GARDINER ROBERTS

October 9, 2017

UPDATE ON CANADA'S IMPLEMENTATION OF THE

OECD'S PLANS TO COMBAT TAX AVOIDANCE

On October 5, 2015, the OECD released fifteen Final Reports on its project entitled, *Base Erosion and Profit Shifting* ("**BEPS**"), intended to "restore confidence in the system (of international taxation) and ensure that profits are taxed where economic activities take place and value is created" (a statement that is present in the foreword to each Report). The OECD's prescription for combatting BEPS is *Transparency* and *Automatic Exchange of Tax Information*. This approach reflects a significant shift in international standards from disclosing mere legal ownership of financial assets to ferreting out the ultimate beneficial ownership.[1]

Common Reporting Standard

The OECD has promulgated a process to combat tax secrecy and tax evasion, and to promote transparency through the automatic exchange of information known as the *Common Reporting Standard* ("**CRS**").[2]

The Canadian Government has taken steps to implement this goal by introducing amendments to the Income Tax Act (Canada)(the "**ITA**"), effective July 1, 2017, to enact the CRS in Canada. [3] The stated purpose is to provide governments with information and tools to combat cross-border tax evasion and aggressive tax avoidance. [4] 101 countries around the world have agreed to implement CRS, which the OECD expects will become the basis for the automatic exchange of financial information among the financial authorities of the participating countries.

A Canadian "**Reporting Financial Institution**" or "**RFI**" must collect information about "**Financial Accounts**" owned by residents of other countries ("**Reportable Persons**"), and must report this information to the CRA. In turn, the CRA will transmit this information to the taxation authority of the country of residence of the account holder. The other countries that implement the CRS will likewise require their financial institutions to collect information about Canadians that will be transferred to the CRA

If the RFI has a Financial Account of a customer, the account is reportable provided the account holder is resident in a participating jurisdiction, or in the case of a so-called passive non-financial entity "**NFE**" it is the "**controlling persons**" who are reported. An active NFE is one that conducts trading, portfolio management or managing financial assets for others. A passive NFE has income primarily from financial assets and is managed by an FI. It would appear that a private trust is a passive NFE, in which case the following persons may be viewed as "controlling" and, therefore, reportable: Settlor, Trustee, Protector, Beneficiary, and any other natural persons exercising ultimate effective control over the trust. While the aim of this definition is expressed to be the protection of the international financial system from misuse, including with respect to tax crimes (in a manner consistent with the recommendations of the Financial Action Task Force), the focus is on the "beneficial owner" of an entity, viewed through the lens of

---

1 In Canada, the Canada Revenue Agency (the "**CRA**") and the courts have interpreted the term *beneficial ownership* to encompass possession, use, risk and control (See *Prévost Car v. MNR,* 2008 TCC 231, aff'd 2009 FCA 57).

2 The OECD instrument for global consistency is the *Multilateral Convention on Mutual Administrative Assistance in Tax Matters.*

3 Sections 270-278 of the ITA.

4 Canada's adoption of the OECD model for CRS is heavily influenced by the U.S. *Foreign Account Tax Compliance Act ("**FATCA**"),* and the Canada-U.S. Intergovernmental Agreement found in sections 263-269 of the ITA. It is interesting to note that the CRA and the IRS seem to agree that a private Canadian trust that does not offer its units to the public does not have a reporting obligation in the latter case. The situation is less clear in the former case.

"control". However, it is difficult to imagine that a Beneficiary, let alone a Protector, could be viewed as being in sufficient control of the trust to be considered its beneficial owner for this purpose. Nor would such a person have possession, use or risk associated with their interest in the trust.

In its zeal to block tax evasion and aggressive tax avoidance, the Canadian government has conflated the meaning of a person with a beneficial interest in a trust (which may be completely contingent on the exercise of discretion by the Trustee of the trust) with someone who has actual control over the trust assets, namely the Trustee, who holds legal title to the assets of the trust for the benefit of the Beneficiaries, and who has possession and use of the trust assets, as well as the one who assumes the risk associated with such assets.[5]

The Canadian rules are heavily influenced by U.S. *FATCA* ("Foreign Account Tax Compliance Act") and the resulting Canada/U.S. Intergovernmental Agreement. But unlike *FATCA* which has heavy sanctions through the imposition of 30% withholding tax, CRS has minor sanctions for failing to file required forms. The OECD expects that peer review among participating states will establish and maintain the Standard.

We are concerned over the infringement on privacy rights, as the CRS rules provide no requirement for natural justice or due process. For example, there is no requirement to inform the account holder that this information is being transmitted to the country of residence, and there is no right to make representations against such a transmission. If an account holder comes from a corrupt country, such information may be used to blackmail, kidnap or otherwise harm the family or their business.[6]

Tax Treaty Abuse

Action 6 of the BEPS Report recommended that states address the perceived problem that taxpayers who are not resident in one of the two jurisdictions that have entered into a bilateral tax treaty will set up an entity in one of the jurisdictions in order to invest in the other treaty jurisdiction principally to obtain tax relief on payments from the other treaty jurisdiction (so-called *treaty shopping*).

Canada along with 67 countries have signed on to the *Multilateral Convention to Implement Tax Treaty Related Measure to Prevent Base Erosion and Profit Shifting* ("**MLI**"), under which states shall adopt either (a) a test based on whether a principal purpose of setting up the aforementioned entity was done principally to obtain tax relief ("**PPT**"), or (b) a detailed set of objective rules, known as the limitation-on-benefits rules ("**LOB**"), to narrowly define taxpayers who may qualify for tax relief on payments from the source state, or (c) an approach combining the PPT and the LOB. The PPT seems to be the default approach.[7]

The U.S.A. has pioneered the LOB rules, which Canada has only adopted in the Canada/U.S. Tax Convention. Otherwise, Canada has stated its preference for the PPT approach.

---

5 In the case of a corporation, 25% share ownership is enough to constitute control.

6 A recent example of a case where these rights were recognized is *Berlioz Investment Fund SA*, C-682/15 (CJEU 2017), in which the Court of Justice of the European Union ruled that the decision to request information from a person is a decision adversely affecting his interests, and that the charged person can claim legal protection and judicial review of the decision.

7 The PPT provision of Article 7(1) of the MLI states that:

> "a benefit under [a tax treaty] 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 [tax treaty]."

Through its adhesion to the MLI, Canada has committed to provide alongside each of its 93 tax treaties this PPT approach to combat the perceived evil of treaty shopping.

It has been argued in the tax literature that Canada does not need an anti-treaty shopping policy, especially one that is so broad and vague, leaving it to the CRA to determine whether the subjective nature of the PPT test has been met, i.e. that <u>one of the principal purposes</u> of the arrangement or transaction is to obtain the tax treaty benefit. This results in much uncertainty for taxpayers and could result perversely in curbing foreign investment into Canada.

As a country that has historically seen itself as a net importer of capital and, therefore, as a "source state" of income, Canada's tax policy has been to guard against dramatic reductions in domestic withholding tax rates to protect the domestic revenue base.

Canada's tax treaty policy, however, generally aims to reduce its 25% domestic withholding tax rates on interest, royalties and dividends to 5%, in exchange for corresponding reductions from its treaty partners. If the Canadian domestic withholding tax rate were uniformly applied at a 5% rate for all non-residents, whether in treaty jurisdictions or not, this change would eliminate treaty shopping into Canada as a source state. Then, Canada as a residence state would see its MNE's able to earn income from treaty countries with negotiated lower withholding taxes. Such a policy initiative would have the General Anti-Avoidance Rule ("**GAAR**") to protect the domestic revenue base, if necessary. It would be consistent with international tax norms and be more predicable for taxpayers.

However, if Canada does follow the MLI prescription, it would be advisable to adopt the GAAR approach when implementing the new anti-treaty shopping rules, by inserting a test that would require the CRA to prove that the arrangement or transaction <u>abused</u> Canada's tax treaty policy, by achieving an outcome that a statutory or treaty provision was intended to prevent, thereby defeating the underlying legislative rationale for the provision.

Country by Country Reporting

Action 13 of the BEPS is *Country by Country Reporting* (**CbC**), another OECD initiative to combat tax avoidance and tax evasion by MNE's and to promote transparency and ease of administration.[8]

An MNE with total consolidated group revenue of €750,000,000 or USD$838,500,00 must file CbC reports disclosing, for example, if the Canadian entity is the ultimate parent entity, surrogate parent entity, or constituent parent entity. If an MNE has several constituent entities in different jurisdictions, it can designate one to be its surrogate parent entity to report on behalf of the group.

A CbC report includes global allocation, by jurisdiction, of key variables for the group, including: revenue, profit, tax paid, stated capital, accumulated earnings, number of employees and tangible assets, as well as the main activities of each constituent entity.

It will be used to assess high level transfer pricing risk; to assess other BEPS-related risks; and for economic and statistical analysis. CbC reports filed with the CRA will be automatically exchanged with other jurisdictions in which the MNE operates, and *vice versa*.

The OECD views CbC as a "game changer" for MNE's, as tax managers will now have to defend their tax minimization strategies in the public domain. MNE's will have to view themselves as accountable to

---

[8] Canada has implemented CbC reporting in section 233.8 of the ITA.

the public, and will now have to gain the confidence of its citizens, as well as the tax authorities, in each jurisdiction in which they operate.

Finally, a key issue will be whether participating countries have the capacity and sagacity to collate, analyse and properly use all the information that will be forthcoming. BEPS will likely increase the risk of double taxation for MNE's, resulting in a concomitant increase in disputes with, and between, multiple governments.

Lorne Saltman · Partner
Gardiner Roberts LLP
416.865.6689
lsaltman@grllp.com