International TAX HIGHLIGHTS

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Volume 3, Number 4, November 2024

In This Issue

This issue brings us more detailed coverage of some of the proposed amendments released by the Department of Finance on August 12, 2024. We also cover some very interesting judicial developments.

With respect to the proposed amendments, two articles focus on international aspects of taxing Canadian-controlled private corporations (CCPCs). For those interested in the broader tax policy considerations in this context, I would summarize the whole debate in one word: integration. The ITA generally recognizes the separate existence of corporations and their shareholders, but this separation poses challenges when it comes to achieving neutrality between (1) income (and gains) derived directly by individuals (who are the only real taxpayers) and (2) indirect earnings derived through a corporation. In principle, as a matter of public policy, there should not be any (ultimate) difference between the two. In practice, however, there is some difference, which varies depending on the interaction of the various technical rules and regimes in the ITA that are designed, essentially, to permit deferral when it comes to the taxation of business income, and to prevent deferral when it comes to investment income. The ITA has reflected this approach since 1917, but it is much easier said than done.

CCPCs are essentially treated as proxies for their individual shareholders with respect to their investment income. As a consequence, they are subject to additional layers of refundable taxation on such income, to approximate the rates and timing that would apply if the earnings had been derived directly by the shareholders. This is also why we have the foreign accrual property income (FAPI) rules: but because we do not tax non-resident corporations on their non-Canadian earnings, we impute these earnings to the resident shareholders and tax them instead. Since 2022, the Department of Finance has been working to design various technical rules to reinforce the proxy functions of the CCPC rules and better integrate them with the FAPI rules. Some of the August 2024 proposed amendments reflect the latest iteration of this initiative, addressing numerous concerns raised by members of the tax community regarding earlier versions.

In this regard, we begin with an article by Christopher Montes, John Farquhar, and Evan Raymer, who provide an overview of the new "foreign accrual business income" (FABI) rules, identifying a number of gaps and other concerns that persist in this regime because the approach to the drafting has been more prescriptive than principles-based. Next, Hetal Kotecha and Daryl Maduke examine these proposals in more detail, with helpful numerical examples involving both income and capital gains. Readers with an interest in the nuts and bolts of these proposals should find the two articles helpful.

On the subject of the August 2024 proposed amendments, we also have Patrick Marley and Oleg Chayka, who cover Canada's ongoing efforts to implement the global minimum tax regime, with this instalment involving the undertaxed profits rule (UTPR), among other proposed amendments to the GMTA. This rule is the so-called backstop, under which participating countries would divide up and take the top-up taxes that non-participating countries have left on the table, which makes the UTPR a rather controversial feature of this regime. It has been debated extensively by practitioners, academics, and tax authorities, and US Republican lawmakers have threatened retaliatory action, while other opponents are taking the path of litigation.

Bryan Madorsky provides a concise account of the proposals to limit the application of the anti-hybrid rules in certain cases involving dividends on shares of an FA. Sam Li is likewise focused on relief measures, covering the proposals to restrict the application of the shareholder loan rules in various contexts involving FAs and partnerships. The ITA's ambivalence about accepting or displacing the separate-entity principle for

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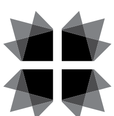

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corporations is even more pronounced when it comes to partnerships, which are sometimes treated as separate entities, sometimes as flowthrough entities, and sometimes as something in between, which leads to a tremendous amount of complexity. Sam unravels some of this complexity, providing a number of useful examples. Another relieving measure involves the removal of withholding obligations for the payment of rent to non-residents on residential property. This issue became controversial after the CRA assessed a residential tenant and then won in court, provoking a media storm for the government. (One might have expected the CRA to assess the non-resident and then start collection actions against the property.) In any event, as described by Suhaylah Sequeira and Alex Cook, we will now have legislation to address this issue.

Moving to the context of judicial developments, we begin with Nathan Boidman's coverage of the American Free Enterprise Chamber of Commerce's court action against the UTPR in the Belgium Constitutional Court (and related developments). We also have Michael Kandev and Taj Kudhail's comprehensive coverage of the UK Court of Appeal's decision in *GE Financial Investments*, a case that involves the interpretation of one of the most important tax treaty terms—namely, "liable to tax by reason of" (relevant to treaty residence). The case also involves the equally fundamental term "business" (relevant to whether a permanent establishment exists within a jurisdiction). In *GE Financial Investments*, the non-US entity was taxable in the United States because its shares were "stapled" to those of a US entity. The court had to determine whether that fact amounted to "a criterion of a similar nature" to those of the enumerated criteria. In another recent decision, in *Susquehanna International*, the Irish High Court also had to interpret the term "liable to tax by reason of"—here in the context of whether a fiscally transparent US LLC was a treaty resident for the purposes of the ownership non-discrimination provision of the US-Ireland tax treaty. The Irish High Court declined to adopt the reasoning accepted by the TCC in the *TD Securities LLC* case. The decision is quite detailed, and we hope to cover it in the next issue of this newsletter.

Rob Kreklewetz and John G. Bassindale cover the SCC's decisions in *Dow Chemical Canada ULC* and in *Iris Technologies*. Both cases involve important procedural issues—specifically, whether a decision of the minister that is related to an assessment can or should be challenged in the TCC as part of an assessment appeal, or in the Federal Court as part of a judicial review proceeding.

In *Dow Chemical*, the issue arose from a transfer-pricing assessment, where the minister declined to accept a "downward adjustment" requested by the taxpayer under subsection 247(10) of the ITA. In *Iris Technologies*, the ministerial decision was related to the taxpayer's claim for GST/HST input tax credits on inputs connected to indirect export sales. The minister appeared slow to issue the favourable assessment that would have facilitated the taxpayer's cash flow recovery, leading the taxpayer to try to compel the minister through judicial review. The minister's somewhat eyebrow-raising reaction was to promptly issue a negative assessment and then move to strike the judicial review application.

Rob and John take us through the SCC's reasoning, which resulted in *Dow* being sent to the Federal Court and *Iris* being sent to the Tax Court. They also comment on the significant practical implications of these decisions for international commerce, highlighting, in particular, the hardships that could arise for small and medium-sized Canadian exporters.

Finally, we have Bal Katlai's commentary on the *Barwicz* decision, a case involving the outbound migration of a family trust, a discussion that includes consideration of alternative approaches that might have been adopted in the circumstances.

Another case that we do not address in this issue (but hope to cover in the next) is the recent TCC decision in *BlackBerry*, a case that involved the FAPI "base erosion" rules in paragraph 95(2)(b) and some of the exceptions in subsection 95(3). The taxpayer was successful, but this is proving to be a controversial decision. The Crown has appealed. . . .

We hope our readers enjoy this issue.

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Mind the Gap: FABI Relief Falls Short for CCPCs

On August 12, 2024, Finance released revised "relevant tax factor" (RTF) proposals for foreign affiliates (FAs) of Canadian-controlled private corporations (CCPCs) and of "substantive CCPCs" (both types of CCPCs are referred to in this article simply as "CCPCs").

The original RTF proposals, announced in the 2022 budget and released on August 9, 2022, were intended to prevent CCPCs from avoiding refundable tax on "aggregate investment income" (AII) by earning the same type of income through an FA. The original RTF proposals subjected all foreign accrual property income (FAPI) and "taxable surplus" of FAs of CCPCs to a low RTF of 1.9 (instead of 4). The effect of this would have been to tax all FAPI and taxable surplus of FAs of CCPCs at a rate of 52.63 percent (instead of 25 percent).

However, some FAPI and taxable surplus amounts would not be AII if earned in Canada by a CCPC. Refundable tax is not avoided in that situation, so it would be unfair to tax income earned by an FA at a corporate tax rate of 52.63 percent when the same type of income would not have been AII if it had been earned in Canada by a CCPC (and, therefore, would have been subject to the regular corporate tax rate of approximately 25 percent).

To address this issue, the revised RTF proposals introduce the concepts of "foreign accrual business income" (FABI) and "FABI surplus."

FABI and FABI Surplus

Effectively, FABI and FABI surplus are limited types of FAPI and taxable surplus, respectively, that are not subject to the low RTF of 1.9 (that is, they continue to be subject to the higher RTF of 4), provided that certain elections are made in a timely manner.

FABI is currently defined to include only two categories of FAPI:

1) services income under subparagraph 95(2)(b)(i), when specific conditions are met; and
2) income from a business of developing real estate for sale, or leasing of real estate or other immovable property, that is an "investment business" but would not be an "investment business" if it were possible to meet the "five full-time employees (or equivalent)" test by counting services performed in Canada by other members of the corporate group.

FABI surplus is defined to include, in addition to FABI and certain other amounts, an FA's net earnings or net loss from an active business carried on by the FA in a country. This definition aims to address a situation where, for example, an FA is carrying on an active business in a foreign treaty jurisdiction but is earning taxable surplus because the mind and management of the FA is in Canada rather than in the foreign treaty jurisdiction.

Omissions in the FABI Definition

Although the introduction of the FABI and FABI surplus concepts provides welcome relief for taxpayers, the FABI definition is not broad enough to capture several other important categories of FAPI that would not be considered AII if earned in Canada by a CCPC. These categories include income from

- an adventure or concern in the nature of trade;
- the active trading of securities, currency, or commodities;
- the business of insuring or reinsuring risks;
- services deemed to be FAPI under subparagraph 95(2)(b)(ii);
- the business of disposing of Canadian or foreign resource properties;
- the business of developing real estate for sale with insufficient employees;
- the business of leasing property other than real or immovable property with insufficient employees; and
- a non-qualifying business.

Policy Implications and Unintended Consequences

To avoid unfairly penalizing taxpayers that did not avoid refundable tax, it is critical that the definition of FABI capture all amounts that are FAPI but would not be AII if earned in Canada by a CCPC. The current definition of FABI fails to do this.

The issue is particularly problematic for CCPCs that have been earning for many years, through an FA, FAPI that would not be AII if earned in Canada by a CCPC. When those CCPCs seek to repatriate that income to Canada in order to reinvest it in their domestic operations, they will face an enormous tax bill (roughly twice the regular rate of corporate tax), largely because of the retroactivity of the rules, despite the fact that these companies have not been avoiding AII at all. In the face of such unfairness, those CCPCs may decide not to repatriate such funds to Canada.

Furthermore, if the FABI definition is not fixed, CCPCs will be hesitant to expand their active business operations outside Canada in circumstances where the income earned by their FAs will be subject to a low RTF (even though it would not be AII if earned directly by the CCPC in Canada) and subject to tax at roughly twice the domestic corporate tax rate.

Recommendation

Rather than trying to enumerate all types of income that are FAPI but would not be AII if earned in Canada by a CCPC, the ideal solution is to define FABI as any amount earned by an FA of a CCPC that (1) is FAPI of the FA, and (2) would not be AII if income of the same type were earned in Canada by a CCPC. That solution would achieve Finance's policy objectives and would not harshly (and retroactively) penalize taxpayers that have not been avoiding refundable tax at all.

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Impact of Capital Gains Realized by Foreign Affiliates and Treatment of Other Income

This article expands on a discussion, previously published in this newsletter, of new legislation concerning the taxation of FAPI and other distributions. (See the article by Hetal Kotecha in (2022) 1:2 *International Tax Highlights*.) We assume that readers have a good working knowledge of the proposed changes, including the financial results and policy anomalies involved. By way of background, the relevant legislation was originally tabled in the 2022 federal budget, which proposed tax changes that significantly changed how Canadian-controlled private corporations (CCPCs) and "substantive CCPCs" (collectively referred to as "CCPCs" in this article) would be taxed when their controlled foreign affiliates (CFAs) earn foreign accrual property income (FAPI). This budget also introduced other tax measures that negatively affected the distribution of taxable surplus, as well as some potentially favourable changes related to the distribution of hybrid surplus.

More than two years later, on August 12, 2024, the Department of Finance introduced a new set of rules concerning the

matters referred to above. A complicating factor is that the 2024 federal budget also included measures to increase the capital gains inclusion rate from 50 percent to 66.67 percent for capital gains realized after June 24, 2024. Although the legislation introducing these measures was included as part of the August 12, 2024 amendments, many Canadian taxpayers undertook planning or other transactions to crystallize capital gains at an inclusion rate of 50 percent before the effective date of the legislation.

With the introduction of these measures, passive income earned by a CFA will require more careful analysis because of the new "foreign accrual business income" (FABI) rules. If we assume that a taxpayer cannot benefit from the FABI regime, CCPCs earning passive income from their CFAs will be negatively affected with respect to the CFAs' investment returns. There are certainly good policy reasons to prevent the purely passive investment income earned by a CFA from benefiting from a tax deferral, but we would argue that the new regime is narrower in scope than the regime for taxing aggregate investment income earned by a CCPC in a purely domestic context. (See Hanna and Rafter's article in (2023) 2:3 *International Tax Highlights*.) Although the new FABI rules propose to address some of these anomalies, the scope of qualifying income under this regime is, in our view, too narrow. Furthermore, CCPCs—if one of their goals is to defer the taxation of income—may now prefer to structure or restructure their foreign operations to minimize the creation of hybrid surplus without sufficient hybrid underlying foreign tax, or to structure these operations so as to provide flexibility to generate hybrid surplus. Thus, CCPCs and their advisers will need to be more careful about structuring, managing, and running their foreign operations according to their specific facts and objectives.

Overview of Recent Changes Affecting CCPCs Earning Passive Income

The new changes, as most practitioners are aware, propose that the relevant tax factor (RTF) for a CCPC earning FAPI be reduced from 4 to 1.9. This would apply not only to FAPI but also to taxable surplus distributions, which, in some circumstances, also include active business income. When a CCPC's CFA earns FAPI, this income would effectively be taxed at the same rate (52.63 percent) as it would be if the income were earned directly by the CCPC. Therefore, because of the change in RTF, incremental tax will arise in Canada unless FAPI is taxed in the foreign jurisdiction at approximately 52.63 percent.

The FAPI definition is broader in scope than the definition of "aggregate investment income" because it penalizes Canadian companies that earn the same types of income through a foreign corporation. The definition of aggregate investment income does not include, for example, real estate development income, active business income (other than "specified investment business" income), or any type of income from services.

To address the concerns outlined above and better align Canada's taxation of passive income under foreign and domestic anti-deferral regimes, a new category of income—"foreign accrual business income" (FABI)—has been proposed (see proposed section 93.4). FABI is a subset of FAPI, and where a CCPC meets the necessary conditions, it may qualify for the higher RTF (that is, 4). This means that, provided that the FABI has been subject to tax in the foreign country at a rate of at least 25 percent, no incremental Canadian tax liability may arise.

Unfortunately, the types of qualifying income included in FABI are so narrowly defined that the regime may provide only limited relief to most taxpayers. FABI includes

1) income from the provision of services that is subject to recharacterization under subparagraph 95(2)(b)(i) if the amounts are payable for services that are deductible by a Canadian taxpayer in computing active business income in Canada or in computing FABI of another FA in the corporate group; and
2) income from an investment business that involves the development or rental of real property (for example, the development of real property for sale or leasing) if the FA or another member of the corporate group employs more than five full-time equivalent employees, provided that this investment business would not qualify as such without the "outside Canada" requirement in the definition of "investment business."

While this is a welcome change, the types of income included in FABI are, in our view, inappropriately narrow in scope. Moreover, this change brings greater complexity for taxpayers. For example, Canadian real estate developers engaged in activities involving the development of foreign real estate rarely employ more than five full-time equivalent employees. In addition, strategic functions related to the management of the real estate portfolio often remain in Canada, and, for commercial reasons, operational aspects of managing the property are generally outsourced to third-party service providers.

Therefore, Canadian developers of cross-border real estate may not be inclined to restructure their affairs so as to qualify for the FABI regime. To build a business substantial enough to need more than five full-time employees requires significant assets. It has become increasingly difficult, accordingly, for Canadian real estate developers to grow their businesses outside Canada without incurring additional Canadian taxes. Moreover, the "more than five full-time employees" test in the definition of "investment business" requires each affiliate to have more than five employees per affiliate and to be charged for the full value of the services provided, which could be challenging unless an income recharacterization provision applies. We suggest expanding the FABI regime to modify subparagraph 95(2)(a)(i) by removing the requirement that property income be "directly related" to active business activities carried

on by another affiliate in a country other than Canada. This provision could be revised to also allow a connection to Canadian business activities.

If a CCPC qualifies for the FABI carve-out, it must file an election in the form and manner prescribed, and it must do so by the taxpayer's filing-due date for the taxation year when the FABI is earned or when the FABI dividends are received from FABI surplus. The election allows foreign accrual tax (FAT) deductions for eligible FABI amounts to be calculated separately from FAT deductions for non-FABI amounts. For the FABI portion, the CCPC is permitted to use the RTF of 4 in computing its deduction under (1) subsection 91(4) (that is, gross-up FAT) in respect of FABI of the CFA (see proposed subsection 93.4(2)); or (2) paragraphs 113(1)(b) and (c) in respect of dividends paid by an FA out of its FABI surplus (see proposed subsection 93.4(3)). The new RTF of 1.9 must be used to compute the non-FABI portion of income earned by the CFA, and this results in a smaller deduction and a higher tax burden overall (as noted above). Additional complexities may arise if an apportionment of foreign taxes between FAPI and FABI income is required. A further complication could arise if active business income exists in the same CFA or if consideration is being given to compensatory payment planning to address the prescribed FAT rules.

Taxpayers should be aware of the various transitional rules under the proposed legislation that are intended to address the application of these legislative changes to past and future taxation years. For pre-2023 taxation years (see proposed subsection 93.4(4)), an election is deemed to have been made in a timely manner for each taxation year beginning before April 7, 2022 if the taxpayer files an election by the filing-due date for its first taxation year beginning after 2024. For the 2023 and 2024 taxation years (see proposed subsection 93.4(5)), an election is deemed to have been made in a timely manner for each taxation year beginning after April 6, 2022 and before 2025 if the taxpayer files an election by the filing-due date for its first taxation year beginning after 2024. These transitional rules allow taxpayers to retroactively apply the FABI election to previous years, potentially reducing their tax liability for those years. Taxpayers that may be affected should ensure that the election under subsections 93.4(2) and (3) is made for the first taxation year beginning after 2024. It is not uncommon for taxpayers to overlook FAPI and then have to amend their prior-year returns. We understand that proposed subsections 93.4(2) and (3) have also been added to regulation 600, which is effective for subsection 220(3.2), thereby permitting the late-filing of elections.

In summary, the new FABI regime creates additional complexity for taxpayers and their advisers, who are already dealing with the numerous legislative developments in Canadian taxation over the past several years. It is not entirely clear whether this complexity is warranted: it remains to be seen how much incremental tax revenue these measures will generate. CCPCs and their advisers will need to spend more time tracking FAPI—for example, by identifying the items that would benefit from the new FABI regime. In addition, CCPCs may no longer want to conduct foreign activities through a CFA; they may prefer conducting their non-Canadian business through a Canadian corporation with a foreign branch or, alternatively, through some form of partnership structure. It is unfortunate that Canada's tax system may motivate such behaviours, particularly when they reflect no mischief beyond the desire to grow a business outside our borders. While it may be possible to structure "greenfield" investments (that is, foreign direct investments whereby a company establishes new operations from the ground up in a foreign country) and plan for new investments, it may be difficult to restructure existing investments that have significant inherent gains. Moreover, it may not be possible, for commercial or non-Canadian tax reasons, to conduct business in alternative forms or to restructure a business to avoid FAPI. In our view, if the policy objective of the proposed amendments is to defer the earning of purely passive income in a CFA, a tool more discrete than the complicated legislation that has been proposed could have been legislated.

Overview of Recent Changes Affecting CCPCs That Earn Taxable and Hybrid Surplus

In addition to the new FABI regime and the taxation of FAPI, significant changes in the taxation of taxable surplus and hybrid surplus distributions have been proposed. We first consider the tax treatment of taxable surplus. Assume that the income generated by a CCPC's CFA is not FAPI or FABI, but active business income earned in a high-tax jurisdiction, and assume that such earnings are included in taxable surplus. We would argue that the tax treatment of taxable surplus distributions under the proposed amendments, though not as punitive as the treatment under the 2022 federal budget measures (which limited the RTF to 1.9), continues to be distortionary for CCPCs. Although the other requisite conditions may be met, a CCPC often cannot (owing to the costs involved) implement the corporate governance procedures needed to establish the central mind and management of its FAs outside Canada and thereby ensure that the income generated is exempt surplus.

From a policy perspective, no erosion of the Canadian tax base occurs when a CFA carrying on active business operations in a high-tax jurisdiction generates taxable surplus. Despite this, dividends paid by an FA from both taxable and hybrid surplus are no longer fully included in the general rate income pool (GRIP). In particular, changes have been proposed to address the integration of an FA's earned income once this income is repatriated to and subsequently distributed by a CCPC to individual shareholders. The proposed changes include

1) excluding certain inclusions from the GRIP of a CCPC for deductions under paragraphs 113(1)(a.1), (b), and (c) on repatriations of an FA's hybrid surplus and taxable surplus, except where surplus arises from FABI for which an election has been filed; and
2) including in the CDA of a CCPC, on repatriation,
   a) the amount of the deduction claimed under paragraph 113(1)(a.1) for a dividend paid out of hybrid surplus, less the withholding tax paid on that dividend;
   b) the deduction amount claimed under paragraph 113(1)(b) for a dividend paid out of taxable surplus, excluding income for which a FABI election has been filed; and
   c) the withholding tax deduction claimed under paragraph 113(1)(c), less the withholding tax paid on repatriations of taxable surplus, excluding, again, withholding tax on distributed income for which a FABI election has been filed.

As illustrated in table 1, taxable surplus distributions paid to an individual that owns shares of a CCPC will pay a combined personal and corporate tax rate of approximately 55.38 percent on a fully distributed basis. This tax rate ignores the possible impact of Canada's new alternative minimum tax.

Similarly, an individual shareholder of a CCPC that receives a distribution of hybrid surplus will pay a combined personal and corporate tax rate of 36.11 percent on a fully distributed basis, as shown in table 2. This tax rate ignores the possible impact of Canada's new alternative minimum tax.

We acknowledge that the changes to the hybrid surplus regime are intended to achieve a degree of integration that would allow an individual earning capital gains in Canada personally to pay a level of tax similar to the level paid if these gains were earned through a disposition of FA shares. However, no discernible rationale exists for taxing at approximately 53 percent, on a fully distributed basis, taxable surplus distributions from active business operations. Furthermore, we do not understand why such a high corporate tax rate is required, particularly in a situation where foreign earnings have been subject to tax at a rate of 25 percent or greater. This change does not align with the general concept of integration and the ability to move after-tax funds freely between corporate entities. Rather, we propose that taxable surplus from an active business operation should continue to benefit from an RTF of 4 and that there should be no change to the rules if the income that generated the taxable surplus is from an active business. The lower RTF is likely to persuade Canadian businesses to hold and reinvest their available capital in active business operations outside Canada where a deferral is available. In our view, this puts CCPCs at a disadvantage relative to their public-company or non-CCPC competitors when it comes to repatriating taxable surplus to Canada for reinvestment.

Table 1 Taxable Surplus

	Current tax	Proposed changes
	dollars	
Earnings in foreign affiliate	10,000	10,000
Foreign income taxes (at 21%)	2,100	2,100
Available to pay as a dividend	7,900	7,900
Withholding tax on dividend (at 5%)	395	395
Income to Canadian parent	7,900	7,900
Taxable in Canadian parent	—	5,260
Corporate tax after dividend refund	—	1,030
Available to distribute to individual	7,505	6,475
Portion to distribute as capital dividend		(2,250)
Taxable dividend to individual	7,505	4,225
Personal tax on dividend	2,952	2,017
Capital dividend to individual		2,250
Net funds to individual	4,553	4,462
Total tax	5,447	5,538

Table 2 Successor Hybrid Surplus

	Current tax	Proposed changes
	dollars	
Capital gain	10,000	10,000
Foreign income taxes (at 21%)	2,100	2,100
Available to pay as a dividend	7,900	7,900
Withholding tax on dividend (at 5%)	395	395
Income to Canadian parent	7,900	7,900
Taxable in Canadian parent	—	1,926
Corporate tax after dividend refund	376	
Available to distribute to individual	7,505	7,129
Portion to distribute as capital dividend		(5,579)
Taxable dividend to individual	7,505	1,550
Personal tax on dividend	2,952	740
Capital dividend to individual		5,579
Net funds to individual	4,553	6,389
Total tax	5,447	3,611

Furthermore, the changes to the taxation of hybrid surplus may encourage CCPCs to structure their affairs upfront to maximize flexibility for a future exit, allowing them to generate either exempt surplus or hybrid surplus as needed. This may involve forming a foreign holding company with a corresponding subsidiary to own each separate business unit.

To round out our discussion, we note that the increase in the capital gains inclusion rate from 50 percent to 67 percent

applies for the purpose of computing the FAPI of a CFA for capital gains and losses realized on dispositions of certain kinds of property (most commonly, property that is not "excluded property"). In addition, there are transitional rules for hybrid surplus realized both before and after June 25, rules that we have not addressed here.

In summary, public companies or non-CCPCs are unlikely to be affected in the same way as CCPCs earning taxable or hybrid surplus. Absent the foregoing, Canadian public companies or non-CCPCs may still prefer to realize capital gains in Canada or, if this is not possible, to maximize exempt surplus and use other FA attributes to minimize reliance on hybrid surplus pools. Whether the taxpayer is a CCPC or a non-CCPC, it is likely to pay more attention to its foreign operations so as to ensure that active business earnings are included in exempt surplus. Furthermore, taxpayers should consider exit planning upfront to ensure that maximum flexibility exists to generate either exempt or hybrid surplus. To ensure that CCPCs have maximum flexibility, it may be preferable to have their FAs sell assets to maximize exempt surplus pools, if an aim is to reinvest funds in the business either outside Canada or in Canada upon repatriation. CCPCs may also want the flexibility to create hybrid surplus if the objective is to repatriate funds on a fully distributed basis to individual shareholders. CCPCs and their advisers will need to carefully plan their business affairs according to their business objectives and to the type of income they expect to earn. All of this will further complicate the planning needed for CCPCs as they expand outside Canada.

Authors' postscript: The authors would like to thank Jennifer Horner and Jill Birks at BDO Canada LLP for their invaluable comments. Any errors or omissions are solely the authors' responsibility.

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The Proposed Canadian UTPR—and Other GMTA Proposed Revisions

On August 12, 2024, the Department of Finance released the first proposed amendments ("the August 12 proposals") to the Global Minimum Tax Act (GMTA), which was enacted into law on June 20, 2024. In the previous issue of this newsletter, we described the GMTA's enactment and important revisions that the draft GMTA underwent before the statute's final approval by Parliament. In that article, we noted that the GMTA introduced two of the three tax measures of the pillar 2 initiative—namely (1) a 15 percent top-up tax under an income inclusion rule (IIR) and (2) a 15 percent domestic minimum top-up tax (DMTT). These measures are in line with the OECD's global anti-base erosion (GloBE) model rules and with the three sets of administrative guidance—published by the OECD before 2024—regarding those model rules. The enacted GMTA, however, did not implement either the pillar 2 initiative's third tax measure (a top-up tax under the undertaxed profit rule [UTPR]) or the fourth instalment of OECD administrative guidance ("fourth AG"), which was published on June 17, 2024, just three days before the GMTA's enactment.

The August 12 proposals introduced the UTPR and the transitional UTPR safe harbour, as well as certain elements of the fourth AG. The UTPR and the transitional UTPR safe-harbour rules are set to apply to fiscal years that begin on or after December 31, 2024, while other proposed GMTA amendments are generally applicable to fiscal years that began on or after December 31, 2023.

The UTPR

A top-up tax under the UTPR, introduced in new part 2.1 of the GMTA, is intended to be interpreted in accordance with the GloBE model rules, the GloBE commentary, and the administrative guidance. The UTPR is intended to operate as a backstop for the other two pillar 2 measures (that is, the DMTT and the IIR). In addition to meeting its backstop purpose, the UTPR also purports to "induce" jurisdictions (especially jurisdictions where large MNEs have global or regional headquarters) to implement pillar 2 (as further discussed below).

The August 12 proposals apply a formulaic approach to determining the relevant UTPR amounts, which is in line with the GloBE model rules, and they use an alternative method for paying a top-up tax under the UTPR. In particular, the GloBE model rules provide that implementing jurisdictions should generally deny tax deductions of the relevant constituent entities. This results in an additional "cash tax expense" that is equal to the UTPR top-up tax amount for the implementing jurisdiction, unless it decides to make an "equivalent adjustment" that achieves the same economic outcome. The GloBE commentary explains that implementing jurisdictions can craft the "equivalent adjustment" according to the design of their domestic tax systems, and that an equivalent adjustment can take the form of, among other things, an additional tax imposed on resident taxpayers, in an amount equal to the jurisdictional UTPR top-up tax amount. It seems that Canada opted for the direct tax payment option, which, compared with the deduction-denial mechanism, should simplify UTPR tax payments.

A top-up tax under the UTPR is a residual top-up tax for an in-scope MNE group that is not paid as a DMTT or a top-up tax under the IIR. This situation exists when the ultimate parent entity for an in-scope MNE group is located in a jurisdiction, such as the United States, that does not implement a global minimum tax under pillar 2. In this case, implementing jurisdictions in which MNE group members are located can collect a global minimum tax that non-implementing parent jurisdictions fail to impose under the IIR. A top-up tax under the UTPR can be paid by subsidiaries even for foreign parent entities and other group members located in non-implementing

jurisdictions, regardless of any transactions the subsidiaries may or may not have with those foreign parent entities and group members.

Consider an analogy: a top-up tax under the UTPR is akin to a tax that the parent entity fails to pay, fully or partially, for the tax consolidated group. In the event of such a failure, all group members are jointly and severally liable for the tax shortage and must pay the group tax debt whether or not they have an ownership interest in, or transactions with, the profitable group members that gave rise to the tax liability for the group. In other words, a top-up tax under the UTPR is effectively a tax on membership in the MNE group. Such a tax is not consistent with the objective of the original base erosion and profit shifting (BEPS) action plan—specifically, the objective to better align taxing rights with the jurisdictions in which the underlying economic activity occurs.

The nature of the UTPR makes it the most controversial element of the pillar 2 initiative. Many publications have considered the likelihood that the UTPR violates double taxation treaties. (See, for example, this article by Nikolakakis and Li, in *Tax Notes International*, February 6, 2023.) Non-implementing jurisdictions, such as the United States, oppose the UTPR and its introduction by other jurisdictions. To buy time to find a feasible solution to this resistance, the Inclusive Framework has introduced a UTPR safe harbour as an interim tax measure, which defers until 2027 the UTPR's application to qualifying non-implementing jurisdictions.

Transitional UTPR Safe Harbour

The August 12 proposals introduced a transitional UTPR safe harbour. Under this provision, the top-up tax of the relevant entities located in the jurisdiction in which the ultimate parent entity (UPE) of the MNE group is located ("the UPE jurisdiction") is deemed to be nil if an election for the UPE jurisdiction is made and the corporate income tax rate of the UPE jurisdiction is at least 20 percent.

The OECD is now exploring various options for enforcing the UTPR as the backstop rule without frustrating the United States after 2026. One option is to make the transitional UTPR safe harbour permanent.

Securitization Entities

The fourth AG introduced a new definition of "securitization entity," and it enabled implementing jurisdictions to exclude such an entity from their qualified DMTT (QDMTT) regimes without tainting their QDMTT safe-harbour status. The August 12 proposals incorporate that definition into the GMTA, and they exclude securitization entities from the Canadian QDMTT as follows:

- the QDMTT is not payable by (or in respect of) a constituent entity that is a securitization entity, and
- a securitization entity is neither assessable nor liable in respect of a QDMTT.

It is possible that, because Canada will not apply its QDMTT to securitization entities, other countries may, through a switch-off rule, apply a global minimum tax to such entities under their IIR and, potentially, their UTPR.

Flowthrough Entities

The term "reverse hybrid entity" is used only in section 17(6) of the GMTA ("Financial accounting income—flow-through entity"). The August 12 proposals repeal that definition from the GMTA. Also, the Department of Finance has significantly revised section 17(6) of the GMTA to account for the proposed deletion of the term "reverse hybrid entity" and to reflect the fourth AG's policies on flowthrough entities.

Deferred Tax Assets

The August 12 proposals amend the transition rules in section 48(5)(b) of the GMTA to reflect the fourth AG's new rules on deferred tax assets in connection with asset transfers before the GloBE transition year—that is, the first year in which the MNE group is subject to a qualified QDMTT, IIR, or UTPR in the constituent entity's jurisdiction. The proposed amendments provide that a deferred tax asset will be deemed to exist for GMTA purposes even if it would not arise, or would arise in a different amount, under the applicable accounting standard. The amendments also cover cases where a deferred tax asset of the transferor (or of the entity paying taxes on behalf of the transferor under a group taxation regime) was reversed or not created solely because any gain from the transfer was included in the transferor's domestic taxable income.

The August 12 proposals add new section 48(5.1) of the GMTA to implement guidance in the fourth AG; this section provides that the creation of a deferred tax asset under section 48(5)(b)(ii) shall not reduce the adjusted covered taxes of any constituent entity in the MNE group.

The proposed legislative changes reflect a new approach in the fourth AG: in certain instances, deferred taxes shall be determined according to a difference between an accounting carrying value and a GloBE carrying value (rather than between accounting and tax carrying values). This means that, in the prescribed situations, the MNE groups will have to determine and trace the GloBE carrying values in addition to the accounting and tax carrying values. The new approach will inevitably complicate the GloBE computations and increase compliance costs for MNE groups.

Amendments to the Income Tax Conventions Interpretation Act

The enactment of the GMTA in general, and the proposed introduction of the UTPR rules in particular, have prompted the Department of Finance to amend the Income Tax Conventions Interpretation Act. The proposed amendments provide that the application of the GMTA is not affected by Canada's double tax treaties, and that Canada is not required to provide

relief for taxes imposed under similar laws in other jurisdictions. These amendments are deemed to have come into force on January 1, 2024.

Given the controversial nature of the global minimum tax under pillar 2, especially the top-up tax under the UTPR, this "treaty override" is intended to ensure that Canada can collect tax under the UTPR—without providing relief for taxes paid under other countries' pillar 2 regimes—despite any conflicting obligations in Canada's bilateral tax treaties.

Conclusions

The August 12 proposals, introducing the UTPR rules and some elements of the fourth AG, bring Canada closer to meeting all of its international tax commitments under pillar 2 and to keeping the GMTA up to date and in line with the last administrative guidance from the OECD. It is therefore expected that the OECD will include the Canadian GMTA in its list of qualifying DMTT and IIR regimes. That said, many important simplification measures and new guiding rules in the fourth AG are not reflected in the August 12 proposals, including an unclaimed accrual five-year election and a five-year election to exclude the allocation of all deferred taxes. The Department of Finance is expected to release further amendments to the GMTA that incorporate these elections and the administrative guidance that the OECD releases from time to time.

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August 2024 Proposed Amendments to Foreign Affiliate Rules: Hybrids

On August 12, 2024, Finance released several packages of draft legislation, including revisions to previous draft legislation dealing with certain foreign affiliate (FA) rules and with the hybrid mismatch rules ("the revisions"). The revisions address feedback that Finance had received on earlier versions. This article describes these important relieving revisions.

Historically, all dividends received by an FA from another FA have been excluded from FAPI by virtue of a carve-out in paragraph (b) of variable A of the definition of FAPI (in subsection 95(1)). The carve-out was recently amended, however, to include in FAPI dividends that are deductible for foreign tax purposes. Specifically, any portion of the dividend for which a deduction would have been denied under new subsection 113(5) if the FA recipient were a corporation resident in Canada is excluded from the carve-out in paragraph (b) and may be included in FAPI.

The revisions amend paragraph (b) of variable A of the definition of FAPI in order to provide relief in two ways:

1) A "same country" exception has been added for dividends paid between FAs that are resident in the same country.
2) The deductible dividend test in subsection 113(5) has been replaced with one that uses the same rules and definitions that are used in applying the hybrid mismatch rules in subsection 12.7(3). Those rules generally apply when the deduction side of a "deduction/non-inclusion hybrid mismatch" arising from a payment is a foreign income tax deduction.

Under the revisions, interaffiliate dividends are to be included in FAPI only to the extent of any deduction/non-inclusion hybrid mismatch. Under existing rules, the portion of the dividend that is deductible for foreign tax purposes is treated as FAPI regardless of whether a deduction/non-inclusion hybrid mismatch exists. Similar changes have been made to variable H of the FAPI definition, which is relevant when an FA is a member of a partnership that receives a dividend from another FA.

The revisions may effectively narrow and streamline the rules, but they seem inadequate to address all concerns about double taxation. These concerns, which were previously raised with Finance, stem from the overlap between the hybrid mismatch rules and the existing "foreign tax credit generator" rules, particularly the foreign accrual tax denial rules in subsection 91(4.1). Although further discussion of this matter is beyond the scope of this article, we hope that Finance will address these issues in future legislation.

These amendments apply in respect of dividends received on or after July 1, 2024.

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The Revised Shareholder Loan Rules

On August 12, 2024, the Department of Finance released for public comment several packages of draft legislative proposals ("the 2024 August proposals"). The proposals included an amendment to the shareholder loan rules in subsection 15(2), an amendment intended to address the sometimes inappropriate application of these rules. However, the proposed amendment does not address all of the concerns that the Tax Executives Institute's 2012 Canadian Liaison Meetings raised about the rules.

Issues with the Current Shareholder Loan Rules

Among the situations in which the current shareholder loan rules may apply is one where a partnership (except for a partnership all of whose members are CRICs) is connected with a shareholder of a particular corporation and the partnership received a loan from, or became indebted to, a partnership of which the particular corporation or a corporation related to the particular corporation is a member. The term "connected with a shareholder of a particular corporation" is defined in subsection 15(2.1), for the purposes of the shareholder loan

rules, to mean that a person (other than a foreign affiliate [FA] of the particular corporation or of a person resident in Canada that does not deal at arm's length with the particular corporation—an exception that I will term "the FA exclusion") or a partnership does not deal at arm's length with, or is affiliated with, the shareholder.

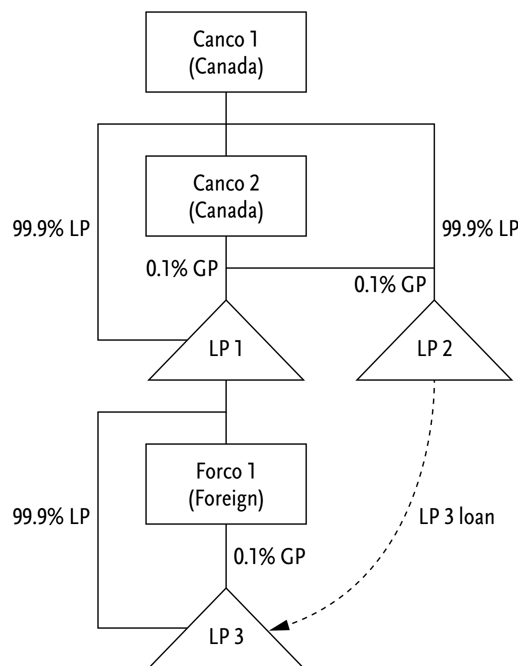
Under a textual interpretation of the relevant provision, the current shareholder loan rules may apply in certain unintended scenarios. Assume the following fact pattern for our first example (depicted in figure 1):

- Canco 1 owns all of the issued and outstanding shares of Canco 2.
- Canco 1 is the 99.9 percent limited partner of LP 1, which is a limited partnership for Canadian tax purposes, while Canco 2 is the 0.1 percent general partner of LP 1.
- Canco 1 is the 99.9 percent limited partner of LP 2, which is a limited partnership for Canadian tax purposes, while Canco 2 is the 0.1 percent general partner of LP 2.
- LP 1 owns all of the issued and outstanding shares of Forco 1, a corporation that was incorporated under the corporate law of a jurisdiction other than Canada and is a corporation for Canadian tax purposes.
- LP 1 is the 99.9 percent limited partner of LP 3, which is a limited partnership for Canadian tax purposes, while Forco 1 is the 0.1 percent general partner of LP 3.
- Each of LP 2 and LP 3 carries on active business operations.
- LP 2 advances a loan ("the LP 3 loan") to LP 3. The proceeds of the LP 3 loan were used by LP 3 to fund its business operations.

For the purposes of applying the current shareholder loan rules, Canco 2 is the particular corporation while Canco 1 is the shareholder of the particular corporation. LP 3 should not be considered to be dealing at arm's length with Canco 1 because it is indirectly controlled (through Canco 2, LP 1, and Forco 1) by Canco 1. Therefore, for the purposes of applying the current shareholder loan rules, LP 3 should be considered to be connected with Canco 1, a shareholder of the particular corporation. In addition, given that Canco 2 is a member of LP 2 and LP 2 advances the LP 3 loan to LP 3, the current shareholder loan rules should apply to the LP 3 loan.

Such results appear to be unintended. Current subsection 15(2.1) was amended in October 2012 ("the 2012 amendment")—in response to the TCC's decision in *Gillette Canada Inc. v. The Queen* (2001 DTC 895)—to clarify that a partnership shall be considered to be connected with a shareholder of a particular corporation if that partnership is affiliated with, or does not deal at arm's length with, the shareholder. Although the 2012 amendment further clarifies the meaning of "connected," it does not include a corresponding change to the

Figure 1



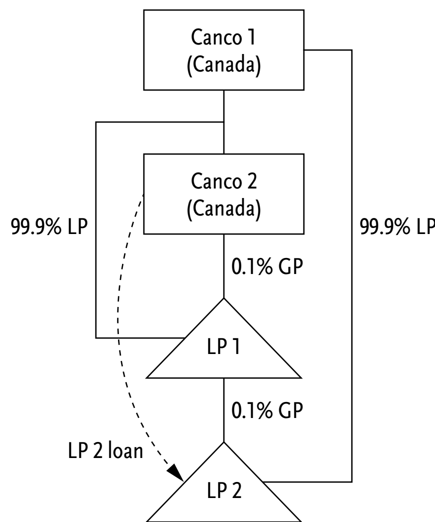
FA exclusion: for example, the current shareholder loan rules may apply to the LP 3 loan if LP 1 is a corporation incorporated in a jurisdiction other than Canada. (Bunn and Dumalski discussed this issue in (2021) 69:1 *Canadian Tax Journal*, maintaining that, from a policy perspective, a corresponding amendment to the FA exclusion is required.)

Interestingly, if the facts in example 1 are changed so that LP 1 is a CRIC and LP 3 is a corporation incorporated outside Canada (and is, therefore, an FA of a person resident in Canada with which the particular corporation does not deal at arm's length), the current shareholder loan rules will likely not apply to the LP 3 loan. The results in example 1, compared with this result, seem unexpected.

Nonetheless, the current shareholder loan rules may also inadvertently apply to a loan in a tiered Canadian partnerships structure. Assume the following facts in our second example (depicted in figure 2):

- Canco 1 owns all of the issued and outstanding shares of Canco 2.
- Canco 1 is the 99.9 percent limited partner of LP 1, which is a limited partnership for Canadian tax purposes, while Canco 2 is the 0.1 percent general partner of LP 1.
- Canco 1 is also the 99.9 percent limited partner of LP 2, which is a limited partnership for Canadian tax purposes, while LP 1 is the 0.1 percent general partner of LP 2.
- Each of LP 1 and LP 2 carries on an active business operation in Canada.

Figure 2



- Canco 2 advances a loan to LP 2 ("the LP 2 loan") the proceeds of which were used by LP 2 in carrying on its active business operation.

For the purposes of applying the current shareholder loan rules, Canco 2 is the particular corporation while Canco 1 is the shareholder of the particular corporation. LP 2 should not be considered to be dealing at arm's length with Canco 1 because LP 2 is indirectly controlled (through Canco 2 and LP 1) by Canco 1. Therefore, for the purposes of applying the current shareholder loan rules, LP 2 should be considered to be connected with Canco 1, a shareholder of the particular corporation. In addition, given that Canco 2 advances the LP 2 loan to LP 2, the current shareholder loan rules should apply to the LP 2 loan.

The current shareholder loan rules do not apply to a partnership whose members are all CRICs. If Canco 2 were the direct general partner of LP 2 (instead of indirectly controlling the LP 2 through the general partnership interest in LP 1), the current shareholder loan rules would likely not apply to the LP 2 loan. The current shareholder loan rules do not appear to apply consistently between a tiered Canadian partnership structure and a one-tier Canadian partnership structure. However, there may be no substantial difference between these two structures with respect to their controlling interest in the limited partnerships.

Proposed Shareholder Loan Rules

The August 2024 proposals' main modification to the shareholder loan rules is the new definition of "excluded persons and partnerships," introduced in proposed subsection 15(2.01). The proposed provision, which is applicable to loans received or indebtedness incurred after August 12, 2024, provides that subsection 15(2) does not apply to a loan the debtor of which is

- a person that is a corporation resident in Canada, a foreign affiliate of the particular corporation referred to in subsection [15(2)], or a foreign affiliate of a person resident in Canada with which the particular corporation referred to in subsection [15(2)] does not deal at arm's length; or
- a partnership, each member of which is a person described in [the] paragraph [above] or another partnership described in this paragraph.

The FA exclusion, which was included in the meaning of "connected" in subsection 15(2.1) in the current shareholder loan rules, has been removed from proposed subsection 15(2.1) and incorporated into proposed subsection 15(2.01). In addition, the proposed provision further resolves the issue (discussed above) by clarifying that the shareholder loan rules do not apply when the debtor of the loan is a partnership each member of which is an FA of the particular corporation or of a corporation that does not deal at arm's length with the particular corporation.

When the proposed shareholder loan rules are applied to the fact pattern in example 1, Canco 2 is the particular corporation. In this scenario, LP 1 is unlikely to be considered to be dealing at arm's length with Canco 2 because LP 1 is controlled by Canco 2 through the general partner interest. Forco 1 is likely to be considered an FA of LP 1, which is likely to be considered a person resident in Canada (for the purposes of computing the income to be allocated to its members) that is not dealing at arm's length with the particular corporation. Moreover, each member of LP 1 is a CRIC. Given these circumstances, LP 3 is likely to be considered a partnership described in proposed paragraph 15(2.01)(b) for the purposes of applying the proposed shareholder loan rules. Therefore, the proposed shareholder loan rules are unlikely to apply to the LP 3 loan.

It should be noted that the August 2024 proposals also provide interim shareholder loan rules for loans received and indebtedness incurred after October 31, 2011 and before August 13, 2024. In particular, the interim shareholder loan rules do not apply to a loan the debtor of which is

- a person that is a CRIC; or
- a partnership each member of which is a person described in the paragraph above or another partnership described in this paragraph.

When the proposed interim shareholder loan rules are applied to the fact pattern in example 2, Canco 2 is the particular corporation. Given that (1) each of the partners of LP 1 is a CRIC, and (2) LP 1 and Canco 1 are partners of LP 2, LP 2 is likely to be considered a partnership described in proposed paragraph 15(2.01)(b) for the purposes of applying the proposed interim shareholder loan rules; therefore, the proposed shareholder loan rules are not expected to apply to the LP 2 loan.

The key difference between the proposed shareholder loan rules and the proposed interim shareholder loan rules is that, in subsection 15(2.01) of the latter, the proposed meaning of "excluded persons and partnerships" does not include the FA exclusion (that exclusion remains in subsection 15(2.1)). It appears that the proposed interim shareholder loan rules may apply to loans received or indebtedness incurred by a partnership each member of which is an FA of a particular corporation or of a person resident in Canada that does not deal at arm's length with the particular corporation.

Unresolved Issues with the Shareholder Loan Rules

In the Tax Executives Institute's 2012 Canadian Liaison Meetings, the Department of Finance was asked for its view on the application of subsection 15(2) to a loan involving a partnership. The particular facts of the question are as follows:

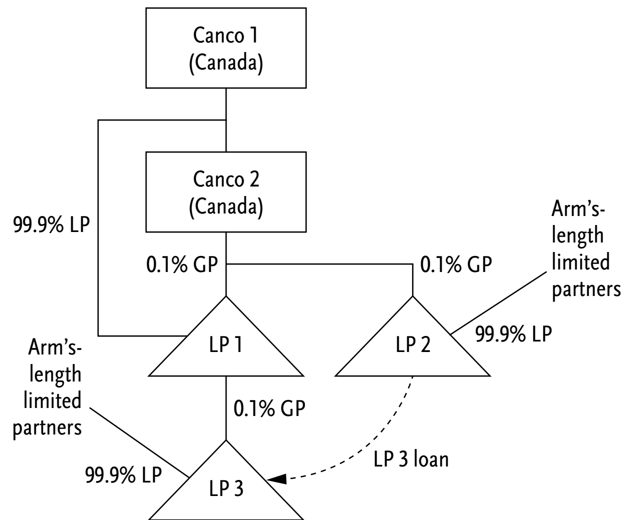
a. the general partner (or a related party of that general partner) [of a partnership] funds some of the expenses of a partnership that are widely held by arm's length limited partners, [and]
b. the general partner (or its related party) likely will not be dealing at arm's length with the partnership and the partnership would be considered "connected" with the shareholder of the general partner.

Tax practitioners specified in the meeting that the result "seems a harsh, though perhaps unintended, effect of the revision since the loan to the partnership does not create a benefit to the general partner or its shareholders." More specifically, the loan is benefiting the arm's-length limited partners, because they are not required to fund the partnership. In the Tax Executives Institute's 2013 Canadian Liaison Meetings, the Department of Finance indicated that it was considering the possibility of recommending, in a future technical bill, relief for a situation where subsection 15(2.1) catches a broader range of facts and circumstances than Parliament intended.

The proposed shareholder loan rules appear not to address the concern raised above, in connection with the existing rules. Assume that the facts in example 3 (as depicted in figure 3) are the same as those in example 1, except that the limited partners of LP 2 and LP 3 consist of various types of arm's-length investors (for example, institutional investors and individual investors).

When the proposed shareholder loan rules are applied to the fact pattern in example 3, Canco 2 is the particular corporation, while Canco 1 is the shareholder of the particular corporation. LP 3 is unlikely to be considered to be dealing at arm's length with Canco 1 because it is indirectly controlled by Canco 1 (through Canco 2, LP 1, and Forco 1). Therefore, for the purposes of applying the current shareholder loan rules, LP 3 is likely to be considered connected with Canco 1,

Figure 3



which is a shareholder of the particular corporation. Moreover, Canco 2 is a member of LP 2, which advances the LP 3 loan to LP 3. Provided that each of LP 2 and LP 3 have arm's-length individual investors, not all of the conditions in proposed subsection 15(2.01) are likely to be met, such that the proposed shareholder loan rules are likely to apply to the LP 3 loan.

Conclusion

The proposed shareholder loan rules may be helpful in addressing the inappropriate application of the current shareholder loan rules in certain circumstances (for example, in the case of an FA-partnership structure and a tiered Canadian partnership). However, readers should be aware that the proposed rules may still apply to loans that a partnership widely held by arm's-length limited partners owes to a connected person or partnership.

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Residential Individual Tenants: Are You Off the Hook for Part XIII Withholding Tax?

The Department of Finance has proposed to exempt individuals from the requirement to withhold and remit part XIII tax on rent paid to a non-resident landlord. The proposed exemption seems to have been motivated by media attention to the decision in *3792391 Canada Inc. v. The King* (2023 TCC 37), a case that we discussed in detail in an article previously published in this newsletter. In *3792391,* the TCC concluded that subsection 215(6) does not provide that a Canadian-resident payer, in order

to be responsible for withholding and remitting part XIII tax, must have knowledge that a payee is a non-resident, and the court held, accordingly, that the Canadian-resident payer was liable for the tax that it had failed to withhold and remit on residential rent payments to its landlord, who (unbeknownst to the payer) was a non-resident.

The TCC's conclusions were twofold: (1) subsection 215(6) does not have an inherent knowledge requirement; and (2) a due diligence defence is not available to taxpayers reassessed under subsection 215(6). The implication of this decision is that a payer who has no reason to believe that the person receiving rental payments is a non-resident—and who, on that basis, fails to withhold and remit part XIII tax on payments to that payee—is nonetheless liable for the applicable part XIII tax if it is determined that the payee is a non-resident.

This outcome creates significant uncertainty for taxpayers, especially for everyday residential tenants. In practice, it is not easy to determine with certainty the residence of an arm's-length person, such as a landlord. Moreover, the options available to average individuals for negotiating some sort of protection in the event that they become liable for part XIII tax on rent payments are limited. It may not be practical, for example, for a tenant to negotiate contractual protection in a lease agreement, particularly in a competitive rental market or in a situation where the amount of rent payable cannot justify the cost of legal advice. Moreover, it is unreasonable to expect the average individual to be aware of part XIII withholding requirements in respect of their rent payments or to expect that individual to be aware of the inquiries needed to determine a prospective landlord's residence status (assuming that the landlord will answer truthfully, if at all).

In April 2024, approximately one year after the TCC's ruling, the national press began to shed light on the scale of the issue at hand for residential tenants. The media criticized the ruling and the CRA's decision to reassess the taxpayer under subsection 215(6). The unfairness of this risk to residential tenants, particularly given the lack of affordable housing across the country, was also discussed. Shortly thereafter, the CRA publicly stated that it would not enforce subsection 215(6) against residential tenants.

The government decided to take action: as part of the 2024 budget's wider focus on addressing matters related to affordable housing, Finance proposed, on August 12, 2024, to add subsections 215(1.2) and (1.3) to the ITA. Proposed subsection 215(1.2) exempts an individual (other than a trust) from withholding obligations under subsection 215(1) in respect of amounts paid or credited by the individual to a non-resident person as rent for the use of a residential property in which the individual resides. For the purposes of the exemption, "residential property" uses the definition outlined in subsection 67.7(1).

Proposed subsection 215(1.3) provides that if subsection 215(1.2) applies and subsection 215(3) does not apply, the non-resident landlord, not the tenant, will have to remit the part XIII withholding tax that needs to be withheld and will have to issue to itself an NR4. Currently, subsection 215(3) typically applies to a property manager or agent who collects rent on behalf of a non-resident landlord, and, in such cases, the provision imposes the withholding and remittance obligations on the property manager or agent if the tenant does not withhold part XIII tax. The effect of proposed subsections 215(1.2) and (1.3) is to shift all part XIII obligations to the non-resident landlord.

The exemption in proposed subsection 215(1.2), if enacted, is deemed to come into force from the August 12, 2024 announcement date. There is no retroactive effect, so residential tenants must rely on the CRA's administrative statements for assurance that they will not be assessed under subsection 215(6) for any failure to withhold part XIII tax on rent paid to a non-resident landlord before that date.

These proposed amendments, along with recent CRA administrative statements, provide welcome relief for residential tenants by ensuring that they do not face undue burdens with which they cannot reasonably comply. Non-resident landlords should be aware that they now have new remittance and compliance obligations.

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Will a US Challenge to Belgium's UTPR Affect Canada's UTPR?

Overview

This article addresses the question of whether a US challenge to the validity of Belgium's undertaxed payments (profits) rule (UTPR)—a fundamental component of the OECD-led pillar 2 global minimum tax project—will affect Canada's forthcoming UTPR. I consider this question, along with the UTPR concept itself, in the course of providing an illustrative discussion that begins with a brief review of pillar 2.

What Is Pillar 2?

Pillar 2 is an agreement made on October 8, 2021, among 137 countries (139 countries, as of June 9, 2023), to enact coordinated laws in each country, ensuring that multinationals with at least €750 million in annual gross revenue pay at least 15 percent tax on their book profits, regardless of where these profits are earned.

Pillar 2 encompasses two primary rules and a backup rule. One primary rule is the "income inclusion rule" (IIR), under which Canada (for example) imposes a "top-up" tax of up to 15 percent on a Canadian corporation, applying the tax to the active business profits of the corporation's tax-haven subsidiary. If the local tax is zero, the top-up tax is 15 percent; if the local tax is 5 percent, the top-up tax is 10 percent. The second primary rule is the "domestic minimum top-up tax" (DMTT) rule, which imposes a tax on a Canadian corporation equal to the amount by which 15 percent of the company's Canadian book profit exceeds the company's tax under the ITA. The backup rule (that is, the UTPR), which is intended to enforce the two primary rules, is explained below.

Enactment Status

In Canada, in June, the two primary rules were enacted in the Global Minimum Tax Act (GMTA). On August 12, the government issued draft UTPR rules to be added to the GMTA. In Belgium, all three components of pillar 2 have been brought into law through the enactment of Council Directive (EU) 2022/2523, which contains the applicable rules. In the United States, the pillar 2 rules have not been enacted because of Republican opposition.

Illustrative Discussion

Assume that a US corporation ("US Parent") with subsidiaries in Belgium and Canada has group gross revenue of at least €750 million and is therefore covered by pillar 2, making the company subject to the pillar 2 global minimum tax rules enacted or being enacted in Belgium and Canada.

Assume that US Parent's book profits from its own direct operations are US$900 million but that its taxable income under the Internal Revenue Code is only US$400 million and that it pays US corporate tax (including state tax) of 25 percent (amounting to $100 million). In other words, US Parent pays an effective tax rate on its book profits of only 11 percent (if we ignore the US corporate alternative minimum tax).

Because the United States has not enacted pillar 2, the DMTT component of pillar 2 does not apply to US Parent. If pillar 2 had been enacted, US Parent would have to pay to the United States the difference between 15 percent (which is the target minimum tax rate) of $900 million and 11 percent of $900 million (that is, $36 million).

However, because the United States has not enacted pillar 2, that liability to the United States does not arise. But the overall pillar 2 project has been designed to capture this $36 million somewhere—and that "somewhere," in this case, is one or more countries where US Parent has subsidiaries and where the UTPR component of pillar 2 has been enacted. As noted above, Belgium is one such country, and Canada is in the process of becoming another. (Assume, for the purposes of this analysis, that the UTPR component has been enacted in Canada.)

Radical and irrational though the next step seems, both Belgium and Canada, under the UTPR, would levy a portion of the $36 million on the local subsidiary of US Parent. The portion would be determined by allocating the $36 million on the basis of (1) the relative amount of the tangible assets owned by each subsidiary and (2) the number of employees of each subsidiary. This aggregate $36 million levy on the two subsidiaries would arise even though neither subsidiary has any economic interest in the profits of the US Parent in respect of which the $36 million arises.

Mounting US Opposition to the UTPR

The spectre of the result described above has led US interests to oppose the UTPR in at least two ways. One way is the threat from Republican members of Congress to enact retaliatory legislation against countries (such as Belgium and Canada) that enact and apply UTPRs to local subsidiaries of US groups. For example, a draft House of Representatives bill, tabled last year but not yet enacted, would add 20 percentage points of tax to the US rate of tax otherwise paid on the US income of persons based in an offending country. Another example is a draft 2023 House bill that would increase, in certain circumstances, the tax paid by US subsidiaries of Belgian and Canadian parent corporations.

The second way in which US interests are opposing the UTPR is by court challenge to the rule's validity. In particular, the American Free Enterprise Chamber of Commerce launched, in July, a court action (no. 8267) in the Belgium Constitutional Court that challenges the validity of the Belgian UTPR legislation. (For specifics of the case, see Soong's article in *Tax Notes Today International*, 2024.) The separate US Chamber of Commerce (which is the world's largest business federation) published a statement on September 30 in support of the court challenge, affirming that the Chamber "shares AmFree's concerns that the UTPR is fundamentally flawed in both design and implementation, and warrants judicial scrutiny." The statement goes on to note the following:

- The UTPR will adversely impact many Chamber members by requiring EU member states in which large U.S. multinational enterprise ("MNE") groups operate to impose a local "top-up tax" on the U.S.-source income of U.S. group companies.
- The UTPR will undermine the efficacy of U.S. tax credits and incentives that were designed to further legitimate U.S. public policy aims.
- The UTPR will inappropriately tax many Chamber members by failing to recognize the United States' preexisting global minimum tax regime as a qualified income inclusion rule ("IIR").
- The UTPR is unprecedented in its design and contemplates the extraterritorial taxation by EU member states of foreign companies' foreign-source income

without any genuine nexus to the taxing jurisdiction, in breach of customary international law.
- A significant UTPR liability could threaten the economic viability of a U.S. MNE's European subsidiary, in breach of EU law.

Effects on Canada of the US Challenge to the Belgian UTPR Legislation

The US challenge may affect Canada's pending UTPR in two ways. First, it may inspire—whether immediately or after the outcome of the Belgian action—a similar action before a Canadian court. If successful, this action would preclude any part of the $36 million from being levied against the Canadian subsidiary. It should be noted, however, that the various amendments proposed by the Department of Finance in August include a proposal to amend the Income Tax Conventions Interpretation Act so as to shield the GMTA from tax treaty challenges.

The second way in which the US challenge to Belgium's legislation may affect Canada's UTPR is more extreme: it could lead to the full $36 million being levied against the Canadian subsidiary if both (1) the Belgian action prevails, such that no Belgian UTPR is levied against the Belgian subsidiary; and (2) no comparable action in Canada is successful.

Concluding Comment

It has been widely argued that the UTPR is inappropriate and perhaps invalid law. (See, for example, articles by Li, in *Tax Notes International* (March 21, 2022); Nikolakakis and Li, in *Tax Notes International* (February 6, 2023); Brown and Whitsitt, in (2023) 71:1 *Canadian Tax Journal*; Kizniacki, in *Tax Notes International* (October 9, 2023); Boidman, in *Tax Management International Journal* (November 4, 2022); Mason, in *Tax Notes International* (September 19, 2022); and Boidman and Kandev, in Wolters Kluwer *International Tax* no. 133 December 2023.)

It is therefore inevitable that the UTPR will be judicially challenged. It seems likely, too, as suggested above, that the challenge to the Belgian UTPR will not be the last. Given the bizarre and unprincipled nature of the rule, it is difficult to predict how the issues raised by the UTPR will play out.

Perhaps the most important question, ultimately, is whether the action against the Belgian UTPR legislation will lead to similar challenges across the European Union (each of which could indirectly affect Canada). After all, a Belgian decision won't bind other EU countries, but if the decision is appealed to the Court of Justice of the European Union (CJEU), it seems inevitable (given that the underlying law is derived from an EU directive that is binding on all EU countries) that challenges to the validity of the UTPR will become widespread.

Moreover, preliminary question procedures, followed during the case hearing, that involve the CJEU could lead to binding effects across the European Union even before a final decision by the Belgian court.

Finally, interested parties should also be following the outcome of another EU pillar 2 court challenge, in *Fugro NV* (Case C-146/24). This challenge was rejected by the General Court in December 2023 on procedural grounds, but that decision has been appealed to the CJEU.

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GE Financial Investments: UK Court of Appeal Denies Double Tax Relief

Introduction

On July 17, 2024, the UK Court of Appeal rendered its decision in *GE Financial Investments* ([2024] EWCA Civ 797; leave to appeal to the UK Supreme Court denied). This was the latest chapter in an ongoing dispute that concerns whether GE Financial Investments ("GEFI UK"), a UK private limited company, is entitled to double taxation relief under the UK-US double taxation convention ("the treaty") in respect of US-source interest income that has been comprehensively taxed by both the United Kingdom and the United States under their respective domestic laws. The court held that GEFI UK was not entitled to claim a foreign tax credit in the United Kingdom for US tax paid on that income, and the court thereby overruled the Upper Tribunal's decision in the matter. We first discussed this case in the November 2023 issue of this newsletter. In this updated discussion, we examine the Court of Appeal's decision, which addresses some of the soft spots we previously observed in the Upper Tribunal's reasons.

The primary issue in this case concerns foundational principles of corporate residence under double taxation treaties—in particular, whether a person's being liable to tax, in the relevant state, on worldwide income is by itself sufficient to establish treaty residence, or whether such tax liability must, in addition, result from a factual connection or attachment between the relevant person and the relevant state. As discussed in greater detail below, the UK Court of Appeal held that article 4(1) of the treaty embodies the latter principle; the court thus rejected the views of the Upper Tribunal, which endorsed a broader, more functional interpretation according to which the establishment of treaty residence requires only that the person be subject to comprehensive taxation in the relevant state.

The secondary issue concerns the level of commercial activity required to engage the provisions of article 7(1) of the treaty with respect to business profits. Although this issue is less striking than the one concerning corporate residence,

we briefly touch on this part of the court's reasons, because it is a useful reminder that, in general, a source state will be allocated primary taxing rights over profits attributable to a permanent establishment (PE) situated in that state only if those profits are earned in the course of activities that rise to the level of a business (as opposed to activities that involve a merely passive endeavour).

Background

GEFI UK and GE Financial Investments Inc. ("GEFI US") were members of a Delaware limited partnership ("the partnership")—GEFI UK as a limited partner and GEFI US as a general partner. The partnership's activities consisted of holding five loan receivables owed by GE affiliates, totalling approximately US $2.8 billion. Two of the debt obligations were contributed to the partnership upon its formation, while the remainder represented new cash contributions made by the partners. During the period at issue, GEFI UK's share of the partnership's interest income amounted to approximately US$790 million.

As a UK incorporated company, GEFI UK was liable to tax in the United Kingdom on its worldwide income. However, given that the shares of GEFI UK and GEFI US were "stapled" (that is to say, the shares of one could not be sold without the shares of the other), section 269B of the US Internal Revenue Code ("the Code") deemed GEFI UK to be a "domestic corporation" and therefore liable to US tax on its worldwide income, notwithstanding the provisions of any US double taxation convention (including the treaty).

As a result, GEFI UK paid approximately US$303 million of US tax (at a rate of 35 percent) on its share of the partnership's interest income during the relevant period and claimed a credit for the US tax paid against its UK tax liability. His Majesty's Revenue & Customs (HMRC), however, denied the credit, so that GEFI UK had to pay—in addition to the US tax—approximately £189 million of UK tax and interest. The First-Tier Tribunal (FTT) upheld HMRC's assessment. The Upper Tribunal vacated it for the reasons mentioned in our November 2023 article.

Decision

The United Kingdom would be required to grant GEFI UK a foreign tax credit for US tax paid under article 24(4) of the treaty only if it could be shown that the US tax was payable "in accordance with" the treaty. GEFI UK's primary position was that the United States had a right to tax the company's share of the partnership's interest income under article 11(1) because GEFI UK was a US resident for treaty purposes. Failing that, GEFI UK's alternative position was that the income was taxable in the United States under article 7(1) because the company had earned it in the course of carrying on business in that country through a PE situated therein. The UK Court of Appeal rejected both arguments for the reasons mentioned below.

Issue 1: Treaty Residence

In order to be a US resident for the purposes of the UK-US treaty, a person must generally be "liable to tax therein by reason of his domicile, residence, citizenship, place of management, place of incorporation, or any other criterion of a similar nature."

It was not disputed that GEFI UK satisfied the "liable to tax" condition: the company was subject to US tax on its worldwide income as a deemed domestic corporation. It was likewise incontrovertible that such tax liability did not result from any of the criteria enumerated in article 4(1) of the treaty—namely, domicile, residence, citizenship, place of management, or place of incorporation. The sole issue for the UK Court of Appeal was whether GEFI UK's comprehensive US tax was imposed by reason of a "criterion of a similar nature."

HMRC argued that this phrase requires the existence of a necessary "connection" or "attachment" between the relevant person and the purported state of residence, and that share stapling does not satisfy that requirement. The taxpayer, on the other hand, asserted that article 4(1) merely establishes that taxation on a worldwide basis (rather than a source basis) is required to establish treaty residence. In the alternative, the taxpayer argued that the factual conditions identified in section 269B of the Code are tantamount to a "criterion of a similar nature." The court held in favour of HMRC, mainly for the five reasons discussed below.

1. Text, Context, and Purpose

First, the court found that a unified textual, contextual, and purposive interpretation of article 4(1) supports HMRC's position that treaty residence requires comprehensive tax imposed on the basis of sufficient factual connections. The ordinary meaning of the text, according to the court, is clearly that treaty residence is not conferred merely on the basis of where a person is liable to tax. Rather, such liability must result from the person having a particular status. Article 4(1) sets out a list identifying specific factual or legal connecting factors in the establishment of treaty residence: domicile, residence, citizenship, place of management, and place of incorporation. Such connecting factors are followed by an ejusdem generis provision (that is, the phrase "any other criterion of a similar nature"). This provision necessarily implies that in order for a person to establish treaty residence on a basis other than the connecting factors specifically listed, the person's liability to tax must stem from a connection that has a character or quality that is similar to those of these listed factors. According to the court, if comprehensive taxation were the only requirement to establish treaty residence, no list of connecting factors would be needed. This is especially true when one considers that the treaty's inclusion of place of incorporation and citizenship in article 4(1) represents a departure from the OECD model tax convention (which refers only to domicile, residence, and place

of management). In the court's view, these additional connecting factors would serve no purpose if worldwide taxation were the sole condition for treaty residence. In short, the court found that what the taxpayer was really attempting to argue was that the phrase "of a similar nature" should be read as "to the same effect" or "having the same consequence," a reading that, in the court's view, could not be reasonably supported.

The court then turned to the context of the definition of "resident of a Contracting State" in article 4(1) and found that this definition, too, suggests that treaty residence is dependent on factual connections. For example, the court noted that article 4(2) provides that an individual without a substantial presence, permanent home, or habitual abode in the United States will not qualify as a US resident under the treaty solely on the basis that he or she has US citizenship or holds a US "green card." In addition, the tiebreaker rules for individuals in article 4(4) generally turn on the relative strength of the connections between the relevant individual and each of the contracting states. Finally, the court pointed to the carve-out provision in article 4(1), which denies treaty residence to certain persons who may otherwise qualify as residents of a contracting state. It noted that the second carve-out (that is, for persons who are liable to tax in a state only in respect of profits attributable to a PE in that state) departs from the OECD model tax convention, and the court posited that the only rational reason for this carve-out was to clarify that the taxation of a PE's profits does not constitute a local connection sufficient to establish treaty residence. The court stated that if worldwide taxation were the only test, this carve-out would be of no moment.

The court then considered the general object and purpose of double taxation treaties, which is, among other things, to relieve double taxation by restricting the taxing right of a contracting state or requiring one state to give credit for tax paid in the other. Citing the majority opinion of the SCC in *Alta Energy Luxembourg SARL* (2021 SCC 49), the court noted that this solution is generally achieved by allocating primary taxing rights between the state of residence and the state of source. In the case of taxing interest, article 11(1) of the UK-US treaty grants the primary taxing right to the state of residence, unless the interest income is attributable to a business carried on through a PE in the source state, in which case the source state would have the primary taxing right under article 7(1).

Given that one state may have to give up or restrict its taxing right if the other has free reign to determine who its residents are for treaty purposes, the Court of Appeal noted that each contracting state has a clear incentive to delineate the scope of the other state's ability to determine who falls within the concept of residence. In the case at hand, if GEFI UK were to be considered a US resident for treaty purposes, the United Kingdom would be required to give credit for US tax paid against UK tax applicable on the same income, absent a mutual agreement between the contracting states on the mode of applying the treaty (articles 4(5) and 24(4)). The court found that it could not have been intended that the United States could unilaterally make certain companies resident therein simply by deeming them domestic corporations. The taxpayer attempted to convince the court otherwise, arguing that the deeming rule in section 269B of the Code existed when the treaty was agreed to, and that any unilateral action by the United States could result in the termination or renegotiation of the treaty. The court, however, held that "a much more sensible interpretation" of article 4(1) is that, in order to establish treaty residence, one must identify a connecting factor that justifies imposing comprehensive taxation.

2. OECD Commentary

Second, the court found that the commentary on article 4 of the 2000 OECD model tax convention (the model on which the treaty was largely based) reinforces the textual, contextual, and purposive interpretation mentioned above. The court noted that the common thread running through the commentary, as the following examples demonstrate, is that treaty residence must generally be established by a requisite level of connection or attachment:

- The general commentary on article 4 refers to the fact that the domestic laws of a state generally impose comprehensive tax on the basis of a person's "personal attachment" to that state.
- The commentary on article 4(1) states that the provision refers to persons who are liable to tax "by reason of various criteria."
- The commentary on article 4(2) explains how a dual-resident individual's treaty residence is resolved by prioritizing the individual's "attachment" to one state over his or her "attachment" to the other.
- Finally, the commentary on article 4(3) (a tiebreaker rule providing that the residence of a person other than an individual is determined by that person's place of effective management) emphasizes the importance of factual connections (that is, the place where key management-and-control decisions are made), rather than purely formal criteria such as registration.

To persuade the court otherwise, the taxpayer cited OECD commentary suggesting that bilateral tax treaties generally defer to domestic law when it comes to determining when a person is fully liable to tax, and it cited additional commentary that acknowledges that comprehensive taxation may be imposed by a deeming rule. However, the court found these passages unhelpful to GEFI UK, because they do not imply that *any* rule that imposes worldwide taxation necessarily establishes treaty residence.

3. Foreign Authorities

Third, the court endorsed academic commentary by Klaus Vogel and Canadian practitioner Robert Couzin, who have

maintained that treaty residence requires, in addition to unlimited tax liability, a territorial connection between the relevant taxpayer and the contracting state. The court also cited Vogel's published view that a provision of domestic law that deems a person to be fully liable to tax generally does not qualify as a "criterion of a similar nature" (paragraph 110).

The taxpayer attempted to persuade the court otherwise by referring to two SCC decisions. It argued that *Crown Forest Industries Ltd.* ([1995] 2 SCR 802) supports the taxpayer's position that the sole criterion for determining treaty residence is whether the person in question is liable to as comprehensive a tax liability as the relevant state imposes. The court rejected that argument, stating that although comprehensive taxation is necessary, *Crown Forest* did not establish whether that, alone, is sufficient.

The court also found that *Alta Energy* was of no help to GEFI UK: that case concerned whether GAAR applied to an entity that was, as the Crown admitted, a treaty resident of Luxembourg under the technical provisions of the treaty. The Crown attempted to argue that treaty benefits should be denied to the entity because the object, spirit, and purpose of the treaty-residence provisions ostensibly require a person to have "sufficient substantive economic connections" to its alleged state of residence, an argument that a majority of the SCC firmly rejected.

4. US-Netherlands Treaty

Fourth, the court addressed a memorandum of understanding concluded between the United States and the Netherlands in which they appear to agree that a stapled entity should be treated as a US resident for the purposes of the US-Netherlands double taxation convention:

> It is understood that, if a company is a resident of the Netherlands under paragraph 1 of Article 4 (Resident) and, because of the application of Section 269 B of the Internal Revenue Code, such company is also a resident of the United States under paragraph 1 of Article 4 (Resident), the question of its residency for the purposes of the application of this Convention shall be subject to a mutual agreement procedure as laid down in paragraph 4 of Article 4 (Resident).

The court held that this is "best seen as no more than the unilateral opinion of one of the parties, which is not a relevant aid to interpretation." The court added that the fact that a third party (that is, the Netherlands) may have acceded to that position in a different treaty context, in circumstances not known, made no difference to the case at hand.

5. Share Stapling: Not a Criterion of a Similar Nature

Finally, the court summarily rejected the taxpayer's alternative argument: that the deeming rule in section 269B of the Code qualifies as a "criterion of a similar nature." It noted that the US connections mentioned in the statutory provision are limited to (1) the stapling of more than 50 percent of a foreign corporation's shares (by value) to those of a US domestic corporation, and (2) at least 50 percent direct or indirect ownership by US persons. The court viewed these factual requirements as insufficient because neither requires any form of link—whether formal (such as incorporation) or factual (such as place of management)—between the foreign corporation and the United States. Moreover, the court held that any finding that GEFI UK may have had "substantive economic ties" to the United States would be inconsequential, because such ties are irrelevant to the operation of section 269B of the Code.

Issue 2: Carrying On Business Through a Permanent Establishment

On the secondary issue, the court affirmed the decisions of the lower tribunals to the effect that GEFI UK did not carry on business, a result that is generally consistent with Canadian tax law (see, for example, *Kallis v. The Queen*, 2021 TCC 58).

The court began by acknowledging that, under UK case law, a company that puts any of its assets to gainful use is generally presumed to carry on business—a legal principle equally applicable in Canada (see, for example, *Canadian Marconi v. R*, [1986] 2 SCR 522). However, the court also stated that a strong presumption or inference that a company is carrying on business does not necessarily mean that it is in fact doing so.

The factual analysis focused on whether GEFI UK carried on business through the activities of the partnership (or, more specifically, the activities of its general partner). The court held that, for the following reasons, the lower tribunals' decisions should not be disturbed:

- The limited partnership agreement showed that the partnership was intended to be a passive holding vehicle, rather than an entity carrying on activities that amount to a business, because its main purpose was to "hold directly or indirectly financial receivables and other assets."
- Holding five affiliate loans over the course of approximately six years (only three of which originated with the partnership) was found to be more of a passive, sporadic, or isolated activity than a regular, continuous series of activities.
- There was no evidence that personnel or agents acting on behalf of the partnership made or conducted continuous or regular commercial activities in the United States.
- The activities of the directors of the general partner demonstrated little strategic direction. They directed cash to debtors without negotiating the terms of the loans, and without the level of consideration at the board level that one would expect from an entity carrying on commercial activities on sound business principles.

- Although the sums involved were clearly substantial (approximately US$2.8 billion in total), their quantum was inconsequential, because the factual test is a qualitative one.

It followed, therefore, that the treaty did not allow the United States to tax GEFI UK's share of the partnership income under article 7(1).

Double Taxation Relief in Canada

Our article in the November 2023 issue of this newsletter provided some comments from a Canadian perspective on the primary issue in this case: corporate treaty residence. Here, we briefly consider how Canada's approach to resolving double taxation issues differs from the United Kingdom's.

In this case, the court did not consider provisions of UK domestic law; rather, it examined the taxpayer's entitlement to a UK foreign tax credit solely through the prism of article 24(4). However, under Canadian treaties, Canada's obligation to grant foreign tax credits in respect of foreign-source income is generally governed by the provisions of the ITA.

Subsection 126(1) of the ITA grants a credit in respect of "non-business-income tax" paid to a foreign country, provided that such tax is paid in respect of income "from sources in that country." Therefore, if GEFI UK were a Canadian resident for tax purposes, its entitlement to a foreign tax credit under the ITA would be conditional on the partnership's interest income coming from a US source.

Although the ITA does not provide detailed sourcing rules, it is a commonplace that passive income should generally be sourced to the payer's state of residence (see, for example, *Income Tax Folio* S5-F2-C1, at paragraph 1.58). Given that the partnership's interest income was received from US-resident debtors, that income would normally be considered US-source income under general principles. However, article XXIV(3)(b) of the Canada-US tax treaty would likely have deemed the income to be from a Canadian source, given that the United States would not have been entitled to tax that income under article VII (Business Profits) or article XI (Interest). Therefore, as in the United Kingdom, no foreign tax credit would have been available in Canada, although double taxation could have been partially mitigated under subsection 20(12) of the ITA, which grants a deduction for non-business-income tax paid to a foreign country in respect of Canadian-source income.

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A Bifurcated Process Looms for Canadian Tax Appeals

One of the hallmarks of the Canadian tax system is the TCC, a specialized court established in 1983 to hear appeals that arise in connection with federal taxing statutes over which the TCC has exclusive jurisdiction. The recent decisions of the SCC in the companion cases of *Dow Chemical Canada ULC v. Canada* (2024 SCC 23) and *Iris Technologies Inc. v. Canada* (2024 SCC 24) consider the limitations of the TCC's jurisdiction, and they provide guidance on when a matter must be brought, generally by way of judicial review, to the Federal Court (FC).

Unfortunately, these two decisions also raise the spectre of bifurcated appeals processes in cases where the relevant statutory provisions grant the minister discretion. This would have wide-ranging implications for both income tax and GST/HST appeals, but an especially obvious area of concern is the treatment of zero-rating sales of exported goods under section 1 of part V of schedule VI of the ETA. This issue may well require appeals to *both* the TCC and the FC.

Dow Chemical Decision

The facts of *Dow Chemical* involved an income tax audit focused on transfer pricing. During the audit, the taxpayer requested a downward transfer-pricing adjustment under subsection 247(2) of the ITA. Under this provision, certain adjustments are restricted unless, "in the opinion of the Minister, the circumstances are such that it would be appropriate that the adjustment be made." In the case of *Dow Chemical*, the minister decided that such downward adjustments were not appropriate and issued an assessment that did not include them. Dow Chemical appealed that assessment to the TCC.

As an initial matter, the TCC (2020 TCC 139) considered its jurisdiction as a question of law under rule 58 of the Tax Court of Canada Rules, and it determined that it *could* hear appeals on whether the minister correctly exercised discretion under subsection 247(10) of the ITA: this discretion was "an essential component of the assessment" and therefore within the TCC's exclusive jurisdiction (see paragraph 29).

On appeal, the FCA (2022 FCA 70) disagreed that the TCC had jurisdiction over the issue. After reviewing the relevant statutory provisions, the FCA concluded that unless "the ITA expressly provides for an appeal from the opinion of the Minister rendered under subsection 247(10) of the ITA . . . the Federal Court would retain jurisdiction to judicially review that opinion" (see paragraph 34).

The SCC upheld the FCA's decision on appeal, concluding that the minister's decision regarding the appropriateness of a downward adjustment involved an exercise of discretion and was therefore "a separate decision that stands apart from the assessment" (see paragraph 6). Given that the TCC's jurisdiction

is "limited to reviewing the correctness of assessments," the FC was the appropriate forum for issues involving the minister's decision under subsection 247(10) of the ITA.

Iris Decision

The facts of *Iris* involved GST/HST input tax credits (ITCs) worth $98 million, which were claimed by Iris for the monthly reporting periods from September 2019 to February 2020. Following the filing of Iris's returns, the CRA began an audit on October 30, 2019, effectively withholding payment of any refunds until the audit was concluded. Iris brought an application in the FC seeking mandamus—that is, an order forcing the CRA to issue reassessments for the monthly reporting periods at issue. While that application was pending, the CRA issued notices of reassessment denying the ITCs and imposing a 25 percent gross negligence penalty on April 9, 2020.

Iris applied to the FC, in July 2020, for judicial review of the minister's decision to issue those assessments, taking the position that (1) the minister had denied it procedural fairness in the audit and assessment process; (2) no evidentiary foundation existed for the assessment; and (3) the assessments were issued for the improper purpose of depriving the FC of the chance to consider the issues in the mandamus application. The Crown brought a motion to strike the judicial review application on the basis that Iris was, in reality, complaining about the correctness of the assessment, which should be challenged through the normal notice of objection and TCC appeals process.

The minister's motion was refused by a prothonotary of the FC, and so the minister appealed. The FC (2021 FC 597) dismissed the Crown's appeal on the basis that the registrant's application challenged the procedural fairness of the assessment, not the assessment itself (see paragraph 32). On appeal, the FCA (2022 FCA 101) overruled the FC, agreeing with the Crown that, although Iris may have framed its judicial review application with a focus on the procedural fairness of the assessment, it was in fact merely a "collateral challenge" to the validity of the assessment and therefore a matter exclusively before the TCC (see paragraph 6).

On further appeal, the SCC upheld the FCA's decision, agreeing that the nature of Iris's application was an attack on the correctness of the assessment; the matter ought to have been dealt with through the normal notice of objection process and then brought before the TCC if the result on objection was unsatisfactory to the taxpayer (see paragraphs 28 and 33). The SCC also took the opportunity to further elucidate its position in *Dow Chemical*; it pointed to the distinction between a "ministerial discretionary decision" and an "assessment" as the key to determining jurisdiction (see paragraph 8). In the SCC's view, Parliament intended "jurisdiction in tax matters" to be "shared between the two courts," with the TCC *not* being "a one-stop judicial shop for resolving tax disputes" (see paragraph 9).

Zero-Rated Exports of Goods

In the SCC's view, Parliament intended that the TCC and FC share jurisdiction in tax matters. However, a quick consideration of the situation for zero-rated sales for export demonstrates how the SCC's decision may result in a new "bifurcated" process for challenging certain audit assessments.

Consider section 1 of part V of schedule VI to the ETA, which generally zero-rates supplies of tangible personal property made to a recipient who intends to export the property, provided that certain conditions are met. One of the conditions in paragraph (e) is that "the [supplier] maintains evidence satisfactory to the Minister of the exportation of the property by the recipient." The phrase "evidence satisfactory to the Minister" appears to invoke exactly the kind of discretionary decision that the SCC has indicated should be reviewed by the FC rather than by the TCC.

If a CRA auditor issues a notice of reassessment to a supplier for failure to charge and collect GST/HST, and the only question is whether the supplier maintained "evidence satisfactory to the Minister of the exportation," that supplier might now be required to take two steps to challenge the assessment: (1) file a notice of objection with respect to the assessment, and (2) file a judicial review application with respect to the minister's discretionary decision that the evidence maintained by the supplier was not "satisfactory to the Minister."

The SCC seems to have presumed in *Dow Chemical* that only large multinational corporate taxpayers challenge discretionary decisions under subsection 247(10) of the ITA. A far more common occurrence, however, is challenges by much smaller suppliers that are relying on the zero-rating provision in section 1 of part V of schedule VI to the ETA in order to zero-rate sales to their customers. These smaller taxpayers are less likely than large corporate taxpayers to understand either the tight time frames for judicial review or the significance of the SCC's decisions, and they may end up filing notices of objection or appealing to the TCC on issues that no longer appear to be within the TCC's jurisdiction.

Accordingly, we expect these companion SCC decisions to continue to have a significant impact for the next number of years, as registrants (and their advisers) come to a full understanding of what these decisions mean for the process of challenging assessments.

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Ceasing Residence: Revisiting Planning in Light of Increased Capital Gain Rates

In *Barwicz c. Le Roi* (2024 CCI 93), a change in the trust's tax residence resulted in a deemed taxation year-end for the trust and a deemed disposition of the property belonging to the trust. The case itself was settled on the basis of the wording in subsection 128.1(4): for greater certainty, paragraph 94(4)(e) deems a trust not to be resident in Canada for the purposes of applying subsection 128.1(4).

The taxpayer's motivation in *Barwicz* is unclear (at least to this author), but the case provides an opportunity to revisit some of the planning considerations and potential pitfalls involved in a taxpayer's ceasing Canadian residence—an especially useful exercise, given the increase in tax rates on capital gains and given that the purpose of subsection 128.1(4) is to crystallize any taxable capital gains as of the date that residence ceases, despite additional compliance requirements from the resulting deemed year-end.

The Case and Outcome

A discretionary Canadian-resident trust was settled on December 13, 2001 by the taxpayer's spouse. The sole trustee was to be a Canadian corporation, and the trust was to have nine beneficiaries, all entitled to the same rights and benefits. On the same day, the trust acquired 1,225,932 shares of a Canadian corporation (held by the Barwicz Family Trust). Four days later, the trustee was changed to a Barbados-resident corporation. Therefore, the trust became a resident of Barbados for the purposes of the Canada-Barbados tax convention, and it remained resident in Barbados. Before its liquidation and dissolution, the trust made two capital distributions to Mr. Barwicz, a taxpayer resident in Canada, in amounts of $2,250,000 (in 2004) and $830,288 (in 2005), the latter a final distribution. The minister, at the time of the second (2005) transfer, assessed the trust with a tax debt in the amount of $1,602,233.35, and the taxpayer was held jointly and severally responsible for that debt. The taxpayer appealed, and this appeal was unsuccessful.

TCC Analysis

The TCC addressed two issues: the tax residence of the trust, and the application of tax liability to the taxpayer under subsection 160(1). (In this article, I focus on the tax residence issue.) Pursuant to paragraph 128.1(4)(a), the change of trustee (from Canadian-resident corporation to Barbados-resident corporation) triggered the end of a taxation year as of the time when the trust ceased to be a Canadian resident; at that particular time, a new taxation year began that ended as of December 31. Thus, there were two different taxation years alongside a deemed disposition of the shares on the date that the trust's Canadian residence ceased. Specifically, paragraph 249(1)(c) requires that the trust have a calendar year-end, while paragraph 128.1(4)(a) deems a year-end to occur at the cessation of residence, overriding paragraph 249(1)(c) and subsection 94(1). The TCC correctly concluded that the taxpayer ignored the wording in paragraph 128.1(4)(a), which took precedence over subsection 94(1) and resulted, accordingly, in a deemed year-end of December 17, 2001. Subsection 94(1) applied only to the new year, for the period spanning December 18, 2001 to December 31, 2001, throughout which the trust was, but for subsection 94(1), a non-resident. The resulting two tax year-ends led to some complex tax compliance issues (which are discussed elsewhere: see the article by Kerslake and Armena in this year's November issue of *Canadian Tax Focus*).

Barwicz Today: Planning Opportunities

A notable fact in *Barwicz* is that the beneficiaries were residents of Canada at the time when the Canadian-resident trustee was replaced by a Barbados-resident trustee, a situation that led to undesirable tax consequences. Could the taxpayer have done better? Some planning options, meant to be illustrative and generic, are addressed below. Some of these options, given the current proposal to increase the capital gains tax from 50 percent to 66.67 percent, could lead to a significant tax benefit if the disposed property is capital in nature.

Note: a careful reader and planner must apply prudence, caution, and proper analysis under the new, broader GAAR (section 245 of the Act) and must also, where appropriate, consider the "reportable transaction" rules under section 237.3. (See, in this regard, the CRA's August 15, 2024 update, titled Mandatory Disclosure Rules—Guidance.)

Some Planning Options

Disposition by a Trust

Factual residence: central management and control (CMC). In *Barwicz*, the disposition was triggered by the trustee's change of residence. Could the trust have benefited from an argument (assuming, for the purposes of this discussion, that this argument corresponded to the facts of that case) that the CMC of the trust was a resident of Canada (before the trustee ceased residence in Canada)? In *Theodoros Darmos Family Trust* (2023 ONSC 6431), a recent ruling, the Ontario court held that the residence of the trust is a "factual residence" that depends on where the CMC resides, not necessarily on the physical location of the trustee itself. The trustee in *Theodoros Darmos* had changed residence from one Canadian province to another. The court's ruling in the case did not fall under subsection 128.1(4), and it remains to be seen whether factual residence and de facto control due to a resident CMC can be extended to a situation where a trustee emigrates from Canada. Depending on the facts, such an extension of the principle would not be inconsistent with the Supreme Court's decision in *St. Michael Trust*, sub nom. *Fundy Settlement v. Canada* (2012 SCC 14).

Share exchanges: marginal gains. Consider a situation where, instead of 1,225,932 shares of a Canadian corporation (Canco) being purchased by the trust from the Barwicz Family Trust, the Barwicz Family Trust exchanged its shares of Canco for fixed freeze shares and new nominal common shares of Canco, and the Canco common shares were then acquired by the trust.

In this case, it is likely that no significant tax would arise from the transfer, since the common shares have nominal value and a similar outcome is involved for the trust as soon as it emigrates from Canada—a trivial consequence.

On the other hand, if the trustee emigrated to Barbados at a later time (and assuming that the common shares pick up value), tax debt will arise because of a deemed disposition. In this case, the tax savings is on account of the trust's not needing to remit any provincial taxes—that is, the savings is the tax difference between the federal and provincial tax rates. In Ontario, for example, this is roughly a 4.69 percent savings, which can be a considerable amount in the case of large dispositions. And it is worth mentioning, too, that in this type of transaction, no qualifying disposition exists that can benefit from being an exclusion for the purposes of subsection 128.1(4), because the common shares were acquired as a consequence of an exchange—that is, share consideration was received because of a previous tax-deferred transfer.

Moreover, a variation of the transaction described above could be one in which the trust ceases residence and then there is a later departure by the beneficiaries; the transaction could be structured in such a way that the beneficiaries' interest is a qualifying disposition. If this is done, the beneficiaries' departure is not subject to a deemed disposition until the individual interest is disposed (see further discussion below).

Minimize tax debt: valuation using life insurance—subsection 70(5.3). Subsection 70(5.3) is a valuation rule that applies to life insurance policies when property is deemed to be disposed of under subsection 70(5), subsection 104(4), and section 128.1. In our case, the relevant section is section 128.1, which applies when the trust ceases to be a resident of Canada.

Assume the following hypothetical. Canco has $50 million of cash (debt-free) and undertakes the following:

- Before the change of trustee to Barbados, the Canadian-resident trust loans $20 million to Canco, such that Canco now has $70 million of cash and a $20 million debt.
- Canco purchases life insurance with a value of $20 million, with the result that the company now has assets of $70 million, a debt of $20 million, and a value of $50 million.
- The trustee moves to Barbados, triggering subsection 70(5.3), which deems the policy value to be equal to its cash surrender value under subsection 148(9). This can reduce the value of the Canco shares and, if the reduction is sufficiently large, may eliminate the share value, thereby reducing or eliminating the tax on the deemed disposition.

A variation on the planning set out above could involve the use of other types of insurance products, but a discussion of that possibility is beyond the scope of this article.

Administrative position. The CRA has cautioned against the use of life insurance policies to minimize departure tax. (See the CRA's comments at the Canadian Life and Health Insurance Association Tax Officers Conference in May 2021, and see also the February 2020 *As a Matter of Tax* blog post.) A complete analysis of the relevant administrative views is beyond the scope of this article.

Disposition by an Individual

Qualifying disposition: excluded right or interest (ERI). An ERI is an asset owned by a taxpayer (for example, an interest in a trust) that would not be deemed to be disposed if that taxpayer ceased residence. If an individual personally owns shares of Canco and subsequently ceases residence in Canada, the individual will be deemed to dispose of the Canco shares. However, if the same individual (1) is a beneficiary of a trust that meets the ERI definition under paragraph 128.1(10)(j) and (2) ceases residence, the beneficiary will not be deemed to dispose of an interest in the trust. When, in such a case, the trust pays income to the now non-resident beneficiary, that income will be subject to part XIII tax. The actual tax can be significantly lower than it would be for an individual disposing of the interest as a Canadian resident. A note of caution: the taxpayer must consider the consequences of the anti-avoidance provisions under paragraph 107.4(3)(h). These rules apply only to individuals and involve determining, as a question of fact, whether the intent to cease residence was motivated by a tax benefit.

Rollover to a spousal trust: triggering paragraph 104(4)(a.3). Paragraph 104(4)(a.3) is a deeming rule that applies when some property has been transferred to a trust pursuant to subsection 73(1) by an individual in anticipation of a subsequent emigration from Canada. Under this rule, the transferred property is deemed to be disposed of by the transferee trust when the individual ceases to reside in Canada, and to be reacquired by the trust. This rule can be used advantageously as follows:

- Before emigrating, a spousal trust is settled, and Canco shares are rolled over on a tax-deferred basis into the spousal trust under subsection 73(1).
- The transferor immediately emigrates from Canada, triggering paragraph 104(4)(a.3), and the spousal trust is now deemed to have disposed of the Canco shares, resulting in a capital gain.
- Subsequently, the spousal trust redeems the Canco shares, resulting in a capital loss that is applied to offset the capital gain from the deemed disposition.

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ISSN 2816-4415 (Online)

The spousal trust can distribute the deemed dividend income subject to part XIII withholding tax. The actual tax rate can be dependent on the tax treaty agreements with Canada.

Deferring taxes: election under subsection 220(4.5). In a scenario where the trust (or individual) emigrates and is not immediately taxed, the trust (or individual) can consider electing under subsection 220(4.5) and providing appropriate security. This election allows for the deferral of taxes immediately payable because of a deemed disposition. Note that this election does not in itself ensure any particular tax treatment by the CRA. An election must be filed on or before the trust's balance-due day for the year of emigration. Paragraph (a) of the definition of "balance-due day" in subsection 248(1) provides that, in the case of a trust, that day is the 90th day after the end of the trust's taxation year. Note that under subsection 220(4.5), the minister can extend this timeline for making an election. The election applies equally to individuals or trusts that are departing Canada. (See also CRA document no. 2021-0892681C6, June 15, 2021.)

Author's postscript: I owe thanks to Kenneth Keung for discussions of subsection 128.1(4), and to Hugh Neilson for his patience and insightful comments on the article.

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