Upcoming Treaty Changes—Review Withholding Obligations Now

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Canadian residents should assess whether their withholding tax obligations will soon change now that Canada has ratified the multilateral instrument (MLI). Canadian residents may have to meet new conditions starting January 1, 2020 to benefit from the lower withholding tax rate under affected treaties when paying or receiving amounts such as interest, dividends and royalties. In addition, these Canadian residents will also have to carefully consider how the MLI may affect different bilateral tax treaties — in some cases, certain optional MLI provisions could apply, depending on whether both Canada and its treaty partner have adopted the particular provision.

As a result of this upcoming change, Canadian residents will need to consider if they meet the new principal purpose test (PPT) in the MLI to qualify for the lower withholding tax rate available under certain treaties. In addition, Canadian corporations that receive foreign dividends may also be required to meet a new 365-day holding period for shares to access treaty-reduced withholding tax rates, or confirm that a non-resident shareholder meets the holding period test before it can apply a treaty-reduced withholding tax rate to dividends it pays to that shareholder. Corporations that have determined that their withholding tax obligations will change should also consider how their financial statements may be affected.

Background
The OECD developed the MLI as part of Action 15 of its Base Erosion and Profit Shifting (BEPS) initiative to modify existing bilateral treaties to implement BEPS measures. The MLI is intended to streamline the implementation of the tax treaty-related measures without the need to individually renegotiate each treaty. As Canada completed its ratification procedures and deposited its ratification instrument with the OECD on
August 29, 2019, the MLI will enter into force in Canada on December 1, 2019, and will affect a significant portion of Canada's treaties beginning in 2020 (see TaxNewsFlash-Canada 2019-37, "MLI to Modify Canadian Tax Treaties in 2020").

For the MLI to modify a particular Canadian tax treaty, Canada's treaty partner must also ratify the MLI and indicate that it wishes its tax treaty with Canada to be covered by the MLI. Where this happens, the MLI will enter into force on the first day of the month following the third month after both countries have deposited their instruments of ratification with the OECD. The MLI’s withholding tax provisions are generally effective beginning on the first day of the calendar year after the MLI enters into force. All other provisions of the MLI are generally effective for taxable periods beginning on or after six months after the MLI enters into force. As a result, the MLI will be read alongside many of Canada's tax treaties for withholding tax purposes starting on January 1, 2020.

In ratifying the MLI, Canada adopted the PPT to address treaty abuse in accordance with the OECD's minimum standard. The PPT is similar to a general anti-abuse rule that considers the principal purposes of an arrangement or transaction. Canada also adopted the “mandatory binding arbitration” provision to improve dispute resolution (see TaxNewsFlash-Canada 2017-33 “Canada Signs on for BEPS Treaty Changes”), additional provisions that allow certain treaty partners to move to a foreign tax credit system (from an exemption system) to relieve double-taxation, and other provisions related to dividends, capital gains and dual-resident entities (see TaxNewsFlash-Canada 2018-26, “Canada Adopts More MLI Provisions”). Canada can still choose to adopt additional provisions of the MLI even though it is ratified.

Affected treaties — Principal purpose test

Where the MLI applies, recipients of payments such as interest, dividends or royalties will have to meet the conditions of the PPT to be eligible for benefits under a Canadian treaty. Specifically, the recipient of the payment will have to ensure that the principal purpose of an arrangement or transaction is to obtain treaty benefits in a way that is in accordance with the object and purpose of the relevant treaty provisions with the other country.

Starting January 1, 2020, this change will affect treaties with countries that Canada has indicated will be covered by the MLI (i.e., a “covered treaty”), and where the other country has also completed the ratification of the MLI, including depositing its ratification instrument with the OECD, and listed its treaty with Canada as a covered treaty by September 30, 2019. Canada’s treaties with the following 24 countries are affected:

- Australia
- Austria
- Belgium
- Luxembourg
- Malta
- Netherlands
- Denmark  
- Finland  
- France  
- Iceland  
- India  
- Ireland  
- Israel  
- Japan  
- Lithuania  
- New Zealand  
- Poland  
- Serbia  
- Singapore  
- Slovak Republic  
- Slovenia  
- Ukraine  
- UAE  
- United Kingdom.

**KPMG observations**

The PPT is a complicated three-part test, with minimal guidance on how it may be applied. Generally, to meet the test, taxpayers must:

- Identify the particular treaty benefit otherwise available for a particular item of income or capital
- Having regard to all relevant facts and circumstances, determine whether obtaining that benefit was one of the principal purposes of any arrangement or transaction that resulted directly or indirectly in that benefit
- Establish that the granting of that benefit is in accordance with the object and purpose of the relevant provisions of the treaty.

Unlike GAAR, the onus is predominantly on the taxpayer to establish that it meets the object and purpose condition.

If the MLI applies to a covered treaty and the PPT is not met, the recipient of the particular payment subject to withholding (ex. interest, royalties or dividends) will not be entitled to treaty benefits, and therefore will be subject to the domestic withholding tax rate. For example, if the CRA determines that a dividend payment to a non-resident shareholder of a Canadian corporation does not meet the PPT, the Canadian corporation must withhold tax at the domestic rate of 25% on dividend payments it makes to that non-resident, rather than the lower rate that may have been available under a relevant treaty. As a result, Canadian residents that make payments to non-residents will need to consider what documentation they may need to determine if the non-resident is entitled to treaty benefits on the payment. For example, Canadian payers may need additional information from non-resident recipients to supplement Form NR301, “Declaration of eligibility for benefits (reduced tax) under a tax treaty for a
non-resident person”, or the equivalent forms NR302 or NR303 for partnerships with non-resident partners or hybrid entities. Similarly, if the tax authorities in a foreign jurisdiction determine that a Canadian corporate shareholder doesn’t meet the PPT, the Canadian corporate shareholder will similarly not be entitled to treaty benefits on a dividend received from a foreign subsidiary, and would be subject to the domestic withholding tax rate applicable in that foreign jurisdiction. Canadian-based multinationals must also assess payments that are made by its foreign entities that could receive the same treatment.

Although Canada signed onto the mandatory binding arbitration provisions of the MLI, these provisions do not apply for purposes of challenging a conclusion that treaty benefits are not available because the PPT is not met. Further, Canada has not adopted the MLI provision that allows for competent authority relief where the CRA applies the principal purpose test to deny all or a portion of a tax benefit which would have provided welcome relief and added certainty for Canadian multinationals. Currently, less than half of the countries signing the MLI have opted into this provision.

It is expected that some of the more detailed considerations and structures affected by the MLI will be discussed at the upcoming 2019 Annual Canadian Tax Foundation conference.

### Dividend transfer transactions — Withholding rate

Canadian corporations that receive or pay dividends under certain covered treaties affected by the MLI, will also have to consider an additional MLI provision starting January 1, 2020. Corporate shareholders will have to meet certain share ownership conditions throughout a 365-day period that includes the day of the payment of the dividends to access the lower dividend withholding tax rate that applies to significant interests held by corporate shareholders (typically 5%, compared to the 15% rate that applies to portfolio shareholders). In computing the 365-day period, corporations do not need to consider ownership changes that would directly result from a corporate reorganization of the company that holds the shares or that pays the dividends, such as a merger or divisive reorganization.

Canadian corporations and non-resident shareholders of Canadian corporations will have to meet this requirement as of January 1, 2020 where they receive a dividend that is entitled to treaty benefits under a covered tax treaty Canada has with a country that has also adopted this MLI provision. So far, Canada’s treaties with the following 13 countries are affected:

- Australia
- Belgium
- Denmark
- France
- Netherlands
- New Zealand
- Poland
- Serbia
KPMG observations
A corporate shareholder that receives a dividend within the 365-day holding period is still eligible for the lower (5%) rate if the ownership period is not met at the time the dividend is received, but is subsequently satisfied. However, Finance has not yet clarified whether the tax should be remitted initially at the higher rate (15%) and the recipient would then reclaim this tax once the time threshold is met.

More changes coming
Although these withholding tax changes are set to apply as of January 1, 2020, all other provisions of the MLI are generally effective for these 24 treaties for taxable periods beginning on or after either June 1, 2020 or July 1, 2020, depending on the treaty. As a result, persons in Canada and the reciprocating treaty partner countries may be required to meet the PPT to obtain any other treaty benefits, and apply MLI changes affecting foreign tax credits and exemptions, capital gains, and dual resident-entity changes as of this date.

KPMG observations
Additional treaties will also be affected as more countries continue to ratify the MLI. In particular, Canada has listed treaties with 84 countries that it intends to be covered by the MLI, 66 of which have reciprocated by signing on to the MLI and listing its tax treaty with Canada as a covered treaty. Where these treaty partners have also listed its treaty with Canada as a covered treaty, and they have deposited their ratification instruments with the OECD after September 30, 2019, the earliest the MLI could apply to that particular treaty for withholding tax purposes would be January 1, 2021.

We can help
Your KPMG adviser can help you assess the potential impact of the Multilateral Instrument on your corporate structure and international tax planning. For more details on these developments and their potential effect, contact your KPMG adviser or one of our international corporate tax partners below:

Penny Woolford
National Leader – International Corporate Tax
T: 416-777-8966
E: Pennywoolford@kpmg.ca

Jill Birks
T: 519 747 8871
E: jillbirks@kpmg.ca