FEATURED PERSPECTIVE

Canada Takes First BEPS Steps

by Nathan Boidman and Michael N. Kandev

Nathan Boidman

Michael Kandev

Nathan Boidman and Michael N. Kandev are with Davies Ward Phillips & Vineberg LLP in Montréal.

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In this article, the authors discuss provisions in Canada's 2016 budget inspired by the OECD's final reports on its base erosion and profit-shifting project.

Last December we discussed from a Canadian perspective the final reports[1] issued by the OECD on the 15 action items in its base erosion and profit-shifting project.[2]

We expressed the view that Canada is unlikely to adopt — at least in the near term — any of the OECD's substantive recommendations, except those in relation to action 6 (treaty abuse), but we foresaw the adoption of several of the BEPS procedural recommendations.

Those predictions have been borne out by the March 22 budget from Canada's new Liberal Party federal government, also containing an unexpected extension of the 2014 anti-back-to-back financing rules, which could be seen to be inspired by the BEPS project. The budget also, unusually, encourages the Canada Revenue Agency to employ most of the action 8-10 recommendations on transfer pricing, even though the Supreme Court made clear in its 2012 decision in *Glaxo* that the OECD transfer pricing guidelines do not, per se, make law in Canada.[3]

This article discusses those aspects of the 2016 budget.

Background

In October 2015 the OECD released the final BEPS package, which was endorsed by the G-20 (including Canada) in November 2015. (Prior coverage: *Tax Notes Int'l*, Oct. 12, 2015, p. 103.) The BEPS recommendations fall into four categories:

- new minimum standards;
- revised existing standards;
- common approaches; and
- guidance drawing on best practices.

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[1]See OECD and G-20 base erosion and profit-shifting final package, *available at* http://www.oecd.org/tax/beps-2015-final-reports.htm. The final package contains a report for each of the 15 action items, together with executive summaries, *available at* http://www.oecd.org/ctp/beps-reports-2015-executive-summaries.pdf; explanatory statement, *available at* http://www.oecd.org/ctp/beps-explanatory-statement-2015.pdf; and various other incidental documents.

[2]Nathan Boidman and Michael N. Kandev, ''BEPS: A Spent Force or Radical Change?'' *Tax Notes Int'l*, Dec. 7, 2015, p. 837. *See also* Boidman and Kandev, ''BEPS: The OECD Discovers America?'' *Tax Notes Int'l*, Dec. 16, 2013, p. 1017; Boidman and Kandev, ''BEPS on Hybrids: A Canadian Perspective,'' *Tax Notes Int'l*, June 30, 2014, p. 1233; Boidman and Kandev, ''The BEPS

(Footnote continued in next column.)

Deliverables: A Macro Critique,'' *Tax Notes Int'l*, Nov. 17, 2014, p. 611; and Boidman and Kandev, ''BEPS and Acquisitions of Canadian Targets,'' *Tax Notes Int'l*, Aug. 3, 2015, p. 431.

[3]*Canada v. GlaxoSmithKline Inc.*, 2012 SCC 52, at para. 20.

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Only the new minimum standards are backed by a commitment of all OECD and G-20 countries to consistent implementation.

According to the explanatory statement,[4] minimum standards have been agreed to in four areas:

- treaty shopping;
- country-by-country (CbC) reporting;
- fighting harmful tax practices; and
- improving dispute resolution.

Existing standards have been updated in the areas of tax treaties and transfer pricing. Further, according to the explanatory statement, the countries participating in the BEPS project have agreed to a general tax policy direction in some areas, such as hybrid mismatch arrangements and interest deductibility.[5] The final package contains guidance based on best practices that purportedly would support countries intending to act in the areas of mandatory disclosure initiatives and controlled foreign corporation legislation.

The 2016 budget proceeds with a cautious and very limited implementation of the BEPS proposals, focusing mainly on the new minimum standards.

Implementation of BEPS Recommendations

Action 6 — Treaty Abuse

The final report on action 6 recommends three possible changes to tax treaties to deal with treaty shopping.[6] One change would see the inclusion of a clear statement that the states entering into a tax treaty intend to avoid creating opportunities for nontaxation or reduced taxation through tax evasion or avoidance, including through treaty-shopping arrangements. A second possible change would be the inclusion of a U.S.-style limitation on benefits rule that limits the availability of treaty benefits to entities that meet specific conditions.[7] Finally, another possible modification is the inclusion of a general antiabuse rule based on the principal purposes of transactions or arrangements (the PPT rule) to address other forms of treaty abuse, including treaty-shopping situations that would not be covered by an LOB rule.[8] Significantly, the minimum standard agreed to by all G-20/OECD countries is to be implemented by countries by both including in their tax treaties the general anti-treaty-shopping statement of intention, and at their option, including in their treaties:

- the combined approach of an LOB and PPT rule;
- the PPT rule alone; or
- the LOB rule, supplemented by a mechanism that would deal with conduit financing arrangements not already dealt with in tax treaties.

In other words, the OECD's formulation of the minimum standard effectively avoids setting a single common standard for combating treaty shopping.

We previously wrote in these pages that action 6 is the only substantive BEPS item that is likely to gain traction in Canada because since 2013 Canada has focused on implementing a new BEPS-inspired anti-treaty-shopping approach. The process started when in its 2013 budget, the government announced it would consult on an anti-treaty-shopping rule. Later that year a consultation paper was issued, and despite opposition from the Canadian tax community, in its 2014 budget the Department of Finance proposed adopting a PPT-type domestic anti-shopping treaty override. But then in August 2014 the government announced it would not move ahead until the OECD's BEPS work was complete.

Now that the final package has been released, short-listing treaty shopping among the four minimum standards, the 2016 budget confirms the government's commitment to addressing treaty abuse in accordance with the BEPS proposals. According to the budgetary materials, in the future Canada will consider using either the LOB article or principal purpose test approach to address treaty shopping, depending on the particular circumstances. The budget notes that amendments to Canada's tax treaties to include a treaty antiabuse rule could be achieved through bilateral negotiations, the multilateral instrument that will be developed in 2016, or a combination of the two.

We have a few observations regarding the 2016 budget announcements. First, and most significantly, in line with the BEPS proposals, Canada seems to have abandoned its initiative, presented in the 2014 budget, to adopt a domestic anti-treaty-shopping rule that would serve as a treaty override. This is a welcome development.

[4] *Supra* note 1.

[5] The OECD's expectation is that the legislative practices of countries would converge over time through the implementation of the agreed common approaches, thus enabling further consideration of whether those measures should become minimum standards in the future.

[6] *See* executive summaries, *supra* note 1, at 21-22.

[7] These conditions, based on the legal nature of, ownership in, and general activities of the entity, seek to ensure that there is a sufficient link between the entity and its state of residence. Such LOB provisions are now found in treaties concluded by a few countries, most notably the U.S.

[8] Under that rule, if one of the principal purposes of transactions or arrangements is to obtain treaty benefits, those benefits would be denied unless it is established that granting them would be in accordance with the object and purpose of the provisions of the treaty.

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Second, the 2016 budget suggests that Canada will not be using the OECD's preferred approach of including both an LOB article and a PPT rule in its treaties.

Third, regarding the statements that Canada's anti-treaty-abuse strategy may be implemented through the action 15 multilateral instrument, as we have previously written, we are not certain that Canada is prepared to forgo the bargaining chip benefits of the bilateral treaty negotiation approach, which would be lost if action 15 were adopted.

Action 13 — CbC Reporting

The action 13 report establishes a new minimum standard that requires the adoption of a standardized approach to transfer pricing documentation. Under this approach, multinationals will be required to provide (i) high-level information regarding their global business operations and transfer pricing policies in a master file that will be available to all relevant tax administrations; and (ii) detailed transactional transfer pricing documentation by way of a local file specific to each country, identifying material related-party transactions, the amounts involved in those transactions, and the company's analysis of the transfer pricing determinations it has made regarding those transactions.

Large multinational enterprises will be required to file a CbC report that will provide annually and for each tax jurisdiction in which they do business the amount of revenue, profit before income tax, and income tax paid and accrued. MNEs will also need to report their number of employees, stated capital, retained earnings, and tangible assets in each tax jurisdiction. Finally, the minimum standard requires MNEs to identify each entity within the group doing business in a particular tax jurisdiction and to provide an indication of the business activities in which each entity engages. The action 13 report states that the new CbC reporting requirements should be implemented for fiscal years beginning on or after January 1, 2016, and should apply, subject to a 2020 review, to MNEs with annual consolidated group revenue equal to or exceeding €750 million.

Predictably, the 2016 budget announced that Canada is moving ahead with the OECD's new minimum standard regarding CbC reporting for large MNEs for years beginning after 2015.

Action 5 — Spontaneous Exchange of Rulings

The action 5 report sets out a new minimum standard that will require:

- substantial activity for preferential regimes;
- improved transparency; and
- peer review of preferential regimes.[9]

[9] *See* executive summaries, *supra* note 1, at 19-20.

The main achievement of the action 5 report is the adoption of the ''nexus approach'' regarding intellectual property boxes and the periodic peer review of those regimes. The action 5 report also includes an agreement on mandatory spontaneous exchange of various types of taxpayer-specific rulings. The framework covers six categories of rulings:

- rulings concerning preferential regimes;
- cross-border unilateral advance pricing agreements or other unilateral transfer pricing rulings;
- rulings giving a downward adjustment to profits;
- permanent establishment rulings;
- conduit rulings; and
- any other type of ruling on which the Forum on Harmful Tax Practices agrees that the absence of exchange would give rise to BEPS concerns.

The 2016 budget announced that Canada is committing to the spontaneous exchange of tax rulings with other tax administrations starting in 2016. Concurrently, the CRA issued Doc. No. 2016-0632941I7, confirming that Canada has committed to the exchange of information with other countries on some tax rulings, in the context of the OECD's BEPS project, and that the exchange initiative applies to binding advance income tax rulings, effective April 1, 2016. The CRA states that to implement this initiative it will update its Information Circular 70-6 to outline the types of rulings potentially subject to this exchange, the process it will follow in performing the exchange, and the additional information it will require regarding requests for rulings within the scope of the exchange initiative. The following paragraphs will be added to the circular:

> [X1.] As part of the Organization for Economic Cooperation and Development's (OECD) Base Erosion and Profit Shifting (BEPS) project, as described in Countering Harmful Tax Practices More Effectively, Taking into Account Transparency and Substance, Action 5 — 2015 Final Report, Canada has committed to the spontaneous exchange of information on tax rulings with certain other countries. In the context of the BEPS project, countries agreed to exchange information on the following types of Rulings that are relevant to the Directorate [footnote 1 removed]:
>
> a) cross-border Rulings related to preferential regimes (for Canada this would include international shipping and certain foreign life insurance operations of a Canadian company);
>
> b) cross-border Rulings related to transfer pricing legislation;
>
> c) cross-border Rulings providing a downward adjustment not directly reflected in the taxpayers' accounts;
>
> d) permanent establishment Rulings; and
>
> e) related party conduit Rulings.

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> [X2.] If a Ruling falls into one of the above categories, a summary of its contents may be exchanged with the countries of residence of the immediate parent company, the ultimate parent company and certain other parties. These countries may then ask to receive relevant portions of the Ruling in more detail. These exchanges of information will be performed in the usual manner, by the CRA's Competent Authority Services Division, in accordance with the terms of Canada's relevant tax treaties and other international agreements. As such, taxpayers making a Ruling request must include sufficient information to allow the CRA to identify the relevant parties for such exchanges. For more information, see the OECD website under Base Erosion and Profit Shifting.

Action 8-10 — Transfer Pricing

The action 8-10 BEPS reports revise the OECD's standards regarding transfer pricing, with the stated purpose of aligning transfer pricing outcomes with value creation while retaining and working within the confines of the arm's-length principle. The proposed updates to the OECD transfer pricing guidelines are likely the most controversial aspect of the final package.

In the 2016 budget, the Department of Finance, quite uniquely, states that the CRA is now applying the revised OECD guidance on transfer pricing, which purportedly "provides an improved interpretation of the arm's-length principle." Significantly, however, it is stated that the CRA will not adjust its administrative practices at this time in the two most controversial areas of the OECD's BEPS-related transfer pricing work: the proposed simplified approach to low-value-adding services and the treatment of so-called cash boxes.[10] Canada will decide on a course of action regarding these measures after follow-up work by the OECD is complete.

It should be reiterated, however — in particular, regarding the controversial BEPS updates to the transfer pricing guidelines — that the Supreme Court of Canada, in the seminal *Glaxo* transfer pricing case, held that the guidelines:

> are not controlling as if they were a Canadian statute and the test of any set of transactions or prices ultimately must be determined according to [Canada's transfer pricing legislation] rather than any particular methodology or commentary set out in the Guidelines.

Since the arm's-length principle is legislated in the Income Tax Act in section 247(2), any OECD pronouncements that are not consistent with it, even if adopted as administrative practice by the CRA, would most likely fail before a Canadian court.[11]

Action Items Not in the 2016 Budget

We had predicted[12] that Canada would not quickly, if ever, act on action 1 (digital business), action 2 (hybrids), action 3 (CFC rules), action 4 (interest deductibility), the portion of action 5 dealing with IP boxes, and action 7 (dealing with PEs).

Except as indicated in the next section (where the inspiration of action 2 can be seen), the 2016 budget does not address any of those actions.

Interestingly, however, there is some development in two of Canada's provinces (which levy separate income tax but are not party, per se, to the G-20/OECD or the BEPS project) regarding IP boxes (involving low rates of tax on IP-related income), which, as noted above, action 5 advocates not be offered by a jurisdiction unless substantial research and development takes place there. In particular, there are two points of interest: The province of Quebec proposed in its budget released on March 17 to reduce its corporate tax rate from 11 percent to 4 percent on a portion of profits from producing and selling based on patents developed in Quebec; and the province of Manitoba announced an IP box, though without detailed plans.

Extension of Back-to-Back Rules

2014 Withholding Tax Back-to-Back Rules

Further to its 2014 budget, the government enacted new antiavoidance measures dealing with back-to-back arrangements in the context of Canada's thin capitalization limitation on interest deductibility[13] and as part of its withholding tax regime as it applies to interest (WHT B2B rules).[14] These proposals have been covered extensively in these pages.[15]

Regarding the WHT B2B rules, if the conditions in section 212(3.1) are satisfied, the operative rule in section 212(3.2) essentially disregards the intermediary in the back-to-back arrangement and deems interest to be

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[10]For a critical assessment of the radical new "cash box" notion, see Boidman and Kandev, "BEPS: A Spent Force or Radical Change?" *supra* note 2.

[11]*See, however,* Boidman, "Canadian Transfer Pricing Decision in *Marzen*: Points of Interest," *Tax Notes Int'l,* Feb. 15, 2016, p. 601, for a discussion of whether lower courts are paying lip service to the Supreme Court's statement concerning the role of the OECD's transfer pricing guidelines.

[12]*See* Boidman and Kandev, "BEPS: A Spent Force or Radical Change?" *supra* note 2.

[13]*See* new section 18(6) and (6.1) of the ITA, R.S.C. 1985, c.1 (5th Supp.) as amended. Unless otherwise specified, section references in this article are to this act.

[14]*See* new section 212(3.1) to (3.3).

[15]Steve Suarez, "Canada's Problematic Proposed New Loan Rules," *Tax Notes Int'l*, May 5, 2014, p. 441; Suarez, "An Analysis of Canada's Latest International Tax Proposals," *Tax Notes Int'l*, Sept. 29, 2014, p. 1131.

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paid by the Canadian resident to the nonresident parent or other affiliated nonresident party.

The B2B rule has three application conditions:

- The Canadian taxpayer must pay or credit a particular amount on account or in lieu of payment of, or in satisfaction of, interest[16] in respect of a particular debt or other obligation to pay an amount to an intermediary person or partnership (the taxpayer debt).

- At any time in the period during which the interest accrued, the intermediary, or non-arm's-length person or partnership, must either have an amount outstanding as or on account of a debt or other obligation to pay an amount to the nonresident parent (the intermediary debt), or have a "specified right"[17] regarding a particular property that was granted directly or indirectly by the nonresident parent. The taxpayer debt and either the intermediary debt or the specified right in the property must be connected based on listed factors. There are two alternative connecting factors between the taxpayer debt and the intermediary debt: Either recourse regarding the intermediary debt must be limited to the taxpayer debt; or it can be reasonably concluded that all or a portion of the taxpayer debt became owing, or was permitted to remain owing, because all or a portion of the intermediary debt was entered into or was permitted to remain outstanding, or the intermediary anticipated that all or a portion of the debt or other obligation would become owing or remain outstanding. Substantially similar connecting factors apply in the context of a specified right.[18]

- The withholding tax that would be payable regarding the particular amount of interest if it was paid or credited to the nonresident parent rather than the intermediary is greater than the withholding tax payable before application of the B2B rule.

The WHT B2B rule is subject to two sets of carveouts. One, actually worded as an application condition, is a 25 percent de minimis rule, which saves situations in which the intermediary debt or value of a specified right is less than 25 percent of the taxpayer debt and debts to a person or partnership not dealing at arm's length with the taxpayer. This rule is intended to save some bona fide cash pooling and securitization arrangements.

The other safe harbor covers specific types of intermediaries. Section 212(3.1)(b) excludes an intermediary that is either a person resident in Canada that does not deal at arm's length with the taxpayer or a partnership of which each member is such a person. Significantly, an intermediary that is a nonresident person not dealing at arm's length with the taxpayer is not carved out.

2016 Proposed Extension to the WHT B2B Rules

The 2016 budget proposes to change the WHT B2B rules by:

- extending their application to rents and royalties;

- adding so-called character substitution rules that prevent the avoidance of the back-to-back rules through the substitution of purportedly economically similar arrangements between the intermediary and another nonresident person; and

- clarifying the application of the back-to-back loan rules to multiple intermediary structures.

These changes are proposed to apply to relevant payments made after 2016. No draft legislation has been released yet; hence, the following summary and comments are based only on the budgetary materials.

First, the 2016 budget proposes to attack back-to-back arrangements involving rents and royalties by extending the WHT B2B rules to them. Presumably, a driving motivation behind the government's action in this regard is its loss in the Velcro beneficial owner case.[19] The budget materials state:

> Part XIII generally imposes a 25-per-cent withholding tax on cross-border payments of rents, royalties or similar payments (collectively referred to as "royalties") made by Canadian-resident persons to non-residents. This 25-per-cent withholding tax rate is often reduced by a tax treaty. Given that not all tax treaties negotiated by Canada provide the same withholding rates and that some countries do not have a tax treaty with Canada, there is an incentive for some taxpayers to interpose, between a Canadian-resident payor

[16]Determined without reference to the thin capitalization B2B rule in section 18(6.1) and the deemed dividend rule for nondeductible interest in subsection 214(16).

[17]"Specified right" regarding a property is defined in section 18(5) as a right to mortgage, hypothecate, assign, pledge, or in any other way encumber the property to secure payment of an obligation — other than the particular debt or other obligation described in paragraph (6)(a), or a debt or other obligation described in subparagraph (6)(d)(ii) — or to use, invest, sell, or otherwise dispose of, or in any way alienate, the property, unless it is established by the taxpayer that all the proceeds (net of costs, if any) received, or that would be received, from exercising the right must first be applied to reduce an amount described in subparagraph (6)(d)(i) or (ii).

[18]Either the existence of the specified right is required under the terms and conditions of the particular debt or other obligation, or it can be reasonably concluded that all or a portion of the particular amount became owing, or was permitted to remain owing, because the specified right was granted, or the intermediary anticipated that the specified right would be granted.

[19]*Velcro Canada Inc. v. Canada,* [2012] DTC 1100.

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of royalties and a non-resident payee, an intermediary entity located in a favorable tax treaty country.

While such transactions may be subject to challenge under existing anti-avoidance rules, Budget 2016 proposes to address these back-to-back arrangements by extending the basic concepts of the back-to-back loan rules under Part XIII to royalty payments.

Essentially, the proposed rules for royalty payments would deem the Canadian resident payer to have made a royalty payment directly to the ultimate nonresident recipient, and an amount of withholding tax, equal to the amount of withholding tax otherwise avoided as a result of the back-to-back arrangement, would become payable on the deemed royalty payment.

Similar to the existing WHT B2B rules for loans, the proposed rules for royalties would consider two arrangements to form a back-to-back arrangement if they are sufficiently connected. The 2016 budget states that such connectedness would exist if:

- the amount the intermediary is obligated to pay is established, in whole or in part, by reference to the royalty payment made by, or the royalty payment obligation of, the Canadian resident person; the fair market value of property; any revenue, profits, income, or cash flow from property; or any other similar criteria regarding property, when a right to use the property is granted under the Canadian leg of the arrangement; or
- it can reasonably be concluded based on all the facts and circumstances that the Canadian leg was entered into or permitted to remain in effect because the second leg was, or was anticipated to be, entered into (in this regard, the fact that the Canadian leg and the second leg concern the same property would generally not be considered sufficient on its own to support the conclusion that this condition has been met).

As under the existing WHT B2B rules, the proposed rules for royalties would apply only when the withholding tax on a royalty payment to the intermediary is less than the tax that would be payable on a direct payment to the other nonresident.

Second, the 2016 budget proposes to extend the WHT B2B rules to prevent their avoidance through the substitution of what the government perceives to be economically similar arrangements between the intermediary and another nonresident person. According to the budget materials, a back-to-back arrangement may exist in situations where:

- interest is paid by a Canadian resident person to an intermediary and there is an agreement that provides payments in respect of royalties between the intermediary and a nonresident person (interest-to-royalties situation);
- royalties are paid by a Canadian resident person to an intermediary and there is a loan between the intermediary and a nonresident person (royalties-to-interest situation); or
- interest or royalties are paid by a Canadian resident person to an intermediary and a nonresident person holds shares of the intermediary that include some obligations to pay dividends or that satisfy other specific conditions (for example, they are redeemable or cancelable) (interest-to-dividends situation).

Under these proposed character substitution rules, a back-to-back arrangement would seemingly exist when a sufficient connection is established between the arrangement under which an interest or royalty payment is made from Canada and the intermediary's obligations in each of the three situations described above. The presence of such a connection would apparently be determined by applying tests similar to those used for back-to-back loans and back-to-back royalty arrangements but adapted to reflect the particular circumstances of those arrangements. When a back-to-back arrangement exists under these proposed rules, a payment of the same character as that paid by the Canadian resident to the intermediary would be deemed to have been made directly by the Canadian resident payer to the other nonresident person.

Third, the 2016 budget proposes to clarify the application of the existing WHT B2B rules to back-to-back arrangements involving multiple intermediaries. The proposed back-to-back rules for royalty payments would also apply to multiple intermediary back-to-back arrangements. Under these proposed rules, a back-to-back arrangement would comprise all the arrangements that are sufficiently connected to the arrangement under which a Canadian resident makes a cross-border payment of interest or royalties to an intermediary. The presence of such a connection would be established by applying similar tests to those used to establish a sufficient connection in a single intermediary context. When a back-to-back arrangement involving multiple intermediaries exists, a payment (of the same character as that paid by the Canadian resident to the first intermediary) would be deemed to have been paid directly by the Canadian resident to the ultimate nonresident recipient in a chain of connected arrangements.

Commentary on WHT B2B Rule Changes

As outlined above, the 2016 budget has proceeded with a cautious and limited implementation of these BEPS proposals. The changes to the WHT B2B rules, however, show that Canada is still proactive, in its own way, regarding BEPS. In fact, although the extension of the WHT B2B rules is not specifically stated to be motivated by the G-20/OECD international tax initiatives, the anti-BEPS undercurrents are very strong in those proposals.

Firstly, although it could initially be thought that the policy objective of the 2014 WHT B2B rule is to protect Canada's domestic withholding tax exemption for

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arm's-length interest (other than participating interest) from abuse through the use of arm's-length back-to-back arrangements, the ''missing'' carveout for nonresident persons that do not deal at arm's length with the taxpayer made it implicit that the WHT B2B rule also has a treaty abuse anti-conduit objective.[20] The government's intentions in this regard are now crystal clear with the extension of the WHT B2B rule to rents and royalties. The budgetary materials spell out the government's concern with back-to-back arrangements to produce a treaty benefit. In light of this, it comes as no surprise that the WHT B2B rules are being extended to rents and royalties. The resulting wide-ranging anti-conduit rule seems to take Canada quite far along the way to implementing an effective BEPS action 6 strategy.

Secondly, much more problematic is the proposed addition of the character substitution rules. Although the government has not put forward specific draft legislation, the fundamental principles behind this part of the proposals are questionable. As outlined above, three particular situations have been singled out by the government as targets of these antiavoidance rules: interest-to-royalties situations, royalties-to-interest situations, and interest-to-dividends situations. The first two cases are troubling in two principal respects.

First, it is unclear through what legal alchemy interest can be transformed into royalties or vice versa in the context of a genuine back-to-back arrangement. Consider, for example, that a parent lends money to an intermediary subsidiary. How does the intermediary convert the borrowed funds into IP that it can license downstream to the Canadian subsidiary? If the intermediary does not already own IP (in which case the borrowed funds would not have any related purpose), it can use the borrowed funds to either buy or develop IP. In any case, it seems obvious that there would be no sufficient connection between the loan and the IP license to establish a back-to-back arrangement.[21]

Second, contrary to the government's suggestion, interest and royalties are not ''economically similar arrangements.'' While the amount of interest is a function of the amount borrowed, the interest rate, and the duration of the borrowing, a royalty is fundamentally different since it is inherently contingent on the use or production from property.

Regarding the third case of interest-to-dividends situations, the above fundamental legal and economic objections are absent. The concerns, instead, are of a tax policy nature. In fact, it is possible and quite common for a nonresident parent to fund an intermediary subsidiary with preferred equity and to see the intermediary lend that capital to a Canadian subsidiary. Superficially, it is difficult to see how such a benign arrangement could be the subject of a WHT B2B antiavoidance rule. The budgetary materials, however, suggest that what is being targeted are situations involving some types of preferred shares that include specific obligations to pay dividends or that satisfy other conditions (for example, they are redeemable or cancelable).

Without identifying the culprits or referring to BEPS action 2, the 2016 budget seems to attack hybrid financial instruments that would be seen as equity in Canada but would be debt in the intermediary's country. For example, convertible preferred equity certificates issued by a Luxembourg corporation would seem to be caught by this particular proposed character substitution rule. In fact, private equity funds sometimes use Luxembourg blockers funded with convertible preferred equity certificates. However, they typically do so not for treaty-shopping purposes, but principally for efficiency purposes. In fact, often a large part of the investor base of private equity funds comprises various tax-exempt and sovereign entities resident in treaty jurisdictions that would benefit from treaty-based or other tax-advantaged treatment. A blocker resident in a treaty country is often used for various tax and nontax commercial reasons, but the principal tax reason is to establish clear entitlement to substantive tax rules (to which the ultimate beneficial owners are likely otherwise entitled) and centralize and simplify tax compliance.

In light of this, it appears that from a tax policy perspective, the proposed interest-to-dividends character substitution rule would be too blunt a tool that would discourage investment by private equity funds in Canada.

Conclusion

The BEPS project has spurred an unprecedented amount of drafting of recommendations to counter what is alleged to be inappropriate international tax planning by leading — particularly U.S. — multinationals. And the project, which can aptly be characterized as a crusade, has stirred up an unprecedented level of controversy and heated written and verbal debate. However, as we foresaw in our first commentary on BEPS, entitled ''BEPS: The OECD Discovers America?'' (*Tax Notes Int'l*, Dec. 16, 2013, p. 1017), there is very little regarding substantive tax rules in the final October 2015 reports that had not already been thought about and dealt with by lawmakers and tax administrators in Canada, the U.S., and other developed countries.

We believe this is borne out by Canada's initial response in its first budget after the 2015 BEPS reports — a response that regarding substantive international tax rules is quite modest and limited to an area in which Canada has long been involved, namely, seeking to counter inbound treaty shopping. As outlined above,

[20]Kandev, ''Canadian Interest Anti-Conduit Rule Soon to Be Law,'' *Tax Notes Int'l*, Dec. 15, 2014, p. 1027.

[21]Arguably, the reverse interest-to-royalties situation is even harder to envision.

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the 2016 budget proposes relevant changes both under the BEPS banner and under the preexisting domestic anti-cross-border back-to-back rules, which seek to protect Canada's withholding tax system regarding passive income payments (for example, interest, rents, and royalties).

By contrast, on the administrative and procedural fronts, BEPS has made its mark in Canada, reflected in the budget's adoption of action 5 (exchange of rulings) and action 13 (CbC reporting).

Finally, it is premature to predict exactly what effect, if any, actions 8-10 will have in Canada. The 2016 budget does not propose any changes to Canada's transfer pricing rules, which are based on the arm's-length principle, but it seems to encourage the CRA to apply some aspects of actions 8-10 as though the OECD transfer pricing guidelines were law in Canada, which of course they are not. ◆

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