taxnotes® international

Volume 98, Number 6 ■ May 11, 2020

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Reprinted from *Tax Notes International*, May 11, 2020, p. 657

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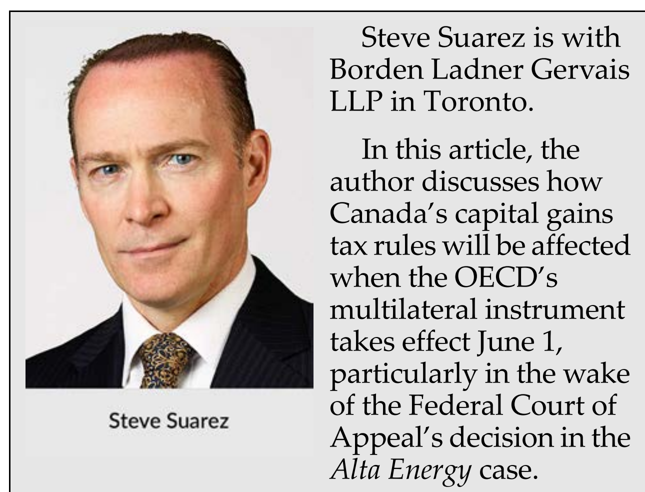

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In this article, the author discusses how Canada's capital gains tax rules will be affected when the OECD's multilateral instrument takes effect June 1, particularly in the wake of the Federal Court of Appeal's decision in the *Alta Energy* case.

The provisions of the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting (MLI) that affect Canada's taxation of capital gains realized by nonresidents will take effect as soon as June 1. In many cases, the changes could cause accrued but unrealized gains that have historically been exempt from Canadian taxation under the applicable tax treaties to become taxable in Canada.

Nonresidents of Canada that hold an interest in an entity (such as owning shares of a corporation or an interest in a partnership) that derives a significant portion of its value from Canadian real property should carefully consider their existing Canadian tax position. In particular, they should evaluate whether the MLI's pending changes will affect them and consider whether they may be able to achieve a better outcome. Specifically, nonresidents already entitled to treaty relief from Canadian capital gains taxation should consider, *inter alia*:

- accelerating contemplated third-party sales or corporate reorganizations that would trigger the realization of gains on relevant entities; and
- pursuing transactions that will generate a treaty-exempt basis step-up to fair market value for Canadian tax purposes without triggering tax in their home countries.

If a nonresident shareholder's entitlement to relief from Canadian taxation on gains from shares of a particular company is unclear, it should update valuations of the company's property (Canadian real property and other property) to reflect present economic conditions. Depending on the circumstances and what other assets and liabilities the company has (or could have), it may be possible to qualify for relief under an existing treaty, which would facilitate a pre-MLI treaty-protected basis step-up or help in terms of the MLI's new lookback test (discussed below).

Canadian Domestic Law

Under the Income Tax Act (Canada), Canada taxes nonresidents on gains from the disposition of capital property only if that property qualifies as "taxable Canadian property," which essentially includes:

1) land or natural resource rights in Canada (that is, Canadian real property);

2) shares of a corporation, interests in a partnership, or interests in a trust that have derived more than 50 percent of their value from property described in point at any time in the preceding five years;[1] and

3) property used in a business carried on in Canada.

[1] Other than through entities or interests that are not taxable Canadian property. Shares listed on a designated stock exchange will only constitute taxable Canadian property if, in addition, the holder (together with non-arm's-length persons) owned 25 percent or more of any class of the issuer's shares at any time during the preceding five years.

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A reporting and remittance regime applies when a nonresident disposes of most forms of taxable Canadian property, which imposes a 25 percent (or for certain types of property, 50 percent) remittance obligation (section 116 withholding) on the purchaser as a prepayment of taxes owed by the nonresident. This regime applies whether the nonresident has an actual gain on the sale and, in some cases, even if treaty relief exempts any gain from Canadian tax. Purchasers generally withhold and remit the required portion of the purchase price to the Canada Revenue Agency unless the property being disposed of is clearly not taxable Canadian property or the nonresident obtains a pre-closing withholding waiver from the CRA (or, alternatively, indemnifies the purchaser).[2]

The Multilateral Instrument

Canada deposited its instrument of ratification with the OECD in August 2019,[3] and the MLI entered into force for Canada on December 1, 2019. Canada has designated 84 tax treaties as covered tax agreements, meaning it wishes to apply the MLI to those treaties.[4] Notable exceptions include Canada's tax treaty with the United States (which did not sign the MLI) and its treaties with Germany and Switzerland (both of which are under renegotiation).

For the covered tax agreements, if the treaty counterparty has also designated its tax treaty with Canada as a covered tax agreement and deposited its instruments of ratification with the OECD (thus bringing the MLI into force in that country on the first day of the month after a period of three calendar months from the deposit) the MLI's provisions will apply:

- to taxes withheld at the source on amounts paid or credited to nonresidents, beginning on the first day of the following calendar year (that is, as early as January 1, 2020, for a Canadian tax treaty, if the MLI entered into force in the other country before the end of 2019); and
- for all other matters (including the taxation of capital gains), for tax years beginning six months after the later of the dates on which the MLI came into force for the two countries (that is, as early as tax years beginning June 1, 2020, for Canadian tax treaties).

Canada's MLI Positions

Canada has adopted the principal purpose test (PPT) in article 7(1) of the MLI as its general treaty abuse measure. However, it has indicated that it is doing so as an interim measure, and it intends, when possible, to adopt a limitation on benefits provision in addition to or as a replacement for the PPT through bilateral negotiation.[5] The PPT reads as follows:

> Notwithstanding any provisions of a Covered Tax Agreement, a benefit under the Covered Tax Agreement shall not be granted in respect of an item of income or capital if it is reasonable to conclude, having regard to all relevant facts and circumstances, that obtaining that benefit was one of the principal purposes of any arrangement or transaction that resulted directly or indirectly in that benefit, unless it is established that granting that benefit in these circumstances would be in accordance with the object and purpose of the relevant provisions of the Covered Tax Agreement.

Therefore, unless the counterparty to a covered tax agreement adopts a contrary position, the PPT will constrain a treaty resident's ability to claim relief under the capital gains article of its home country's tax treaty with Canada for tax years beginning as early as June 1, 2020, depending on when the MLI comes into force in the other jurisdiction.

The use of the PPT to limit relief marks a major change in Canada's tax treaty policy, particularly for the taxation of capital gains; currently, only one tax treaty (the Canada-Israel treaty) has such

[2] *See* Steve Suarez and Marie-Eve Gosselin, "Canada's Section 116 System for Nonresident Vendors of Taxable Canadian Property," *Tax Notes Int'l*, Apr. 9, 2012, p. 175.

[3] *See* Department of Finance, "Canada Ratifies the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting" (Aug. 29, 2019).

[4] *See* OECD, "Status of List of Reservations and Notifications Upon Deposit of the Instrument of Ratification" (Aug. 29, 2019).

[5] *Id.*

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a provision relating to the taxation of capital gains.[6] Generally, Canadian courts have not viewed treaty shopping as inherently abusive under Canada's domestic general antiavoidance rule (as discussed below), and capital gains relief from source country taxation is typically binary in nature — that is, either the entire gain is taxed, or it isn't. The effect of importing a PPT into Canada's taxation of nonresidents' capital gains could be quite substantial, depending on the particular treaty and how expansively the PPT is interpreted.

Canada has also adopted article 9(1)(a) of the MLI, which applies when capital gains taxation in a particular covered tax agreement is based on whether shares or other participation interests in an entity derive their value primarily from (or an entity's assets consist primarily of) one treaty country's real property. Most of Canada's tax treaties already have this rule in some form, with Canada (in the case of Canadian real property) being entitled to tax gains realized by a resident of the other country on the disposition of shares of a company only if, at the time of the disposition:

- the shares derive their value primarily from Canadian real property (or, under some treaties, Canadian real property excluding property, other than rental property, through which the company carries on its business);[7] or
- the company's property consists primarily of Canadian real property.[8]

The table shows which Canadian treaties use which test and also notes other variations found in some treaties that preclude Canada from taxing shares listed on specified stock exchanges or base Canada's right to tax on the fiscal residence of the company whose shares are being disposed of (the issuer company). It is important to be aware that Canada interprets and applies its income tax treaties with reference to the provisions of the Income Tax Conventions Interpretation Act, which provides that:

> (1) The terms "immoveable property" and "real property" include the right to explore for or exploit (or rights computed by reference to production from) mineral deposits, sources, and other natural resources in Canada (section 5).
>
> (2) Gains and losses from the disposition of taxable Canadian property are deemed to arise in Canada unless a treaty expressly provides otherwise (section 6.3). Canada interprets the sourcing rule in section 6.3 expansively and, in its view, fairly explicit treaty language is required to prevent Canada from taxing gains from taxable Canadian property.[9]

Article 9(1)(a) of the MLI creates a 365-day lookback test for determining whether shares derive their value from (or a company's property consists primarily of) real property in a particular country. This means that instead of the source country's right to tax being determined applying this test at the moment of disposition, it will be deemed to have been met if the relevant value threshold is met at any time during the 365 days before the disposition, thus expanding the source country's right to tax. Paragraph 128 of the explanatory statement to the MLI describes this provision as addressing:

> situations in which assets are contributed to an entity shortly before the sale of

[6]Notably, Canada has reserved its position on article 7(4), which allows treaty benefits otherwise denied under the PPT to be fully or partially granted in appropriate circumstances.

[7]On several occasions, the CRA has confirmed that treaties with this business property carveout exclude Canadian taxation of gains on interests in entities that derive their value principally from mines, mineral reserves, processing mills and related land, buildings, and equipment in Canada that the entity uses to carry on a mining and processing business. *See, e.g.*, CRA Docs. FE91_040 and FE91_037.039 (Feb. 25, 1991); CRA Docs. 1999-0010583 and 2000-0022523 (June 6, 2001); and CRA Doc. 9703965 (June 12, 1997). There is considerable authority that a "mining business" includes cases in which the relevant resource properties are owned by subsidiaries. *See, e.g.*, *Minister of National Revenue v. Consolidated Mogul Mines Ltd.*, 68 DTC 5284 (S.C.C.).

[8]These two tests could produce different results depending on the company's liabilities and whether the asset test is read as focusing on gross assets or net assets. Somewhat strangely, the CRA interprets the share test on a gross assets basis, ignoring the company's liabilities. *See* CRA Doc. 2015-0624511I7 (May 1, 2017).

[9]*See, e.g.*, CRA Doc. 2000-0024247 (Jan. 3, 2001): "In this regard unless there is a provision in one of Canada's income tax conventions which explicitly prohibits Canada from taxing the capital gain realized on the disposition of taxable Canadian property by a resident of the other Contracting State, it is our understanding that it was the intention of the Department of Finance that Canada retains its first right to tax such gain."

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Canadian Tax on Capital Gains From Shares: Treatment Under Tax Treaties

Canada May Tax Share Sale Gains	Countries
All (no residual allocation of taxing rights to country of residence)	Argentina, Australia,[a] Brazil,[a] Cameroon, Chile, China,[a] Egypt, Guyana,[b] India, Japan, Jordan, New Zealand, Nigeria, Papua New Guinea, Trinidad and Tobago, Vietnam
Shares deriving their value primarily from Canadian real property	*Algeria*, Barbados, Colombia,[c, d, e, f] Gabon, Hong Kong, Indonesia,[d, e] *Ireland*, Israel, Korea,[d, e, f] Madagascar,[a, b] Poland, Portugal, Senegal, Serbia,[c] Taiwan,[b] Turkey,[g] United Arab Emirates, United States[b, d, e]
Shares deriving their value primarily from Canadian real property (excluding non-rental real property used in issuer company's business)	Armenia, *Austria*,[e] Azerbaijan,[c] *Belgium*,[d] *Bulgaria*,[d] *Croatia*, Czech Republic,[e] Denmark,[d] Ecuador,[b] *Estonia*,[d, e] *Germany*,[a, b, d, e] *Greece*,[e] *Hungary*,[d, e] *Iceland*, *Italy*, *Kazakhstan*,[e] *Kyrgyzstan*,[b, d, e] *Latvia*,[d, e] *Lithuania*,[d, e] *Luxembourg*, Mexico,[c, d, f] Moldova, Mongolia, Namibia,[a, b] *Netherlands*,[a, d, e] Norway, Oman, Peru, Romania, Russia,[d, e] Slovakia, *Slovenia*, *South Africa*,[d, e] *Sweden*,[d, e] *Switzerland*,[a, b, d, e] *Tanzania*,[d, e] *Ukraine*,[d, e] *United Kingdom*,[e] *Uzbekistan*,[b, e] *Venezuela*[b]
Shares of company whose property consists primarily of Canadian real property	Bangladesh, Cyprus, Dominican Republic,[h] Finland,[c, i] France,[c, i] Ivory Coast, Jamaica,[h] Kenya, *Kuwait*,[i] Malaysia,[a, h] Malta,[i] Morocco,[h] Pakistan,[d, e, f, h] Philippines,[h] Singapore,[h] Spain,[i] Thailand, Tunisia, Zambia

Notes: *Italics* indicate exemption for exchange-listed shares.

Underlining indicates size of share ownership in issuer company relevant.

Canada's right to tax a resident of Zimbabwe on share gains is limited to shares of Canadian resident companies.

[a]Treaty under renegotiation or signed but not yet in force.

[b]Canada has not designated treaty as a covered tax agreement for MLI purposes.

[c]Rules refer to other interests in issuer company beyond shares.

[d]Fiscal residence of issuer company relevant.

[e]Rules for partnership interests differ from those for shares of companies.

[f]Canada may tax a resident of Colombia, Korea, Mexico, Pakistan, or Sri Lanka on gains from shares that are part of a substantial interest in a Canadian resident company irrespective of what they derive their value from.

[g]Canada may also tax gains realized within one year.

[h]No indirect ownership test.

[i]Excluding real property through which the issuer company carries on business.

> shares or comparable interests (such as interests in a partnership or trust) in that entity in order to dilute the proportion of the value of the entity that is derived from immovable property.[10]

Clearly, however, the lookback provision extends well beyond that simple fact pattern. This is another major change in Canadian capital gains taxation — very few of Canada's existing tax treaties have a similar provision.

As noted, some Canadian tax treaties include exemptions based on whether the disposed-of shares are listed on specified stock exchanges or based on the fiscal residence of the company (or governing law, in the case of partnerships) on whose shares the gain is realized. While not immediately apparent from reading the MLI

[10]*See* OECD, "Explanatory Statement to the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting," para. 128 (Nov. 24, 2016).

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itself, the explanatory statement clarifies that article 9(1) does not affect these exemptions.[11]

Finally, Canada has also expressed its desire to adopt article 9(4) of the MLI, which reads as follows:

> For purposes of a Covered Tax Agreement, gains derived by a resident of a Contracting Jurisdiction from the alienation of shares or comparable interests, such as interests in a partnership or trust, may be taxed in the other Contracting Jurisdiction if, at any time during the 365 days preceding the alienation, these shares or comparable interests derived more than 50 per cent of their value directly or indirectly from immovable property (real property) situated in that other Contracting Jurisdiction.

Article 9(5) clarifies that, if adopted by both treaty parties, article 9(4) "shall apply in place of or in the absence of provisions of a Covered Tax Agreement" of the type described above, and in so doing would also displace article 9(1) (which itself amends rather than replaces existing treaty provisions). It will be interesting to see how many of the counterparties to Canada's covered tax agreements agree to adopt article 9(4) to displace the comparable provisions of their existing covered tax agreements.[12]

Now What?

The MLI's impact on Canada's right to tax nonresidents on capital gains will obviously depend on the elections that the counterparties to its covered tax agreements make, but in many cases the effect will be quite significant. Canadian courts have generally read Canada's tax treaties liberally with a view toward supporting the underlying objective of relieving taxation, and they have not been very sympathetic toward the CRA's allegations that taxpayers were treaty shopping. This was recently illustrated in the Federal Court of Appeal's dismissal of the government's appeal in *Canada v. Alta Energy Luxembourg SARL*, 2020 FCA 43. The appellate court upheld the Tax Court of Canada's decision allowing the taxpayer's claim for relief under the capital gains exemption in the Canada-Luxembourg tax convention.

The CRA based its argument on Canada's GAAR, which requires both a tax-reduction motive on the taxpayer's part (which the Luxembourg resident effectively conceded) and a finding that the result would constitute an abuse of the relevant tax treaty. This argument essentially asked the court to interpret the treaty in a manner that would read words, intentions, or conditions into the text that were not apparent from the plain text itself. The court refused to do so, instead finding that the signatories' intentions — and, by extension, the object, spirit, and purpose of the relevant provisions — were fully reflected in the words of the treaty that the parties had agreed upon. As the court explains in paragraphs 69 and 70:

> In my view, the rationale for the relevant provisions of the Luxembourg Convention can be found in the text of these provisions. These provisions are neither lengthy nor complex. . . . As a result, these provisions speak for themselves.

Responding in particular to the CRA's allegation of treaty shopping, the *Alta Energy* court notes with approval the prior decision of the Tax Court in *MIL (Investments) SA v. Canada*, 2006 TCC 460, *aff'd* 2007 FCA 236, to the effect that simply choosing a favorable tax treaty is clearly not enough to constitute "abuse" that would trigger Canada's domestic GAAR. At paragraph 69, the Tax Court in *MIL* explains:

> I do not agree that Justice Iaccobucci's *obiter dicta* can be used to establish a *prima facie* finding of abuse arising from the choice of the most beneficial treaty. There is nothing inherently proper or improper with selecting one foreign regime over another. [CRA]'s counsel was correct in arguing that the selection of a low tax

[11] Para. 131 of the explanatory statement states: "Where Covered Tax Agreements contain exceptions to the application of the existing provisions (for example, some Covered Tax Agreements may exclude gains derived from the alienation of shares of companies that are listed on an approved stock exchange of one of the Contracting Jurisdictions), those exceptions would continue to apply."

[12] See the OECD's MLI Matching Database, which projects how the MLI will modify a specific covered tax agreement by matching information from the signatories' MLI positions.

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> jurisdiction may speak persuasively as evidence of a tax purpose for an alleged avoidance transaction, but the shopping or selection of a treaty to minimize tax on its own cannot be viewed as being abusive. It is the *use* of the selected treaty that must be examined. [Emphasis in original.]

Thus, nonresidents with indirect interests in Canadian real property have a fair bit of room as they plan to crystallize the benefits of existing treaty provisions — for example, making a treaty-protected disposition to step-up the cost basis of exempted property to present-day fair market value — before the MLI takes effect or to make use of favorable variations in Canada's existing tax treaties. Given the considerable uncertainty surrounding how the PPT will be interpreted and its relationship to the domestic GAAR,[13] it is reasonable — and, in fact, prudent — for taxpayers to consider their circumstances and take appropriate action before the MLI provisions change — in some cases, significantly — the manner in which Canada taxes nonresidents on capital gains. ■

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[13] *See, e.g.*, Michael Kandev and John Lennard, "The OECD Multilateral Instrument: A Canadian Perspective on the Principal Purpose Test," 74(1) *Bulletin for Int'l Tax.* 54 (Jan. 2020); Nathan Boidman and Kandev, "Canada Enacts Multilateral Instrument: What Happens Next?" *Tax Notes Int'l*, July 22, 2019, p. 315; David Duff, "Tax Treaty Abuse and the Principal Purpose Test — Part 1," 66(3) *Can. Tax J.* 619 (2018); and Duff, "Tax Treaty Abuse and the Principal Purpose Test — Part 2," 66(4) *Can. Tax J.* 947 (2018).

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