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CURRENT INTERNATIONAL TAX TOPICS

Canadian Petroleum Tax Society Annual Conference

June 6, 2023

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AGENDA

1. Structuring in Light of the Multilateral Instrument
2. Excessive Interest and Financing Expense Limitations – Some Things to Consider
3. Cross-border Application of the Stock Buyback Rules
4. Proposed Amendments – Part XIII and Partnerships
5. Foreign Affiliate Share-for-Share Exchanges – Subsection 85.1(4) Proposed Amendment

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GLOSSARY

Defined Term	
ATI	Adjusted Taxable Income
BEPS	Base Erosion and Profit Shifting
Canada-UK Treaty	*Convention between the Government of the United Kingdom of Great Britain, and Northern Ireland and the Government of Canada for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income and Capital Gains*
Canada-US Treaty	*Canada-United States Convention with Respect to Taxes on Income and on Capital*
EIFEL	Excessive interest and financing expense limitation
FA	Foreign affiliate
FAPI	Foreign accrual property income
FAPL	Foreign accrual property loss
GAAR	General anti-avoidance rule in section 245

GLOSSARY

Defined Term	
ITA	*Income Tax Act* (Canada) (all statutory references herein are to the ITA unless otherwise noted)
MLI	Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting
PPT	Principal purpose test
RIFE	Restricted interest and financing expenses
SAAR	Specific anti-avoidance rule
TCP	Taxable Canadian property as defined in subsection 248(1)
UK	United Kingdom of Great Britain and Northern Ireland
US	United States of America
WHT	Withholding tax

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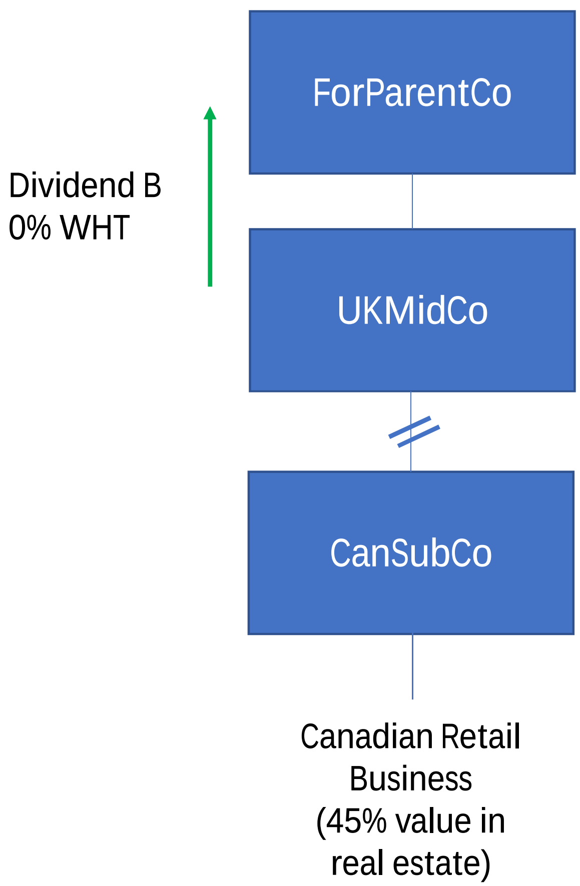
STRUCTURING IN LIGHT OF THE MLI

DISPOSING OF CANSUBCO



➢ Canada-UK Treaty, Article 13
- Gain from disposition of shares deriving >50% value directly or indirectly from "immovable property" in a contracting state taxable in that contracting state
- "immovable property" does not include any property (other than rental property) in which the business of the company was carried on

➢ Canada Domestic
- TCP definition: 60-month lookback
- MLI, Art. 9(1) and (4): adopted 365-day lookback for adopting treaty partners

➢ PPT or Canadian GAAR applicable?
- MLI – preamble implications?

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PREAMBLE MODIFIED BY THE MLI

- Original:
  - "The Government of the United Kingdom of Great Britain and Northern Ireland and the Government of Canada, desiring to conclude a Convention <u>for the avoidance of double taxation and the prevention of fiscal evasion</u> with respect to taxes on income and capital gains, have agreed as follows:"
- MLI Modified:
  - "Intending to <u>eliminate double taxation</u> with respect to the taxes covered by [this Convention] <u>without creating opportunities for non-taxation or reduced taxation through tax evasion or avoidance</u> (including through <u>treaty-shopping arrangements</u> aimed at obtaining reliefs provided in [the Convention] for the indirect benefit of residents of third jurisdictions)"

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DUAL RESIDENCY CONSEQUENCES MODIFIED BY THE MLI

- Original:
  - "... If the competent authorities are unable to determine the matter by mutual agreement, they shall endeavour to determine by mutual agreement the mode of application of the Convention to that person."
- Modified:
  - "... In the absence of such agreement, such person shall not be entitled to any relief or exemption from tax provided by [the Convention] except to the extent and in such manner as may be agreed upon by the competent authorities of the [Contracting States]."

PRINCIPAL PURPOSE TEST (PPT)

- Adoption of Article 7 of the MLI - Prevention of Treaty Abuse
  - "Notwithstanding any provisions of [the Convention], a benefit under [the Convention] 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 Convention]."

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PROPOSED EXCESSIVE INTEREST AND FINANCING EXPENSE LIMITATION RULES – SOME THINGS TO CONSIDER

EIFEL: BACKGROUND

- BEPS Action 4 Report: Recommended limitations on deductibility of interest and other financing costs.

- Consistent with BEPS Action 4, proposed EIFEL rules adopt an “earnings-stripping” approach, *i.e.*, deduction of net interest and financing expenses limited to fixed ratio of Tax EBITDA.

- Applies after all other rules considered (none of the existing interest deductibility rules are proposed to be repealed).

EIFEL: GENERAL MECHANICS

Broad definition of "interest and financing expenses"

Interest

Lender

Taxpayer

Can be related or third party

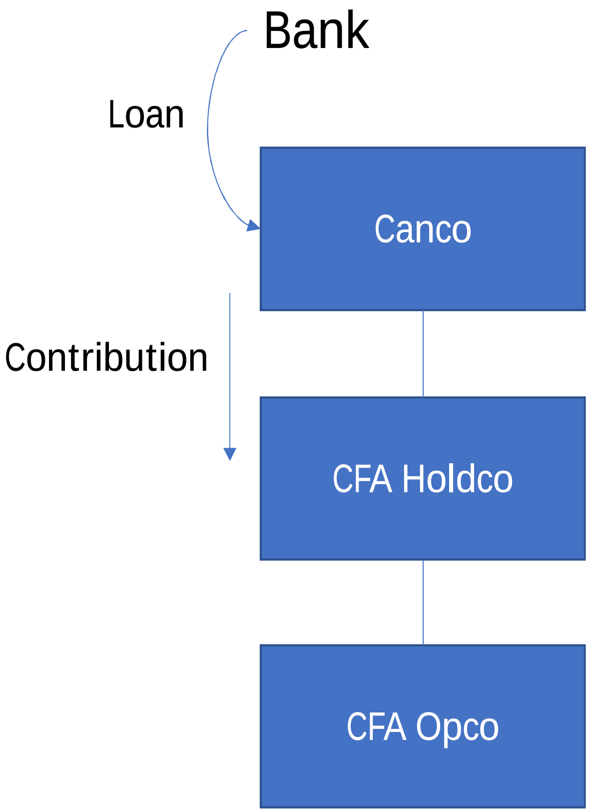
EIFEL: net interest deduction is limited to <u>30</u>% of <u>Tax EBIDTA</u>

Corporations or Trusts (some entities excluded on a group basis)

Maybe higher under group ratio

Detailed and complex calculation

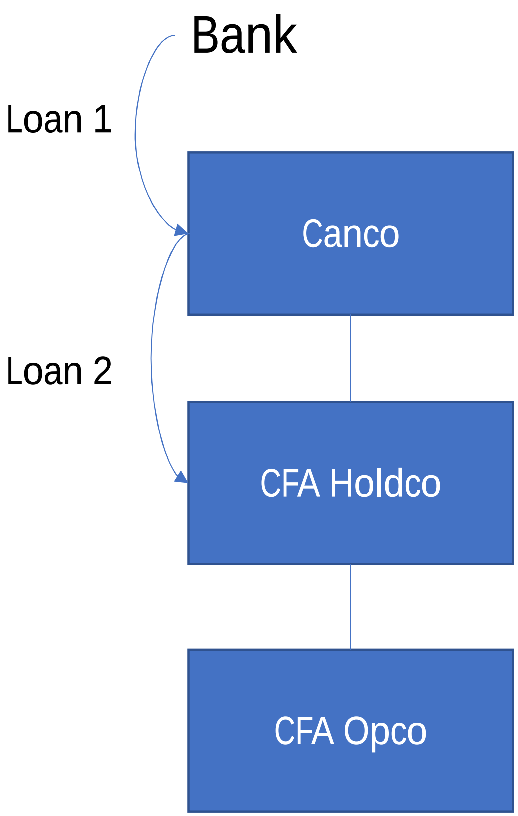
EIFEL: FINANCING OF CFAs



Foreign affiliates – Example 1

- Canco borrows from Bank and makes a contribution to CFA Holdco to acquire the shares of CFA Opco which are excluded property.
- ATI does not include dividends received from CFA Holdco that are deductible under section 113.
- Absent any other sources of income, Canco should have an EIFEL interest limitation.

EIFEL: FINANCING OF CFAs



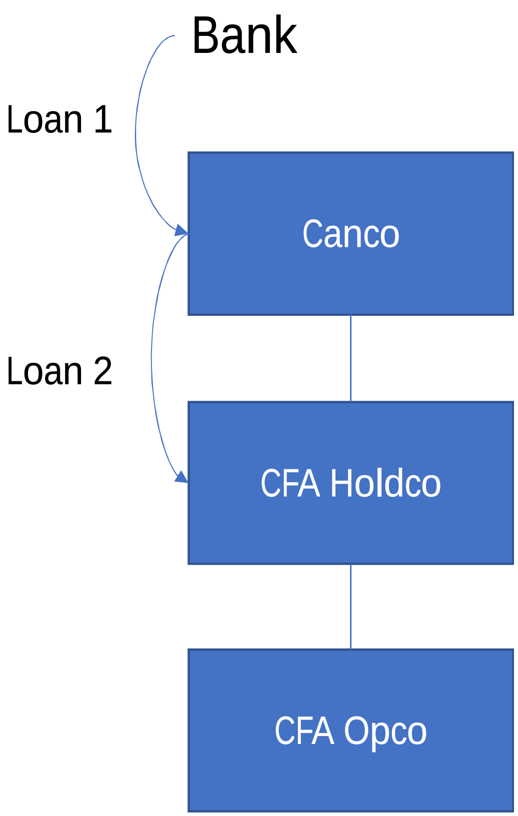
Before EIFEL

Canco	
Income	200
FAPI	0
Interest expense (Bank)	-100
Interest revenue (CFA Holdco)	100
Taxable income	200
CFA Holdco	
Income	0
Interest expense (Canco)	-100
FAPL	-100

Foreign affiliates – Example 2

- Canco borrows from Bank and makes a loan to CFA Holdco to acquire the shares of CFA Opco which are excluded property.
- Canco's ATI = $200
- Canco's IFE = $200
  - $100 bank interest expense plus $100 CFA Holdco interest expense

EIFEL: FINANCING OF CFAs



Post EIFEL

Canco	
Income	200
FAPI	0
Interest expense (Bank)	-100
Interest revenue (CFA Holdco)	100
Interest limitation (s. 18.2(2))	20
Taxable income	220
CFA Holdco	
Income	0
Interest expense (Canco)	-100
Interest limitation (s. 18.2(2))	20
FAPL	-80

Foreign affiliates – Example 2

- % of disallowed interest per ss. 18.2(2) = 20%
  - (IFE – (Ratio x ATI + IFR))/IFE
  - (200 – (30% x 200 + 100))/200
- Canco has a denied interest deduction of $20 (added to RIFE carryforward)
- CFA Holdco has a denied interest deduction of $20 and FAPL of $80.
- Canco's taxable income (post EIFEL) = $220

EIFEL: GROUP RATIO

- Group ratio can allow a taxpayer to deduct IFE in excess of the fixed ratio provided the taxpayer is a member of an accounting consolidated group with audited financial statements and makes an election.

- “Group Ratio” is the group’s net interest expense (“**GNIE**”) over the group’s adjusted net book income (“**GANBI**”)

- Flexible “allocated group ratio amount” (“**AGRA**”) that is allocated to Canadian “member of the consolidated group”
  - Generally, can allocate sum of “Group Ratio” x ATI of all Canadian members

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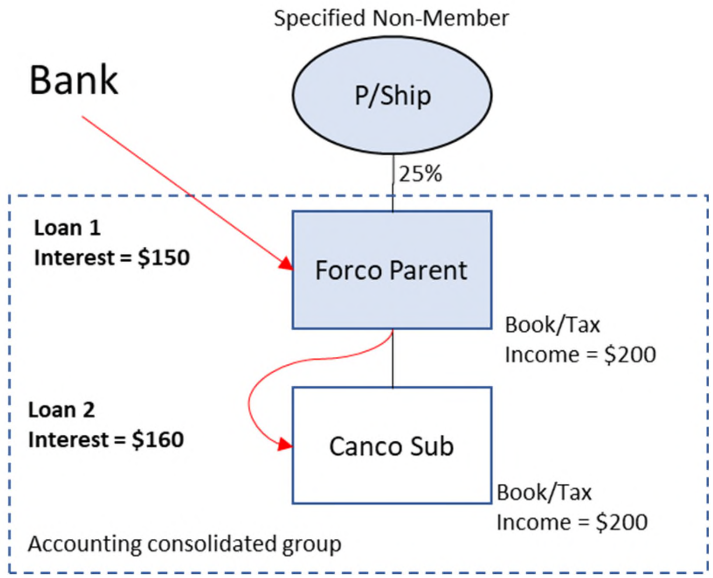
EIFEL: GROUP RATIO

- Recommended where group has a high level of third-party debt.

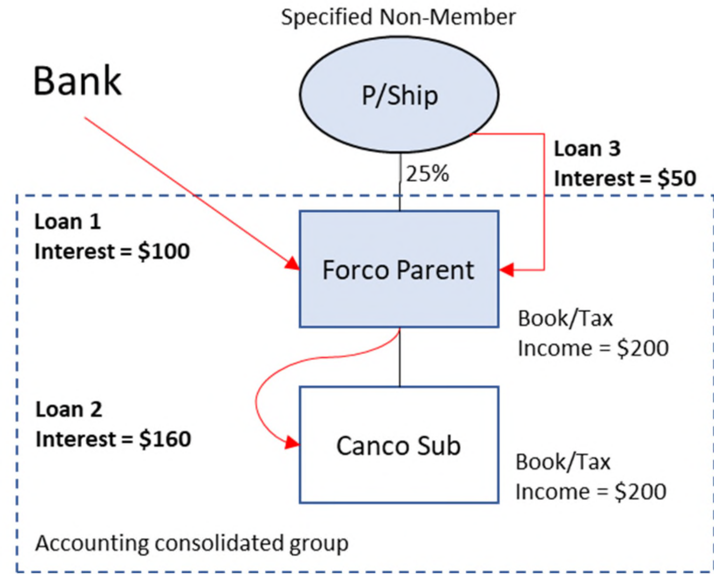
- Items to note:
  - Specified non-members can reduce the group ratio (example on next slide)
  - Over allocation of AGRA in the group ratio election = nil AGRA
  - Possible mismatches between IFE and “specified interest expense”
  - Group ratio election can be applied (beneficially) in pre-regime election
  - Excess capacity deemed to be nil in a group ratio year (cannot carry forward)
  - One time opportunity to make a fair value election (proposed 18.21(4))

EIFEL: GROUP RATIO (SPECIFIED NON-MEMBER EXAMPLE)



GNIE	150	A
GANBI	400	B
Group Ratio	38%	A/B
EIFEL %	15%	[$160 - (38% x $360)]/$160
Canco RIFE	$ 24	[$160 x 15%]

Group ratio = 38% (higher than 30% default method)



GNIE	100	A
GANBI	400	B
Group Ratio	25%	A/B
EIFEL %	44%	[$160 - (25% x $360)]/$160
Canco RIFE	$ 70	[$160 x 44%]

Group ratio = 25% (lower than 30% default method)

EIFEL: NON-CAPITAL LOSSES

- NCLs deducted in a taxation year reduce ATI
- However, NCL deducted may be partly or wholly added back under variable B(h) of the ATI definition
- Amount of addback depends on the proportion of certain amounts over the NCL for the "taxpayer loss year": "**J x K/L**"
  - J = NCL deducted in current year
  - K = Lesser of (i) NCL for the taxpayer loss year and (ii) "formula" amount
  - L = NCL for the taxpayer loss year
- Generally, the more the NCL is generated from:
  - Operational expenses = reduced addback
  - IFE, CCA, Resource pools, etc. = increased addback

EIFEL: NON-CAPITAL LOSSES

- Note: deducting an NCL can cause RIFE in the claim year
  - E.g., deducting a pre-regime (2020) NCL in 2024 where IFE is deducted in 2024
  - Deduction of NCL reduces 2024 capacity (ATI), resulting in RIFE

- Note: deducting an NCL can also cause RIFE in the loss year
  - E.g., carrying back a 2025 NCL to 2024 where IFE is deducted in both years.
  - Deduction of IFE in loss year (2025) relied on excess capacity from the prior year (2024)
  - Deduction of NCL in 2024 reduces excess capacity that was carried forward to loss year

- <u>Above results occur when there is not a full add-back to ATI under variable B(h) of ATI definition (generally depends on source of loss)</u>.

CROSS BORDER APPLICATION OF THE STOCK BUYBACK RULES

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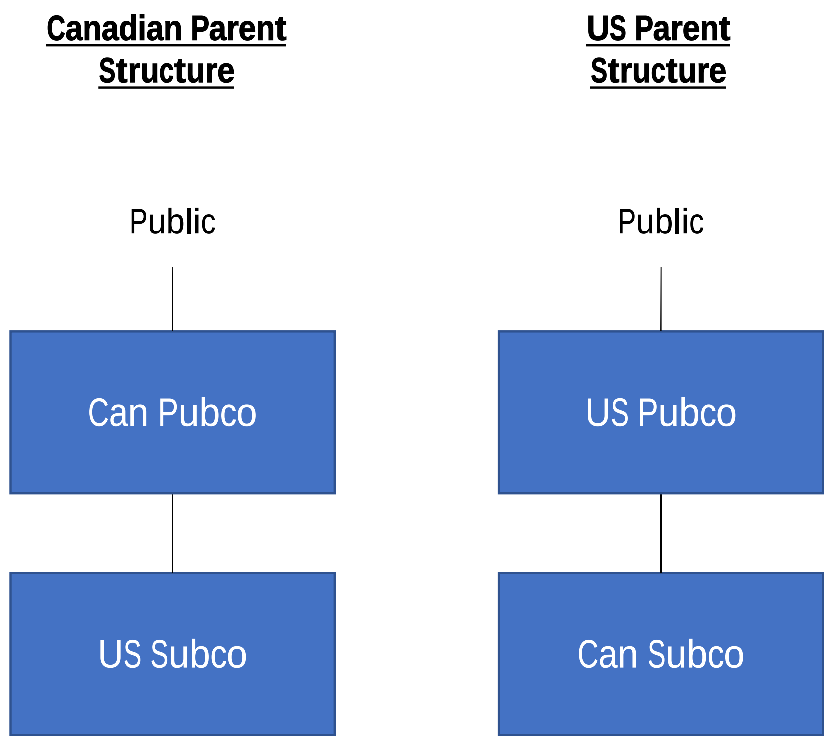
DO THE US OR PROPOSED CANADIAN STOCK BUYBACK RULES APPLY?



➢ Scenarios to Discuss:

A. Pubco repurchases Pubco common shares
   i. Subco paid dividend to parent in prior year
   ii. Subco made loan to parent in prior year

B. Subco repurchases Pubco common shares

C. Shares repurchased are non-voting preferred shares

PROPOSED AMENDMENTS – PART XIII AND FOREIGN PARTNERSHIPS

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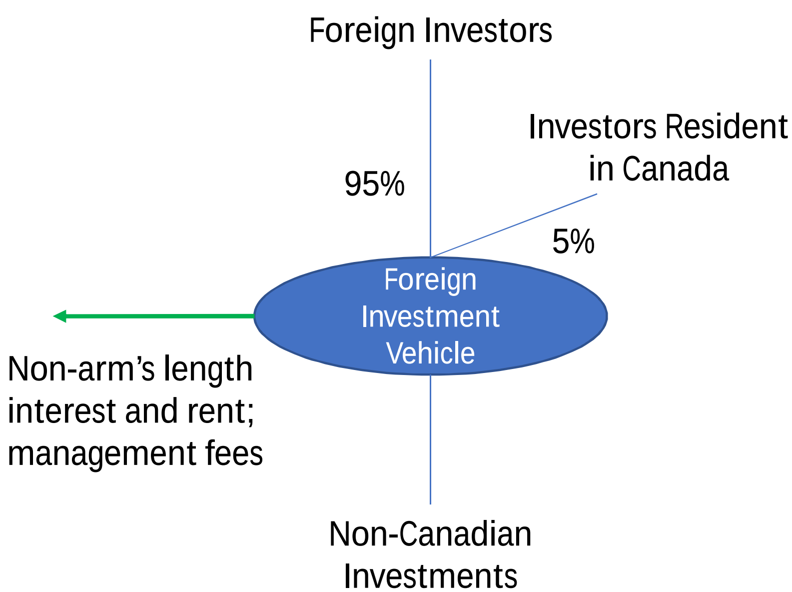
AUGUST 9, 2022 DRAFT LEGISLATIVE AMENDMENTS

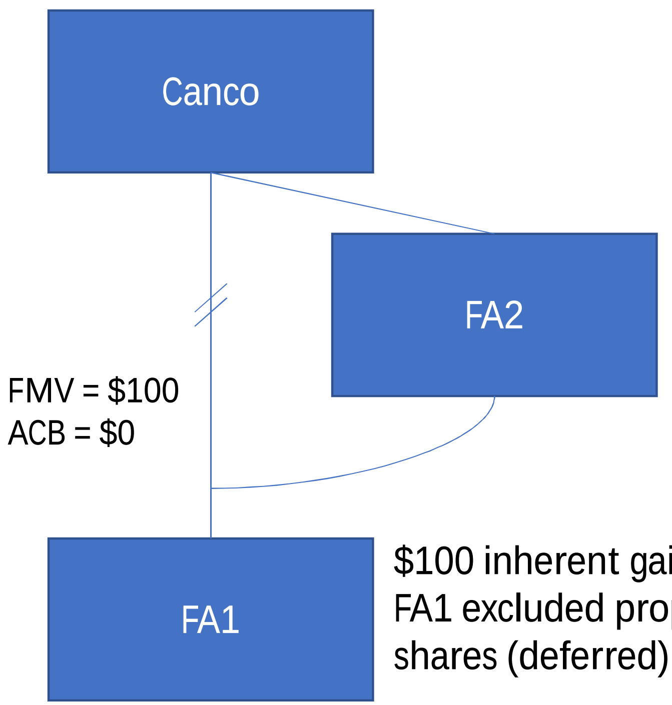


- Proposed paragraph 212(13.1)(a)
  - Amount paid to a non-resident person by a partnership and deductible in computing the income allocated to a Canadian partner under paragraph 96(1)(f) or (g)?
  - If yes, Part XIII withholding applies to that portion of the payment
- Is the foreign investment vehicle a "partnership"?
  - Canadian legal principles apply
- Practicality of enforcement?

FOREIGN AFFILIATE SHARE-FOR-SHARE EXCHANGES – SUBSECTION 85.1(4) PROPOSED AMENDMENT

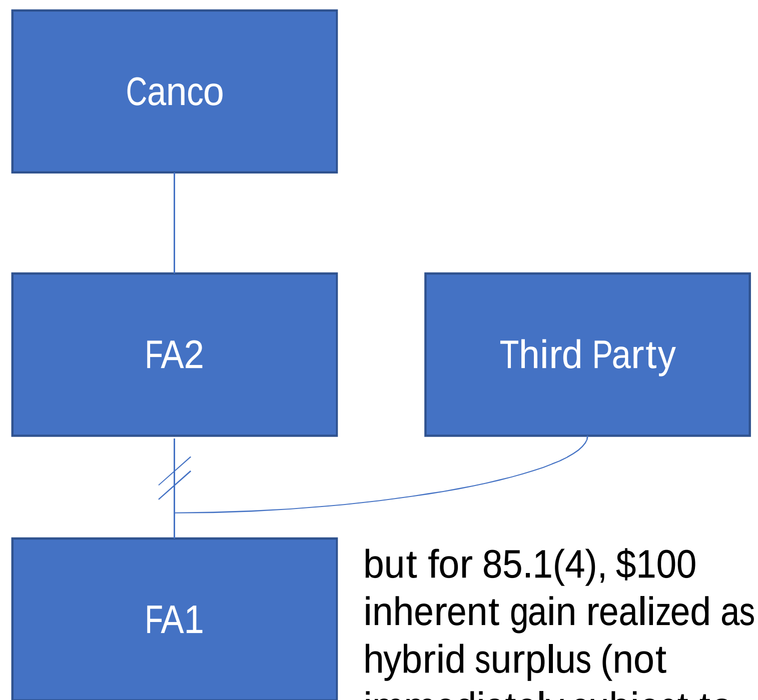
SUBSECTION 85.1(4) – EXAMPLE OF EXISTING RULE

85.1(3) rollover of FA1 excluded property shares to FA2



$100 inherent gain on FA1 excluded property shares (deferred)

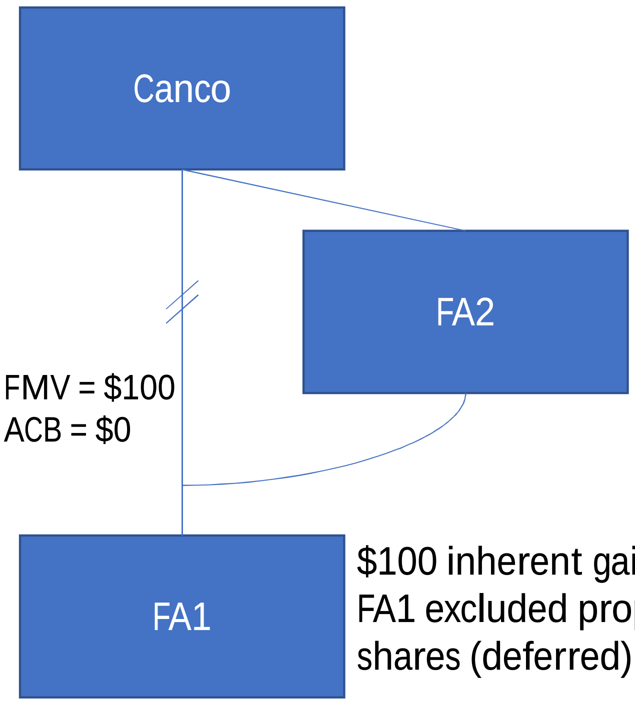
85.1(4) denies previous 85.1(3) rollover on subsequent disposition to 3rd Party



but for 85.1(4), $100 inherent gain realized as hybrid surplus (not immediately subject to tax in Canada)

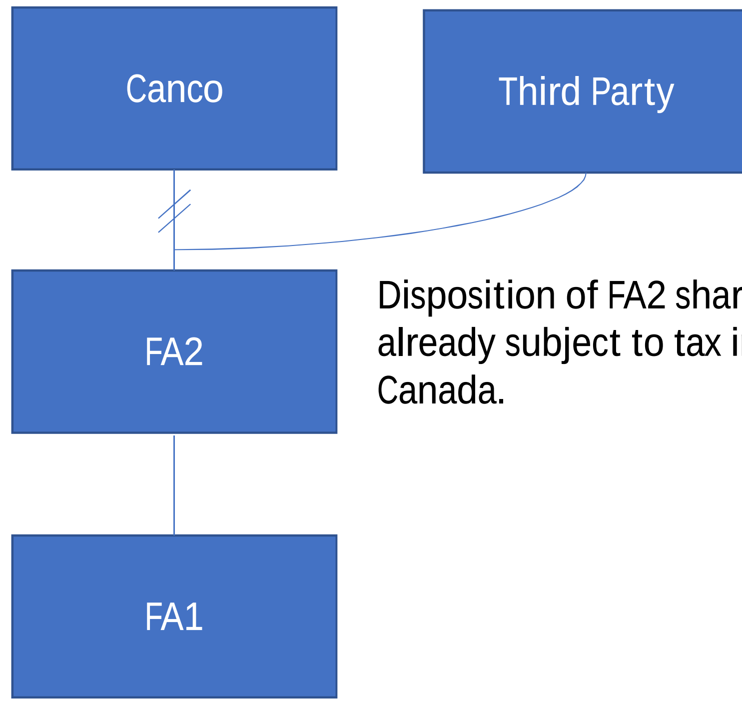
SUBSECTION 85.1(4) – EXAMPLE 1 OF PROPOSED AMENDMENT

85.1(3) rollover of FA1 excluded property shares to FA2



$100 inherent gain on FA1 excluded property shares (deferred)

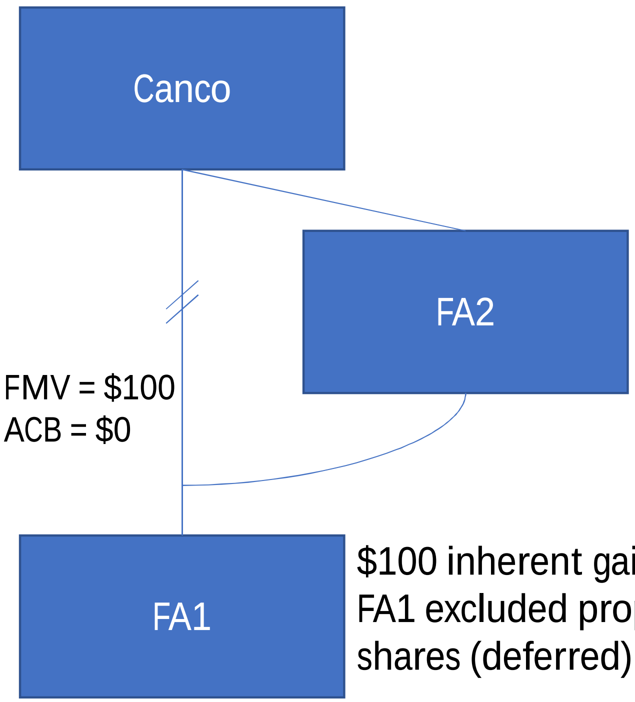
Amended 85.1(4) can deny previous 85.1(3) rollover on subsequent disposition of FA2 shares



Disposition of FA2 shares already subject to tax in Canada.

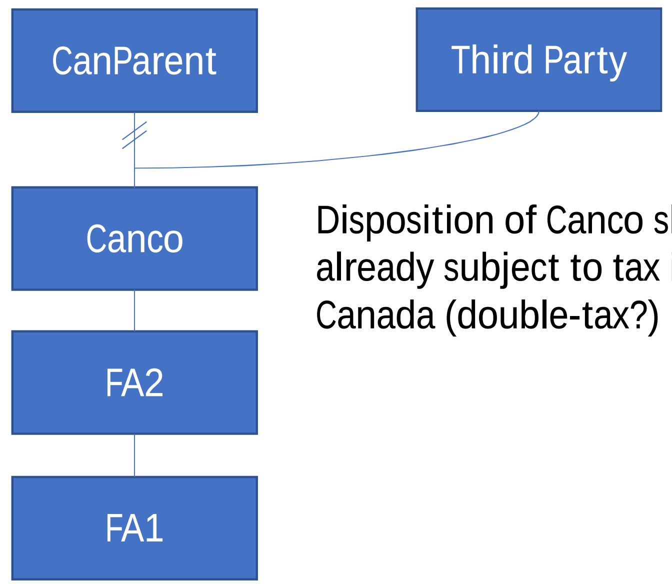
SUBSECTION 85.1(4) – EXAMPLE 2 OF PROPOSED AMENDMENT

85.1(3) rollover of FA1 excluded property shares to FA2



$100 inherent gain on FA1 excluded property shares (deferred)

Amended 85.1(4) can deny previous 85.1(3) rollover on subsequent disposition of Canco shares



Disposition of Canco shares already subject to tax in Canada (double-tax?)

Thank You For Joining Us - We Welcome Your Questions!

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