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International Tax

Report No.: 100

Date: June, 2018

CANADA & THE MLI: A REVIEW & UPDATE

- –*Matias Milet, Emily Gilmour, and Taylor Cao, Osler, Hoskin & Harcourt LLP*

The Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting—also known as the Multilateral Instrument or MLI — has been signed by more than 75 jurisdictions (including Canada). Once in effect, the MLI will modify a significant number of existing bilateral tax treaties, including up to 75 of Canada's bilateral tax treaties. On May 28, 2018, Canada tabled a Notice of Ways and Means Motion (NWMM) in the House of Commons, formalizing Canada's intention to introduce legislation to enact the MLI into Canadian law, and revealed publicly some of the optional MLI provisions that Canada intends to adopt.

The MLI will enter into force on July 1, 2018, three months after it has been ratified by at least five countries (i.e., Austria, Isle of Man, Jersey, Poland, and Slovenia).[1]

The MLI will enter into force for Canada on the first day of the month beginning three months after Canada deposits its instrument of ratification with the OECD. Where the MLI is already in force for a counterparty to a Covered Tax Agreement, the MLI will then enter into effect for that Covered Tax Agreement for (a) withholding taxes, on the first day of the next calendar year, and (b) for other taxes, for tax years beginning six months after the MLI enters into force for Canada. Where the MLI is not yet in force for a counterparty, the timeline for entry into effect for that Covered Tax Agreement will depend on the date on which the MLI enters into force for that counterparty.

THE MINIMUM STANDARDS

All signatories to the MLI, including Canada, must agree to certain minimum standards on treaty abuse and improving dispute resolution.

The minimum standard to address treaty abuse consists of two parts:

(i) an amended preamble, suggesting that covered tax treaties are intended to eliminate double taxation without creating opportunities for non-taxation or reduced taxation through tax evasion or avoidance; and

(ii) (ii) a broad anti-avoidance rule, referred to as the principal purpose test or PPT. Under the PPT, a treaty benefit may be denied where it is reasonable to conclude that one of the principal purposes of an arrangement or transaction is to gain the benefit, unless it is established that granting the benefit would be in accordance with the object and purposes of the relevant provisions of the treaty.

In addition, Canada has agreed under the MLI to implement the minimum standard with respect to dispute resolution features of its tax treaties, and has also agreed to adopt mandatory binding arbitration to assist in resolving treaty-based disputes in a timely manner.

RESERVATIONS UNDER THE MLI

Signatories to the MLI are allowed to register reservations on measures other than the minimum standards (i.e., the optional provisions). Generally, decisions as to whether Canada should register or withdraw reservations are taken by the executive branch of government.

At the time of signing the MLI in June 2017, the Minister of Finance reserved on all provisions except the required minimum standards. However, concurrent with the tabling of the NWMM, the Department of Finance announced its intention to remove some of its initial reservations on optional MLI provisions. The NWMM itself is silent as to reservations, and refers to the implementation of the MLI in full, which includes the built-in optionality in the MLI for how countries can enter and remove reservations in respect of the optional provisions. Accordingly, Parliamentary approval will not be required to change Canada's positions on any of the optional provisions.

In the nearer term, certain reservations, if removed, can have a significant impact on the Canadian fisc (such as if Canada were to agree to the MLI's changes to the "permanent establishment" threshold — which will give other countries an increased ability to tax foreign profits of Canadian taxpayers). As a result, we hope that Parliament will carefully consider the MLI, together with the potential consequences of removing Canada's current reservations, prior to approving the MLI's ratification.

As reservations can be removed at any time, but new reservations are not permitted, this raises an issue as to Canada's flexibility to modify its Covered Tax Agreements — and the MLI's effect on such Covered Tax Agreements — after the MLI enters into force for Canada. Within the framework of the MLI, it seems that such flexibility will be one-sided, since following ratification, Canada cannot add any further reservations but can only withdraw or narrow a reservation. In other words, to the extent that Canada wishes the MLI to govern with respect to a particular Covered Tax Agreement, Canada's commitment to the MLI (as it applies to that Covered Tax Agreement) can only increase over time, but cannot decrease.

However, there are other ways for Canada to potentially limit the MLI's effect on its tax treaties. For example, parties to a Covered Tax Agreement can agree to replace or amend their bilateral tax treaty with a new tax treaty or protocol. The MLI will not apply to a new treaty unless both contracting parties notify the OECD and list such new treaty as a Covered Tax Agreement. Furthermore, a bilateral protocol could amend the manner in which the MLI otherwise applies to a Covered Tax Agreement under the general "later in time" principle, if the parties explicitly provide that the MLI shall not apply to the extent of any inconsistency.[2] However, such an action may be unlikely, as the MLI restricts the extent to which signatories can modify their adherence to the MLI and does so in a manner that does not contemplate inconsistent subsequent amendments to Covered Tax Agreements.[3] On the other hand, if a subsequent amendment to a Covered Tax Agreement is inconsistent with a provision of the MLI but is silent as to the interaction with the MLI, the MLI provision may continue to govern even after such purported amendment.[4]

CANADA'S ALTERATION OF INITIAL RESERVATIONS

On May 28, 2018, Canada announced that it intends to remove three reservations to the MLI. The removal of these reservations will materially change taxpayers' rights under Canada's Covered Tax Agreements, unless the other contracting state has reserved on these articles.

Article 8 — Dividend Transfer Transactions

The first announced change is the adoption of Article 8(1) of the MLI, which includes a 365-day holding period test in the context of withholding tax on dividends. According to the Department of Finance, such a change will ensure that lower rates of withholding tax on dividends will not be available to non-resident companies that engage in "certain short-term share acquisitions".

Generally, Article 8(1) provides that the 365-day holding period test applies where a Covered Tax Agreement provides for a lower rate of withholding tax on dividends if the beneficial owner (or recipient) of the dividend is a company that owns more than a certain amount of the capital, shares, stock, voting power, voting rights, or similar ownership interests of the dividend payor. In order to satisfy the test under Article 8(1), the applicable ownership condition imposed by a Covered Tax Agreement must be met "throughout a 365-day period" that includes the day of the dividend payment. Article 8(1) provides that for purposes of this 365-day test, changes of ownership resulting directly from corporate reorganisations involving either the payor or the recipient of the dividend, such as mergers or divisive reorganisations, should be ignored.

One example of a provision to which Article 8(1) will apply is Article 10(2)(*a*) of the Canada–U.K. Tax Treaty, which generally limits withholding rates on dividends to 5% if the beneficial owner of the dividend owns at least 10% of the voting power in the company paying the dividend. If this ownership condition is not met, the withholding rate is limited to 15% pursuant to Article 10(2)(*b*).

After the MLI enters into effect for the Canada–U.K. Tax Treaty, the 5% withholding rate under Article 10(2)(*a*) will be narrowed to apply only where the dividend recipient owns at least 10% of the voting power of the dividend payer throughout a 365-day period that includes the day of the dividend payment. If the dividend recipient only satisfies the ownership test for a shorter period of time, the applicable withholding rate will be limited to 15%. Note that in cases where taxpayers only seek to benefit from the 15% rate under Article 10(2)(*b*) of the Canada–U.K. Treaty (or similar provisions in other treaties), no holding period test will be required.

According to the Explanatory Statement to the MLI (the "**Explanatory Statement**"), Article 8(1) of the MLI is based on Article 10(2) of the OECD Model Treaty, which reduces withholding tax on dividends to 5% "if the beneficial owner of the dividend is a company which holds directly at least 25 per cent of the capital of the company paying the dividends throughout a 365 day period that includes the day of the payment of the dividend". However, unlike Article 10(2) of the OECD Model Treaty, Article 8(1) of the MLI does not refer to any specific tax rates or ownership threshold. The Explanatory Statement makes it clear that Article 8(1) is not intended to modify any other terms in the Covered Tax Agreements regarding withholding tax on dividends.

Interestingly, the text of both Article 8(1) of the MLI and Article 10(2) of the 2017 OECD Model Treaty (the "**OECD Model**") refer to "*a* 365 day period" that includes the date of the dividend. This suggests that the 365-day test can be satisfied by *any* 365-day period that includes the date of the dividend, which should include periods that end after the dividend payment. In other words, Article 8(1) appears to allow a corporate taxpayer to benefit from the lowest rate of withholding on a dividend (e.g., 5%) even if that taxpayer acquires the requisite percentage of shares the day before the dividend is paid, as long as that taxpayer continues to hold such shares for at least 365 days. (Practical timing issues around how this treaty benefit may be claimed in such circumstances are discussed below.)

The language of Article 8(1) can be compared with the language in Article 9(1) of the MLI, discussed below, which refers to "*the* 365 days *preceding* the alienation". Article 9(1) refers to one specific period during which the value test on the transferred equity interests should be performed. By contrast, the 365-day holding period in Article 8(1) is not framed with such specificity, and does not refer to, as an example, "the 365 days preceding the dividend".

The holding period test for dividend withholding was motivated by a concern regarding "dividend transfer transactions". According to the Final Report on Action 6 of the BEPS Project (the "**Action 6 Report**"), there was a concern that shareholders would increase their holding in a corporation shortly before a dividend becomes payable, primarily for the purpose of lowering their withholding tax burdens. However, this concern should not arise if the shareholder holds the acquired shares for a prolonged period (i.e., 365 days), regardless of what portion of such 365-day period occurs before or after the payment of the dividend.

The apparent flexibility of the 365-day holding period may give rise to practical issues. Generally, Canadian withholding tax on dividends is due on the 15th of the month following the dividend payment. However, under Article 8(1), the applicable rate of withholding on dividends may depend on events occurring after the withholding taxes are due (e.g., a sale of shares within a particular time period). It is possible that the CRA or the dividend payor may require non-resident dividend recipients who have not satisfied the 365-day test at the time of the dividend to pay a higher rate of withholding, leaving it to the recipient to claim a partial refund after the 365-day test is satisfied.

Another potential issue regarding the application of Article 8(1) is the ambiguity of the terms "a corporate reorganisation, such as a merger or divisive reorganisation". Neither the Explanatory Statement nor the Action 6 Report provide specific guidance on the types of "corporate reorganisations" that will be ignored for purposes of the holding period test. It is not clear, for example, whether a "corporate reorganisation" (i) is restricted to certain transactional forms (e.g., mergers, divisive reorganisations, wind-ups, etc.), (ii) must be governed by certain statutory provisions,[5] (iii) can include any taxable transactions, or (iv) can include all transactions involving sufficiently-related parties. It is helpful, however, that Article 8(1) simply refers to "a corporate reorganisation" without attaching any conditions to the types of reorganizations that qualify.

Article 9 — Capital Gains from Alienation of Shares or Interests of Entities Deriving their Value Principally from Immovable Property

The second change announced by the Department of Finance is to add a one-year lookback testing period in determining whether a Covered Tax Agreement exempts capital gains on a sale of equity interests (including shares) that do not derive their value principally from immovable property situated in the source state. Canada's domestic "taxable Canadian property" rules impose a five-year lookback period for determining whether shares and equity interests in trusts and partnerships derive their value principally from certain types of Canadian properties (such as real property and resource properties). By contrast, many of Canada's tax treaties exempt gains from being taxed in Canada where the shares sold by a resident of the other state do not derive their value principally from immovable property in Canada *at the time of disposition*. Article 9(1) of the MLI, which Canada proposes to adopt, will allow the source country to tax such gains if the relevant value threshold is met at any time during the 365 days preceding the disposition.

Article 9(1) also provides that the source country shall have the right to tax not only shares, but also "comparable interests, such as interests in a partnership or trust", that derive their value primarily from real property situated in the source state. To the extent that Canada has any existing Covered Tax Agreements that grant source countries the right to tax gains realized on the disposition of shares (that derive their value principally from real property in the source state), but not trust and/or partnership interests, the result of adopting this provision will be to broaden the scope of gains that can be taxed under such a Covered Tax Agreement. The term "comparable interests" is apparently intended to apply to interests comparable to shares in non-corporate entities,[6] rather than to corporate-issued, equity-like instruments that are not shares.

Article 4 — Dual Resident Entities

The third change is to adopt a provision for resolving dual resident entity cases.

Under the *Income Tax Act* (Canada) (the "**Act**"), a person resident in Canada at any time in a taxation year is liable to report and pay tax on its taxable income earned in the year from any source (whether Canadian or foreign). While "resident" is not defined in the Act, a corporation will be considered resident in Canada if either: (i) it was incorporated in Canada;[7] or, (ii) it meets the common law "central management and control" test for residency, which seeks to establish where the substance of a corporations' business is carried on.[8]

Absent any relief provided by an applicable tax treaty, a corporation that is resident in Canada will still generally be taxable under the Act regardless of whether it is also considered resident in another country. However, where a treaty applies to deem a corporation to be resident in another country and not to be resident in Canada, subsection 250(5) of the Act provides that the corporation is deemed not to be resident in Canada for purposes of domestic law.

As such, Canada's tax treaties provide mechanisms to resolve dual residency cases. Many of Canada's tax treaties provide that the dual residence of persons other than individuals (such as corporations) is to be resolved, if agreement can be reached by the competent authorities of the two treaty partner countries in which the entity is resident (e.g., Canada's treaties with the UK, Ireland, and Singapore). Other treaties, including the Canada–US Tax Treaty, use place of incorporation as a tie-breaker rule.

Article 4 of the MLI is meant to replace any other tie-breaker rule under a Covered Tax Agreement, for persons other than individuals, with a determination of residency by the applicable competent authorities. Therefore, for one of Canada's Covered Tax Agreements where the other contracting party has also not reserved on Article 4, dual residency for corporations under that agreement will be addressed by the competent authorities endeavouring to reach a resolution. Article 4 adds certain factors that the competent authorities should take into account when seeking to resolve dual residency under a Covered Tax Agreement. These factors are: (i) place of effective management; (ii) place where the entity is incorporated or otherwise constituted; and (iii) "and any other relevant factors."

The commentary to Article 4 of the MLI provides that Article 4 is based on Article 4(3) of the OECD Model. The commentary to the OECD Model (the "**OECD Model Commentary**"), updated in November 2017, specifically notes that in prior drafts of Article 4, preference was given to the "effective management" test in resolving cases of dual residency, as opposed to a "purely formal criterion like registration". However, given a number of tax avoidance cases involving dual resident companies, the OECD has concluded that the better solution is to deal with such situations on a "case-by-case" basis by the relevant competent authorities.[9]

The OECD Model Commentary also lists factors which should be taken into account by a competent authority when resolving cases of dual residency.[10] These factors are similar to those that Canadian courts have looked to when determining residency of a corporation, which include: (i) location of board meetings (including whether board members attend in person); (ii) the residence of board members, directors and managers; (iii) where senior day-to-day management and business operations are carried on; (iv) the location of its books and records; (v) the location of its assets and bank accounts; (vi) the location of its auditors and lawyers; and (vii) the location of its head office. As such, the "other factors" referred to in Article 4 of the MLI should be substantially similar to those listed above.

Overall, Canada's decision not to reserve on Article 4 indicates its willingness to review each case on its merits, without a decided preference to adopt either a place of effective management test or a bright-line test based on place of incorporation.

The new article on dual resident entities does not provide for a clear result where the entity is a dual resident by virtue of a corporate continuance. Some such entities may be governed by the laws of both the jurisdiction under which they are created and the one to which they are continued. The U.S.–Canada treaty contains a tie-breaker rule that provides that such an entity would be resident only in the jurisdiction where the entity was created. By referring to the place where the entity is incorporated or otherwise constituted as a relevant factor, the new MLI provision may be signalling that a similar approach should be applied, although without treating any one particular factor as a mechanical bright-line rule.

ADDITIONAL COMMENTS

Finally, Canada intends to adopt a provision of the MLI that will allow certain treaty partners to move from an exemption system as their method of relieving double taxation, to a foreign tax credit system. This change appears consistent with Canada's general treaty policy over the past two decades — which has generally removed treaty-based guarantees of an exemption system. We note that Article 5 of the MLI allows countries to adopt one of three different options when removing such treaty-based guarantees, and at this point, it is uncertain which of the three options Canada intends to adopt. In any case, the removal of a treaty-based guarantee of an exemption system would allow Canada's treaty partners to change their domestic laws to adopt a foreign tax credit system as an alternative. However, the general trend for many years has been for countries (including Canada) to provide for an exemption system — and any change to a foreign tax credit system by Canada's treaty partners may have a significant adverse impact on cross-border investments.

Unfortunately, Canada did not announce an intention to remove its reservation on Article 7(4) of the MLI — which would specifically allow treaty benefits that would otherwise be denied under the PPT to be granted in full or in part by the competent authorities in appropriate circumstances. For example, assume that an investor would be entitled to a 15% withholding tax rate on dividends had it made a direct investment into Canada, but instead invests into Canada through an intermediary that would have been entitled to a 10% withholding tax rate. A denial of treaty benefits under the PPT could lead to a 25% withholding tax rate on dividends to the investor. However, Article 7(4) would provide a specific mechanism to allow the investor to access the 15% rate notwithstanding the application of the PPT — if the CRA determines that the 15% rate would have applied had the investor invested into Canada directly. This is particularly important, for example, for private equity and other collective investors that may be resident in multiple jurisdictions. Canada has also not provided any additional guidance on when or how the PPT is intended to apply to private equity and other collective investment vehicles — despite many suggestions that further guidance is needed (either on a unilateral or bilateral basis). In particular, the PPT is very broadly worded, and the current OECD guidance is ambiguous and open to different interpretations.

BUY, BUMP, AND RUN WITH A TWIST

- –John J. Lennard and Olivia Khazam, Davies

In a recent Ruling (2016-0643931R3), the Canada Revenue Agency (the "**CRA**") opined on the timing of the paid-up capital ("**PUC**") reinstatement provisions that can apply on a corporate continuance where the foreign affiliate dumping rules[11] (the "**FAD rules**") had previously reduced PUC in the context of a so-called "buy, bump, and run" arrangement. Specifically, the CRA concluded that PUC is reinstated prior to the relevant time for computing the section 219.1 departure tax. As well, the CRA implicitly blessed an unconventional amalgamation as being a qualifying vertical amalgamation under section 87(11), even though the terms of the amalgamation provided that only one of two predecessor entities was deemed to survive.

THE BASIC FACTS

The facts in this Ruling are relatively straightforward. A non-resident partnership ("**Partnership**") and other non-resident co-investors (collectively, the "**Investors**") acquired a Canadian public corporation ("**Target**") pursuant to a statutory Plan of Arrangement. Target's assets consisted primarily of two wholly-owned non-resident subsidiaries ("**Subcos**"). The Investors capitalized a Canadian acquisition company ("**Parent**"), which acquired the Target shares. Specifically, Partnership and certain other Investors subscribed for shares of Parent for cash, and one existing shareholder of Target ("**Significant Shareholder**") transferred its Target shares to Parent for cash and shares of Parent. Each Target share was then transferred to Parent for cash.

The FAD rules applied to the acquisition of the Target shares by Parent. As a result, Parent was deemed to have paid a dividend equal to the fair market value ("**FMV**") of the non-share consideration paid by Parent on the acquisition. However, it appears that the amount of the deemed dividend was less than the total PUC of the “cross-border classes” in respect of the investment, such that the PUC offset rule paragraph 212.3(7)(*c*) applied to reduce the amount of the deemed dividend to nil and to reduce the PUC of the shares of Parent by the amount that would otherwise have been the deemed dividend. Moreover, by virtue of paragraph 212.3(2)(*b*), the PUC of the shares of Parent was reduced by the amount of the PUC increase that would otherwise have arisen on the share issuance to Significant Shareholder.

Parent and Target were then amalgamated to form Amalco. To avoid a deemed disposition of the shares of the Subcos for foreign tax law purposes, the Plan of Arrangement provided that the legal existence of Target did not cease and survived the amalgamation with Parent.

Following the amalgamation, the shares of the Subcos were “bumped” under paragraph 88(1)(*d*). The parties then wanted to eliminate the superfluous Canadian component of the structure. However, the “run” portion of the “buy, bump, and run” was complicated by the fact that a distribution of the shares of the Subcos by Amalco to the Investors in order to wind up the structure would have triggered a significant tax liability for the Subcos in their home jurisdictions. In this regard, although it is not expressly mentioned in the Ruling, the assets of the Subcos presumably consisted of real property, and the home jurisdictions presumably imposed some sort of withholding tax regime similar to the section 116 regime in cases where a non-resident disposes of shares of a corporation that derive most of their value from real property. As such, the parties proposed an alternative transaction whereby Amalco would instead be continued outside of Canada (which continuance would presumably not result in a deemed disposition of the underlying assets of the Subcos for foreign tax law purposes).

The tax resulting from the deemed disposition on Amalco ceasing to be resident in Canada under paragraph 128.1(4)(*b*) would seemingly have been minimized by the effect of the bump; however, one concern was the impact of the PUC grinds under the FAD rules on the amount of departure tax that would be payable by Amalco under section 219.1 on its continuance.

THE PUC REINSTATEMENT AND DEPARTURE TAX RULING

Where a Canadian-resident corporation is continued outside of Canada, section 219.1 provides that the emigrating corporation is required to pay a departure tax in an amount equal to 25 percent (subject to reduction under an applicable tax treaty) of the difference between (a) the FMV of all of its property, and (b) the total of its PUC and its outstanding liabilities. This tax is generally designed to represent the Part XIII tax that would have been payable on amounts available then for distribution, had they been distributed as dividends by the Canadian-resident corporation.

Where the PUC of the emigrating corporation has been reduced by the FAD rules, subsection 219.1(4) can apply to reinstate the “ground” PUC. Generally, PUC is reinstated to the extent of the lesser of (i) the FMV of the shares of the non-resident subject corporation owned by the emigrating corporation, and (ii) the total of all amounts required by paragraph 212.3(2)(*b*) or subsection 212.3(7) to be deducted in computing the PUC of the emigrating corporation.

However, pursuant to subsection 219.1(4), the PUC of the emigrating corporation is increased “immediately before the time that is immediately before” the time at which the corporation ceased to be resident in Canada. For purposes of computing the amount of departure tax payable, pursuant to paragraph (a) of variable B in subsection 219.1(1), PUC is computed immediately before the time at which the tax year of the corporation is deemed (by paragraph 128.1(4)(*a*)) to have ended, which is also immediately before the time at which the corporation ceased to be resident in Canada. As such, on a purely textual interpretation of the rules, it appears that the timing of the PUC reinstatement under subsection 219.1(4) coincides with — rather than precedes — the time at which PUC is to be computed for purposes of computing the departure tax.

The CRA ruled that, pursuant to subsection 219.1(4) and for purposes of the section 219.1 departure tax, the continuation would give rise to a PUC reinstatement in respect of Amalco's shares, effectively confirming that subsection 219.1(4) reinstates PUC prior to the relevant time for computing PUC for purposes of calculating the section 219.1 departure tax.

THE BUMP RULING

Generally speaking, Canadian corporate statutes such as the *Canada Business Corporations Act* reflect what might be called a “continuation” theory of amalgamation — that is, the corporation formed by the amalgamation of two or more corporations results in the continued legal existence of each of the predecessors in the form of a single corporation, “like a river formed by the confluence of two streams”.[12] This is in contrast to other what might be called US-style or “survivor-type” mergers, whereby one of the corporations “survives” the merger and absorbs the assets and liabilities of the other corporations, whose legal existence then ceases. In the case of an amalgamation involving Canada and a foreign country, whether an amalgamation can qualify for a particular tax treatment (particularly rollover treatment) under the laws of each jurisdiction depends on how the corporate law in each jurisdiction characterizes the transactions at issue. For example, where a Canadian corporation has US shareholders, the differences in the characterization of a ‘‘merger’’ under Canadian law may require that a Canadian amalgamation be structured to conform to US corporate law principles in order to mitigate US tax concerns, which may, in turn, create concerns on how the amalgamation will be taxed in Canada.

For Canadian tax purposes, the consequences of an amalgamation are governed by section 87. The provisions of section 87 apply to a "qualifying amalgamation" that meets the criteria set out in subsection 87(1), which provides that an amalgamation, for purposes of section 87, means a merger of two or more taxable Canadian corporations (each referred to as a "predecessor corporation") to form one corporate entity (referred to as the "new corporation") in such a manner that (i) all of the property and liabilities (other than certain intercorporate receivables and other amounts) of the predecessor corporations becomes the property and liabilities of the new corporation, and (ii) all of the shareholders of the amalgamating corporations receive shares of the new corporation created by virtue of the merger, otherwise than as a result of the acquisition of property of one corporation by another corporation, pursuant to the purchase of that property by the other corporation or as a result of the distribution of that property to the other corporation on the winding-up of the corporation.

In the case of a vertical amalgamation between a parent and one or more subsidiaries, subsection 87(1.1) deems the shares of the predecessor parent corporation to be the shares of the “new” corporation created on the amalgamation. Moreover, subsection 87(11) provides that the cost to the new corporation formed on the amalgamation of each capital property of the subsidiary acquired on the amalgamation is deemed to be the amount that would have been the cost to the new corporation of the property if the property had been distributed at that time to the parent corporation on a winding-up of the subsidiary and subsections 88(1) and 88(1.7) had applied to the winding-up. In other words, subsection 87(11) effectively deems the new corporation formed on the amalgamation to have acquired non-depreciable capital property of the subsidiary at a cost equal to the subsidiary's adjusted cost base of such property, in much the same way a parent would be deemed, under paragraph 88(1)(*b*), to have acquired such property from its subsidiary at cost had the subsidiary instead been wound-up into the parent. This rollover treatment is, in turn, subject to the “bump” rule in paragraph 88(1)(*d*), which generally permits a parent to step up the cost basis of non-depreciable capital property of a subsidiary acquired by the parent on the wind-up of, or vertical amalgamation with, the subsidiary.

With respect to this Ruling, the fact that Target rather than Parent was the survivor pursuant to the Plan of Arrangement may have raised technical concerns over whether a paragraph 88(1)(*d*) “bump” was available in the circumstances. In other words, because a vertical amalgamation resulted in a “survivor” and that survivor was the former subsidiary, it may have been conceptually peculiar to consider that the subsidiary corporation “acquired” its own assets, the cost of which could thereafter be stepped up under paragraph 88(1)(*d*). Moreover, in light of the complex anti-avoidance rules in section 88 which are designed to ensure that the “bump” is not available in circumstances considered inappropriate, the taxpayers presumably wanted comfort that a mere mention of survivorship in the Plan of Arrangement would not raise any policy concerns or anomalies from a Canadian tax perspective, given that the bump and amalgamation rules in the Act were presumably drafted with Canadian-style amalgamations in mind.

Thankfully for the taxpayer, the CRA ruled that Amalco was entitled to a paragraph 88(1)(*d*) bump, even though the amalgamation of Parent and Target was not a conventional amalgamation but one which was specified under the Plan of Arrangement to entail the continued existence of Target. By giving a favourable bump ruling, the CRA effectively reiterated its position, as expressed in previous rulings,[13] that a survivor-type merger may be a qualifying vertical amalgamation for the purposes of subsection 87(1.1), even in the case where the former subsidiary is the “survivor” under a vertical amalgamation.

In our view, the results of this Ruling are logical, fair and entirely consistent with the FAD rules, the departure tax regime and the bump rules. In addition, this Ruling highlights certain planning tools that taxpayers may employ to mitigate the foreign tax results of Canadian corporate reorganizations.

ECONOMIC NEXUS: IMPACT ON CANADIAN FOREIGN TAX CREDITS

- –Susan McKilligan, PricewaterhouseCoopers LLP

THE EXPANSION OF US STATE NEXUS

In general, “nexus” is the minimum level of activity a taxpayer must have in a US state before that state has the right to tax the taxpayer. Historically, the concept of nexus has been based on the taxpayer’s physical presence in a state.

With e-commerce eroding states’ historic tax base, a number of states have expanded nexus for corporate income tax purposes by introducing the concept of “economic nexus” without a physical presence. For example, in New York and California, a taxpayer can have nexus for corporate income tax purposes if the level of sales to customers in these states reaches a prescribed threshold, even if the taxpayer never sets foot in these states. Similarly, Ohio, Washington, and West Virginia have enacted laws (that have been upheld in state courts) that impose business tax on taxpayers without physical presence in the state.

Unlike the economic nexus standard for corporate income tax purposes, nexus for state sales and use taxes has historically been based predominately on physical presence in a state. However, the US Supreme Court released its decision on *South Dakota v. Wayfair, Inc.* on June 21, 2018. The US Supreme Court ruled in favour of South Dakota, upholding the state’s legislation requiring out-of-state online retailers to collect and remit sales tax on sales to customers in the state based solely on the retailer exceeding certain economic thresholds in the state. As a result, retailers are no longer required to have a physical presence (i.e., property or employees) in the state before the state can require it to collect and remit sales tax. Bolstered by the US Supreme Court’s decision, US states will continue to expand the scope of nexus to increase their eroding tax base. This favourable (for the state) decision from the US Supreme Court will substantially accelerate this process and, although the case relates to sales and use tax, will likely be used to support the expansion of nexus for income tax.

Regardless of the US Supreme Court’s decision, US states will continue to expand the scope of nexus to increase their eroding tax base. A favourable (for the state) decision from the US Supreme Court will substantially accelerate this process and, although the case relates to sales and use tax, will likely be used to support the expansion of nexus for income tax.

IMPACT OF ECONOMIC NEXUS ON CANADIAN FOREIGN TAX CREDIT

A Canadian corporation that is subject to US taxation cannot assume that any US tax paid will be creditable against the corporation’s Canadian tax liability.

In theory, the Canadian corporation should be taxable in Canada on its worldwide income, including income that has already been taxed in the US. Canada should grant the Canadian corporation a foreign tax credit for business-income taxes paid to the US.[14] Essentially, the amount of the foreign tax credit allowable is the lesser of:

- the foreign business-income taxes paid for the year, and
- the amount of Canadian taxes otherwise payable for the year on the US-source business income.[15]

The effect of the foreign tax credit rules is that the Canadian corporation would generally pay the higher of the US and Canadian tax rates on the income subject to US taxation.

In reality, there are a number of restrictions that reduce the foreign tax credit available to a Canadian corporation and result in a higher tax rate. One of those restrictions limits business-income tax to the portion of any income or profits tax paid by the taxpayer to the government of another country that can reasonably be regarded as tax "in respect of businesses carried on by the taxpayer in a country other than Canada."[16] The purpose of this limitation is to ensure that Canada does not allow foreign taxes to be used as a credit against Canadian tax on Canadian source income.

The Canada Revenue Agency's position is that foreign-source business income must be determined in accordance with Canadian rules[17] rather than the foreign country rules and is limited to income attributable to activities carried on in the particular foreign country. While, the Act does not provide a detailed method to determine the territorial source of income, there is a body of case law,[18] tax treaties, and OECD commentary[19] that set out various rules for sourcing income.

This case law and commentary generally provides that income is sourced based on separate entity and arm's length principles. According to paragraph 15 of the OECD commentary, the profits attributable to a particular country should be based on the profits that would be earned by a:

> … separate and independent enterprise engaged in the same or similar activities under the same or similar conditions, taking into account the functions performed, assets used and risks assumed …

This methodology is similar to that used for transfer-pricing purposes.

Based on these transfer-pricing methodologies, it is likely that economic nexus without a physical presence (without people and assets in the state) will not necessarily be treated as sourced to that state in accordance with Canadian rules. If the source of the income is Canada, any foreign tax paid will not be creditable (or deductible in computing income).

While this restriction on foreign tax credits is not new, as US states expand the scope of nexus, it is likely that we will see many more instances of denied foreign tax credits relating to US state taxation.

Footnotes

[1] On June 5, 2018, Serbia became the sixth country to ratify the MLI.

[2] As a general matter, conflicts between statutes that could not otherwise be resolved is settled by giving priority to the statute that was later in time. See Brian J. Arnold, "The Relationship between Tax Treaties and the Income Tax Act: Cherry Picking", 1995 CTJ 43:4, 869, at 873. A conflict between the MLI's implementing legislation and a subsequent bill that explicitly ousts the effect of the MLI would be such an otherwise irresolvable conflict.

[3] In addition, Canada always has the option of formally withdrawing from the MLI, as contemplated by Article 37 of the MLI.

[4] This conclusion is supported by section 4 of the NWMM, which provides that in the event of any inconsistency between the provisions of (i) the MLI or its implementation Act, and (ii) the provisions of any other law (except the *Income Tax Conventions Interpretation Act*), the provisions of the MLI and its implementing legislation prevail to the extent of the inconsistency. However, the implementing legislation of a subsequent amendment to a Covered Tax Agreement may also include a similar provision, which creates the potential for an irresolvable conflict referred to in note 2, *supra*.

[5] For example, the "corporate reorganisation" exception to the foreign affiliate dumping rules in subsection 212.3(18) includes a lengthy list of "qualifying" reorganizations.

[6] See Commentary to the OECD Model, November 18, 2017, at para 28.5.

[7] See subsection 250(4) of the Act.

[8] The House of Lords established the "central management and control" test in *De Beers Consolidated Mines, Limited v. Howe*, [1906] AC 455.

[9] OECD Model Commentary on Article 4 at paras 23-24.

[10] *Ibid*, para 24.1.

[11] See section 212.3 of the *Income Tax Act* (Canada) (the "Act"). All statutory references herein are to the Act.

[12] *The Queen v. Black and Decker Manufacturing Co.*, [1975] SCR 411 at 420.
[13] See, e.g., CRA Document No. 2006-0178571R3 and CRA Document No. 2010-0355941R3.
[14] Subsection 126(2) of the *Income Tax Act* (Canada) (the "Act"). All statutory references herein are to the Act.
[15] *Ibid*.
[16] Subsection 126(7) "business-income tax".
[17] Income Tax Folio S5-F2-C1, *Foreign Tax Credit*; CRA Document 2006-0181911I7, dated July 17, 2006; CRA Document no. 2000-0001017, dated January 11, 2001; and CRA Document no. AC74305, dated December 8, 1989.
[18] For example, *Imperial Oil Ltd.*, [1960] C.T.C. 279 (S.C.C.), *Interprovincial Pipelines Co.*, [1968] C.T.C. 156 (S.C.C.), and *Cudd Pressure Control Inc. v. The Queen*, 98 DTC 6630 (F.C.A.).
[19] Commentary on 2017 OECD Model Tax Convention on Income and on Capital, Article 7.