

BUDGET 2019: INTERNATIONAL TAX CHANGES ANNOUNCED

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On March 19, 2019, the Federal Minister of Finance, Bill Morneau, presented the Liberal government's final Budget before the 2019 election. Budget 2019 introduced modifications to Canada's transfer pricing rules and included an update on the base erosion and profit shifting ("**BEPS**") initiative, and proposed changes to the foreign affiliate dumping rules and the provisions governing the taxation of cross-border share lending arrangements.

Transfer pricing

Budget 2019 includes two proposed changes to the transfer pricing rules in the *Income Tax Act* (Canada) (the "**Tax Act**").

First, the Government proposes to introduce an ordering rule to ameliorate the confusion that may arise when the transfer pricing rules in subsection 247(2) of the Tax Act, and provisions relating to the computation of income for the purpose of Part I of the Tax Act can each apply to a transaction. The new ordering rule will clarify that the transfer pricing provisions in the Tax Act apply in priority to the application of other income computation rules. The Government notes that the new ordering rule may impact the calculation of the transfer pricing penalties provided for in subsection 247(3) of the Tax Act. The new rule does not affect the existing exemption from the transfer pricing rules for certain loans and guarantees provided by Canadian-resident corporations to controlled foreign affiliates.

Second, the Government proposes to amend the Tax Act so that the expanded definition of a "transaction"^[1] used in the transfer pricing provisions will also now apply to the extended reassessment period during which the Canada Revenue Agency may reassess a taxpayer in respect of "transactions" involving a taxpayer and non-residents with whom the taxpayer does not deal at arm's length. Under the existing rules in the Tax Act, the normal reassessment period is generally extended by three years for reassessments relating to cross-border intercompany transactions.

The proposed changes apply to taxation years that begin after March 18, 2019.

Update on BEPS

Canada continues to be an active participant in the BEPS initiative, including by administering the country-by-country reporting regime envisioned by BEPS Action 13 in respect of the multinational groups. Budget 2019 confirms that Canada is participating in the review by the Organisation for Economic Co-operation and Development (OECD) of the country-by-country reports to ensure that they provide tax administrators with information necessary to allow for proper assessment of transfer pricing and other BEPS risks. This review is scheduled to be completed in 2020.

Canada, along with 86 other jurisdictions, is a signatory to the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent BEPS (known as the Multilateral Instrument or MLI). The Government is taking the necessary steps to enact the MLI into law and ratify the MLI as needed to bring it into force.

Foreign Affiliate Dumping

The scope of the “foreign affiliate dumping” (“**FAD**”) rules in the Tax Act is being expanded such that the rules will now also apply to Canadian resident corporations controlled not only by non-resident corporations, but also by non-resident individuals, non-resident trusts, or a group of non-resident corporations, non-resident individuals, and/or non-resident trusts, who do not deal with each other at arm's length.

Presently, the FAD rules generally apply where a corporation resident in Canada (a “**CRIC**”) makes an investment in a foreign affiliate, and the CRIC is controlled by a non-resident corporation (or by a related group of non-resident corporations). The application of these rules can result in reductions in the paid-up capital of certain shares of the CRIC (or related Canadian corporations) and/or deemed dividends for non-resident withholding tax purposes.

When determining related status or controlled status for the purposes of these rules, a trust will be deemed to be a corporation, the shares of which are owned by its beneficiaries. The FAD proposals made in Budget 2019 are particularly far reaching in respect of the deeming rules that may be applied when determining whether persons are related to one another or whether one person controls another.

The proposed changes apply to transactions or events occurring after March 18, 2019.

Cross-Border Securities Lending

A securities lending arrangement (an “**SLA**”) is an arrangement in which one person (the lender) transfers a security to another person (the borrower), who agrees to return an identical security to the lender in the future. The borrower typically provides collateral to the lender. The borrower is obligated to make payments to the lender, as compensation for dividends received on the security over the term of the arrangement. The overall effect of an SLA is that the lender retains the economic exposure to the borrowed security.

The Tax Act contains rules that generally seek to put the lender in the same position, for tax purposes, as if the security had not been lent, including rules that deem dividend compensation payments paid by Canadian securities borrowers to non-resident lenders to be dividends in certain circumstances. In order to combat planning undertaken by certain non-residents that attempts to avoid the application of these deemed dividend rules and the resultant withholding tax, the Government proposes to modify the rules relating to SLAs as follows:

- The SLA rules will now apply to compensation payments made under both SLAs and "specified securities lending arrangements" ("**Specified SLAs**"). The definition of Specified SLAs was introduced in Budget 2018 and includes securities loans that are substantially similar to SLAs;
- All dividend compensation payments made under SLAs and Specified SLAs will be treated as dividends for withholding tax purposes, regardless of whether the arrangement is fully collateralized; and
- Certain new rules will apply for purposes of determining the applicable withholding tax rate under a tax treaty. The general effect of these rules is to make it more difficult for a lender to access the reduced withholding tax rates that are available under certain treaties where the dividend recipient owns at least 10% of the shares of the dividend payer (in terms of voting rights and fair market value).

These new rules apply to compensation payments made after March 18, 2019, except that for securities loans entered into before March 19, 2019, the measures will apply only to compensation payments made after September 2019.

Finally, Budget 2019 proposes a relieving measure for dividend compensation payments made in respect of non-Canadian shares after March 18, 2019, to ensure that such payments will be exempt from withholding tax if the related SLA is fully collateralized.

by Yongchong Mao and Adam Gotfried

[1] Subsection 247(1) of the Tax Act provides that, for the purposes of section 247, a "transaction" includes an arrangement or event.[ps2id id='1' target='']

A Cautionary Note

The foregoing provides only an overview and does not constitute legal advice. Readers are cautioned against making any decisions based on this material alone. Rather, specific legal advice should be obtained.

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