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Legal update

Canada proposes to adopt BEPS recommendations

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Tax

Canada has been an active participant in the base erosion and profit shifting project, a project of the Organisation for Economic Co-operation and Development (OECD) and the G20, for a number of years and has generally supported the OECD's action plan on base erosion and profit shifting. As defined by the OECD, base erosion and profit shifting (BEPS) generally refers to tax planning strategies that exploit gaps and mismatches in national tax laws to shift profits to low- or no-tax locations where there is little or no economic activity.

The March 22, 2016, Canadian federal budget (Budget 2016) contained a number of proposed tax measures to adopt certain recommendations arising out of the BEPS project.

This legal update discusses the BEPS proposals and identifies action items and key insights arising from Budget 2016. Companies should take steps to understand the impact of these proposals on their business and develop action plans to ensure compliance with the proposals.

Overview of BEPS and international tax reform

On October 5, 2015, the OECD released its final reports relating to the BEPS project (the Final Reports), which outline the OECD's recommendations and the participant countries' consensus for addressing each of the 15 specific actions identified in the OECD's July 19, 2013, *Action Plan on Base Erosion and Profit Shifting*. Following the release of the Final Reports, many countries expressed a willingness to follow the OECD's recommendations. The G20 and OECD countries have also agreed to work toward a consistent and coordinated implementation of the BEPS recommendations.

Budget 2016 confirms Canada's intention to move forward with certain recommendations contained in the Final Reports and, in particular, certain recommendations in the Final Reports for:

- *Preventing the Granting of Treaty Benefits in Inappropriate Circumstances – Action 6* (the Action 6 Final Report); and

- *Transfer Pricing Documentation and Country-by-Country Reporting – Action 13* (the Action 13 Final Report),

relating to country-by-country (CbC) reporting for large multinational enterprises (MNEs), applying revised guidance on transfer pricing, adopting treaty-based measures to address perceived treaty-shopping, and undertaking the spontaneous exchange of tax rulings with other tax administrators.

Introduction of country-by-country reporting

The Action 13 Final Report confirmed the OECD's recommendations that countries adopt the following three-tiered standardized approach to transfer pricing for large MNEs.

- First, a master file is to be maintained that contains an overview of the MNE group business, including the nature of the global business operations, its overall transfer pricing policies and its global allocation of income and economic activity. The master file is intended to provide a blueprint of the MNE group and be available to all relevant country tax administrations.

- Second, a local file containing detailed information about intercompany transactions and transfer pricing positions is to be maintained in the jurisdiction where each entity operates. The local file is intended to focus on information that is relevant to the transfer pricing analysis relating to intercompany transactions between the local entity and entities in other jurisdictions.

- Third, a CbC report is to be filed in the jurisdiction where the ultimate parent of the MNE is located containing information relating to the global allocation, by jurisdiction where the MNE group operates, of certain key indicators of economic activity such as income, profit, taxes paid, accumulated earnings, stated capital, number of employees, activities and tangible assets. The CbC report is intended to be automatically exchanged with the tax administrators in each jurisdiction in which the MNE group conducts business.

The Action 13 Final Report included an implementation package containing model legislation relating to CbC reporting, three model competent authority agreements to facilitate the exchange of CbC reports and a common template for the CbC report. The Final Report on Action 13 also recommended that domestic legislation require the master file and the local file to be filed directly with the local tax administrators and the ultimate parent of the MNE group be required to file the CbC report in its jurisdiction of residence.

Budget 2016 proposes that Canada will implement CbC reporting for Canadian MNEs with total annual consolidated group revenue of EUR 750 million or more. While many countries have adopted the recommended threshold of EUR 750 million or more, a number of countries have proposed using a local currency threshold for CbC reporting. For example, in Australia the reporting threshold is AUD 1 billion and in the United States it is proposed to be USD 850 million. Using different currencies for CbC reporting could lead to different global CbC reporting obligations for MNEs based on currency fluctuations.

Consistent with the BEPS recommendations, CbC reporting will be required by Canadian MNEs for taxation years that begin after 2015, with the first reports due within one year of the end of the fiscal year to which the report relates (i.e., by December 31, 2017, for MNEs with a December 31, 2016, fiscal year end). Once filed, the CbC reports will be automatically exchanged with other jurisdictions where the MNE operates provided: (i) the other jurisdiction has implemented CbC reporting; (ii) the other jurisdiction has a legal framework in place with Canada for the automatic exchange of information; and (iii) there is a competent authority agreement relating to CbC reporting in place between Canada and the other jurisdiction. Budget 2016 also indicates that the first exchanges between governments of CbC reports are expected to occur by June 2018 and the government intends to enter into agreements with each jurisdiction on the exchange of CbC report information.

Budget 2016 also indicates that, in certain circumstances, Canadian CbC reporting may be required by a Canadian subsidiary if the foreign parent entity is not subject to CbC reporting in its home jurisdiction or if Canada is unable to obtain the CbC report of the parent entity through an automatic exchange of information. Budget 2016 suggests an MNE may avoid having this filing requirement imposed on multiple subsidiaries in multiple jurisdictions by designating one of its subsidiaries to be a "surrogate" for filing purposes. If the surrogate is located in a jurisdiction that has implemented CbC reporting, the surrogate could file the CbC report on behalf of the MNE group.

Budget 2016 did not include draft legislation relating to these proposals, but the government indicated that draft legislation will be released for comment in the coming months. While indicators in Budget 2016 are that Canada's CbC rules will be consistent with the recommendations in the Action 13 Final Report, it remains to be seen whether the draft

legislation will follow the model legislation included with the Action 13 Final Report or whether specific Canadian nuances are adopted in the legislation, including enforcement mechanisms and potential penalties for failure to file.

Canada is not alone in adopting CbC reporting; France, Ireland, the Netherlands, Australia, the United Kingdom and the United States have introduced domestic legislation to require CbC reporting for large MNEs. However, CbC reporting is likely to be required in Canada one year earlier than in the United States as the US proposed regulations are expected to apply to taxable years beginning on or after the date of the publication of the US Treasury decision adopting the final regulations. Since the US regulations are expected to be published sometime in 2016, taxpayers in the United States with a calendar year end are expected to have their first CbC reporting requirement for US purposes for the year ending December 31, 2017, rather than December 31, 2016.

In addition to timing requirements, there are expected to be other differences in the CbC regimes across jurisdictions. In particular, while the OECD CbC reporting requirements are private to tax authorities, the European Commission has developed a proposal that is in addition to the OECD CbC reporting and will require public disclosure of certain CbC data. If such proposal is passed, it will require filing of certain CbC data points with the relevant business register and made available on a company's website for five years.

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- The introduction of CbC reporting will likely lead to an increase in compliance costs in Canada and around the world for MNEs. The use of different currencies by different jurisdictions could also lead to inconsistent reporting obligations across countries.
- MNEs should evaluate their data collection processes and transfer pricing policies to ensure the relevant information is gathered and prepared in a timely manner. If necessary, existing information systems should be upgraded or new processes implemented to enable the required data to be collected and retrieved.
- MNEs should consider the filing requirements of subsidiaries as well as the parent entity since the requirements across jurisdictions will vary and some jurisdictions, like Canada, will require CbC reporting for subsidiaries even if the jurisdiction where the parent entity is located does not require CbC reporting.
- Non-Canadian-based MNEs with Canadian subsidiaries should be mindful of the potential obligation to file a CbC report in Canada for the 2016 taxation year even where there is no obligation to file a CbC report in the jurisdiction of the parent entity for 2016. This is particularly relevant for US-based MNEs given that the US is delaying implementing CbC reporting until one year after Canada and some other jurisdictions. Such MNEs may choose their Canadian subsidiary as a surrogate for filing the CbC report given Canada's extensive network of tax treaties and tax information exchange agreements.
- Depending on how other jurisdictions implement CbC reporting or certain other elements of the Final Reports relating to transfer pricing, it is possible that the BEPS recommendations could lead to an increase in international tax disputes.
- Canadian-based MNEs should consider the possibility that certain information in their CbC reports could be made public by jurisdictions in which it has subsidiaries or branches.

Revised transfer pricing guidance

The arm's length principle generally refers to the principle that the prices at which members of an MNE group transact should reflect the prices that would be agreed to by parties dealing at arm's length. While the arm's length principle is mandated by the *Income Tax Act* (Canada) (the Tax Act) and most of Canada's bilateral tax treaties, the Tax Act does not mandate how the principle is to be applied or interpreted. The Canada Revenue Agency (CRA) and Canadian courts have used the OECD's *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrators* (Guidelines), which provide guidance on applying the arm's length principle in the context of transfer pricing, in applying and interpreting the transfer pricing rules in the Tax Act. However, since the Guidelines were written by tax

administrators, not legislators, Canadian courts have made it clear that the Guidelines are not law in Canada; ultimately, the appropriate transfer price must be determined according to the Tax Act rather than the Guidelines.

The recommendations in the Final Reports included significant revisions to the Guidelines (the Revised Guidelines). According to Budget 2016, the revisions to the Guidelines provide "an improved interpretation of the arm's length principle, and are intended to better ensure alignment of the profits of MNEs with the economic activities generating those profits."

The government's view as set out in Budget 2016 is the Revised Guidelines are generally consistent with the CRA's current interpretation and application of the arm's length principle and are already being applied by the CRA; therefore, current practices in Canada in this regard are not expected to change significantly. Budget 2016 also indicated the CRA will not be adjusting its administrative practices relating to "low value-adding" services and "risk-free and risk-adjusted returns for minimally functional entities" (often referred to as "cash boxes") until the BEPS project follow-up work in these areas is complete.

The announcement that the Revised Guidelines are already being applied by the CRA could have implications for taxpayers in Canada. For example, the comments in Budget 2016 suggest that the CRA may seek to apply the Revised Guidelines retroactively. The Revised Guidelines also adopt a three-tiered standardized approach to transfer pricing for large MNEs, including a master file and a local file in addition to the CbC reports. Budget 2016 is silent on whether Canada intends to adopt the master file and local file requirements or otherwise amend the existing transfer pricing documentation rules in the Tax Act to adopt the requirements set out in the Revised Guidelines.

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- Although the revisions to the OECD Guidelines have been described by the OECD as "clarifying," the revisions may represent a departure from the arm's length principle as it has been understood by the courts and taxpayers.
- The comments in Budget 2016 surrounding the Revised Guidelines may signal the Canadian tax authorities' intention to apply the Revised Guidelines retroactively.
- The real impact of the Revised Guidelines is unlikely to be known until the CRA's audit and assessing practices are adjudicated by the courts, but it is possible that this could lead to an increase in transfer pricing disputes.
- Further clarity from the CRA will likely be required for taxpayers to fully understand the impact of the Revised Guidelines on their business and structure.

Treaty shopping

The BEPS project identified treaty abuse, and in particular treaty shopping, as one of the most important sources of BEPS concerns. Separate from the OECD developments on measures to prevent treaty shopping, Canada's 2014 federal budget had proposed adopting a domestic principal purpose test that would have denied treaty benefits where the principal purpose of a transaction was to obtain those benefits.

However, after engaging in consultations on the proposed domestic rule, Canada announced on August 29, 2014, that it would instead await further work from the BEPS project before proceeding with a domestic treaty-shopping rule. Earlier government announcements also contemplated that the domestic treaty-shopping rule would apply to taxation years commencing after the enactment of the rule and the Canadian government was considering whether a transitional relief period would be appropriate to allow taxpayers sufficient time to reorder their affairs.

The Action 6 Final Report included recommendations to combat treaty abuse, including a minimum standard for preventing treaty shopping.

The minimum standard requires countries to include in their tax treaties an express statement that their common intention is to eliminate double taxation without creating opportunities for non-taxation or reduced taxation through tax evasion or avoidance, including treaty-shopping arrangements. Countries can implement the minimum standard in their tax treaties in one of two ways.

The first approach is to adopt a general anti-abuse rule that is based on the principal purpose of transactions or arrangements and would deny treaty benefits where one of the principal purposes of the transactions or arrangements was to secure a benefit under a tax treaty and obtaining that benefit would be contrary to the object and purpose of the relevant provisions of the tax treaty (a principal purpose test). The second approach is to adopt a specific anti-abuse rule that requires satisfying a number of criteria in order to qualify for treaty benefits (a limitation-on-benefits rule).

Budget 2016 confirms the government's commitment to address treaty abuse in accordance with the minimum standard. Canada currently has one tax treaty that has adopted a limitation-on-benefits approach as well as several tax treaties that have adopted a limited principal purpose test approach to prevent treaty shopping. Going forward, Budget 2016 indicates that Canada will consider either minimum standard approach, depending on the particular circumstances and discussions with Canada's tax treaty partners.

Budget 2016 also indicates that Canada's tax treaties may be amended to include a treaty anti-abuse rule through bilateral negotiations, a multilateral instrument that will be developed in 2016, or a combination of the two. The multilateral instrument is a tax treaty that would modify provisions in existing bilateral tax treaties and could be signed by multiple jurisdictions. Using a multilateral instrument will streamline the implementation of the recommendations contained in the Action 6 Final Report relating to treaty abuse.

Budget 2016 does not refer to the domestic treaty-shopping rule that was originally proposed in 2014 and it is not clear whether that proposal has been abandoned or simply sidelined, although it may be inferred from this proposal and other proposals contained in Budget 2016 that the government will not proceed with the domestic rule. Budget 2016 also does not refer to grandfathering of any existing structures or whether a transitional relief period will be available to allow taxpayers sufficient time to reorder their affairs.

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- Although it is not clear when Canada's tax treaties will be amended, any such amendments could have a significant impact on foreign-based multinationals with operations in Canada and Canadian corporations with operations and activities outside Canada, which in many circumstances are structured through international holding entities.
- Taxpayers should carefully review their existing inbound and outbound corporate structures to assess whether the introduction of a principal purpose test or a limitation-on-benefits rule in a relevant tax treaty could result in a denial of treaty benefits that were sought through the structure.

Spontaneous exchange of tax rulings

Budget 2016 confirms the government's intention to implement the BEPS minimum standard for the spontaneous exchange of certain tax rulings that could give rise to BEPS concerns. The Canada Revenue Agency will commence exchanging tax rulings in 2016 with other jurisdictions that have committed to the minimum standard.

The CRA will exchange rulings pursuant to tax treaties, tax information exchange agreements and the multilateral *Convention on Mutual Administrative Assistance in Tax Matters*, each of which generally provides limitations on using the exchanged information to enforce tax laws and have confidentiality provisions to protect the exchanged information in the same manner as taxpayer information is protected in Canada.

Other recommendations

Budget 2016 also confirmed the government is continuing to examine the other recommendations contained in the Final Reports and confirmed Canada is committed to the BEPS project and will continue to work with the international community to ensure a coherent and consistent response to BEPS.

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