CANADIAN TAX Highlights

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Power To Lengthen Assessment Period

The successful administration of Canada's tax system depends on both the taxpayer's integrity in reporting income and the minister's ability to verify and enforce compliance. It is expected that the minister needs an array of legislative powers to administer the governing legislation and to assess a taxpayer's liability for tax; those powers include the minister's ability to issue a requirement for information or documents from a taxpayer "for any purpose" related to administration or enforcement and also her power to apply for a compliance order. The relationship between these powers and the statutory reassessment periods is affected by a new provision in the federal 2018 budget.

The objectives of certainty and finality compel the minister to exercise the powers set out above within the legislated reassessment period. The role of statutory limitation periods in encouraging diligence and imposing finality has long been endorsed by the courts. Subsection 152(4)—which sets out assessment periods—allows a taxpayer to know that its tax burden has been settled and concluded within a legislatively mandated time. In limited circumstances, such as misrepresentation attributable to carelessness, the minister can reassess beyond the normal reassessment period: the underlying policy is clear—if a taxpayer has unfairly denied the minister the opportunity to correctly assess tax in the first instance, the passage of time should not preclude the minister from doing so.

Certain provisions directly address the interplay between the minister's powers and the statutory reassessment periods. For example, section 231.6 gives the minister the power to require production of any foreign-based information or document. A person served with such a requirement may apply to a court for judicial review, in which case the time that elapses between the application and its final disposition is not counted in computing the reassessment period (subsection 231.6(7)).

Budget 2018 proposes to introduce a similar stop-the-clock rule for domestic requirements for information and applications for compliance orders. Proposed section 231.8 extends the reassessment period by the period of time during which the requirement or compliance order is contested by a taxpayer. The stop-the-clock period begins (1) in respect of a requirement, when the taxpayer applies for judicial review; and (2) in respect of a compliance order, when the taxpayer opposes the application. The period ends on the day the relevant application is "finally disposed of." Supplementary information to tax measures that was published in the budget 2018 papers justifies proposed section 231.8 as follows: "Contesting requirements for information and compliance orders effectively shortens the period during which the CRA may reassess a taxpayer, thus hampering the ability of the CRA to reassess in a timely fashion and on the basis of complete information."

Proposed section 231.8 has much wider application than its foreign counterpart. Unlike foreign-based requirements, which affect only taxpayers with information or documents outside Canada, domestic requirements potentially affect all Canadian taxpayers (individuals and all corporations alike).

Moreover, as currently drafted, the stop-the-clock suspension operates in respect of all audit issues, not just those to which the requirement or compliance application relates. In effect, proposed section 231.8 may deter taxpayers from challenging a requirement through the judicial review process because the challenge would result in extending the life of all issues to which the reassessment period relates.

Recent jurisprudence demonstrates that the proposed stop-the-clock period could be lengthy. Based on the court record, in *BP Canada Energy Company* (2017 FCA 61), the minister applied for a compliance order in May 2012. The matter was "finally disposed of"—in the taxpayer's favour—by the FCA decision in March 2017. Should CRA efforts to otherwise complete the audit have been deferred for five years as a result of an unsuccessful compliance application on its part?

It is sound policy—as reflected in the budget's supplementary information—that prevents a taxpayer from using the judicial review process to stall and thus attempt to wait out the reassessment period. However, the minister should not be able to issue a requirement or compliance application in order to lengthen or delay the entire audit either. Is such a delay the intention of the broad wording of proposed section 231.8? A taxpayer's analogous entitlement to a waiver

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vices—resulting in a digital services tax. Until this change is implemented, an interim 3 percent tax would apply on gross revenue derived from digital services.

The interim measure would apply to the supply of certain digital services characterized by user value creation: online placement of advertising, sale of collected user data, and digital platforms that facilitate interaction between users that then can exchange goods and services directly via the platform. The provision of digital content, payment services, online sales of goods or services, and certain regulated financial and crowdfunding services are excluded.

Larger businesses—those with total consolidated annual global revenue over €750 million and annual revenue from taxable digital activities in the EU over €50 million—would be subject to the interim measure. The digital services tax would apply regardless of whether a business is established within the EU.

Services would be deemed to be supplied, and tax would therefore be due, in a particular jurisdiction as follows:

- for services involving the provision of user data collected by means of making advertising space available, or the sale of data, a relevant jurisdiction would be the location where the advertisement is displayed or where the users are located that supplied the data that are being sold; and
- for services involving making digital platforms/marketplaces available to users, the location would be where the user paying for access to the platform (or to conclude a transaction within the platform) is located.

Additional reporting requirements would be imposed and a single EU-wide payment and reporting portal would be established, based on the one-stop-shop model currently used for VAT purposes. Businesses would be required to self-assess the tax liability and pay it annually; consolidated groups could nominate one company to deal with compliance and payment.

The long-term changes to the taxation of digital services would create a "significant digital presence" concept as a new category of PE. The proposal would extend the current PE rules by establishing a taxable nexus for digital businesses operating across borders, if at least one of the following thresholds is met:

- revenue from digital services provided to users located in a member state exceeds €7 million;
- active users of digital services located in a member state exceed 100,000; and
- business contracts for digital services concluded by users located in a member state exceed 3,000.

The definition of "digital services" would follow the definition used for VAT purposes under the EU VAT directive. These thresholds would apply to the services supplied by the entity and associated enterprises (as defined).

The profit allocation rules for digital services would be aligned with the OECD transfer-pricing guidelines. The basic assumption would be that profits should be taxed where value is created. In terms of digital services, value creation would be the location where the buyers are established and the data are collected and processed. To this end, additional criteria for profit allocation would be developed, focusing specifically on digital services, which could relate to users' engagement and contributions to a platform; data collected from users in an EU member state through a digital platform; number of users; and amount of user-generated content.

Unanimous approval by all EU member states is required for the adoption of the proposed directives. It is unclear when this will occur, but the EC aims for an effective date of January 1, 2020 for the interim measure.

The EC intends that the directive would result in the amendment of tax treaties between EU member states, and treaties between EU member states and other countries, and that it also would apply to transactions between member states and third countries that have not concluded tax treaties.

The EC would prefer rules agreed to at the global level but considers that an unacceptable amount of profits currently is untaxed, and it has therefore introduced these solutions at the EU level. The EC intends that these proposals will contribute to the ongoing work at the OECD level to influence international discussions on a global solution.

It remains to be seen whether a global solution can be achieved. However, international consensus in this area is clearly a far better outcome than unilateral action by individual countries—a result that would trigger double taxation and impede trade and growth.

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US Territoriality: A Promise Not Kept

The adoption of US tax reform in December 2017 (the Tax Cuts and Jobs Act [TCJA]) brought to an end several years of intense debate in US governmental, business, professional, and academic circles regarding a substantial reduction of the corporate tax rate and the adoption for US multinationals of a territorial system of taxation. The two objectives were agreed on by all except some academics and small groups. The TCJA slashed the US federal corporate tax rate from 35 to 21 percent (state and city corporate income taxes can bring the combined rate to more than 30 to 33.94 percent—for example, in Philadelphia). The second objective of territoriality does not seem to have been met.

A territorial system denotes a tax system for domestic multinationals with three basic features: (1) no domestic tax in respect of a foreign subsidiary that earns active business income, (2) no domestic tax on those repatriated earnings, and

(3) immediate domestic tax if a foreign subsidiary earns passive income unrelated to the active conduct of business.

Canada has a territorial system (for foreign subsidiaries based in a country with which Canada has an income tax treaty or a tax information exchange agreement) as do most EU countries, the United Kingdom, Australia, and Japan. Until 2009, only three major countries—Japan, the United Kingdom, and the United States—did not have a territorial system: they had the first and third elements and instead of the second element granted foreign tax credits (FTCs). In 2009, Japan and the United Kingdom adopted the second element; then the United States was the only major country that taxed multinationals on the repatriation of foreign profits.

It was long recognized that the US system encouraged keeping profits abroad with consequential negatives for the US economy. In 2004, there was a two-year reprieve—a 5 percent tax was substituted for a 35 percent tax on repatriations—and hundreds of billions of dollars came home.

New Code section 245A exempts US corporate shareholders from US tax on dividends received from CFCs provided that it is not a hybrid payment (a dividend for US law and an interest payment for foreign law). However, section 951A—global intangible low-taxed income (GILTI)—provides an immediate tax on the US shareholder of a CFC if the holder's proportionate interest in the CFC's income from any business exceeds 10 percent of the CFC's tax basis in tangible property. For example, if a CFC earns $1 million before tax from widget sales and has $500,000 of basis in tangible property, its GILTI is $950,000 ($1 million − 10% × $500,000). US tax is imposed if (1) the US shareholder is a corporation (allowed a 50 percent deduction and an 80 percent foreign tax credit) if the CFC's local tax rate is less than 13.125 percent, or (2) the US shareholder is an individual (no deduction or credit but a deduction for foreign taxes) unless section 962 is amended (as discussed below) to provide the individual with benefits available to corporate shareholders.

Whether or not US tax is paid via GILTI, a partial worldwide and a partial territorial system still exists, except that the territorial elements have changed from 1 and 3 to 2 and 3. Except for short periods some years ago in New Zealand and Finland, such a system has not been seen in other countries. One rationale (long harboured in US government circles) for this change says that GILTI is intended to counter or neutralize tax revenue loss that arises if transfer-pricing rules and perhaps permanent establishment rules are not operating effectively: the concern is that business intangibles developed or managed in the United States are not properly recognized in the US parent's accounts and the tax revenue loss is not being picked up under the CFC/subpart F income rules. And this has been further fuelled by the BEPS project, which has pushed governments to adopt aggressive rules to counter international tax-planning strategies, including subsidiaries in tax havens.

GILTI is a blunt instrument. For a US person to be taxed on a hotel's profit from a tax haven does not make tax policy sense; furthermore, an individual should not suffer from a supposedly low-tax-related rule when his or her CFC in Canada pays 27 percent tax (6 points higher than the new US federal corporate rate). The latter situation relates back to section 962's deficiencies, which block it from the elimination of a GILTI tax for individual CFC shareholders. Section 962 allows the US individual shareholder of a CFC to elect to determine the CFC's tax liability as if a US corporation was interposed: the rule ought to allow the hypothetical holdco to claim a 50 percent deduction and an 80 percent foreign tax credit, discussed above. Given Canadian corporate tax rates (even if the US individual is a Canadian resident and the Canco is a CCPC), that mechanism would eliminate all or substantially all US tax, but it is deficient—see the New York State Bar Association's May 4 submission to the Treasury—and a regulatory or statutory amendment is required to make section 962 work.

Clearly the only real fix that makes sense would be for the United States to resurrect the promise of the long debate leading up to tax reform, and repeal GILTI. Only in that way can the United States have a truly territorial tax system.

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Unfavourable Guidance on Section 965 Tax

On April 13, 2018, the IRS made a surprising and disappointing announcement that overpayments of 2017 estimated taxes by US shareholders will be applied first to future (post-2017) instalments of section 965 tax; such an overpayment is not eligible for refund or for credit against other 2018 US tax liabilities until the entire section 965 tax has been paid. The position is contrary to what most practitioners were expecting and contrary perhaps to the congressional intent of allowing a taxpayer to pay a section 965 tax liability in prescribed instalments over eight years: in the result, this IRS position could force the current payment of taxes not yet due. Barring an IRS change of view, as a practical matter the position imposes an initial instalment payment in excess of the stated 8 percent amount.

The onerous new US rules under section 965 impose a tax on a US shareholder of a foreign (non-US) corporation that is a controlled foreign corporation or specified foreign corporation on its share of post-1986 undistributed earnings. The section has a particularly harsh effect on many US citizens resident in Canada. The new rules not only impose substantial US tax on such earnings payable in instalments over eight years starting in 2017, but also present obstacles to synchronizing the timing of the tax on the income in Canada and the United States: lack of synchronization may lead to double tax.