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Tax Alert – Canada

Canada proposes the undertaxed profits rule and further amends the GMTA

EY Tax Alerts cover significant tax news, developments and changes in legislation that affect Canadian businesses. They act as technical summaries to keep you on top of the latest tax issues. For more information, please contact your EY advisor or EY Law advisor.

The Department of Finance released several packages of draft legislative proposals for public comment on 12 August 2024, including draft legislative proposals relating to the *Global Minimum Tax Act* (GMTA). The proposals reflect additional administrative guidance released by the Organisation for Economic Co-operation and Development (OECD) (e.g., on securitization entities), implement the undertaxed profits rule (UTPR) and make a consequential amendment to the *Income Tax Conventions Interpretation Act* relating to the application of the GMTA.

In this Tax Alert, we provide a brief overview of certain measures included in this package of draft legislative proposals. Interested parties are invited to provide comments to the Department of Finance on the draft legislative proposals by 11 September 2024.

For more information on the other draft legislative proposals released on 12 August 2024, refer to EY Tax Alert 2024 Issue No. 42, *Finance releases draft legislation for 2024 budget and other measures*, and EY Tax Alert 2024 Issue No. 45, *Finance releases revised legislative details to implement changes to increase the capital gains inclusion rate*.

Building a better working world

Undertaxed profits rule

The GMTA, as enacted before the summer break, did not contain any references to the UTPR.

The UTPR is the third element of the Pillar Two global anti-base erosion (GloBE) model rules, operating as a backstop to the income inclusion rule (implemented in Canada as the "Global Minimum Tax") and the qualified domestic minimum top-up tax (QDMTT, also included in the GMTA). Broadly, the UTPR requires a taxpayer to pay top-up tax relating to low-taxed profit of any group entity if it has not been already subject to an income inclusion rule. The UTPR liability is reduced by the amount of QDMTT paid on the low-taxed profit.

The draft legislative proposals introduce Part 2.1 in the GMTA, titled UTPR. Part 2.1 broadly aligns with the OECD Model Rules, allocating to Canadian taxpayers a certain amount of top-up tax, based on a ratio of substance of the Canadian entities, compared to the substance of other entities of the group operating in jurisdictions that have a UTPR. The UTPR would operate through a new levy.

The UTPR proposals also contain specific transitional rules — one relating to the initial phase of international activity to ensure that groups with limited foreign presence would not be subject to the UTPR, and a second rule to prevent the application of the UTPR to the ultimate parent entity jurisdiction if that jurisdiction's statutory corporate income tax rate is equal to or greater than 20%. This second rule is particularly relevant for US multinational enterprise (MNE) groups with inbound activity into Canada, as the US does not have a QDMTT.

The UTPR is to enter into effect for financial years commencing on or after 31 December 2024, which is one year after the entry into effect of the Global Minimum Tax and the QDMTT in Canada.

Other measures

The draft legislative proposals also include a number of modifications, which are intended to reflect certain items from the OECD/G20 Inclusive Framework's fourth Additional Administrative Guidance, which was released on 17 June 2024.[1]

Securitization entity

Broadly speaking, in a typical securitization transaction, assets like loans or mortgages are transferred from the creditor (the originator) to a special purpose vehicle (SPV) or multiple SPVs, which could be a corporation, trust or similar arrangement. Where the SPV is a corporation, it is often owned by an unconnected third party. The corporation typically issues debt instruments on the bond market to finance the asset pool acquisition or enters into a

[1] For more information, refer to OECD/G20 Inclusive Framework releases fourth tranche of Administrative Guidance on Pillar Two GloBE Rules.

synthetic securitization transaction in which the SPV becomes party to a derivative contract or guarantee and assumes the risk of the underlying asset pool's performance, while also owning highly secured assets, such as government debt. The SPV's asset pool (and/or derivatives or other instruments) generates income to service the debt. Any excess is returned to the originator or related entity through a defined cash-extraction mechanism, under which payments are commonly made on a monthly or quarterly basis so surplus cash is typically not retained in the SPV for a significant period of time.

The SPV structure ensures bankruptcy remoteness from the originator and isolates the risk of the asset pool from the wider credit risk associated with the originator.

While there are only limited situations where such vehicles would raise Pillar Two issues, such entities in scope of the rules could potentially be adversely impacted, undermining securitization transactions, the solvency of the entity, as well as its credit rating.

To address the issue, the OECD provided countries with the ability to exclude these entities from the scope of the QDMTT and the UTPR, which Canada opted to do.

Flow-through entities

Notably, the draft legislative proposals repeal the definition of reverse hybrid entity from the GMTA, as it is no longer referenced within the GMTA, and the revised drafting of subsection 17(6) no longer requires this concept to operate.

In addition, part of subsection 17(6) of the GMTA — relating to flow-through entities — is replaced to better align to the latest Additional Administrative Guidance from the OECD on flow-through entities.

Deferred tax assets

A specific regime applies to intragroup transfers of assets occurring before the GloBE rules apply to a specific jurisdiction, providing that any step-up realized (or deferred tax asset recorded) through this transaction would be ignored for GloBE purposes (Article 9.1.3 of the OECD Model Rules), unless taxes are paid, or a valuable tax attribute is used. In this latter case, a GloBE-only deferred tax asset would be recognized to take this into consideration.

The draft legislative proposals aim to further align subparagraph 48(5)(b)(ii) of the GMTA to the latest amendments adopted by the OECD to the Commentary in Article 9.1.3., ensuring that (i) a deferred tax asset can be recognized for GloBE purposes even if no deferred tax asset is recognized under the MNE group's accounting standard, (ii) in situations where a group taxation regime applies, the amount of taxes paid by an entity other than the transferor of the assets is taken into account when determining the amount of the deferred tax asset authorized and, finally, (iii) where a deferred tax asset is reversed — or never arises — further

to the transfer, that amount is also taken into account when determining the authorized deferred tax asset amount.

Income Tax Conventions Interpretation Act

The draft legislative proposals also include new section 4.4 to the *Income Tax Conventions Interpretation Act*, clarifying that Canada's tax treaties do not prevent the taxation of income in accordance with the GMTA, nor do they require Canada to provide relief, such as tax credits, for tax imposed under another state's Pillar Two implementing legislation.

Proposed section 4.4 is to enter into effect as from 1 January 2024.

What's next

The draft GMTA legislative proposals will now continue to advance in the legislative process.

As further OECD guidance is anticipated, we should expect the GMTA to continue to require amendments in the future to remain aligned to the global framework.

Learn more

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