of the corporation's assets is greater than or equal to CAD$50m at the end of the year; and
- the corporation is required to file a return of income for the year

Where there is non-compliance with the new rules for reportable transactions, notifiable transactions and uncertain tax treatments, penalties and extended limitation periods will apply (subject to defences for due diligence).

Conclusion

In the past few years, significant changes to the Tax Act have been proposed and enacted. In the context of international tax reform, targeting high-net-worth individuals and large corporations, and confronting aggressive tax planning, 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.