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Canada

MLI Update — Prepare for More Treaty Changes

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Individuals and multinationals should assess how they may be affected by recent and upcoming changes to Canada's international tax treaties. While the multilateral instrument (MLI) may already affect a significant portion of Canada's treaties, additional tax treaties will be impacted throughout 2021 and 2022 as more of Canada's treaty partners complete domestic procedures and deposit their MLI ratification instruments with the OECD. As a result, affected taxpayers that rely on treaty benefits will need to keep a close eye on the full list of provisions that Canada's treaty partners agree to, whether they match with Canada's adopted provisions, and when the MLI is effective, in order to ensure that they meet their tax obligations and properly reflect these changes on their financial statements.

Canada indicated that the MLI would cover its treaties with 84 countries, and 68 of these countries reciprocated by listing their tax treaty with Canada as a covered treaty when signing on to the MLI. As of the OECD's last update on April 20, 2021, there are 42 reciprocating countries that have now filed their ratification instruments with the OECD, such that the MLI now affects (or will soon affect) 42 of Canada's tax treaties. This edition of *TaxNewsFlash-Canada* provides an overview of the withholding tax provisions and certain other MLI provisions Canada has adopted. In addition, this publication provides an update on 2021 and 2022 effective dates of the applicable MLI provisions, and which countries have adopted matching optional provisions that modify or will modify Canada's existing tax treaty provisions, for purposes of accessing treaty benefits under a particular treaty.

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. Following the completion of the ratification procedures, the MLI entered into force in Canada on December 1, 2019, and began to affect a significant portion of Canada's treaties beginning in 2020 (see *TaxNewsFlash-Canada* 2019-37, "MLI to Modify Canadian Tax Treaties in 2020" and *TaxNewsFlash-Canada* 2019-52, "Upcoming Treaty Changes— Review Withholding Obligations Now").

For the MLI to modify a particular Canadian tax treaty, Canada must have listed the treaty as one it indicated that it wanted to be covered by the MLI, and Canada's treaty partner must also ratify the MLI and indicate that it wanted 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 for Canada's tax treaties 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 was required to be read alongside many of Canada's tax treaties for withholding tax purposes starting on January 1, 2020, with additional treaties affected as Canada's treaty partners continue to deposit their ratification instruments with the OECD.

When it signed onto the MLI, Canada adopted the principal purposes test (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"). Canada subsequently adopted 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. These additional provisions will only apply to a covered treaty to the extent Canada's treaty partner has also adopted these provisions (i.e., there is a match) (see *TaxNewsFlash-Canada* 2018-26, "Canada Adopts More MLI Provisions"). Although Canada has not indicated any further changes, it may still choose to adopt additional provisions of the MLI in the future.

Withholding tax provisions

Application of the Principal Purposes Test

Where the MLI applies for withholding tax purposes, 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, a Canadian-resident payer will have to ensure that if a principal purpose of an arrangement or transaction is for the recipient to obtain treaty benefits, obtaining such benefits is in accordance with the object and purpose of the relevant treaty provisions with the other country. Similarly, Canadian taxpayers receiving payments from non-resident payers which are eligible for treaty benefits may also have to meet the conditions of the PPT to be eligible for benefits under an applicable treaty.

Dividend transfer transactions — Holding period test for withholding tax rate

Canadian corporations that receive or pay dividends under certain covered treaties affected by the MLI will also have to consider whether an additional MLI provision applies. Canada adopted an optional provision of the MLI whereby corporate shareholders have to meet 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). However, for the provision to apply, Canada's treaty partner must have also adopted this provision. As not all of Canada's treaty partners have adopted this provision (e.g., currently less than 20 jurisdictions), whether this change applies will depend upon the treaty. For example, this change currently applies to the Canada-Australia treaty, but not to the Canada-UK treaty. Since countries may also adopt additional provisions of the MLI at any time, taxpayers that rely on treaty benefits must continue to carefully monitor whether there are any changes in MLI provision matches between Canada and its treaty partners, which may modify the application of the MLI.

Current status of treaties affected for withholding tax purposes

The MLI had to be read alongside 24 of Canada's tax treaties for withholding tax purposes starting January 1, 2020. As Canada's treaty partners have continued to deposit their ratification instruments with the OECD, the MLI must be read alongside an additional 11 of Canada's tax treaties for withholding tax purposes as of January 1, 2021. As a result, the MLI must be read alongside the following 35 treaties for withholding taxes purposes in 2021:

- Australia
- Austria
- Belgium
- Cyprus
- Czech Republic
- Denmark
- Egypt
- Finland
- Latvia
- Lithuania
- Luxembourg
- Malta
- Netherlands
- New Zealand
- Oman
- Poland

- France
- Iceland
- India
- Indonesia
- Ireland
- Israel
- Japan
- Jordan
- Kazakhstan
- Korea
- Portugal
- Russia
- Serbia
- Singapore
- Slovak Republic
- Slovenia
- Ukraine
- UAE
- United Kingdom.

Based on Canada's treaty partners that have deposited their ratification instrument of the MLI to date, the MLI will apply for withholding tax purposes in respect of certain payments to seven additional treaties, beginning January 1, 2022:

- Barbados
- Chile
- Croatia
- Greece
- Hungary
- Malaysia
- Pakistan

Note that the list of treaties affected for withholding tax purposes beginning January 1, 2022 may increase as additional countries deposit their ratification instruments with the OECD. In addition, the application date of the MLI on Canada's treaties with Sweden and Estonia is not yet available. Although Sweden and Estonia have both deposited their ratification instruments with the OECD, neither country has notified the OECD that they completed the appropriate domestic procedures.

Additional provisions

Application of the Principal Purposes Test

For all other taxes besides withholding tax, including the optional provisions affecting taxes on capital gains and dual-residents, a taxpayer that wants to claim benefits under any other provision of the treaty will have to meet the conditions of the PPT to be eligible for treaty benefits under most of Canada's MLI-impacted tax treaties.

Capital gains from alienation of certain shares or interests of entities

Taxpayers who realize capital gains on the disposition of shares or interests that derive their value from immovable property located in the other jurisdiction will have to consider whether an additional MLI provision applies. Canada adopted an MLI provision that would allow for taxation of the gain on these interests in the other jurisdiction where the value of shares or other interests directly or indirectly attributable to immovable property located in that jurisdiction exceeds 50% at any time during the 365 days preceding the disposition (not just at the time of disposition). As Canada's treaty partner must have also adopted this provision in order for it to apply to modify a particular treaty, this provision does not apply to all of Canada's treaties covered by the MLI. For example, this 365-day "look-back" test currently applies to the Canada-Australia treaty, but not the Canada-UK treaty.

Where the MLI becomes effective and this provision applies, taxpayers will have to apply the 12-month look-back period, rather than the existing "point-in-time" test to determine whether relief may be available under the treaty. Currently, where non-residents realize gains on the disposition of shares, those gains are taxable in Canada where the shares derive more than 50% of their value from Canadian real property or resource property at any time within the five-year period ending at the time of disposition. Most of Canada's treaties also have a 50% value threshold, but only the asset composition at the time of disposition is relevant (the "point-in-time" test). As a result of this change, affected taxpayers will have to perform additional due diligence to review changes in asset composition or relative values of different types of assets throughout the preceding year. Some of Canada's tax treaties also contain a favourable provision that allows a company that carries on business in an immovable property to exclude that property for purposes of computing the 50% value threshold under the point-in-time test. However, this provision is not included in certain treaties where the "look-back" test has been adopted. Therefore, taxpayers that rely on this provision should consider whether the MLI affects this treatment.

Since countries may also adopt additional provisions of the MLI at any time, taxpayers relying on treaty benefits should continue to monitor whether there are any changes in MLI provision matches between Canada and its treaty partners.

Dual-resident entities

Taxpayers (other than individuals) who are resident in more than one jurisdiction will also have to consider whether an additional MLI provision applies to modify the treaty's dual-residency tie-breaker provision. Canada adopted an optional provision of the MLI that will require taxpayers to apply for competent authority determination to resolve dual-resident entity cases, instead of the automatic objective tie-breaker test typically based on jurisdiction of incorporation or place of effective management in most of Canada's treaties. Canada's treaty partner must have also adopted this MLI provision in order for it to apply to modify a particular treaty and therefore this provision does not apply to all of Canada's treaties covered by the MLI. For example, this new tie-breaker rule currently applies to the

Canada-Australia treaty (which would have otherwise determined residency based on place of incorporation).

Where this provision applies, taxpayers in a dual-residency situation who have to apply for a competent authority determination may be at risk of losing all benefits under the treaty. Therefore, these taxpayers will want to take additional care to avoid dual-residence situations in the first place by, for example, ensuring that they always maintain central management and control of a corporation in its country of incorporation.

Current status of treaties affected for all other tax purposes

The timing of application of the MLI for all other taxes besides withholding tax varies depending on the particular treaty, and generally does not come into force on January 1 of a given year as it does for withholding tax purposes. In addition, in some cases, Canada and its treaty partner may not begin to apply the MLI provisions at the same time. Therefore, taxpayers with a taxable period that doesn't correspond to the calendar year should review the application date of the MLI to a particular treaty from both Canada's perspective and the perspective of Canada's treaty partner to determine when it applies. For a corporation with a calendar taxation year, Canada's tax treaties with the following 28 countries must be read alongside the MLI for all other tax purposes for the corporation's taxation year beginning January 1, 2021:

- Australia
- Austria
- Belgium
- Cyprus
- Denmark
- Finland
- France
- Iceland
- India
- Ireland
- Israel
- Japan
- Latvia
- Luxembourg
- Malta
- Netherlands
- New Zealand
- Poland
- Portugal
- Russia
- Serbia
- Singapore
- Slovak Republic
- Slovenia
- Ukraine
- UAE

- Lithuania
- United Kingdom.

For a corporation with a calendar taxation year, Canada's tax treaties with the following 14 countries must be read alongside the MLI for all other tax purposes for the corporation's taxation year beginning January 1, 2022:

- Barbados
- Chile
- Croatia
- Czech Republic
- Egypt
- Greece
- Hungary
- Indonesia
- Jordan
- Kazakhstan
- Korea
- Malaysia
- Oman
- Pakistan

Note that the list of treaties affected for all other tax purposes for taxpayers with a calendar taxation year beginning January 1, 2022 may increase as additional countries deposit their ratification instruments with the OECD. In addition, the application date of the MLI on Canada's treaties with Sweden and Estonia is not yet available. Although Sweden and Estonia have both deposited their ratification instruments with the OECD, neither country has notified the OECD that they completed the appropriate domestic procedures.

We can help

Your KPMG adviser can help you assess the potential impact of the MLI on your corporate structure and international tax planning, including how the PPT, dividend, capital gains and dual-residency provisions may affect your treaty benefits. For more details on these developments and their potential effect, contact your KPMG adviser or one of our international corporate tax partners below:

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