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2016 federal budget: cross-border impact

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The new Liberal government's first budget included a number of cross-border measures impacting transfer pricing documentation, the arm's length principle for transfer pricing, the back-to-back loan anti-avoidance rules, and the cross border anti-surplus stripping rules.

Canada to legislate country-by-country reporting

The budget signalled the government's intention to strengthen transfer pricing documentation by legislating country-by-country reporting requirements for large multinationals.

For taxation years beginning after 2015, Canadian headquartered multinationals or Canadian subsidiaries of foreign multinationals with total annual consolidated group revenues of €750 million or more will be required to file a country-by-country report with the Canada Revenue Agency (CRA) within one year of the end of the fiscal year to which it relates. The country-by-country report will provide a high-level overview of the global operations of large multinationals including revenues, profits, tax paid, stated capital, accumulated earnings, number of employees and tangible assets, as well as the main activities of each subsidiary. Multinationals may be able to avoid having this filing requirement imposed on multiple subsidiaries in multiple jurisdictions by designating one of their subsidiaries to be the "surrogate" for filing purposes.

The first exchanges of country-by-country reports between tax jurisdictions of reports are expected to occur by June 2018. Before any exchange of information with another tax jurisdiction occurs, the CRA will formalize an exchange arrangement with the other jurisdiction and will ensure that it has appropriate safeguards in place to protect the confidentiality of the reports.

Draft legislation will be released for comment in the coming months. While the actual impact of country-by-country reporting is uncertain at this point, it is expected to increase audit activity related to the transfer pricing arrangement of multinational corporations.

No support for the simplified approach to low value-adding services in Canada

The budget also announced the government's intention to apply the "improved interpretation" of the arm's length principle included in the revisions to the Organization for Economic Cooperation and Development's (OECD) transfer pricing guidelines to ensure alignment of the profits reported by multinationals with the economic activities generating those profits.

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The CRA has held off fully supporting the revised transfer pricing guidelines by announcing that it will not be adjusting its administrative practices at this time to follow the OECD in two areas where the Base Erosion and Profit Shifting (BEPS) project participants are still engaged in follow-up work: the development of a threshold for the proposed simplified approach to low value-adding services; and, work on the definition of risk-free and risk-adjusted returns for minimally functional entities (often referred to as "cash boxes").

The budget announcement is consistent with the administrative policy of the CRA that mark-ups on ancillary services provided by foreign affiliates should not be allowed, as was reiterated recently in a revised transfer pricing memorandum. The CRA's decision to continue applying this administrative policy regarding the pricing of ancillary services despite changes to the OECD transfer pricing guidelines may lead to more tax controversy and lengthy resolutions of double tax cases, primarily with the IRS. In summary, the administrative position of the CRA may affect many multinationals with low value adding services conducted by their Canadian subsidiaries for other international subsidiaries.

Back-to-back loan rules

The federal budget also proposes new rules broadening the application of the back-to-back loan rules that were first introduced in the 2014 federal budget. The Income Tax Act (Canada) (the Act) levies a 25 percent withholding tax on cross-border payments of interest (in certain circumstances), dividends, rents, royalties or similar payments made by Canadian-resident persons to non-residents. This 25 percent withholding tax rate is often reduced by a tax treaty. The back-to-back loan rules were introduced to prevent treaty shopping, whereby taxpayers interpose a third party (located in a country with a more favourable tax treaty) between a Canadian borrower and a foreign lender in order to obtain a lower withholding tax rate on interest payments[1] than they would have had if the payments had been made directly between the two taxpayers.

The budget proposes to extend the application of the back-to-back rules to royalty payments, where an intermediary located in a favourable tax treaty country is interposed between a Canadian-resident payer of royalties and a non-resident in order to reduce the rate of applicable withholding taxes. The proposed rules will deem the Canadian-resident payer to have made a royalty payment directly to the ultimate non-resident recipient and the corresponding higher withholding tax rates will apply as if the payment had been made directly.

The proposed rules will also apply to encompass character substitution arrangements whereby the back-to-back rules are avoided by changing the character of the payment made between the intermediary and the non-resident person. For example, the broader rules will capture situations where a royalty is paid to an intermediary by the Canadian resident payer, and the intermediary makes a loan to the non-resident person, rather than making another royalty payment. Under the proposed character substitution rules, a back-to-back arrangement will be deemed to exist where a sufficient connection is established regarding the payment arrangement among the parties concerned. In this situation, the arrangement will be re-characterized to be a payment of the same character made directly from the Canadian resident payer to the non-resident person. The government has also signalled its intent to broaden the application of the back-to-back rules to structures with multiple intermediaries.

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[1] Subject to the thin-capitalization rules.

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The proposed changes to the back-to-back loan rules are applicable to payments made after 2016.

Cross border anti-surplus stripping rules

The Act contains a specific 'anti-surplus stripping' rule that prevents non-resident shareholders from extracting retained earnings of a Canadian corporation that are in excess of its paid up capital (PUC), or from artificially increasing the PUC of the shares.[2] The PUC of the shares of a Canadian corporation is generally the amount of capital contributed to the corporation by its shareholders, and can be returned to its shareholders on a tax-free basis. The retained earnings of a corporation that are in excess of PUC can be distributed to its shareholders as a taxable dividend, which is generally subject to withholding tax when paid to a non-resident shareholder.

An exception to the anti-surplus stripping rules exists where a Canadian corporation acquires shares of a non-resident corporation that, in turn, owns shares of a Canadian corporation (effectively 'sandwiching' the non-resident corporation between the two Canadian corporations) and the non-resident corporation disposes its shares in the lower-tier Canadian corporation to the Canadian purchaser corporation in order to unwind the sandwich structure. The federal budget includes a proposed amendment to this exception to target its perceived misuse.[3] The exception will be amended so that it will not apply where there is a sandwich structure and the non-resident owns, directly or indirectly, shares of the top-tier Canadian purchaser corporation and does not deal at arm's length with the Canadian purchaser corporation.

This proposed amendment will limit the ability of taxpayers to engage in post-acquisition PUC planning used to increase the PUC of the acquired company where a non-resident company acquires a target Canadian company with low PUC. Instead, a Canadian acquisition corporation that is well capitalized (high-PUC) could still be used by a non-resident to acquire a Canadian target company with low PUC. This will allow the acquisition company's PUC to reflect the capital used for the acquisition of the Canadian target. The proposed amendment is effective for dispositions after March 21, 2016.

The anti-surplus stripping rule will also be amended to clarify that where a non-resident vendor disposes of shares of the lower-tier Canadian corporation to the Canadian purchaser corporation for no consideration – for example, in instances where there is a return of capital or an in-kind dividend distribution – the non-resident will be deemed to have received non-share consideration from the Canadian purchaser corporation equal to the fair market value of the shares of the lower-tier Canadian corporation received by the Canadian purchaser corporation. This proposal is also effective for dispositions after March 21, 2016.

If you would like to learn more about any of the measures included in this release or other measures announced in the 2016 federal budget, please consult with your tax advisor.

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[2] The anti-surplus stripping rule, where applied, results in a deemed dividend to the non-resident shareholder or a suppression of the PUC of the shares that would otherwise have been increased as a result of the transaction.

[3] Some non-resident corporations with Canadian subsidiaries have misused the exception by reorganizing their group structure into a sandwich structure as part of a series of transactions designed to artificially increase the PUC of the shares of the Canadian subsidiaries, and then relying on the exception when unwinding the sandwich structure.

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