https://resource.intelliconnect.ca/resource/scion/document/default/cchca79c0c801f84567a71d8257a0b0c8b1e1?cfu=WKCAN&cpid=WKCA-TAL-IC&uAppCtx=RWI

International Tax

Report No.: 124

Date: June, 2022

EDITOR-IN-CHIEF

Sam J. Tyler—KPMG Law LLP

EDITORIAL BOARD

Barry D. Horne—PwC Law LLP

Matias Milet—Osler, Hoskin & Harcourt LLP

Susan McKilligan—PricewaterhouseCoopers LLP

Angelo Nikolakakis—EY Law LLP

Sabrina Wong—KPMG Law LLP

Carrie Smit—Goodmans LLP

Ken Snider—Cassels Brock & Blackwell LLP

Christopher J. Steeves—Fasken Martineau DuMoulin LLP

Michael N. Kandev—Davies Ward Phillips & Vineberg LLP

Andrew Wong—Torys LLP

Richard Lewin—Wildeboer Dellelce LLP

UK UPPER TRIBUNAL ON MULTILINGUAL TAX TREATY INTERPRETATION: THE RBC V. HMRC DECISION

- –Marc Pietro Allard and Michael N. Kandev of Davies Ward Phillips & Vineberg LLP

INTRODUCTION

Earlier this year the United Kingdom Upper Tribunal (Tax and Chancery Chamber) (the "**UT**") rendered its decision in the *Royal Bank of Canada v. the Commissioners for Her Majesty's Revenue & Customs* ("***RBC v. HMRC***").[1] The case should be of interest to Canadian readers not only because it involves a household name Canadian bank but because it raises fundamental issues of tax treaty interpretation and application in the context of the *Canada-United Kingdom Tax Treaty* (the "**Treaty**").[2]

The principal issue[3] before the UT was whether certain contractual payments made to the Royal Bank of Canada (the "**Taxpayer**") were taxable in the UK as consideration for the right to work in oil fields located within the UK continental shelf of the North Sea, thus falling within the definition of "immovable property" in Article 6 of the Treaty. In rendering its decision, the UT considered the French version of the Treaty in order

©2022 Wolters Kluwer. All rights reserved.

to ascertain the meaning and scope of the Treaty definition of “immovable property”. As such, this decision confirms the UK’s approach to multilingual tax treaty interpretation.

In the context of the decision, which we summarize below, we provide our insights with respect to the UT’s approach to the interpretation and application of the Treaty.

BACKGROUND

RBC v. HMRC concerned the Taxpayer, a Canadian chartered bank, that in the early 1980s loaned money to Sulpetro Ltd. (“**Sulpetro**”), a Canadian company which, together with its UK subsidiary (“**SUKL**”),[4] exploited oil from the Buchan Field of the North Sea. In the mid-1980s, Sulpetro entered into financial difficulties and, as a result, it sold its Buchan Field operations to BP Petroleum Development Ltd. (**“BP”**).

Pursuant to the sale agreement, Sulpetro sold all of its shares in SUKL to BP along with its other assets relating to the Buchan Field operations. In consideration, BP would, *inter alia*, pay Sulpetro royalties in respect of the production of oil from the Buchan Field (the “**Payments**”). Specifically, BP was liable to make the Payments when the fair market price per barrel of oil exceeded US$20. These Payments were at issue in the case. The rights to the Payments were eventually transferred to Talisman Energy Inc. Meanwhile, Sulpetro continued to owe money to the Taxpayer with respect to its loan.

When Sulpetro went into receivership in 1993, the rights to the Payments were assigned under a court order to the Taxpayer. For Canadian tax purposes, the Taxpayer treated its outstanding loan of approximately US $185M to Sulpetro as a bad debt, thereby claiming a tax deduction in 1993 for the amount of the outstanding loan. However, each time the Taxpayer received a Payment, it treated the amount as a recovery of bad debt, thus including it in its calculation of taxable income for Canadian tax purposes.

The Taxpayer took the position that the Payments were not taxable in the UK because the Payments were not “income from immovable property” as that expression is understood in the Treaty. Under Article 6(1) of the Treaty, income from immovable property may be taxed in the country where the immovable property is situated. Article 6(2) of the Treaty states that the term “immovable property” shall be defined in accordance with the law of the country in which the property in question is situated. The provision then expands the definition of “immovable property” to specifically include, *inter alia*, rights to variable or fixed payments as consideration for the working of, or the right to work, mineral deposits, sources, and other natural resources.

HMRC disagreed with the Taxpayer, taking the position that the UK had a right to tax the Payments under the Treaty as they arose from rights to variable or fixed payments as consideration for the working of, or the right to work, mineral deposits, sources, and other natural resources (oil being the natural resource). Accordingly, between 2014 and 2017, HMRC issued assessments to the Taxpayer in respect of the 2008 to 2012 taxation years (the “**Taxation Years**”). The Taxpayer appealed the assessments before the First-tier Tribunal (Tax Chamber) (the “**FTT**”), which found in favour of HMRC.[5] The Taxpayer then appealed the FTT decision before the UT.

THE DECISION

In the UK and in Canada, tax treaties are both statutory and contractual in nature. As the UT states in its decision, the aim when interpreting a tax treaty is to establish by objective and rational means the common intention of the signatories, which can be determined by looking to the text and its purpose.

The first ground of the Taxpayer’s appeal[6] rested on a two-pronged argument that the FTT failed to address and give proper weight to the purpose of Article 6(2) of the Treaty when interpreted in the context of: (i) other provisions of the Treaty; and (ii) other tax treaties entered into by the UK or Canada. The UT rejected the Taxpayer’s contention that, in order to interpret the Treaty, it must look to other tax treaties signed by the UK or Canada. According to the UT, it is not possible to ascertain the common intention of the signatories to the Treaty by looking to other treaties that both those signatories were not a party to.

The Taxpayer’s argument that the UT must look to other provisions within the Treaty in the context of its interpretive exercise dealt specifically with the interaction between Articles 6(2) and 13(4) of the Treaty.

©2022 Wolters Kluwer. All rights reserved.

The Taxpayer based its argument on the principle that the definition of a term (immovable property) must be consistent throughout the whole Treaty. The Taxpayer argued that Article 13(4) of the Treaty, which addresses specifically the treatment of gains from the alienation of a right, licence, or privilege to explore for, drill for, or take petroleum, implicitly limited the nature of the rights described in Article 6(2) and thus, the Payments did not constitute “immovable property” under Article 6. Arguing that Article 13(4) of the Treaty effectively carves out “gains from the alienation of any right, licence or privilege to explore for, drill for, or take petroleum, natural gas or other related hydrocarbons situated in the UK” from the definition of immovable property in Article 13, the Taxpayer took the position that it was the intent of the drafters of the Treaty to exclude oil exploration and drilling rights from the definition of “immovable property” throughout the entire Treaty, including at Article 6(2). The UT rejected this argument, explaining that, although treaty provisions must be interpreted within the context of the whole treaty and not in isolation of its other provisions, it is possible that certain sections of the Treaty limit the scope of definitions for purposes specific to that section.

Furthermore, the UT indicated that a limitation, if there were any, on the meaning of “immovable property” under Article 6(2) by looking to the language of Article 13(4) would need to be clearly expressed in the Treaty. The UT also indicated that such a limitation on Article 6(2) would create a hole in the taxation scheme of income from oil in the Treaty. If the Taxpayer’s interpretation of Article 6(2) were accepted, neither country would be able to tax income derived from oil worked in that country (if, as in this case, the foreign corporation did not have a permanent establishment in that country)—only gains derived from an alienation within the terms of Article 13(4) would be taxed in the source country. According to the UT, it is difficult to accept that the signatories to the Treaty would have intended for such a schematic hole in the taxation of income related to oil.

The second ground of the Taxpayer’s appeal rested on the French version of the Treaty. HMRC objected to this ground being pursued as expert evidence, it argued, that had not been submitted before the FTT would be necessary in order for the UT to consider the French version of the Treaty. The UT accepted that both versions of the Treaty, being English and French, were equally authentic and authoritative. As such, the UT confirmed that it was its duty to consider both versions of the Treaty in its interpretive exercise of Article 6(2). The Taxpayer was allowed to pursue this ground of appeal by submitting to the UT *legal* materials as to the meaning of the French text, such materials not constituting expert evidence.

The Taxpayer’s argument on the merits with respect to the French text concerned the use of the term “*la concession*” in Article 6(2) of the Treaty, which, according to the Taxpayer, limits income to that derived from the original grant of the right to work the natural resource.[7] The UT rejected the Taxpayer’s argument, largely based on the fact that there is no reference to the term “grant” in the English version of the Treaty and that the legal materials submitted by the Taxpayer with respect to the French meaning of the text do not establish that the term *la concession* means only the grant or the original grant of the right to work natural resources. The UT decided that the Canadian legislation, Canadian case law, and Canadian legal dictionaries cited by the Taxpayer did not clearly point to the words *la concession* as meaning the grant of rights of working.

The third ground of the Taxpayer’s appeal rested on the “true contractual position” of the parties involved with the Payments. Essentially, the Taxpayer took the position that it did not acquire a right encompassed by Article 6(2) because SUKL was the only party which actually had the right to work the oilfield. It therefore follows that the Payments received by the Taxpayer could not have been captured within Article 6(2) because they were not paid on the basis of a right to work the oilfield. The UT rejected the Taxpayer’s argument. When Sulpetro sold SUKL and its interest in the Buchan Field to BP, it sold the right to work the oilfield. Part of the consideration for the sale to BP included the obligation to make the Payments, the amount of which was directly tied to the future price of oil. The UT therefore concluded that the Payments fell within the definition of “immovable property” of Article 6(2) of the Treaty and continued to qualify as such when the right to the Payments was assigned to the Taxpayer pursuant to the Canadian court order.

OUR OBSERVATIONS

General Principles of Treaty Interpretation

©2022 Wolters Kluwer. All rights reserved.

This judgment provides an insightful analysis of the interpretation of tax treaties from a UK perspective. As mentioned, the interpretation of tax treaties differs from the interpretation of domestic legislation. Although tax treaties, when ratified by a country that is a party to the treaty, are statutory in nature, they also constitute an agreement between two, or more, countries. As the Supreme Court of Canada (the "**SCC**") recently stated in *Canada v. Alta Energy Luxembourg S.A.R.L.* ("***Alta Energy***"),[8] consideration of the contractual element is crucial when interpreting tax treaties. The emphasis on the contractual nature of tax treaties was reflected in *RBC v. HMRC* by the UT's insistence that the aim of treaty interpretation is to establish the common intention of the signatories.

The interpretation of tax treaties is governed by the *Vienna Convention on the Law of Treaties*[9] (the "**Vienna Convention**"). The general rule of interpretation of the Vienna Convention, found at Article 31(1), stipulates that a "treaty shall be interpreted in good faith in accordance with the ordinary meaning to be given to the terms of the treaty in their context and in the light of its object and purpose." This method of interpretation, as the SCC indicated in *Alta Energy*, is quite similar to the modern principle of interpretation applicable to domestic statutes in Canada. The Vienna Convention further indicates that, to determine the object and purpose of the treaty, we must look to its text, including the preamble and annexes (Article 31(2) of the Vienna Convention). When the meaning of a provision in a treaty is ambiguous, obscure, or leads to a manifestly absurd or unreasonable result, Article 32 of the Vienna Convention informs us that we may have recourse to the preparatory work of the treaty and the circumstances of its conclusion. This rule of interpretation gives broad power to courts to consider a vast array of supplementary interpretive tools. This can prove useful when determining the common intention between two signatories of a treaty. In its interpretation of Article 6(2) of the Treaty, the UT referred to the fact that both the UK and Canada were aware that they each possessed significant reserves of oil at the time the Treaty was negotiated. As such, the UT indicates that one of the objects of the Treaty was for each country to be able to tax income generated from its oil reserves. Giving consideration to this extraneous element allowed the UT to support its conclusion that the Payments fell within the definition of "immovable property" at Article 6(2). The fact that the UK and Canada each sought to preserve its taxing rights over any and all income from the exploitation of natural resources provided the UT with sufficient grounds to indicate that it was unlikely that either the UK or Canada intended that income derived from the extraction of oil was to be taxed in the non-source country.

Article 33 of the Vienna Convention also stipulates that when a treaty has been authenticated in two or more languages, the text in each language is equally authoritative. Moreover, the terms used in each version of the treaty are presumed to have the same meaning in each authentic text. If a comparison of the authentic texts reveals a difference of meaning, one must look to the object and purpose of the treaty to determine the meaning which best reconciles the texts. As we will discuss below, where there is no prevailing language, courts must look to all versions of a treaty, as the UT did in the present case.

Multilingual Tax Treaties

Interpreting and applying multilingual treaties gives rise to important and sometimes difficult interpretative issues.[10] In law, there is only one treaty—although a treaty can be multilingual in its expression, it remains a single treaty with a single set of terms.[11] Therefore, as mentioned above, courts have a duty under the Vienna Convention to consider all authentic versions of a tax treaty. However, it is quite easy to imagine that in practice a majority of courts do not give proper consideration to the foreign language version of a tax treaty before them.

In *RBC v. HMRC* the UT stated that it was its duty to consider the French text of the Treaty and that it could not correctly interpret the English text without considering the French text. The UT goes on to explain, citing the decision in *Fothergill v. Monarch Airlines Ltd*,[12] that courts must provide a view as to the meaning of the French text, even where the parties do not present either evidence or arguments based on an alleged inconsistency in the meaning between both texts. However, how can a judge, without any knowledge of a language in which a treaty is drafted, be expected to identify potential inconsistencies in the meaning of the texts? It seems difficult to imagine a case where a judge can properly accomplish such a task without the help of expert evidence. Moreover, as was the case in *RBC v. HMRC*, if expert evidence is not submitted at trial, then the appellate court seems limited in its ability to properly interpret the text in another language.

©2022 Wolters Kluwer. All rights reserved.

When analyzing the meaning of the term *la concession* from the French text, the UT only had recourse to legal materials. Ultimately, the UT decided that *la concession* did not mean the "grant" or the "original grant" of the right to work natural resources. As such, the UT did not find any inconsistency between the English and French texts. However, the UT admitted that it was unable to say whether its position would have been different if expert evidence had been submitted to assist in the consideration of the French text. Such an admission appears to contradict the UT's earlier statements that proper regard had to be given to the French text in order to avoid treaty misapplication.

The UK's approach to multilingual treaty interpretation is of interest to Canadian readers, due to the fact that Canada has a long tradition of bilingual statutory interpretation. Canada has a unique advantage with respect to multilingual treaty interpretation. Canada's federal laws are adopted in both of Canada's official languages, being English and French,[13] with both texts being equally authentic and authoritative. Due to the fact that tax treaties are ratified as laws by the Parliament of Canada, all Canadian tax treaties are concluded in, at least, both languages. This implies that Canada cannot adopt a treaty with a prevailing language. If a judge fails to consider both versions of the text, it is possible that his/her decision may be overturned, or at the very least, provide counsel with grounds to appeal. Given the presence of Canadian language laws, Canadian law has developed a well-defined structure when interpreting bilingual statutes. In *The Queen v. Daoust*,[14] the SCC described the three-step method for bilingual interpretation: (i) whether there is a discordance between the two versions of the text; (ii) whether the common meaning between the texts is, according to the ordinary rules of statutory interpretation, consistent with Parliament's intent; and (iii) is the interpretation consistent with other principles of interpretation in the given circumstances? This method for bilingual statutory interpretation in Canada mirrors the interpretation rules for multilingual treaties pursuant to the Vienna Convention.[15]

A leading authority from a Canadian perspective on the topic of multilingual tax treaty interpretation is the case of *Prévost Car v. The Queen*.[16] In that case, the court had to consider the definition of "beneficial ownership" as that term is used in the *Canada-Netherlands Tax Treaty*,[17] a treaty with three authentic texts: English, French, and Dutch. The case concerned the treatment of dividends paid by a Canadian resident corporation to its Dutch corporate shareholder, which in turn paid dividends in similar amounts to its Swedish and UK corporate shareholders. To benefit from a lower withholding rate on the dividends paid by the Canadian corporation under the *Canada-Netherlands Tax Treaty*, it was necessary that the "beneficial owner" of those dividends be the Dutch-based shareholder of the Canadian corporation. At trial and on appeal, the courts found in favour of the taxpayer, thereby disagreeing with the Crown's position that the "beneficial owners" were the Swedish and UK corporate shareholders. In his analysis, the trial judge looked to the English, French, and Dutch versions of the term "beneficial owner" to determine the term's meaning in the *Canada-Netherlands Tax Treaty*. In doing so, the judge considered expert evidence as to the meaning of the equivalent Dutch term so as to reveal the common meaning between the three authentic texts. Nonetheless, one cannot help but notice that the analysis with respect to the meaning of "beneficial owner" in the *Canada-Netherlands Tax Treaty* was heavily influenced by the common law notion of that term. This highlights an issue with multilingual treaty interpretation and finding the common intention of the parties when using language that carries particular significance in the legal tradition of one language (i.e., beneficial ownership in English common law), whilst its equally authoritative translation does not embody that meaning.

Interestingly, in *RBC v. HMRC*, the French term at issue (*la concession de l'exploitation*) replaced the English term "right to work." However, the French text does not seem to include an equivalent translation for the term "*consideration*" that is used in the English text. It is well known in the common law legal tradition that the term *consideration* also has particular significance, which, at first glance, does not seem to be reflected in the French text. It seems to us that a more elaborate analysis on the meaning of the terms *la concession* and *consideration*, as those terms are used in each version of the Treaty, would have been pertinent in ascertaining the common intention of the signatories to the Treaty.

The coming into force of the *Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting* (the "**MLI**") will highlight the issues related to multilingual treaty interpretation. The MLI is a treaty that superimposes itself onto already-existing tax treaties to modify them. The MLI is a treaty with two authentic texts, being English and French, without a prevailing text. The

©2022 Wolters Kluwer. All rights reserved.

complexity of taking into account both authentic versions of the MLI in concert with existing tax treaties drafted in neither English nor French will undoubtedly cause much confusion for courts.

Application of Article 6(2) of the Treaty

As mentioned above, Article 6 of the Treaty provides the source country with taxing rights over income from immovable property situated in that country. The Organisation for Economic Co-operation and Development's (the "**OECD**") *Commentaries on the Articles of the Model Tax Convention* informs us that this is due to the fact that there is a close economic connection between the source of this income and the source country.[18] Therefore, in deciding that the Payments consisted of immovable property as understood in Article 6(2) of the Treaty, the UT is essentially confirming that the reason for giving the UK taxing rights over the Payments is due to that fact that the Payments share a closer economic connection to the UK than they do to Canada.

In arriving at this conclusion, the UT states that the Payments were clearly "rights to variable or fixed payments as consideration for the working of, or right to work" the Buchan Field. By selling SUKL and its licence interests to BP, Sulpetro received, as part of the consideration, a right to receive the Payments. As such, Sulpetro received amounts in respect of oil produced from the Buchan Field, calculated by reference to the fair market value of a barrel of oil. The Buchan Field clearly has an economic nexus to the UK and, as such, the UT holding appears consistent with the object and purpose of the Treaty that income derived from property with such a nexus be taxed in the UK.

However, the UT provides limited analysis with respect to the proper characterisation of the contractual substance of the Payments. The Taxpayer was assigned the right to receive the Payments due to an underlying debt that Sulpetro could not pay back. As such, the Taxpayer understandably took the position that it did not receive the Payments in consideration for the working of, or the right to work, the Buchan Field. According to the UT, based on the reality of the transactions, the Payments continued to qualify as such consideration when the Taxpayer began to receive them. The UT's analysis and conclusion on this point should be a warning to creditors facing similar situations from an international tax perspective.

PROPOSED AMENDMENTS TO CANADIAN CHARITY TAX LAW: POTENTIAL IMPACT ON INTERNATIONAL CHARITABLE ACTIVITIES

- –Ilana Ludwin and Mashoka Maimona[19]

Cross-border collaboration can be critical for some charities to achieve their charitable purposes and make meaningful social impact. For years, it has been a challenge for Canadian registered charities to work with foreign organizations that are not "qualified donees" for Canadian tax purposes. Specifically, the requirement that Canadian registered charities can only carry out their "own activities", a requirement found in the federal income tax statute that governs charitable status in Canada, has created an imposing burden on Canadian registered charities seeking to engage in international charitable activities—particularly given the further restrictions imposed by the Canada Revenue Agency ("CRA").

In the 2022 federal budget released on April 7, 2022 ("Budget 2022"), the Government of Canada proposed to amend some of the rules in the *Income Tax Act* (Canada) (the "ITA")[20] governing Canadian charities. Among these amendments are changes to how Canadian charities may work with non-qualified donee organizations that may help address barriers to international charitable activities.

The two most significant proposed changes affecting Canada's charitable sector are: 1) amendments to the rules relating to how Canadian charities can deal with "non-qualified donees", including foreign charities and non-profits that are not charities, and 2) related amendments to the disbursement quota, the minimum amount that charities must expend annually on charitable activities or gifts. On April 27, 2022, the federal government released a bill to implement some of the new proposed rules and requirements.[21] The changes in the draft legislation will come into force on the day the bill is enacted.

©2022 Wolters Kluwer. All rights reserved.

CURRENT RULES

Charities Working with Foreign Entities

A “charity” in Canada is defined for tax purposes as being a “charitable organization” or “charitable foundation”.[22] Charities are defined and governed by section 149.1 for purposes of being allowed to issue donation receipts that entitle donors to a tax credit. Under current subsection 149.1(1), a “charitable organization” is required to devote all of its resources to charitable activities carried on by the organization itself or to provide gifts or grants to “qualified donees” (which, along with other registered charities and certain specified domestic entities, include foreign entities such as the United Nations, a limited number of foreign charities that receive donations from the Canadian government, and certain foreign universities customarily attended by Canadians). This requirement is known as the “own activities test”. Charities may either carry out such activities directly through staff or volunteers, or indirectly through appropriately structured third-party relationships (e.g., contracts for services, intermediary or agency agreements, joint venture arrangements, etc.).

The CRA has developed administrative policies in respect of the own activities test that require charities to maintain “direction and control” over their resources and activities when working through an intermediary (other than a qualified donee). These policies are known as the “direction and control” requirement. Charities that wish to operate certain activities through an intermediary organization are required to maintain ongoing direction and control over the activities in order to demonstrate that they remain the charity’s “own activities”.

Briefly, the “direction and control” requirement applied by the CRA to charities using intermediaries to carry on activities outside Canada is that “the charity must make decisions and set parameters on significant issues related to the activity, on an ongoing basis.” These decisions and parameters include “how the activity will be carried on”, “the overall goals of the activity”, “the area or region where the activity will be carried on”, “who will benefit from the activity”, “what goods and services the charity's money will buy”, and “when the activity will begin and end”. A limited number of day-to-day decisions, such as choosing their staff, suppliers, and location, may be made by the intermediary as long as the charity can overrule all these decisions.[23] The charity must be able to demonstrate “that it has a real, ongoing, and active relationship with its intermediary,” including through regular reporting by the intermediary and supervision by the charity.[24]

When it comes to working with other organizations that are not qualified donees, especially entities located outside Canada, it can be a struggle for charities to meet the “own activities” requirement by showing full “direction and control” over foreign charitable activities. Moreover, the high degree of control that Canadian charities are required to exercise over their partners has been described as “paternalistic” and “colonial”, resulting in Canadian charities having to “impose a hierarchical structure on organizations that wish to work collaboratively.”[25] This approach is particularly inappropriate for Canadian charities seeking to partner with Global South[26] or domestic Indigenous groups.

Annual Disbursement Quota for Charities

Every year, charities are required to spend a minimum amount on their charitable activities or gifts to qualified donees. The minimum amount is currently 3.5% of the value of their investment assets (i.e., property owned by the charity in the preceding 24 months that is not used directly in charitable activities or administration). This is known as the “disbursement quota”, set out in subsection 149.1(1). The disbursement quota “is designed to ensure the timely disbursement of tax-assisted funds towards charitable purposes, while allowing for reasonable asset growth within the charitable sector to support charitable activities in the future”—instead of merely accumulating indefinitely.[27]

WHY THE CURRENT RULES ARE PROBLEMATIC, ESPECIALLY FOR INTERNATIONAL WORK

©2022 Wolters Kluwer. All rights reserved.

Many charities worldwide depend on collaborating with like-minded organizations across borders to make a positive social impact and achieve charitable outcomes. However, the Canadian legislative and administrative requirements imposed on charities seeking to provide aid outside the country restrict such collaboration. The restrictions Canadian charities must place on their foreign partners are so strenuous that some Canadian charities can have difficulty finding foreign entities that are willing to work with them.

Many in the charitable sector and their advocates have expressed concerns with the CRA's interpretation of the "own activities test" and the "direction and control" construct over the years.[28] As charities lawyer Robert B. Hayhoe wrote nearly two decades ago, the "tax rules applicable to Canadian registered charities that fund foreign activities or foreign charities do not facilitate international philanthropy."[29] Clarifying the "own activities test" and the "direction and control" rules have been a long-standing ask by those in the sector.

There is no question that Canada has a legitimate policy interest in effectively regulating charities so as to prevent potential misuse by those who seek to exploit the legitimacy and fiscal benefits conferred by having registered charitable status under the ITA. However, the "own activities test" and the "direction and control" construct are built upon the assumption that it is necessary that everything that a charity does through a third-party intermediary be structured as the activity of the charity itself. This assumption does not entirely follow from the legitimate policy objectives; the gap is particularly apparent for Canadian charities that work internationally, where any work done by a Canadian charity is likely to be far less effective and viable than if that work were instead carried out by a local organization pursuing the same ends as the Canadian charity.

Furthermore, all grants made by Canadian charities to foreign non-qualified donees are currently required to be disclosed. However, as Toronto charity lawyers Mark Blumberg and Helene Mersky flag, there is no transparency about grants to non-qualified donees that are made *within* Canada: "If the foreign activities are about $3.8 billion per year, we have no idea how much money goes from Canadian charities to non-qualified donees in Canada. It might be much more than what leaves the country."[30] This isolationist model is inequitable for international charitable groups operating outside Canada that may rely on grants and donations from Canadians.

PROPOSED NEW RULES

Budget 2022 proposes what at first blush appears to be significant reform and streamlining of these onerous rules on how Canadian charities work with and make disbursements to third-party non-qualified donees (including foreign organizations). The headline change is that registered charities would be allowed to make gifts/grants to persons that are not qualified donees, provided that any such disbursements must further the Canadian charity's charitable purposes. However, the Canadian charity must meet proposed accountability requirements that have some similarity to the CRA's existing direction and control requirements.

The changes will be effected by amending section 149.1 to introduce the new defined terms of "grantee organizations" and "qualifying disbursement". Once the ITA is so amended, charities will be allowed to use their resources not only for charitable activities they carry on directly and to provide gifts or grants to qualified donees, but also to make disbursements to "grantee organizations". A grantee organization is simply any entity or natural person other than a qualified donee. The key term is "qualifying disbursement", which can be made either to qualified donees or to grantee organizations. In order for a disbursement to a grantee organization to be permissible, it has to satisfy certain conditions, which are set out immediately below. The concept of disbursement is broad and includes non-monetary support or resources being provided to the grantee organization.

Charities Working with Other Entities

Provided that a charity meets "certain requirements designed to ensure accountability", proposed amendments to the ITA would allow a charity to provide its resources to organizations that are not qualified donees.[31] The amendments are described in Budget 2022 as intending "[t]o ensure sufficient flexibility for charities to carry out their work".[32]

©2022 Wolters Kluwer. All rights reserved.

The conditions that need to be met for a disbursement by a Canadian charity to a grantee organization to be a "qualifying disbursement" are:

(1) the disbursement must further one of the charity's charitable purposes;
(2) the charity must ensure that the grantee organization uses the disbursement exclusively to further one of the charity's charitable purposes; and
(3) the disbursement must meet prescribed conditions, which will be found in new regulation 3703 of the *Income Tax Regulations* (Canada), and as currently proposed include the following:

    (1) the charity makes the disbursement subject to a written agreement with the grantee organization that meets seven specified requirements (including requirements related to the use of the disbursement, reporting requirements, and record keeping requirements);
    (2) the charity conducts sufficient inquiries prior to making the disbursement "to obtain reasonable assurances" the grantee organization will comply with the written agreement;
    (3) the charity is required to undertake certain monitoring, review, and approval measures, both periodically and in respect of a required final report, to ensure that the agreement is complied with and that the grantee organization applies the disbursement correctly; and
    (4) the charity must undertake adequate remedial action if it becomes aware of any non-compliance by the grantee organization with the agreement.

Charities would also be required under new regulation 3704 to disclose all grantee organizations receiving $5,000 or more on their public annual information return, as well as the purpose of those qualifying disbursements.

Budget 2022 states that the government intends to implement the "spirit" of Bill S-216, the *Effective and Accountable Charities Act*.[33] Bill S-216 is a private member's bill that was passed by the Senate in December 2021 and completed the first reading stage in the House of Commons on February 3, 2022—prior to Budget 2022 and the introduction of the *Budget Implementation Act*. However, while both bills seek to reduce the burden created by the "own activities test", Bill S-216 goes much further in doing so by proposing to eliminate the test altogether. Instead, Bill S-216 would require charities to take "reasonable steps" to ensure their resources are used for charitable activities only.

Even if Bill S-216 is passed by the House of Commons and comes into force, clause 51 of the *Budget Implementation Act* provides: "If Bill S-216 … receives royal assent before or on the same day as this Act receives royal assent, then, on the day this Act receives royal assent, that Act is deemed never to come into force and is repealed."

Changes to "Disbursement Quota"

Consequential to the introduction of grantee organizations and qualifying disbursements, the *Budget Implementation Act* proposes to amend the disbursement quota to take qualifying disbursements into account. Such disbursements will count towards the quota charities are required to spend or distribute every year. This modification further implements the changes to the "own activities test" and will make it easier for charities to comply with the disbursement quota requirement.

Budget 2022 also sets out several other changes to the disbursement quota that are unrelated to the amendments discussed above. These proposed changes are not directly relevant to international activities by Canadian charities and accordingly will not be addressed here.

EXPECTED IMPACT

Canada's new legislative measures in respect of charities working with other entities, and the related changes to the disbursement quota, somewhat ease the ability of Canadian charities to carry out important work by partnering with other entities—an ability that is particularly crucial for international charitable activities. The remaining barriers are still significant, reflecting parts of the CRA's current interpretation of the "own activities" test in this new "grantee organization" and "qualifying disbursement" regime. These barriers are attributable to the competing policy goal of ensuring the benefits available to Canadian charities are only enjoyed by entities that are truly carrying out officially recognized charitable work.

©2022 Wolters Kluwer. All rights reserved.

While the changes have the potential to result in a more workable and effective balance than the current rules, it remains to be seen whether this potential will actually be realized and result in increased, sustainable, and effective activities by Canadian charities both within and beyond Canada's borders.

2022 IFA ROUNDTABLES

- –Nadia Virani, KPMG LLP and Rachel Gold, KPMG Law[34]

This article discusses select topics addressed during the Department of Finance ("**Finance**") and Canada Revenue Agency (**"CRA"**) roundtables at the 2022 IFA[35] conference. Specifically, we discuss Finance's legislative update on the hybrid mismatch arrangement rules and excessive interest and financing expenses limitation ("**EIFEL**") rules, among other developments. We also summarize certain CRA comments, such as on the meaning of "goods" for purposes of paragraph 95(3)(b) of the *Income Tax Act* (the "**Act**")[36] and surplus account maintenance.

FINANCE UPDATE—PROGRESS OF LEGISLATION AND CONSULTATIONS

At the Finance roundtable, Finance[37] provided an update on recent legislative activity and highlighted two bills that were before Parliament at the time:

- Bill C-8, which implements certain measures announced in the 2021 federal fall economic update, and
- Bill C-19, which will implement certain measures from the 2022 Federal budget ("**Budget 2022**") (it does not contain the budget's international tax measures).[38]

Finance stated that it expects to release draft legislation for other measures announced in Budget 2022 (not covered by Bill C-19) and revised draft legislation for certain measures such as the mandatory disclosure rules and EIFEL rules by August 2022.

Finance further discussed select technical comments on the draft mandatory disclosure rules, hybrid mismatch arrangement rules, EIFEL rules, and the Organisation for Economic Co-operation and Development's ("**OECD**") base erosion and profit shifting ("**BEPS**") 2.0[39] two-pillar approach.

Mandatory Disclosure Rules

Finance stated it is currently working through over 25 submissions it received from stakeholders (with the CRA where appropriate).[40]

Finance previously released draft legislation on February 4, 2022 to amend the existing reportable transaction rules and introduce reporting requirements for "notifiable" transactions in the Act.[41] The legislative proposals generally require taxpayers to disclose:

- Reportable transactions involving one of (previously two of) the hallmarks of contingent fee arrangements, confidential protections, or contractual protections where it can reasonably be concluded that one of the main purposes of entering into the transaction is to obtain a tax benefit
- A "notifiable" transaction, including transactions that the CRA has found to be abusive and other transactions identified as transactions of interest (as determined by the CRA and Finance).

Finance is considering removing the definition of solicitor-client privilege from the rules and relying on common law principles instead. Finance also commented that the requirement for any person to file information returns for transactions that have not been completed achieves the right balance between wanting early tax disclosure and limiting the reporting of false starts. In Finance's view, these new reporting requirements are sufficiently clear on when reporting is required.

In response to concerns with the requirement for multiple advisors to report the same transaction, Finance stated that the rules are intended to require a broader category of people to report, including people who are

©2022 Wolters Kluwer. All rights reserved.

not just providing advice and irrespective of the type of advice that the advisor is providing (consistent with other rules, e.g., civil penalty rules in section 163.2). Finance noted that it wants to be consistent with the BEPS Action 12 report, "Mandatory Disclosure Rules", that suggests aligning with Canada's tax shelter rules, but also says that multiple reporting is an acceptable alternative. Finance said multiple reporting is consistent with the rules in Quebec and internationally, and helps the CRA incentivize disclosure and risk assessments.

Moreover, Finance stated that in respect of filing obligations and timelines it has tried to be consistent with international norms. Finance indicated that it will also consider submissions that were received on the *de minimis* threshold, penalties, and coming into force provisions.

Hybrid Mismatch Arrangement Rules

Finance released the first package of draft hybrid mismatch arrangement rules on April 29, 2022. Given how recently these rules were released, Finance's comments on the draft rules were limited.

Finance clarified that based on how the rules are currently drafted, instruments between two non-resident entities can constitute a hybrid mismatch arrangement. Finance indicated that it considers this necessary for the imported mismatch rules.[42] Finance also noted that, although these rules were intended to apply for the purposes of computing foreign accrual property income ("**FAPI**"), they were not intended to override the recharacterization rules in paragraph 95(2)(a) or other provisions of the foreign affiliate rules such as the definition of FAPI that carves out inter-affiliate dividends.

Finance is also seeking drafting suggestions, specifically on how the hybrid mismatch rules should apply in computing FAPI. Finance stated that the rules (as currently drafted) are not intended to apply to include certain payments as FAPI. For example, the hybrid rules would not apply to include a payment as FAPI, if the payment is deductible in computing the payor affiliate's active business income, but produces a deduction/non-inclusion mismatch because there is no corresponding income inclusion to the payee affiliate under foreign law. Similarly, if an instrument is a non-interest-bearing loan, FAPI should not arise where interest payments, if payable, would have otherwise been recharacterized as active business income under paragraph 95(2)(a). Finance cautioned that while this is the current policy intent, it is always subject to change in the future.

With respect to non-interest-bearing loans, the debtor may be deemed by proposed subsection 18.4(9) to make a payment in the year. Finance noted it intends for the hybrid mismatch rules to apply only to the extent the deductible/notional interest expense accrues on or after July 1, 2022. However, Finance intends that the hybrid mismatch rules apply to the entire amount of any actual payment on an interest-bearing instrument that is made on or after July 1, 2022 (even if a portion of the payment relates to a period before July 1, 2022).

Finance also addressed whether the substitute payment arrangement rules were only intended to apply to cross-border payments, and acknowledged that in certain cases payments between two Canadian resident taxpayers can come within the scope of these rules. Finance commented that this was intended and consistent with the BEPS Action 2 Report, "Neutralizing the Effects of Hybrid Mismatch Arrangements". However, Finance indicated that it is seeking feedback on why the scope of these rules should be narrowed (e.g., by adding a requirement that there be some form of foreign element to the transaction). Finance asked that submissions on the substitute payment arrangement rules should include what types of real-life transactions are inappropriately caught and the Canadian rules that are relevant to the mismatch.

Finance asked that feedback on the first package of draft legislation be submitted as soon as possible given their effective date of July 1, 2022. Finance also noted it will be releasing the second package of the draft hybrid mismatch rules well in advance of 2023 with plenty of time for consultation.

EIFEL rules

The EIFEL rules were included in the draft legislation released on February 4, 2022. Finance indicated that it received over 60 submissions as part of the public consultation process, which closed on May 5, 2022.[43]

EFFECTIVE DATE AND TRANSITIONAL RULES

©2022 Wolters Kluwer. All rights reserved.

Finance acknowledged the requests received by the various stakeholders to extend the effective date of the EIFEL rules to 2024 (instead of 2023) and to provide for transitional rules in respect of third-party debt. Finance noted that the government will be briefed on these requests and the rationale behind the requests. Finance went on to state that the government is committed to move forward quickly on these rules given that the BEPS Action 4 Report, "Limiting Base Erosion Involving Interest Deductions and Other Financial Payments", was released in 2015 and many of Canada's peers have already implemented similar rules. Finance also indicated that these measures were announced in the 2021 federal budget (with sufficient notice before the effective date of the proposed rules), and the rules (as currently drafted) also include a higher 40% ratio in the first year as well as an elective carryforward of excess capacity up to three pre-regime years to help ease taxpayers into these new rules.

SPECIFIC EXEMPTIONS

In response to several submissions that requested specific industry or sector exemptions (e.g., real estate, infrastructure, or utilities), exemptions for taxpayers undertaking specific activities, or a carve-out for public benefit projects (as stated in the BEPS Action 4 report), Finance commented that it preferred to keep the rules neutral across sectors. Specifically, Finance said its preference is to amend the base rules instead of including specific exemptions, as it is better from a legislative perspective and clearer for those looking to apply the rules to newer or novel circumstances.

EXCLUDED ENTITIES

Finance stated that it is considering the recommendation to expand the definition of "excluded entity" (which is not subject to the EIFEL rules). For example, the Joint Committee recommended that Finance broaden the definition of "excluded entity" so that more entities that pose a sufficiently low BEPS risk are excluded from these rules.[44] Also, some submissions noted the Budget 2022 proposal to broaden eligibility of the small business deduction (i.e., increase the range of taxable capital employed in Canada to $50 million (from $15 million)) and recommended a corresponding change for defining Canadian-controlled private corporations ("**CCPCs**") exempted from the EIFEL rules. Finance also noted that it is exploring ways to relax the rules for purely domestic entities or groups that do not currently fall within the definition of an "excluded entity" (e.g., where all or substantially all of the interest is paid to tax-indifferent investors). Specifically, Finance is considering whether expanding the definition of an "excluded entity" would solve the issue and whether the availability of the group ratio rules could provide greater relief.

Finance stated that it will consider an increase to the *de minimis* exception to an amount that is higher than the current $250,000 threshold, to better align with other countries.

GROUP RATIO

Finance noted that it is exploring the possibility of more targeted group ratio rules. Specifically, Finance stated that it is considering appropriate relief in light of the caps that limit the group ratio, which it says were intended to target inflated ratios resulting from losses or negative earnings before interest, tax, depreciation, and amortization ("**EBITDA**") entities in a consolidated group.

The Joint Committee, for example, has recommended that Finance revise the group ratio definition to eliminate the caps that limit the group ratio, and provide a mechanism that would account for actual losses within a consolidated group without presuming the existence of losses, to better approximate the natural leverage ratio of the group (e.g., allow for an interest deduction equal to the greater of two amounts including an allocation of a ratio based on debt-to-equity or debt-to-assets).[45]

RELEVANT FINANCIAL INSTITUTIONS

Finance is also considering how relevant financial institutions could be allowed to transfer excess capacity to other group entities in certain circumstances or to certain categories of entities, as well as how to narrow the definition of "relevant financial institution". The Joint Committee made these recommendations in its EIFEL submission to Finance and further recommended that Finance undertake consultations with the applicable finance industry groups to ensure the consequences imposed on a group with an eligible group entity that is a relevant financial institution are appropriate, particularly in light of existing restrictions and regulations on these entities.

©2022 Wolters Kluwer. All rights reserved.

ANTI-AVOIDANCE PROVISIONS

Finance stated that it is seriously considering providing further guidance on targeted transactions under the anti-avoidance rules, and clarified that there were specific transactions that were not intended to be caught by the rules (e.g., typical loss consolidation plans).

Proposed subsection 18.2(12) provides that interest income from related foreign entities may not be included in a taxpayer's interest and financing revenues, which may have a significant impact in circumstances where Canadian parent companies act as the market-facing entity to raise debt for the wider multinational enterprise ("**MNE**") group. Finance acknowledged that the BEPS Action 4 Report notes that interest limitation rules should not impede a corporate group's flexibility from borrowing, wherever it is commercially optimal, and subsequently loaning the funds to a subsidiary. Finance indicated that the draft rules are not intended to prevent that kind of structuring and that proposed subsection 18.2(12) appears to have that unintended result. Finance intends to correct that, but is also considering safeguards and restrictions as to who a loan can be made to and requiring certain conditions for the use of the borrowing.

RESOURCE EXPENDITURE ADD BACK

In computing adjusted taxable income under the rules,[46] Finance is considering whether to include an add-back for resource pool expenditures, similar to the treatment of capital cost allowance ("**CCA**") deductions. Finance indicated that an add-back for resource pool expenditures was intentionally omitted in the current draft rules, but given the feedback, may include such an add-back in the revised legislation.

FOREIGN AFFILIATES

The draft rules did not address the interaction between the EIFEL regime and Canada's foreign affiliate regime, however Finance indicated that it always intended to introduce specific rules for foreign affiliates. Finance noted that the submissions received in this regard provide good feedback on how it could design these rules.

FAPI and CCPCs

Budget 2022 announced the elimination of the tax-deferral advantage available to CCPCs and their shareholders earning investment income through controlled foreign affiliates ("**CFAs**"). This would be addressed by applying the same relevant tax factor to individuals, CCPCS, and "substantive CCPCs"[47] (i.e., the relevant tax factor of 1.9 that is currently applicable to individuals, instead of 4 that is currently applicable to CCPCs). This change would reduce the grossed-up deduction available to a CCPC for tax paid by its foreign affiliate on its FAPI.[48] As a result, a CCPC would generally be taxed on the FAPI of its foreign affiliate at a rate approximating the highest combined personal tax rate for a Canadian resident individual (consistent with the Refundable Dividend Tax on Hand ("**RDTOH**") regime).[49]

Finance noted at the roundtable that the Budget 2022 measure with respect to FAPI earned through a CCPC was intended to apply to all FAPI. However, Finance indicated that it is open to suggestions as to whether certain types of FAPI should be subject to the "old" relevant tax factor. Finance requested that submissions in this regard should set out specific examples where these rules should not apply (e.g., paragraph 95(2)(b) services income, real estate income, etc.).

Pillar One and Pillar Two

PILLAR ONE

Finance noted that intensive negotiations have been underway since the OECD announced its detailed plan to move forward with its two-pillar approach in October 2021 and acknowledged that the OECD has been providing very short timelines for public comment on several draft proposals, but noted that these timelines were agreed to by political leaders. Finance is still expecting consultations on other elements, including:

- The mechanism for eliminating double taxation;
- The marketing and distribution safe harbour;
- Dispute prevention and resolution;

©2022 Wolters Kluwer. All rights reserved.

- Administration issues.

Finance stated that its work on "Amount A" and "Amount B" is ongoing with the goal of concluding by the end of 2022.

In addition, Finance also stated that its proposed Digital Services Tax ("**DST**")[50] will serve as a back-up measure given Finance's preference for a multilateral solution under Pillar One.[51]

PILLAR TWO

In its update, Finance says it is seeking stakeholder input on specific issues related to the domestic implementation of the OECD's model rules and commentary. However, Finance indicated that there is limited flexibility to deviate from the model rules, as they were approved by the OECD/G20 Inclusive Framework members, including Canada.

Finance noted that considering the requirement for consistency with the model rules, the Pillar Two consultation announced in Budget 2022 is focused mainly on ensuring that the legislation anticipates any necessary adaptations of the model rules and makes necessary changes to Canadian tax laws to address interactions with Pillar Two. Finance noted that it is interested in feedback on "any and all" potential interactions. Specifically, Finance is seeking input on:

- Changes to the foreign affiliate rules to ensure appropriate results where there's a top-up tax liability (e.g., changes to surplus regulations to reflect top-up tax and adjustments to adjusted cost base of foreign affiliate shares);
- Changes to foreign tax credit rules including foreign accrual tax (in terms of FAPI) to address top-up tax under other countries' Pillar Two rules;
- The potential application of the general anti-avoidance rule ("GAAR") and Canada's transfer pricing rules in relation to Canada's eventual Pillar Two legislation;
- How to ensure the commentary to the model rules and the OECD's future administrative guidance has appropriate status such that Canadian courts interpret Canada's Pillar Two legislation in a manner consistent with those sources;
- Certain existing Canadian incentives[52] including Scientific Research and Experimental Development that do not appear to qualify for favourable treatment under the Pillar Two model rules because refundable credits get more favourable treatment compared to non-refundable credits.

CRA ROUNDTABLE

At the CRA roundtable, Yves Moreno of the CRA answered a number of questions on current international tax issues. The CRA's unofficial responses were provided to those who attended the conference. The answers to the CRA roundtable questions should be verified to the CRA's official responses when available.

The Meaning of "Goods"—Paragraph 95(3)(*b*)

The CRA addressed the sale of goods exception in paragraph 95(3)(b) for purposes of paragraph 95(2)(*b*) regarding the sale of real estate inventory. The rule in paragraph 95(2)(b) is part of the FAPI "base erosion" rules and deems certain service income of a foreign affiliate to be income from a business other than an active business, which consequently constitutes FAPI.[53] Certain services are excluded from the application of paragraph 95(2)(b), as set out in paragraphs 95(3)(a) to (d).[54]

The CRA was asked whether real estate inventory (such as residential condominiums) held for sale in the regular course of business qualify as "goods" under paragraph 95(3)(b), where marketing services are provided by a wholly-owned foreign affiliate of a corporation resident in Canada in respect of the sales.[55] The CRA responded that since residential condominiums are real estate (or immovable property in Quebec), they are not considered "goods" under paragraph 95(3)(b).[56] As a result, the CRA said that if no other

©2022 Wolters Kluwer. All rights reserved.

exclusions are met, paragraph 95(2)(b) would apply to services provided in connection with the sale of real estate inventory, including residential condominiums.

Additional Guidance in Respect of Surplus Accounts and Subsection 113(1) Deductions

The CRA was asked to provide additional guidance on the required documentation and best practices to adopt in respect of the preparation of surplus account calculations.[57] The CRA indicated that it is good practice for a taxpayer to maintain surplus account calculations annually in respect of a foreign affiliate, as part of their annual compliance for Form T1134[58] or FAPI determination. The CRA also indicated that each component of the surplus accounts must be validated by appropriate information and documentation, which can vary depending on the facts and circumstances, but may include:

- Non-consolidated financial statements of the foreign affiliate;
- Trial balance of the foreign affiliate;
- Complete minute books of the foreign affiliate;
- Income tax returns and all relevant supporting schedules for the income tax returns of the foreign affiliate;
- Support for income tax paid by the foreign affiliate;
- Relevant supporting documentation:
    - Describing businesses of the foreign affiliate,
    - Related to the nature of the income earned by the foreign affiliate,
    - Related to transactions involving the foreign affiliate,
    - Related to dividends paid or received by the foreign affiliate.

Separately, the CRA was asked whether a Canadian corporation (Canco) should maintain any other information, in addition to the surplus calculation, to support a dividend deduction claimed under paragraph 113(1)(a) in respect of a foreign affiliate's exempt surplus.

In this regard, the CRA noted that Canco is required to keep records that support that the foreign affiliate is a resident of a particular country under common law principles to satisfy the condition that the foreign affiliate is "resident in a designated treaty country" under the definition of "exempt earnings" in paragraph 5907(1)(d) of the *Income Tax Regulations*. The information in those records must support that the central management and control of the foreign affiliate is exercised in the treaty country, and include information relating to the whole "course of business and trading" of the foreign affiliate. The CRA stated that the information should not be limited to the location of board meetings or where board members are resident.

Corporate Residency

The CRA was asked whether it is considering changing its approach to corporate residency, in light of comments made at the 2021 United Nations climate change conference that noted that too much focus on the location of board meetings encourages a waste of time and energy (as motivated taxpayers will simply fly where they need to) and distracts from ensuring board composition is based on good governance.

In its response, the CRA indicated that its role is to administer the Act, and the residence of a corporation that is incorporated outside Canada is based on common law principles[59] subject to statutory rules in the Act (generally initiated by Finance). The CRA noted that the presence of board meetings in the country in which the corporation is asserting residence would not be sufficient on its own to conclude that the corporation is resident in that country, as the courts have repeatedly looked at the whole "course of business and trading" of a corporation.

Foreign Entity Classification List

The CRA was asked whether it will publish and maintain an online list of foreign entities that the CRA has classified for reference purposes, given the CRA's recent announcements on the classification of certain US LLLPs[60] and the introduction of anti-hybrid mismatch rules in certain countries (e.g., Luxembourg).

©2022 Wolters Kluwer. All rights reserved.

The CRA responded that it is not in a position to publish and maintain an online list of foreign entity or arrangement classifications because classifying a particular foreign entity or arrangement is determined on a case-by-case basis. Instead, the CRA said that it would consider advance income tax ruling requests for the classification of a foreign entity or arrangement, provided that the taxpayer provides certain analysis and information.[61]

The CRA's response is consistent with its previous response at the 2015 Society of Trust and Estate Practitioners ("**STEP**") CRA roundtable in which the CRA said it does not keep a list of foreign entities that it generally considers to be trusts that could be shared publicly.[62] The CRA has been accepting ruling requests from taxpayers on foreign entity classification since 2012, so its comments on such requests are not new.[63]

PPT in the MLI

The CRA was asked to comment on:

- The number of matters the CRA has recommended applying the principal purpose test ("PPT")[64] in the *Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting* ("MLI")[65] and examples of situations in which it has done so. The CRA was also asked to indicate whether the GAAR is being applied; and
- Whether it has received any PPT ruling requests.

The CRA reiterated that it is monitoring compliance with the MLI on a priority basis in advance of the normal audit cycle, but has not yet issued any assessments based on the PPT since the MLI entered into force.[66] The CRA also noted that compliance review processes are underway.

Regarding PPT ruling requests, the CRA said it has only received one pre-ruling consultation request for the PPT (the same one the CRA described in Question 2 of the 2021 IFA Conference CRA roundtable). The CRA confirmed that it has not received any PPT ruling request to date. It will be interesting to see how the CRA's application of the PPT (and possibly the GAAR) will progress as the MLI comes into effect for more and more of Canada's tax treaties over time.

Footnotes

[1] [2022] UKUT 45 (TCC) (February 17, 2022).

[2] *Convention Between the Government of Canada and the Government of the United Kingdom of Great Britain and Northern Ireland for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion With Respect to Taxes on Income and Capital Gains*, as signed on September 8, 1978 and amended by the Protocols signed on April 15, 1980 and October 16, 1985.

[3] There were three issues before the UT, the first one being the treaty issue above and the latter two issues dealing with the taxability and ability to use offsetting losses under UK domestic tax law. Our discussion in this article is limited to the UT's interpretation and application of the Treaty.

[4] SUKL was the only one that could be granted rights by the UK government to explore and exploit the Buchan Field. Based on the terms of an Illustrative Agreement between Sulpetro and SUKL, the former was to provide all funds and equipment required by the latter and in consideration Sulpetro was to own and receive all petroleum won and saved by SUKL. It does not appear that Sulpetro and SUKL were in an agency/nomineeship relationship, but economically Sulpetro effectively acted as a conduit in respect of Sulpetro.

[5] [2020] UKFTT 267 (TC).

[6] There were five grounds in total; however, only the first three concerned the issue related to the interpretation and application of the Treaty. As such, we will focus only on those three grounds.

[7] The French version of Article 6(2) reads as follows: "*Au sens de la présente Convention, l'expression « biens immobiliers » est définie conformément au droit de l'État contractant où les biens considérés sont situés. L'expression englobe en tous cas les accessoires, le cheptel mort ou vif des exploitations agricoles et forestières, les droits auxquels s'appliquent les dispositions*

©2022 Wolters Kluwer. All rights reserved.

du droit privé concernant la propriété foncière, l'usufruit des biens immobiliers et *<u>les droits à des redevances variables ou fixes pour l'exploitation ou la concession de l'exploitation de gisements minéraux, sources et autres richesses du sol</u>; les navires, bateaux et aéronefs ne sont pas considérés comme biens immobiliers*" (our emphasis).

[8] 2021 SCC 49.

[9] Can. T.S. 1980 No. 37.

[10] See P. Arginelli, *Multilingual Tax Treaties: Interpretation, Semantic Analysis and Legal Theory* (IBFD: Amsterdam, 2015).

[11] See comments by Avery Jones J. regarding multilingual tax treaties in the UK, in the "Report on the International Association of Tax Judges Webinar: Tax Courts and the Interpretation of Multilingual Tax Treaties," *Bulletin for International Taxation*, 2021, vol. 75, no. 6., published May 27, 2021.

[12] [1981] AC 251 (HL).

[13] Subsection 18(1) of the Canadian Charter of Rights and Freedoms, *The Constitution Act, 1982*, Schedule B to the *Canada Act 1982*, 1982, c. 11 (UK).

[14] 2004 SCC 6 at para 26-31.

[15] See comments by Hogan J. regarding multilingual tax treaties in Canada, in the "Report on the International Association of Tax Judges Webinar: Tax Courts and the Interpretation of Multilingual Tax Treaties," *Bulletin for International Taxation*, 2021, vol. 75, no. 6., published May 27, 2021.

[16] 2009 FCA 57 (affirming the Tax Court of Canada's decision in 2008 TCC 231).

[17] *Convention Between Canada and the Kingdom of the Netherlands for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion With Respect to Taxes on Income*, as signed on May 27, 1986 and amended by the Protocols signed on March 4, 1993 and August 25, 1997.

[18] OECD (2017), *Model Tax Convention on Income and on Capital: Condensed Version 2017*, OECD Publishing, as it read on November 21, 2017, at p 170.

[19] Ilana Ludwin is a tax lawyer and Mashoka Maimona was, at the time of writing, an articling student (and will be starting as an associate in fall 2022) with Osler, Hoskin & Harcourt LLP in Toronto. The authors would like to thank Matias Milet, partner with Osler, Hoskin & Harcourt LLP in Toronto, for his helpful review and comments.

[20] All statutory references are to the ITA unless indicated otherwise.

[21] Bill C-19, *Budget Implementation Act, 2022, No 1*, 1st Sess, 44th Parl, 2022, cls 16, 21, 23, 40 (first reading Apr. 28, 2022) (the "Budget Implementation Act"); see also Canada, Department of Finance, *Explanatory Notes Relating to the Income Tax Act and Other Legislation* (April 2022), and Canada, Federal Budget 2022, *Tax Measures: Supplementary Information* (Apr. 7, 2022), online: https://www.budget.gc.ca/2022/report-rapport/tm-mf-en.html ("Supplementary Information").

[22] Definition of "charity" in subsection 149.1(1) of the ITA. Charitable foundations are not discussed in this paper, and generally refer to a corporation or trust that is constituted and operated exclusively for charitable purposes. Charitable foundations can be public (must disburse more than half of its income to other qualified donees, and be controlled by a group, the majority of which deal at arm's length with each other) or private (all other charitable foundations).

[23] CRA, CG-002, "Canadian registered charities carrying on activities outside Canada" (27 November 2020), online: https://www.canada.ca/en/revenue-agency/services/charities-giving/charities/policies-guidance/guidance-002-canadian-registered-charities-carrying-activities-outside-canada.html.

[24] *Ibid.*

[25] Letter signed by Canadian charity lawyers (Feb. 19, 2021), online: https://carleton.ca/panl/wp-content/uploads/Making-It-Easier-To-Do-Good-Signed-By-37-Lawyers.pdf. "Partner" here is used in the non-technical sense of two entities working together, but not as partners in a formal partnership.

[26] I.e., the regions of Latin America, Asia, Africa, and Oceania.

[27] Supplementary Information, "Annual Disbursement Quota for Registered Charities".

[28] See, among others: Robert B. Hayhoe, "Cross-Border Operations by Canadian Registered Charities" (2004) 52:3 Can Tax J 941; Robert B. Hayhoe, "A Critical Description of the Canadian Tax Treatment of Cross-Border Charitable Giving and Activities" (2001) 49:2 Can Tax J 320; E. Blake Bromley, "Political, Foreign and Business Activities: Problems in the Law of Charities," in

©2022 Wolters Kluwer. All rights reserved.

Report of Proceedings of the Forty-First Tax Conference, 1989 Conference Report (Toronto: Canadian Tax Foundation, 1990), 36:1-35, at 36:25-26; and David G. Duff, “Charities and Terrorist Financing” (2011) 61:1 U Toronto LJ 73.

[29] Robert B. Hayhoe, “Cross-Border Operations by Canadian Registered Charities” (2004) 52:3 Can Tax J 941, at 942.

[30] Mark Blumberg and Helene Mersky, “2022 Canadian Federal Budget—How will it affect the Canadian charitable sector?” (Apr. 7, 2022), online: https://www.canadiancharitylaw.ca/wp-content/uploads/2022/04/2022-Canadian-Federal-Budget-and-its-impact-on-the-Canadian-charitable-sector-1.pdf.

[31] Canada, “Chapter 8: Safe and Inclusive Communities”, Federal Budget 2022 (Apr. 7, 2022), online: https://budget.gc.ca/2022/report-rapport/chap8-en.html.

[32] Canada, “Chapter 8: Safe and Inclusive Communities”, Federal Budget 2022 (Apr. 7, 2022), online: https://budget.gc.ca/2022/report-rapport/chap8-en.html.

[33] Bill S-216, *Effective and Accountable Charities Act*, 1st Sess, 44th Parl, 2021 (House of Commons first reading Feb. 3, 2022).

[34] The authors thank Sabrina Wong of KPMG Law for her comments on this article.

[35] The International Fiscal Association (IFA) (Canadian Branch) held its annual International Tax Conference on May 16th and 17th in Toronto, Ontario and online (the “**2022 IFA Conference**”).

[36] R.S.C. 1985, c.1 (5th Supplement), as amended. Unless otherwise noted, all statutory references are to the Act.

[37] Finance was represented by Trevor McGowan, Director General of the Tax Legislation Division, and Peter Repetto, Senior Director of the International Outbound Taxation sections (Tax Legislation Division).

[38] These bills received Royal Assent on June 9, 2022 and June 23, 2022, respectively.

[39] BEPS 2.0 refers to the OECD’s proposals to address challenges of tax and the digital economy in a program of work in 2019 as part of its BEPS project. Generally, the OECD/G20 Inclusive Framework looks at tax proposals under two specific "pillars". The first pillar (Pillar One) focuses on the allocation of taxing rights, including nexus issues. These proposals typically allocate more taxing rights to market or user jurisdictions where value is created through businesses' participation in the user or market jurisdiction that is not recognized in the current framework for allocating profits. The second pillar (Pillar Two) focuses on ensuring multinational entities pay a minimum rate of tax.

[40] While Finance said it is considering all recommendations, Finance only addressed certain items noted from the submissions received.

[41] These proposals were originally announced in the 2021 federal budget.

[42] Finance noted that the imported mismatch rules are contemplated for inclusion in the second hybrid mismatch legislative package which is to be effective no earlier than 2023.

[43] While Finance stated that all issues identified in the submissions are being considered, it limited its comments at the 2022 IFA conference to certain issues.

[44] CBA/CPA Joint Committee on Taxation’s submission to Finance dated May 5, 2022.

[45] CBA/CPA Joint Committee on Taxation’s submission to Finance dated May 5, 2022.

[46] Broadly speaking, adjusted taxable income is the basis for calculating a taxpayer’s interest deductibility capacity and is intended to reflect a taxpayer’s tax EBITDA.

[47] This concept was introduced in Budget 2022, which says substantive CCPCs would be private corporations resident in Canada (other than CCPCs) that are ultimately controlled, in law or in fact, by Canadian-resident individuals.

[48] Subsection 91(4).

[49] Under the current rules, the CCPC may be subject to a combined corporate tax rate similar to the general corporate tax rate (which is a lower rate of tax).

[50] This tax was originally announced in the 2021 federal budget.

[51] Finance is planning to implement the DST in 2024 if a multilateral solution is not available. Draft legislation for the GST was included in a Notice of Ways and Means Motion on December 14, 2021 but has not yet been included in a bill.

©2022 Wolters Kluwer. All rights reserved.

[52] In light of how Pillar Two affects incentives, Finance committed in Budget 2022 to review tax incentives for research and development in part because of a broader competitiveness review and also as part of the review to explore and consult on the possibility of a patent box regime.
[53] FAPI of a foreign affiliate is defined in subsection 95(1), which is based on a formula that generally includes the total amount of the affiliate's income for the year from a business other than an active business.
[54] In particular, "services" for purposes of paragraph 95(2)(*b*) does not include (a) transportation of persons or goods, (b) services performed in connection with the purchase or sale of goods, (c) the transmission of electronic signals or electricity through a transmission system outside Canada, and (d) certain manufacturing or processing of tangible property outside Canada.
[55] In the situation considered by the CRA, the residential condominiums are owned either by the Canadian company or non-arm's length entities. It was also assumed that the Canadian company and the non-arm's-length entities are subject to Canadian tax in relation to income earned on the sale of the residential condominiums and reasonable consideration is paid for the marketing services and that these costs are deductible against income earned in Canada.
[56] The CRA explained that the word "goods" is defined broadly to generally include all tangible, moveable, personal property intended for sale, in various legal and English dictionaries and in *Canadian Wirevision Ltd. v. the Queen* (79 DTC 5101 (FCA)), in the context of the processing and manufacturing deduction.
[57] At the 2019 IFA Conference, the CRA commented in response to Question 9 of the roundtable that in situations where detailed surplus calculations are not provided, it is the CRA's general practice to deny any deduction under subsection 113(1).
[58] Information Return Relating to Controlled and Non-Controlled Foreign Affiliates.
[59] The common law test for determining corporate residence considers the corporation's place of central management and control, rather than where the corporation ought to be managed, unless there is an overriding statutory rule in the Act. The test for corporate residence was first established in *De Beers Consolidated Mines Ltd. v. Howe*, [1906] AC 455 (HL).
[60] CRA document no. 2016-0634951C6, June 10, 2016. The CRA takes a two-step approach to determine the status of a foreign entity or arrangement for Canadian tax purposes; see CRA, Income Tax Technical News 38 (September 22, 2008), which the CRA reiterated at the 2022 IFA CRA roundtable.
[61] The CRA noted that it does not consider classification of a foreign entity or arrangement to be a situation that would require interpretation of a law not administered by the CRA, including foreign law (which would otherwise be a circumstance in which the CRA will not issue a ruling): see paragraph 19(k) of the CRA's Information Circular 70-R612, "Advance Income Tax Rulings and Technical Interpretations", April 1, 2022.
[62] CRA document no. 2015-0581961C6, June 18, 2015 (Question 8 of the 2015 STEP CRA roundtable).
[63] CRA document no. 2012-0463021C6, October 30, 2012.
[64] The PPT is intended to address treaty abuse. It is a general anti-abuse rule that considers whether one of the principal purposes of an arrangement or transaction is to obtain treaty benefits in a way that is not in accordance with the object and purpose of the relevant provisions of the treaty.
[65] See http://www.oecd.org/tax/treaties/multilateral-convention-to-implement-tax-treaty-related-measures-to-prevent-beps.htm. This website also provides a list of the signatories, the parties that have ratified the MLI, and the reservations against any particular MLI provisions. The MLI entered into force in Canada on December 1, 2019 and began to affect a significant portion of Canada's treaties beginning on January 1, 2020. As of May 25, 2022, the MLI affects (or will soon affect) 46 of Canada's tax treaties.
[66] The CRA made similar comments in response to Question 2 of the 2021 IFA Conference CRA roundtable.

©2022 Wolters Kluwer. All rights reserved.