Tax Perspectives

Review of 2022 & 2023 Outlook

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Tax Perspectives: Review of 2022 & 2023 Outlook

2022 brought significant developments in Canadian tax law. There was an avalanche of new legislative proposals, draft legislation implementing prior proposals, technical amendments, and a commitment by Government of Canada ("**Government**") to further tax reform in the future. The Canadian tax community has spent 2022 digesting these complex and, in some cases, detailed proposals, considering their impact on current transactions and structures, and providing comments and critique to the Department of Finance ("**Finance**").

This article provides an overview of the important Canadian legislative and judicial tax developments of 2022, and looks ahead to potential significant Canadian tax changes in 2023. Given the substantial volume of tax developments this year, this article does not attempt to be comprehensive but highlights those developments we consider to be most impactful to a broad audience of our clients.

Our commentary is divided into sections as follows:

- **Part 1 – Overview of Canadian Tax Developments in 2022**
  - Income Tax – Legislation
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- **Part 2 – Outlook for 2023**

Part 1 - Overview of Canadian Tax Developments in 2022

INCOME TAX – LEGISLATION

The significant volume of new proposals and draft legislation implementing previously announced proposals included the following.[1]

- On February 4, 2022, Finance released draft legislation for a number of previously announced proposals ("**February Release**"). The package of draft legislation included the "excess interest and financing expenses limitation rules" ("**EIFEL Rules**"), new trust reporting rules ("**Trust Reporting Rules**") and mandatory disclosure rules ("**Mandatory Disclosure Rules**").
- On April 7, 2022, the Government released the 2022 federal budget ("**Budget 2022**") which included significant proposals such as the Canada recovery dividend and additional tax on banks and life insurers, substantive CCPC rules ("**Substantive CCPC Rules**") and rules regarding foreign accrual property income earned by controlled foreign affiliates of Canadian-controlled private corporations, an update on the Government's commitment to follow through on the Organization for Economic Co-operation and Development ("**OECD**") international tax reform recommendations, and a consultation process on "modernizing" the general anti-avoidance rule ("**GAAR**"). The McCarthy Tétrault LLP overview of Budget 2022 provides a more detailed review.

1 All statutory references herein are to the *Income Tax Act* (Canada) ("**Act**") unless specifically otherwise noted.

- On April 29, 2022, Finance released the first of two packages of draft legislation for the "anti-hybrid mismatch" rules ("**Hybrid Mismatch Rules**") announced in the 2021 federal budget.
- On August 9, 2022, the Government released proposed draft legislation in respect of certain measures proposed in Budget 2022 and prior budgets. The package of legislation included amended draft legislation implementing the Mandatory Disclosure Rules and Trust Reporting Rules responding to comments from the tax community since February 4, 2022. The package also included new draft legislation for Budget 2022 proposals such as the Canada recovery dividend and additional tax on banks and life insurers, investment tax credit for carbon capture, utilization and storage, the critical mineral exploration tax credit, the elimination of flow-through shares for oil, gas and coal exploration and development, rules addressing hedging and short selling by Canadian financial institutions, Substantive CCPC Rules and many more. The August 9 package of legislation also included a number of "technical amendments" that Finance described as "amendments to improve the certainty and integrity of the tax system" but include substantive changes that will have a meaningful impact on tax planning.
- Also on August 9, 2022, Finance released a consultation paper entitled "Modernizing and Strengthening the General Anti-avoidance Rule", and began the GAAR consultation process announced in Budget 2022.
- On November 3, 2022, the Government presented the Fall Economic Statement 2022 ("**Fall Economic Statement**") in the House of Commons. In tandem with the Fall Economic Statement, the Government released a series of draft legislative proposals for public consultation on a variety of previously announced tax measures. On November 4, 2022, the Government introduced Bill C-32, the Fall Economic Statement Implementation Act ("**Bill C-32**") in the House of Commons. This November package of draft legislation and Bill C-32 included, inter alia, (i) revised EIFEL Rules, with changes intended to address stakeholder comments and other issues identified and defer the coming into force of such rules from taxation years beginning on or after January 1, 2023 to taxation years beginning on or after October 1, 2023; (ii) a deferral of the coming into force date for amended reporting requirements for reportable transactions and new reporting requirements for notifiable transactions until the date on which a bill implementing such legislation receives Royal Assent; and (iii) a deferral of coming into force of the enhanced reporting requirements for trusts (including bare trusts) by one year from taxation years ending after December 30, 2022 (as previously contemplated) to taxation years ending after December 30, 2023.
- On December 15, 2022, Bill C-32 received Royal Assent.

The volume of legislative developments in the year precludes a comprehensive review. In the immediately following sections, we provide an overview of some of the more noteworthy 2022 developments.

EIFEL RULES

The February Release included draft legislation implementing the proposed EIFEL Rules. On November 3rd, 2022, the government released a revised version of the EIFEL Rules. This summary discusses the EIFEL Rules as proposed in the November 3rd draft legislation. The deadline to comment on this draft legislation was January 6, 2023.

The EIFEL Rules are intended to apply to taxation years beginning on or after October 1, 2023. Once enacted, they will essentially limit the deduction of interest to a fixed ratio of "tax EBITDA", subject to a corporate group qualifying for and electing to use the "Group Ratio" method (described below). Consistent with the Action 4 report under the OECD/G20 Base Erosion and Profit Shifting ("**BEPS**") Project, the EIFEL Rules are intended to address concerns about base erosion arising from the deduction for income tax purposes of excessive interest and other financing costs, principally in the context of multinational enterprises ("**MNEs**") and cross-border investments. The EIFEL Rules are complex, especially considering that they are intended to apply in conjunction with, and not replace, the myriad of existing rules that target the deductibility of interest expense for Canadian tax purposes.

The existing rules limiting interest deductibility primarily target non-residents investing in Canada. Enacting the EIFEL Rules without removing any of the existing rules suggests that the EIFEL Rules are targeted at Canadian MNEs and represents a significant shift in Canadian tax policy. In the past Canadian tax policy has not limited Canadian MNEs from borrowing to invest in their foreign operations to allow them to become stronger Canadian companies and not themselves become targets of foreign takeovers.

Overview of the EIFEL Rules

The EIFEL Rules limit the amount that a taxpayer may deduct in respect of interest and financing expenses in any given taxation year to a fixed ratio of the taxpayer's "adjusted taxable income" (**"ATI"**). The fixed ratio is 30% of the taxpayer's ATI for the year (except for taxation years beginning after September 30, 2023 and before January 1, 2024, for which the fixed ratio is 40%). ATI is effectively "tax EBITDA" earned in Canada; essentially a taxpayer's taxable income for the year (or, if the taxpayer is a non-resident, its taxable income earned in Canada), adjusted to add back any deductions claimed in computing taxable income in respect of interest and financing expenses ("**IFE**"), certain tax expenses, capital cost allowance and resource pool deductions, and to subtract any income inclusions for interest and financing revenues ("**IFR**"), untaxed income (including foreign source income in respect of which a foreign tax credit is claimed in Canada) and certain other amounts. Notably excluded from the computation of a taxpayer's ATI is dividend income to the extent the taxpayer is entitled to claim an off-setting deduction under section 112 (for inter-corporate dividends from Canadian corporations) or section 113 (for dividends received from foreign affiliates).

The EIFEL Rules are intended to apply broadly to both Canadian-resident and non-resident corporations and trusts. There are, however, exceptions for certain specified categories of entities (an "excluded entity") whose IFEs should pose a low BEPS risk. Excluded entities include, in general terms; (i) Canadian-controlled private corporations with taxable capital employed in Canada (together with any associated corporations) of less than $50 million; (ii) groups comprised of corporations and trusts resident in Canada whose aggregate net interest and financing expenses is $1 million or less; and (iii) a Canadian-resident corporation or trust provided that such entity, along with any other eligible group entities (generally, Canadian-resident related or affiliated entities) carry on substantially all of its business, undertakings and activities in Canada, all or substantially all of its interest and financing expenses are paid to persons or partnerships that are not non-arm's length "tax-indifferent investors", and the group's foreign affiliate holdings, if any, are de minimis, (i.e. the greater of the book cost of all foreign affiliate shares held by the group and the fair market value of the assets of all foreign affiliates held by the group does not exceed $5,000,000) and no non-resident holds a significant interest in, any group member.

The EIFEL regime includes a number of ancillary rules that are generally relieving in nature. Under the proposed rules, a taxpayer that is a member of an accounting consolidated group may elect to compute its IFE limit using a "group ratio" (generally, the group's ratio of net third-party interest expense to book EBITDA) in lieu of the fixed ratio, where the "group ratio" exceeds the applicable fixed ratio. This group ratio should effectively exempt a taxpayer that is a member of a group with only Canadian operations from the application of the 30% deduction limitation. The proposed rules also provide for the ability in certain circumstances to transfer unused capacity to claim IFE deductions to other Canadian members of the group. Finally, the EIFEL Rules contain provisions that permit the carry forward of denied IFEs indefinitely such that a taxpayer can potentially claim a denied IFE in any subsequent year in which it has capacity. The rules also provide for a three-year carry forward of unused deduction capacity (effectively equivalent to a three-year carry back of denied IFE).

In addition, the proposals include an exemption for expenses relating to certain Canadian public-private partnership infrastructure projects where all or substantially all of the relevant expenses are directly or indirectly borne by the public sector authority.

The EIFEL Rules also allow two related or affiliated taxable Canadian corporations, and some partnerships, to jointly elect that certain interest or financing expenses ("**excluded interest**") made by one to the other in a taxation year be excluded from the 30% limitation. This election is principally intended to ensure that the EIFEL Rules do not negatively impact commonly used loss consolidation transactions undertaken in a Canadian group.

Specific rules applicable to financial institutions are included in the EIFEL Rules and are beyond the scope of this summary.

Interaction with CFA's

The November proposals clarified how the EIFEL Rules interact with the foreign affiliate regime. In short, Canadian taxpayers will be required to include their share of a controlled foreign affiliate's ("**CFA**") "relevant affiliate interest and financing expenses" and "relevant affiliate interest and financing revenue" in the taxpayer's IFE and IFR, respectively. If a portion of a taxpayer's IFEs are denied pursuant to the EIFEL Rules, a proportionate amount of the CFA's relevant affiliate interest and financing expenses will also be denied for purposes of computing the CFA's foreign accrual property income. No provision provides for a carryforward of the CFA's restricted expenses.

Anti-avoidance rules

The proposals contain anti-avoidance rules intended to prevent a taxpayer's IFR from being inflated, or its IFE from being understated, as a result of certain types of transactions. In addition, the Government has specified that it may apply the GAAR where one of the specific anti-avoidance rules does not apply.

TRUST REPORTING RULES

A proposal to introduce new trust reporting rules was first announced in Budget 2018, and the draft Trust Reporting Rules were included in the February Release, with a revised version released on August 9, 2022. Initially, the proposed rules were to apply for trusts with taxation years ending after December 30, 2021. The coming into force date was extended by the February Release and further extended by the Fall Economic Statement. Currently the rules will apply for trust taxation years that end after December 30, 2023.

Finance is of the view that the information collected under the current rules is insufficient, covering only those trusts that pay taxes, dispose of capital property or make distributions to beneficiaries. The proposed new rules aim to resolve this perceived inadequacy by implementing more extensive reporting requirements for certain types of trusts.

Under the new reporting rules, all trusts subject to the rules would be required to file a trust return and provide information regarding all "reportable entities", including the trust's trustees, beneficiaries and settlors. In addition any person who has control or the ability to exert control or override trustee decisions (for example, a protector) would be a reportable entity.

The new rules also require that for each reportable entity the following information be provided: name, type and classification or entity, address, date of birth (if a natural person), country of residence and tax identification number (e.g. social insurance number, trust account number, or business number).

In its original iteration, which appeared in draft legislation on July 27, 2018, the new rules were to apply to all express trusts resident in Canada and non-resident trusts that currently file a T3 return, for taxation years ending after December 30, 2021.

The February Release contained, revised draft legislative proposals which while generally similar to the original draft legislation, (a) expanded the rules to apply to "bare trust" arrangements by adding proposed subsection 150(1.3); (b) limited the disclosure of information subject to solicitor-client privilege under proposed subsection 150(1.4); and (c) exempted trusts, all the units of which are listed on a designated stock exchange (among other specific exemptions for certain trusts).

The August 9, 2022, draft legislation included revisions that clarified the reporting requirements for trusts with publicly traded units and added employee profit sharing plans, registered supplementary unemployment benefit plans and first home saving accounts to the list of trusts exempted from the new reporting requirements.

The Trust Reporting Rules, were included in Bill C-32.

Failure to comply with the new trust reporting requirements may result in harsh penalties of either: (i) $100; or (ii) $25 per day of non-compliance for up to a maximum of $2,500; and additional penalties will apply where the failure to file or provide accurate information was done knowingly or as a result of gross negligence.

MANDATORY DISCLOSURE RULES

The February Release included draft legislation for the Mandatory Disclosure Rules proposed in Budget 2021. The Mandatory Disclosure Rules were subsequently updated on August 9, 2022. The draft legislation includes rules that (a) broaden the potential application of the "reportable transaction" rules, (b) create a new regime for reporting "notifiable transactions" and (c) require the reporting of uncertain tax treatments by corporations when certain conditions are met. Taxpayers (along with advisors and promoters) that fail to comply with the proposed disclosure rules may be subject to significant penalties and, in some cases, extended reassessment periods.

Reportable Transactions

Generally, a transaction will be a reportable transaction under the draft legislation if:

1. it would be reasonable to consider one of the main purposes of the transaction or series of transactions is to obtain a tax benefit; and

2. one of the following hallmarks is true in respect of the transaction or series of transactions:

a. the fees of an advisor, promoter, or person that does not deal at arm's length with an advisor or promoter are to any extent (i) based on the quantum of the tax benefit achieved; (ii) contingent upon achieving a tax benefit; or (iii) attributable to the number of persons who participate in the same or similar transaction or series of transactions or have been provided access to advice or an opinion given by an advisor or promoter regarding the tax consequences from the same or similar transaction or series;

b. an adviser, promoter, or person that does not deal at arm's length with an advisor or promoter, obtains confidential protection with respect of the tax treatment in relation to the transaction or series of transactions; or

c. any of the taxpayer, advisor, promoter, or a person that does not deal at arm's length with any of the foregoing, receives contractual protection that protects against the failure of the transaction or series of transactions achieving a tax benefit.

Notifiable Transactions

A notifiable transaction is a transaction, or a transaction in a series of transactions, that is the same as, or substantially similar to, a transaction or a series of transactions that is designated at that time by the Minister of National Revenue. The following list of designated notifiable transactions was released along with the draft legislation on February 4, 2022:

1. manipulating Canadian-controlled private corporation status to avoid anti-deferral rules applicable to investment income;

2. straddle loss creation transactions using a partnership;

3. avoidance of deemed disposal of trust property;

4. manipulation of bankrupt status to reduce a forgiven amount in respect of a commercial obligation;

5. reliance on purpose tests in section 256.1 of the Act to avoid a deemed acquisition of control; and

6. back-to-back arrangements.

Uncertain Tax Positions

For certain corporations that file a Canadian income tax return and have assets with a carrying value of at least $50 million at the end of the taxation year, the draft legislation requires the reporting of an uncertain tax position related to Canadian income tax that is reflected in the corporation's financial statements.

Exceptions

Certain exceptions to the reporting requirements under the new mandatory disclosure rules exist. First, lawyers that are advisors in respect of reportable or notifiable transactions are not required to disclose information protected by solicitor-client privilege. Second, persons that only provide clerical or secretarial services with respect to the planning are excluded from the reporting obligations in respect of reportable transactions and notifiable transactions. Third, certain banks, insurance companies and credit unions do not have to report a notifiable transaction if the bank, insurance company or credit union only acts as an advisor or promotor (or person not dealing at arm's length with an advisor or promotor that is entitled to a fee in respect of the notifiable transaction) provided the bank, insurance company or credit union does not know and would not reasonably be expected to know that the transaction is a notifiable transaction.

With regard to notifiable transactions only, if an employer or partnership files the required information return, then the employees or partners, as applicable, are deemed to have made the required filing. There is no similar current or proposed rule that would apply to employees or partners in respect of any filing obligation under the reportable transaction rules.

Coming into force

The mandatory disclosure rules were subject to multiple public consultations, the most recent of which ran from August 9, 2022 to September 30, 2022. On November 3, 2022, the federal government stated that, in order to fully assess the feedback received, it intends for the new reporting requirements with regard to reportable transactions and notifiable transactions to come into force when a bill implementing the changes receives Royal Assent. With regard to uncertain tax treatments, the federal government confirmed that the new rules will be effective for taxation years beginning after 2022, with penalties only applying after Royal Assent.

CANADA RECOVERY DIVIDEND AND ADDITIONAL TAX ON BANKS AND LIFE INSURERS

Canada Recovery Dividend

Budget 2022 proposed the Canada Recovery Dividend ("**CRD**"), an additional, one-time, 15% tax on bank and life insurer groups. Draft legislation for the CRD was released on August 9, 2022, and was included in Bill C-32. Under the rules contained in Bill C-32, new Part VI.2 of the Act will impose a 15% tax on each corporation that was a "bank or life insurer group member" during its 2021 taxation year.

The defined term "bank or life insurer group member" means a bank, a life insurance corporation that carries on business in Canada, or a financial institution (as defined in subsection 190(1)) that is related to a bank or life insurance corporation that carries on business in Canada.

The additional tax is calculated as 15% of the average of the corporation's 2020 and 2021 taxable income that exceeds $1 billion income. The first $1 billion of taxable income is excluded from the CRD by a deduction that can be shared among related bank or life insurer group members. The calculation excludes any non-capital or net capital losses carried back or carried forward to reduce the corporation's 2020 or 2021 taxable income. Additionally, if a corporation has more than one 2020 or 2021 taxation year, the taxable income of the corporation for each of those taxation years is included in the calculation. Any liability of a corporation for Part VI.2 tax is payable in instalments over five years. A corporation liable to pay Part VI.2 tax for the 2022 taxation year must file a prescribed form with the Minister with the corporation's tax return for the 2022 taxation year.

Additional Tax on Banks and Life Insurers

Budget 2022 proposed to introduce an additional tax of 1.5% of taxable income for members of bank and life insurer groups and draft legislation was released and included in Bill C-32 August 9, 2022.

The additional tax on banks and life insurers applies to a "bank or life insurer group member". Although defined in its own section, the definition of this term is the same as it is for the CRD. Under Bill C-32, each corporation that is a bank or life insurer group member must add to its tax otherwise payable for a year under Part I of the Act an amount equal to 1.5% of the corporation's taxable income that exceeds a $100 million. The $100 million limit is shared by related bank or life insurer group members. The tax applies to taxation years that end after April 7, 2022 (subject to any proration for any taxation year that includes April 7, 2022).

The proposed rules contain an anti-avoidance rule to address tax planning that reduces the additional tax payable. If a corporation that is a bank or life insurer group member deducts from its taxable income an amount that can reasonably be considered to have been paid or payable, directly or indirectly, to a non-arm's length person that is not a bank or life insurer group member, and it is reasonable to consider that one of the purposes of this payment was to reduce the corporation's additional tax payable, the amount is deemed not to have been deducted in computing the corporation's taxable income for the purposes of calculating the additional tax.

SUBSTANTIVE CCPC RULES / FAPI EARNED BY CONTROLLED FOREIGN AFFILIATE OF CCPCS

Substantive CCPC Rules

Budget 2022 included a proposal to introduce rules to combat a specific type of planning involving Canadian-controlled private corporations ("**CCPCs**") that the Government considered to be inconsistent with the policy of the CCPC regime. Draft legislation implementing the Substantive CCPC rules was released on August 9, 2022.

CCPCs are subject to refundable tax on investment income that, generally, removes the incentive for a Canadian individual to earn investment income in a corporation rather than directly. In certain circumstances, a private corporation controlled by Canadian residents may not qualify as a CCPC and, therefore, would not be subject to refundable tax on its investment income. The Government is of the view that certain taxpayers have been purposefully taking steps to cause corporations not to be CCPCs for the purpose of avoiding the refundable tax.

Budget 2022 describes examples of the steps a taxpayer may take to avoid CCPC status, including continuing a corporation to a foreign jurisdiction so that it is governed under foreign corporate law while it continues to be resident in Canada (such a corporation would not be a CCPC because the definition of CCPC only includes corporations that are governed under Canadian corporate law) or allowing a non-resident to acquire options to acquire control of the corporation.

In order to counter this perceived manipulation of a corporation's CCPC status, the Substantive CCPC rules introduce a new definition of a "substantive Canadian-controlled private corporation" ("**substantive CCPC**"). Private corporations that are not otherwise CCPCs will be substantive CCPCs if they are controlled, legally or factually, by Canadian resident individuals. A private corporation that would be a CCPC if a non-resident or public corporation did not own options or rights to acquire shares of such private corporation will also be a substantive CCPC.

Substantive CCPCs will be subject to the same refundable tax regime on their investment income as CCPCs. While the objective of the rules is to place a substantive CCPC in the same position as a CCPC with respect to investment income, a substantive CCPC will not be treated as a CCPC for any other purpose. As a result, a substantive CCPC will not be entitled to any of the preferential measures available to CCPCs, such as the small business deduction or the enhanced credit for scientific research and experimental development.

The new definition and related rules will be supported by; (i) a targeted anti-avoidance rule to deal with situations where it is reasonable to consider that one of the purposes of particular arrangements, transactions or series of transactions is to avoid the refundable tax on investment income; and (ii) certain amendments to assist in the administration of the rules that apply to substantive CCPCs. The explanatory notes released along with the draft legislation on August 9, 2022, provide examples of situations where the substantive CCPC definition would or would not apply and situations where the anti-avoidance rule could be applicable. The Substantive CCPC Rules were not included in Bill C-32.

The Substantive CCPC Rules apply to taxation years that end on or after Budget Day, with an exception for taxation years that end as the result of the sale of all or substantially all of the shares of the corporation to an arm's-length purchaser if the purchase and sale agreement was entered into before Budget Day and the sale closes before the end of 2022.

Foreign Accrual Property Income (FAPI) by Controlled Foreign Affiliates of CCPCs

Budget 2022 also proposed rules to prevent the deferral of tax on investment

income earned by a controlled foreign affiliate of a CCPC or substantive CCPC. Draft legislation implementing the proposed rules was released on August 9, 2022.

A Canadian shareholder of a controlled foreign affiliate is, generally, required to include an amount in income in respect of the investment income earned by that controlled foreign affiliate in that year as foreign accrual property income ("**FAPI**"). If the shareholder is a CCPC, FAPI is included in its investment income and subject to the refundable tax mechanisms to prevent a deferral benefit from being achieved by earning the FAPI in a CCPC rather than directly by an individual. The FAPI rules provide a mechanism for avoiding double taxation when the investment income earned by the controlled foreign affiliate is subject to tax in the foreign country. This relieving mechanism works by providing a deduction from the Canadian shareholder's income. The amount of the deduction is computed by multiplying the tax payable in the foreign jurisdiction by a "relevant tax factor". If the shareholder is a corporation, including a CCPC, the relevant tax factor is 4, such that the deduction from income will fully offset the FAPI inclusion if the foreign tax rate is 25% or higher. For other shareholders, including individuals, the relevant tax factor is 1.9, such that if the foreign tax rate is less than 52.63%, the deduction from income will not fully offset the FAPI inclusion.

The Government believes there is a potential for an inappropriate tax deferral on investment income when a CCPC is the shareholder of the controlled foreign affiliate earning such income. That is, if the CCPC earned investment income directly, the income would be subject to the refundable tax regime to prevent any deferral advantage. When the after-tax portion of the investment income is distributed to the shareholder as a dividend, it would be paid as a non-eligible dividend. By contrast, if the CCPC owns shares of a controlled foreign affiliate and the controlled foreign affiliate earns the same investment income in a country with a 25% corporate tax rate, the FAPI inclusion would be offset by the deduction for foreign tax such that there would be no net income at the CCPC level and, as a consequence, none of the investment income would be subject to the refundable tax regime. Further, certain amounts in respect of FAPI are added to a CCPC's general rate income pool which allows those amounts to be distributed to shareholders as eligible dividends.

To eliminate this potential deferral advantage, the draft legislation changes the relevant tax factor for CCPCs, substantive CCPCs, and partnerships one or more members of which are CCPCs or substantive CCPCs to be the same as that for individuals (i.e., 1.9 rather than 4). The draft legislation also includes amendments that are intended to achieve integration when amounts are paid out to individual shareholders since the existing rules will not achieve integration with the new relevant tax factor. The amendments reduce the CCPC's (and substantive CCPC's) general rate income pool by certain amounts and add certain amounts to the capital dividend account of the CCPC (or substantive CCPC) in an attempt to allow the portion of certain after-tax earnings repatriated from a foreign affiliate that had been subjected to a tax rate of 52.63% or higher to flow tax free to an individual shareholder while ensuring income that has been subject to lower rates of tax is subject to the appropriate level of tax on an integrated basis.

These rules apply to taxation years that begin on or after April 7, 2022.

HYBRID MISMATCH RULES

On April 29, 2022, Finance released draft legislation related to the proposals to amend the Act with respect to hybrid mismatch arrangements. The draft legislation released on April 29 is the first of two separate legislative packages intended to implement the recommendations of the BEPS Action 2 Report published by the OECD and G20 countries.

The Hybrid Mismatch Rules implement the recommendations in Chapters 1 and 2 of the BEPS Action 2 Report with respect to hybrid financial instruments and are currently proposed to apply to payments on or after July 1, 2022 despite both an initial delay in release and an indication from the Government that the proposed legislation will be amended to take into account consultations and comments since April 29, 2022.

The Hybrid Mismatch Rules include two main operative provisions:

— A primary operative rule which neutralizes a deduction/non-inclusion mismatch arising from a payment under a hybrid mismatch arrangement by restricting the deduction by the payer; and

— A secondary operative rule which is intended as a defensive rule that neutralizes a deduction/non-inclusion mismatch by including an amount in the income of the payment recipient.

The starting point for determining whether the Hybrid Mismatch Rules will apply is to determine whether there is a deduction/non-inclusion mismatch in respect of a hybrid mismatch arrangement. Very generally, a deduction non-inclusion mismatch arises where either (i) the amount deductible by the payer in computing the payer's income in Canada in respect of the payment exceeds the amount of the inclusion in the payment recipient's "foreign ordinary income" or "Canadian ordinary income" in respect of the payment; or (ii) the amount deductible by the payer in computing the payer's income in a foreign country in respect of the payment exceeds the amount of the inclusion in the payment recipient's Canadian ordinary income or foreign ordinary income in respect of the payment. The Canadian ordinary income and foreign ordinary income concepts are complex. However, these concepts broadly refer to amounts in respect of a payment that is included in respect of a taxpayer's income for Canadian tax purposes (or its taxable income earned in Canada, if the taxpayer is a non-resident) and an entity's income taxable in a foreign country.

The second issue is to determine whether the relevant payment arises under a "hybrid mismatch arrangement". A hybrid mismatch arrangement is defined in the Hybrid Mismatch Rules to mean any of the following three specified types of arrangements (with more categories to be added in the future).

— Hybrid financial instrument arrangement – simplified, where the mismatch arises from differences in the income tax treatment of payments under or in connection with a financial instrument due to the terms or conditions of the instrument.

— Hybrid financial transfer arrangement – simplified, where mismatch results from different entities being treated as the owner of returns on a transferred instrument.

— Substitute payment arrangement – generally, where a payment under, or in connection with, a transfer of a financial instrument functions as a substitute for certain returns on the instrument.

To consider a payment to arise under a hybrid mismatch arrangement, the Hybrid Mismatch Rules generally

require there to be some degree of nexus between the payer and payment recipient (i.e. a relationship test) or that the arrangement itself be considered a structured arrangement. The relationship test generally looks at whether the parties are non-arm's length or whether one party is a specified entity of the other (very generally, 25% of votes or value). There are various factors to consider in assessing whether the arrangement may be considered a structured arrangement; however, a structured arrangement is generally considered to arise where the deduction/non-inclusion mismatch is priced into the arrangement or the arrangement is designed to produce the mismatch.

The Hybrid Mismatch Rules specifically contemplate that the relevant provisions of the Act are to be interpreted consistently with the OECD's recommendations in the BEPS Action 2 Report unless the context specifically requires otherwise. This is the first time the Act will include an interpretive rule specifically requiring provisions of the Act to be interpreted in a manner consistent with an OECD publication.

Although the BEPS Action 2 Report is to be used as an interpretive guide, the Hybrid Mismatch Rules deviate from the OECD's recommendations in the BEPS Action 2 Report in several key ways including:

— providing for a deduction under paragraph 20(1)(yy) where the Hybrid Mismatch Rules restrict a deduction in respect of a payment and the taxpayer demonstrates that an amount has actually been included in income for foreign tax purposes in respect of the payment.

— applying where a foreign country allows an income tax deduction for a notional interest expense in respect of a debt and such deduction results in a deduction/non-inclusion mismatch.

— restricting the ability to deduct amounts under section 113 in respect of dividends from a foreign affiliate to the extent that a foreign income tax deduction in respect of the dividend is available to the foreign affiliate (or certain other entities because they have an equity interest in the foreign affiliate).

These rules are effective with respect to payments made on or after July 1, 2022.

GAAR AMENDMENTS AND CONSULTATION PROCESS

Amendments

Budget 2022 proposed changes to the GAAR in section 245 to overturn the Federal Court of Appeal's decision in Wild, sub nom. 1245989 Alberta Ltd v Canada (Attorney General) (2018 FCA 114). In Wild, the creation of a tax attribute (in that case, paid-up capital) that had not yet been utilized to reduce tax was held not to be a "tax benefit" and, as such, the GAAR could not apply.

Bill C-32 included legislation that will amend the GAAR to allow it to apply to transactions even when the tax attributes have not yet become relevant in computing an item of tax.

— The definition of "tax benefit" is amended to include a reduction, increase

or preservation of an amount that could at a subsequent time; (i) be relevant for the purpose of computing a reduction, avoidance or deferral of tax or other amount payable under the Act; (ii) be relevant for the purpose of computing an increase in a refund of tax or other amount under the Act; or (iii) result in such an effect.

— The definition of "tax consequences" is amended to include an amount that is, or could, at a subsequent time be relevant for the purpose of computing an amount of income, taxable income or taxable income earned in Canada under the Act, or the tax or other amount payable by, or refundable to, a person under the Act.

The proposed amendments apply to any transaction that occurs on or after April 7, 2022 or before April 7, 2022 if a determination under subsection 152(1.11) in respect of such transaction is made on or after such date.

GAAR Consultation

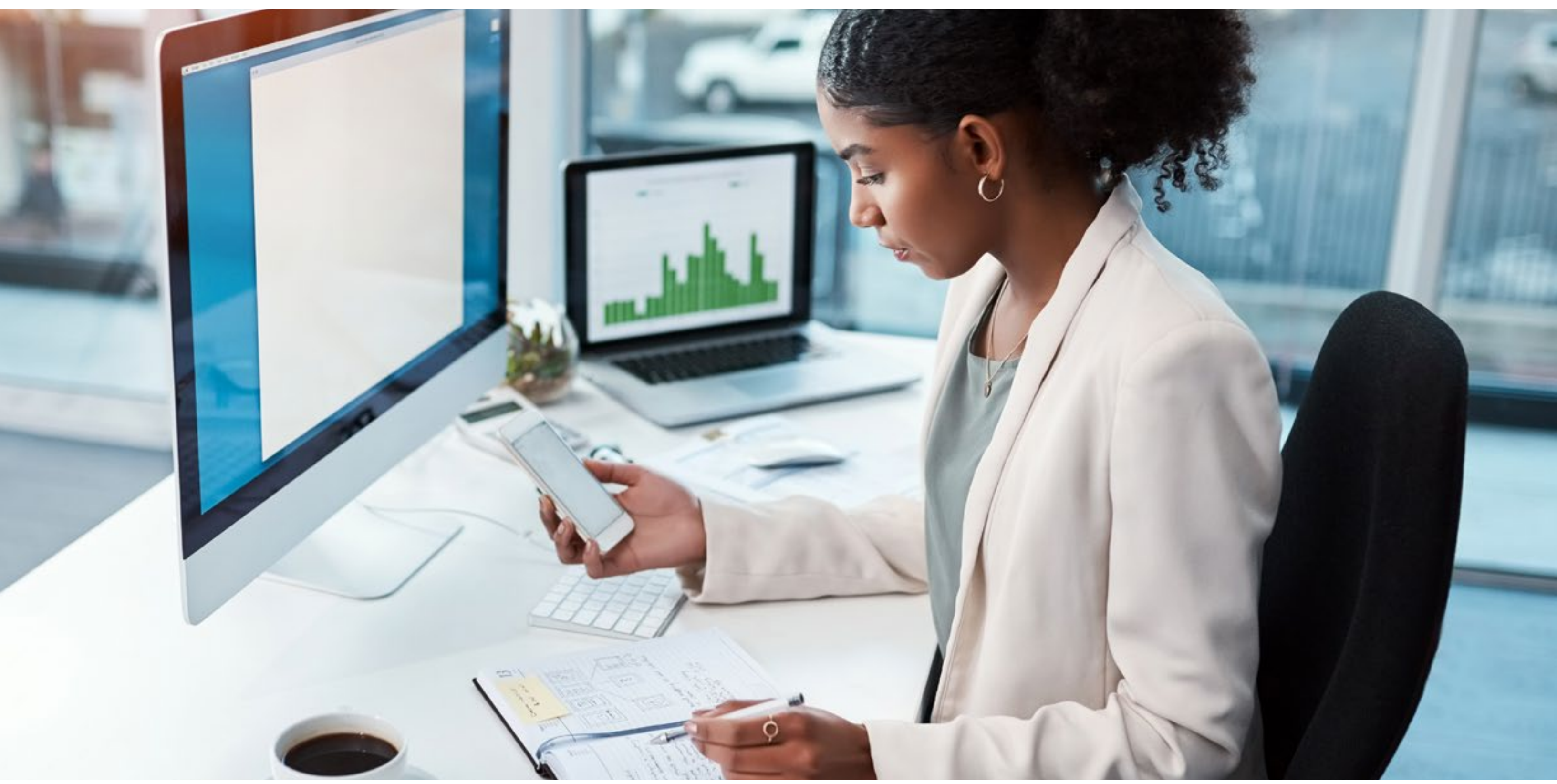
On August 9, 2022, the Government released a consultation paper seeking feedback on specific proposals to modernize and strengthen the GAAR ("**GAAR Paper**"). The Government announced a formal consultation period between August 9, 2022 and September 30, 2022. A detailed review of the GAAR Paper is beyond the scope of this summary, however, two points are particularly salient.

First, the Government expresses dissatisfaction in how the Supreme Court of Canada interprets the misuse and abuse requirement in subsection 245(4) in *Canada Trustco Mortgage Co. v Canada* (2005 SCC 54). Second, to enhance the deterrent effect, the Government proposes various penal provisions.

Reversing Canada Trustco

Per the Supreme Court in Canada Trustco, subsection 245(4) first requires the Court to determine the object, spirit and purpose of the specific provisions at issue. An overarching policy not grounded in the specific provisions at issue cannot give rise to abuse. Similarly, economic substance is relevant only to the extent the specific provisions at issue say it is. Once an underlying policy of the provisions is identified, the Court considers whether the transactions frustrate or defeat this underlying policy. If an abuse is unclear, the taxpayer must succeed. The onus on establishing an abuse is on the Government.

The Government laments the interpretation of 245(4) in Canada Trustco in three respects. In the Government's opinion: (i) it gives very little weight to general schemes of the Act in establishing the relevant underlying policy; (ii) it places the onus of establishing "clear" abuse on the Government; and (iii) it does not sufficiently consider the economic substance of the transactions.



The Government proposes to amend subsection 245(4) to ensure general schemes of the Act are given more weight in establishing the relevant policy subject to abuse. The introductions of preambles and other interpretive rules stating the purpose of certain provisions is also considered.

The Government also proposes to shift the burden to the taxpayer to show that the tax benefit achieved is consistent with the relevant underlying policies. This shift could be for all cases, or only in limited circumstances. For example, the burden may only shift to the taxpayer if the transactions lack economic substance.

Most notably, the Government intends to integrate an "economic substance" rule into the GAAR.

The Government considers various ways of defining economic substance without stating a preference for one method over another. These include by reference to the "pre-tax profit" realized on the transactions, by reference to the economic positions of the participants, and by reference to a mismatch between accounting and tax treatment.

Approaches considered for integrating economic substance into the GAAR include amending subsection 245(4) to direct courts to always consider economic substance in the abuse analysis, and adding a standalone deeming rule such that when the transactions lack economic substance certain consequences are deemed to follow.

Finally, the Government considers the consequences if a lack of economic substance is found. Alternatives include deeming the transaction to be abusive, and applying a more stringent abuse test.

Penalties

The Government notes that when GAAR applies, it only seeks to deny the tax benefit sought. The economic downside of GAAR applying generally consists of advisory fees and interest on the taxes owing, whereas the upside of creative tax planning is limited only by the amount of the taxpayer's tax otherwise payable, which can be substantial.

To enhance the deterrent effect, the Government solicits feedback on various penal provisions including a proposal to have an automatic penalty equal to between 10% and 100% of the tax benefit sought.

As a practical matter, the introduction of penalties would likely have a significant chilling effect on creative tax planning.

OTHER TAX PROPOSALS AND TECHNICAL AMENDMENTS

Other key new proposals and draft legislation implementing previously announced proposals in 2022 include the following.

— ***Interest Coupon Stripping:*** Budget 2022 proposed new Part XIII anti-avoidance rules to address certain variations of interest coupon stripping arrangements not previously caught by the existing rule in subparagraph 212(1)(b)(i). Under an interest coupon stripping arrangement, a non-resident lender makes an interest-bearing loan

to a non-arm's length Canadian-resident borrower and sells the right to receive interest payments (interest coupons) in respect of such loan to a person who would not be subject to Part XIII withholding tax, or would be subject to a lower rate of withholding tax than would apply to a payment directly to the non-resident lender. Subparagraph 212(1)(b)(i) is intended to prevent certain interest coupon stripping arrangements from achieving a reduction in the applicable withholding tax rate. Subparagraph 212(1)(b)(i) generally provides that interest that is paid or payable "in respect of" a debt or other obligation to pay an amount to a non-arm's-length person is subject to Part XIII withholding tax. As such, where a non-arm's-length, non-resident lender makes an interest-bearing loan to a Canadian resident and sells the interest coupons to an arm's-length person, subparagraph 212(1)(b)(i) causes the interest payment to remain subject to withholding tax because the interest is in respect of a debt owing to a non-arm's-length non-resident. However, the rule does not apply to payments to a Canadian resident or override the Canada-U.S. tax treaty, such that an interest coupon stripping arrangement where a non-resident, non-U.S. lender sells the interest coupons to a U.S.-resident person entitled to the benefits of that treaty or to a Canadian resident may still be effective in reducing (or eliminating) the withholding tax applicable to the payment. The new anti-avoidance rule proposed in Budget 2022 is intended to ensure that, in general terms, any Part XIII tax paid under an interest coupon stripping arrangement is the same as if the arrangement had not been undertaken and the interest had been paid to the non-resident lender. The proposed rules apply to a Canadian resident borrower in respect of interest that is paid or payable to an interest coupon holder if the interest accrues on or after April 7, 2022, subject to a limited grandfathering rule of one year for certain existing arrangements.

— ***Investment Tax Credit for Carbon Capture, Utilization and Storage ("CCUS"):*** Budget 2022 contained a proposal for a new refundable investment tax credit ("**CCUS ITC**") to encourage investment in CCUS project development. The CCUS ITC is proposed to apply to eligible expenses incurred to acquire equipment used solely to capture, transport, store or use CO2 as part of a qualifying CCUS project after 2021 through 2040. The rate of the CCUS ITC depends on the type of expense and the period of time in which the expense is incurred. Between 2022 and 2030, the CCUS ITC rate will range between 37.5% to 60% of eligible expenditures, with expenses related to capture equipment used in the capture of CO2 directly from ambient air being eligible for the highest rate of 60%, expenses related to capture equipment used in non-ambient air projects being eligible for the 50% rate, and expenses for eligible transportation, storage and use equipment being eligible for the 37.5% rate. Between 2031 and 2040, the CCUS ITC rates will be one-half of the rates for 2022 to 2030. The August 9th package included draft legislation for the CCUS ITC; however, the legislation has yet to be introduced in Parliament and, as such, changes to the CCUS ITC regime may still yet occur.

— ***Investment Tax Credit for Clean Technologies and Hydrogen:*** In response to tax incentives introduced under the Inflation Reduction Act in the United States, the Fall Economic Statement included a proposal for new refundable investment tax credits of up to 30% for investments in clean technologies and at least 40% for investments in clean hydrogen production. The Government also announced that it will launch a consultation on how to implement the refundable investment tax credit for clean hydrogen. These investment tax credits will be available for eligible investments made as of the day of Budget 2023. Draft legislation in respect of these measures are yet to be released.

— ***Subsections 212(13.1) and (13.2):*** The August 9, 2022 package of draft legislation included amendments that significantly expand the potential application of subsections 212(13.1) and (13.2).

Subsection 212(13.1) provides certain deeming rules to cause payments to or from partnerships to be subject to Part XIII withholding tax. Generally, current paragraph 212(13.1)(a) deems a partnership to be a person resident in Canada (imposing withholding and remittance obligations) where the partnership pays or credits an amount to a non-resident person to the extent the amount paid or credited is deductible to the partnership in computing its Canadian source income. Proposed paragraph 212(13.1)(a) deems a partnership to be a person resident in Canada where the partnership pays or credits an amount to a non-resident person to the extent the amount is deductible in computing a partner's share of partnership income or loss under Part I of the Act. As a result, a partnership with no Canadian source income (or activity in Canada) could be subject to withholding and remittance obligations under Part XIII if one of its partners is a Canadian resident to the extent of the portion of the payment that is deductible by the Canadian resident partner in computing income under the Act.

Currently, subsection 212(13.2) deems a non-resident person to be a person resident in Canada (imposing withholding and remittance obligations) where the non-resident person pays or credits an amount to another non-resident person to the extent the amount paid or credited is deductible in computing the person's taxable income earned in Canada from a source that is not a treaty-protected business or property. Proposed subsection 212(13.2) is expanded to (a) apply to payments by a non-resident person to a partnership (other than a Canadian partnership) and (b) apply to a non-resident that has filed an election under section 216.

These amendments significantly expand the breadth of situations to which subsection 212(13.1) and (13.2) could apply. The effective date of the amendments to subsection 212(13.1) (and related amendments) is not known. The amendments to subsection 212(13.2) are effective to amounts paid or credited after 2022. It is understood the Government is considering narrowing the potential application of subsection 212(13.1) given as currently drafted it could apply to partnership with no activity in Canada that has one minority Canadian resident partner.

— ***Tax on Share Buybacks:*** A 2 percent tax on Canadian public corporations that undertake share buybacks was proposed in the Fall Economic Statement. No legislation has been released, but additional details of the tax are expected to be included in Budget 2023. The tax is stated to come into force on January 1, 2024.

— ***BEPS 2.0 – Pillars One and Two:*** The Government confirmed in the Fall Economic Statement its commitment to Pillar One (Reallocation of Taxing Rights) and Pillar Two (Global Minimum Tax). The Fall Economic Statement notes that the Inclusive Framework intends to complete multilateral negotiations so that a treaty to implement Pillar One can be signed in the first half of 2023, with a view to it entering into force in 2024. No timing update was included in respect of Pillar Two.

Numerous other previously announced tax and related measures and technical amendments were included in the August 9th package. The Government confirmed in the Fall Economic Statement that it intends move forward with these measures "as modified to take into account consultations and deliberations since their release". The list of enumerated measures includes the following:

— Reporting Requirements for Registered Retirement Savings Plans (RRSPs) and Registered Retirement Income Funds (RRIFs)

— Clean Technology Tax Incentives – Air-Source Heat Pumps

— Critical Mineral Exploration Tax Credit

— Flow-Through Shares for Oil, Gas and Coal Activities

— The Small Business Deduction

— International Financial Reporting Standards (IFRS 17)

— Hedging and Short Selling by Canadian Financial Institutions

— The Application of the General Anti-Avoidance Rule to Tax Attributes

— Electronic Filing and Certification of Tax Information Returns

— Electronic Payments

— Enhanced Reporting Requirements for Trusts

— Avoidance of Tax Debts

See our Firm's commentary on Budget 2022 and the Fall Economic Statement for background information on these newly proposed measures.

INCOME TAX CASES

In this section, we review the following decisions of the Supreme Court of Canada ("**SCC**"), Tax Court of Canada

("**TCC**") and Quebec Court ("**QC**"):

— *Canada v. Collins, 2022 SCC 26 ("**Collins**");*

— *Thinaddictives Inc. v. Quebec Revenue Agency,* 2022 QCCQ 3029 *("**Thinaddictives**"); and*

— *3295940 Canada Inc. v. Her Majesty the Queen, 2022 TCC 68 ("**3295**").*

Collins - Supreme Court confirms limit to correcting tax mistakes

Six years ago, the Supreme Court of Canada ruled in *Fairmont*[1] and *Jean Coutu*[2] that transactions previously entered into could not be modified to achieve the parties intended tax result through judicial rectification. In *Collins*, the Supreme Court confirmed that the same principle applies to all other equitable relief against mistakes, including rescission.[3] Incomplete or erroneous legal documentation can still be corrected after the fact, provided compelling evidence as to the parties' original intent can be presented.[4]

For Canadian tax purposes, it is well established that the legal substance of transactions freely agreed upon prevails.[5] Absent a sham, agreements validly entered into have to be respected, even if they lack economic substance.[6] Here, the Supreme Court emphasized that consequently, taxpayers must also be subject to the tax consequences resulting from their decisions, even if they appear ill-considered in hindsight.[7] Equitable relief turns on what the taxpayer can prove that it agreed to do, not on whether the taxpayer or the CRA has obtained a "windfall".[8]

Facts and Decision

The transactions in issue were designed to take advantage of subsection 75(2),[9] an anti-avoidance provision targeting income splitting through a trust. It operates by attributing the trust's income from a property back to its original transferor, notably in circumstances where that property can revert to the transferor. In such context, the expected tax consequence was that dividends paid to the trust be included in the income of the transferor of those shares, another Canadian corporation which was also a beneficiary of the trust. It would then have been entitled to claim a full deduction in respect of the attributed inter-corporate dividends pursuant to subsection 112(1).

The parties' expectations as to the applicable tax consequences were based on guidelines issued by the CRA. At the time, the CRA's published position was that subsection 75(2) attributed property income back to the transferor, whether the property in question was gifted or sold at its fair market value to the trust. In a case released after the taxpayer completed the transactions at issues, the Tax Court released its decision in *Sommerer* in which it concluded that transfers at fair market value transfers were outside of the ambit of subsection 75(2).[10] As a result, the CRA changed its administrative position in respect of subsection 75(2).[11]

1 *Canada* v. *Fairmont Hotels*, 2016 SCC 56 (***"Fairmont"***).

2 *Canada* v. *Jean Coutu Group*, 2016 SCC 5 (***"Jean Coutu"***).

3 *Collins*, para 22

4 *Collins*, para. 16, referring to *Fairmont* (see paras. 14, 24 and 38), and *Jean Coutu* (see paras. 41, 44 and 48).

5 *Shell Canada Limited* v. *Her Majesty the Queen*, [1999] 3 S.C.R. 622, para. 39.

6 *Stubart Investments Ltd.* v. *Her Majesty the Queen*, [1984] 1 S.C.R. 536, pp. 540 and 575-576.

7 *Collins*, para. 13.

8 *Collins*, para. 14.

9 All references to legislative provisions in the present text are to the *Income Tax* Act (Canada).

10 *Her Majesty the Queen* v. *Sommerer*, 2012 FCA 207, paras. 47-49 and 57 (***"Sommerer"***).

11 CRA Views 2013-0480351C6, "STEP CRA Roundtable Q9", June 11, 2013 and CRA Views 2013-0495721C6, "APFF 2013 – Round Table Question 7", October 11, 2013.

Although the taxpayer (and the CRA) did not anticipate the impact Sommerer would have on subsection 75(2)'s ambit and the transactions undertaken, the majority found that there is nothing unfair about the tax authorities administering the law as it stands.[12] Equitable remedies are not available to prevent its ordinary application to agreements freely agreed upon.[13]

In her dissent, Justice Côté emphasized that the very purpose of rescission is to relieve from all types of mistakes (but not from mere ignorance or "misprediction").[14] Justice Côté characterized the taxpayer's mistake as a "mistake of law and not a misprediction in relation to a change in law". The taxpayer assumed that the CRA could not retroactively change its position and in that respect, made a mistake which does not amount to a legal misprediction and the dissent decision concluded that rescission was available to remedy the taxpayer's mistake about the law.[15]

When Can Mistakes Be Corrected?

In light of the recent Supreme Court decisions, no equitable remedy is available to relieve taxpayers from the unexpected application of Canadian tax laws. The same conclusion applies, regardless of whether the relevant regime was overlooked or misinterpreted. The correction of mistakes remains available where the parties are in a position to prove the existence of a definite and ascertainable agreement, which is not accurately reflected in their documentation:[16]

> *[…] The point, again, is that rectification corrects the recording in an instrument of an agreement (here, to redeem shares). Rectification does not operate simply because an agreement failed to achieve an intended effect (here, tax neutrality) – irrespective of whether the intention to achieve that effect was "common" and "continuing".*[17]

Such agreement could arguably relate to a specific tax component that was correctly anticipated,[18] but clearly not to a general goal to achieve tax neutrality.

It will be interesting to monitor whether Canadian courts will be deferential in respect of rectification or rescission validly completed under foreign laws. Recently, the Supreme Court of British Columbia stated that there is no obvious reason why an annulment, valid and enforceable under foreign law, would not be respected by a Canadian Court.[19] Although such foreign equitable remedies do not necessarily bind the Canadian tax authorities, the Federal Court of Appeal has also previously indicated that their grant would represent a relevant fact that would have to be considered in a Canadian tax litigation context.[20]

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[12] *Collins*, para. 7.
[13] *Collins*, para. 22.
[14] *Collins*, paras. 49 and 56.
[15] *Collins*, paras. 71-72, 80 and 93.
[16] *Fairmont*, para. 38, *Jean Coutu*, paras. 23-24 and *Quebec (Agence du revenu)* v. *Services Environnementaux AES Inc.*, 2013 SCC 65, paras. 53-54.
[17] *Fairmont*, para. 30.
[18] For example, the specific intent that the transfer of a property be realized at an amount corresponding to its cost, or to distribute precisely the outstanding balance of an available tax pool.
[19] *Kraft Heinz Canada ULC* v. *Canada*, 2022 BCSC 796, paras. 20-21 (***"Heinz"***).
[20] *Canadian Forest Navigation Co.* v. *Her Majesty the Queen*, 2017 FCA 39, paras. 15 and 19-20. See also *Heinz*, para. 42.

THINADDICTIVES - AMOUNT MISTAKENLY RECORDED AS DEBT AND NOT CAPITAL CONTRIBUTION DOES NOT BIND TAXPAYER

In *Weisdorf*,[21] Chief Justice Bowman held that accounting entries do not create reality, but instead, are intended to reflect reality. The Quebec Court applied that principle in *Thinaddictives* in concluding that an accounting error (recording a capital contribution as debt) should not be binding for tax purposes. [22]

Thinaddictives concerned denied interest expenses resulting from the application of the "thin-capitalization rule". In general, similar to the Act, the Taxation Act (Quebec) (the "Taxation Act") imposes a limit on a corporation's ability to deduct interest paid or payable on outstanding debts to non-residents in computing the corporation's income for a taxation year. A corporation is unable to deduct such interest expenses where its debt-to-equity ratio exceeds the allowable limit of 1.5:1.[23]

Facts

The taxpayer was a wholly owned subsidiary of a non-resident corporation. In January 2012, the taxpayer acquired the assets of another corporation. A large portion of the purchase price was paid by its foreign parent on its behalf. The taxpayer's accountant recorded this amount as debt advanced by the foreign parent to the taxpayer. Such amount was also reflected on the taxpayer's Quebec income tax returns as debt, such that it impacted its debt-to-equity ratio for its 2012 to 2015 taxation years.

The accountant testified that the amount should have been recorded as equity, and not debt, and when he became aware of the error, he promptly took steps to correct the error. The legal and tax advisors involved in the asset acquisition testified the amount was intended to be equity. Further, an expert witness analyzed the characteristics of the amount and concluded that it did not have the characteristics of debt.

Decision

The Court reviewed how accounting errors were treated in other contexts under the Act. From previous decisions, courts have accepted that an honest accounting error does not give rise to taxation.[24] Further, decisions including Weisdorf held that taxation is based on what happened and not on accounting entries.[25]

Evidence Required to Demonstrate Accounting Mistake

The taxpayer was successful as it was able to prove that the accounting entry was not reflective of what actually took place. The evidence that supported the taxpayer's position included witness testimony and, in particular, the "clear and precise testimony" of its accountant.[26] Such evidence could be difficult to obtain in practice due to potential professional liability issues.

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[21] *Weisdorf* v. *The Queen*, [1993] 2 CTC 2756 (TCC) ("Weisdorf").

[22] *Thinaddictives*, para. 84 to 86.

[23] See sections 169 and 170 of the Taxation Act.

[24] *Thinaddictives*, para. 49 to 53. See, for example, *Chopp* v. *Canada*, [1995] 2 CTC 2946 (TCC); aff'd [1998] 1 CTC 407 (FCA) and *Long* v. *Canada*, [1998] 1 CTC 2995 (TCC).

[25] *Thinaddictives*, para. 58 to 60.

[26] *Thinaddictives*, para. 76 and 77.

3295 - NOT ALL ALTERNATIVE TRANSACTIONS ARE RELEVANT FOR THE PURPOSES OF THE GAAR ABUSE ANALYSIS

In *3295*, the Tax Court of Canada decided that the GAAR applied to the circumvention of subsection 55(2) on a cross-redemption of shares. The plan involved circulating the capital dividend account ("CDA") of a parent company to its subsidiary (on the first redemption), then back to the parent (on the second redemption). Through such "CDA recycling", the parent company indirectly obtained a bump of its subsidiary's low basis shares prior to their sale in a context where paragraph 88(1)(d) was otherwise unavailable.[27] The decision has been appealed to the Federal Court of Appeal.

Summary of Findings

The facts of this case are complex. In essence, the parent formerly operated a pharmaceutical business[28] and the purchaser wanted to acquire a subsidiary of the parent rather than the shares of the parent in which the shareholders had relatively high adjusted cost base. The plan allowed the parent to sell the shares of the subsidiary and obtain similar tax consequences to those that would have resulted from the sale of the parent company shares.

The Court concluded that the purpose of the CDA regime is to trace corporate surpluses that can be distributed tax free to shareholders. In the present case, the CDA regime did not allow the tracing of surpluses towards the top of the corporate structure: a CDA balance was artificially circulated in a corporate group back to its original starting point. The application of subsection 55(2) was avoided in the process as capital dividends are not targeted by that provision.[29]

The Court also found that no double taxation resulted from the fact that the taxpayer was not able to benefit from the cost in its own shares as part of the sale of its assets.[30]

Relevance of Alternative Transactions for the GAAR Analysis

It is well-established that alternative transactions can be relied on to demonstrate the presence of a tax benefit.[31] More recently, their potential relevance as part of the abuse analysis was confirmed in *Univar*.[32]

> *In GAAR cases the issue is whether the taxpayer has abused the provisions of the ITA. In my view, these alternative transactions are a relevant factor in determining whether or not there has been an abuse of the provisions of the ITA. If the taxpayer can illustrate that there are other transactions that could have achieved the same result without triggering any tax, then, in my view, this would be a relevant consideration in determining whether or not the avoidance transaction is abusive.*[33]

[27] *3295*, para. 131, 136 and 143.

[28] *3295*, para. 12 and 13.

[29] *3295*, para. 120 and 121.

[30] *3295*, para. 144.

[31] When the existence of a tax benefit is not clear, the fact that a taxpayer reduced, avoided or deferred tax payable has to be established by comparison with an alternative arrangement. See *Canada Trustco Mortgage Co.* v. *Canada*, 2005 SCC 54, para. 20.

[32] *Univar Holdco Canada ULC* v. *The Queen*, 2017 FCA 207 ("Univar"), which overturned *Univar Holdco Canada ULC* v. *R.*, 2016 TCC 159 ("***Univar TCC***"). See also more recently *Fiducie Financière Satoma* v. *Canada*, 2018 FCA 74, para. 59 and 60.

[33] *Ibid.*, para. 19.

In 3295, the Court refused to consider the sale of the parent corporation (which would have triggered less tax) as a relevant alternative to the sale of its subsidiary for the purposes of the abuse analysis: the object of the sale, the price and the commercial consequences would all have been different.[34] It is worth specifying that in Univar, the alternative transaction accepted by the Court involved the transfer of the same corporate entities.[35]

In the case at hand, the Court did confirm that the fact that the purchaser did not want to acquire the parent corporation because of its contingent liabilities was not relevant in and of itself to the abuse analysis.[36] However, the Court stated that the fact that an alternate scenario could not be implemented due to factual circumstances of a transaction or reorganization does not prevent a court from considering the alternative transaction in its determination of whether the transaction or reorganization undertaken is abusive.[37]

In conclusion, alternative transactions should remain relevant to the GAAR analysis, even when merely theoretical. Taxpayers should ensure that the alternative transactions relied on are equivalent commercially, and that they provide further illustration as to the reasonable tax consequences applicable to them.

COMMODITY / INDIRECT TAX – LEGISLATION

Legislative developments in 2022 have continued apace for Canadian commodity tax including the enactment of the new federal luxury tax as well as a series of amendments to the goods and services tax / harmonized sales tax ("**GST/HST**") imposed under the *Excise Tax Act* (Canada), Quebec sales tax ("**QST**"), the provincial sales tax ("**PST**") of British Columbia and Saskatchewan, and retail sales tax ("**RST**") of Manitoba.

Federal Luxury Tax

As proposed in Budget 2021 and effective September 1, 2022, the *Select Luxury Items Tax Act*, SC 2022, c 10, s 135 ("***Luxury Tax Act***"), imposes a luxury tax on the sale and importation of subject vehicles and subject aircraft exceeding a price threshold of $100,000, and subject vessels exceeding a price threshold of $250,000. Unlike the GST/HST but similar to certain excise taxes and duties, vendors are not responsible for the collection and remittance of the tax but rather must generally pay the luxury tax themselves, subject to limited exceptions. As a result, to recover the cost of the tax, vendors need to factor the tax into the sale of subject items. The amount of the tax is generally calculated on the lesser of 10% of the "taxable amount" of the subject item and 20% of the excess of the "taxable amount" over the price threshold for the subject item. The "taxable amount" of a subject item in a sale will generally be the value of consideration for the sale plus the value of improvements to the subject item. On import the taxable amount is the value of the subject item plus certain duties and taxes. The "taxable amount" can be subject to other methods of calculation and adjustment in certain circumstances.

[34] *3295*, para. 159, 160 and 161.

[35] For the relevant facts, see *Univar TCC*, para. 17, 52, 53, 104 and 105.

[36] *3295*, para. 113. This was precisely the case in *Univar*.

[37] *3295*, para. 156 and 157.

Certain exemptions to the luxury tax are available. For instance, the following are not subject to the luxury tax:

- aircraft, vehicles and vessels manufactured in 2018 or earlier;
- aircraft, vehicles and vessels registered with a government before September 2022 and in respect of which a user has taken possession before September 2022;
- recreational vehicles intended to provide temporary residential accommodations meeting certain conditions and floating homes as defined in subsection 123(1) of the Excise Tax Act;
- certain military and police vehicles and aircraft;
- certain vessels used for commercial fishing or the ferrying of passengers; and
- vehicles exceeding a gross vehicle weight rating of 3,856 kg.

Additionally, the *Luxury Tax Act* is generally intended to apply only once to a subject item. If an "exemption certificate" or "tax certificate" is effective and associated requirements are met in respect of a subject item, the tax will not apply.

In August 2022, the *Select Luxury Items Tax Regulations* were introduced, and include prescribed circumstances

where an exemption certificate can apply in respect of a sale of a subject aircraft that is to be exported; an exemption from reporting obligations for certain registered vendors of subject vehicles; and an exemption from the luxury tax in certain cases where a written agreement was entered into prior to 2022.

The *Luxury Tax Act* creates compliance obligations that are important for vendors of subject items to be aware of, as noteworthy penalties exist for non-compliance, including failure to comply with the registration and filing requirements.

August 9, 2022 Legislative and Regulatory Proposals

On August 9, 2022 (the "**Announcement Date**"), the Department of Finance released legislative and regulatory proposals alongside explanatory notes to amend the *Excise Tax Act* (the "**Amendments**"). The Amendments may impact a variety of registrants from financial institutions to registrants engaged exclusively in commercial activities.

Amendments Affecting Pension Entities and other Financial Institutions

The Amendments propose to expand the application of the rule under sebsection 149(4) to partnerships. As a result, partnerships receiving interest or dividends from certain corporations that are either controlled controlleddirectly or indirectly by the partnership will no longer need to include such revenue in the calculation of their "financial revenue" for purposes of determining whether they are a de minimis financial institution under paragraphs 149(1)(b) and (c). New subsection 149(4) applies to taxation years that begin after the Announcement Date.

A number of amendments to, among other provisions, sections 172.1, 232.02 and 261.01, are proposed in order to resolve an issue that arose in situations where an employer that failed to charge the correct amount of tax in respect of a supply (or deemed supply) it made to a pension entity is assessed by the Minister for such failure and the assessment relates to a supply that was made by the employer during a reporting period for which the pension entity can no longer claim a pension rebate.

The Amendments also added paragraph (k.2) to the definition of "permitted deduction" in section 217 of the ETA. New paragraph (k.2) will allow a "qualifying taxpayer" (e.g., a financial institution resident in Canada), under certain conditions, to deduct in calculating the amount of "qualifying consideration" on which it is required to self-assess, an amount that represents consideration for a supply deemed under subsection 150(1) to be a supply of a financial service.

The Amendments also include several amendments to the Selected Listed Financial Institutions Attribution Method (GST/HST) Regulations (the "**SLFI Regulations**"). Perhaps the most significant of the proposed amendments relates to the introduction of a "ranking system" to determine the provinces in which a financial institution is deemed under section 3 of the SLFI Regulations to have a permanent establishment in circumstances where the financial institution may qualify as more than one type of financial institution (e.g., bank and insurer, bank and loan corporation, loan corporation and investment plan). This amendment not only may affect a financial institution's status as a selected listed financial institutions andinstitution, but also clarifies the rules applicable to the financial institution in determining its net tax pursuant to the special attribution method, or "SAM".

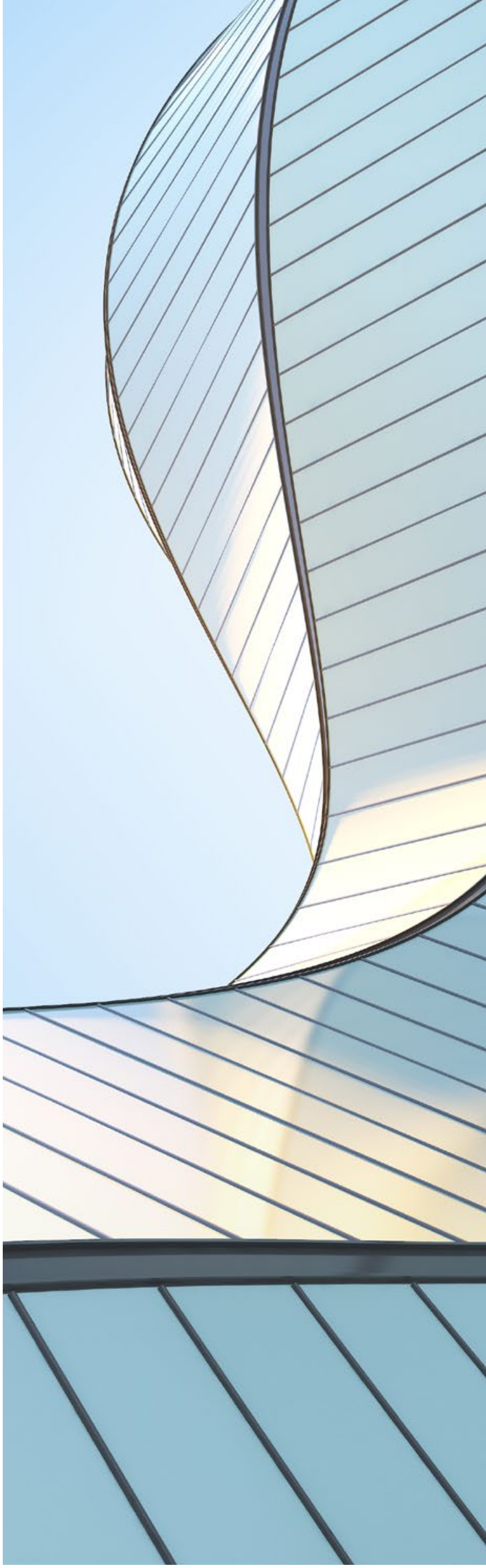
The Amendments increase the threshold amount for a person to qualify as a "reporting institution" for purposes of section 273.2 from $1,000,000 to $2,000,000, which could result in several financial institutions no longer being required to file an annual information return. This amendment applies in respect of fiscal years of a person that end after the Announcement Date.

Finally, the Amendments contain other proposals including rules to specifically account for Lloyd's associations (unincorporated associations who issue insurance), rules respecting the revocation of section 150 elections for exempt supplies between members of a closely related group, and amendments to the SLFI Regulations respecting "qualifying private investment plans" that modify the exceptions to the definition of a "prescribed financial institution" for purposes of paragraph 225.2(1)(b).

Amendments to Certain GST/HST Elections

Section 156 of the Excise Tax Act allows, in certain situations, entities in a closely related corporations and Canadian partnerships that form a "qualifying group" to treat taxable supplies between them as having been made for nil consideration. The Amendments to section 156 solve an issue that arose where two corporations resident in Canada that would otherwise be entitled to make the election were unable to do so because they were closely related through a non-resident partnership. As a result, the two corporations could not form a "qualifying group" as defined under subsection 156(1) and thus could not qualify for the election. As a result of the Amendments, two Canadian resident corporations closely related through a non-resident partnership may now make the election if the other conditions for the election are satisfied.

The existing election under section 273 of the *Excise Tax Act* allows the participants in a joint venture engaged in prescribed activities to make an election that allows one of the participants to act as operator and undertake on behalf of the other participants most of the GST/HST obligations associated with the joint venture. The Amendments propose to expand the scope of prescribed activities for which the election can be made to include the operation of a pipeline, rail terminal, or truck



terminal for the transportation of oil, natural gas, or related or ancillary products. In addition to this narrow expansion of prescribed activities under the relevant regulations, Budget 2022 confirmed the government's continuing intention to proceed with measures first announced in 2014 to broaden the range of prescribed activities to encompass all commercial activities.

GST/HST and Cryptoasset Mining

In the draft legislation released on February 4, 2022, Finance announced measures relating to cryptoasset mining activities which, once enacted, will be deemed to have come into force on February 5, 2022. Under the draft legislation, cryptoasset mining activities are excluded from the general GST/HST regime. As of the effective date of the proposed rules, the provision of a "mining activity" and the payment of a property or service in return will generally be deemed not to be supplies. Any acquisition, importation, use, or consumption of property or services by a person in the course of or in connection with a "mining activity" will, in general, be deemed to occur otherwise than in the course of commercial activities, which will effectively prevent the person from claiming input tax credits to recover GST/HST paid on inputs to the activity.

GST/HST Rules for Health Care Rebate and Assignment Sales from Budget 2022

The most notable GST/HST measures announced in Budget 2022 include the expansion of the health care rebate and the deeming of "assignment sales" to be taxable supplies of real property.

The existing GST/HST health care rebate allows hospitals to claim an 83% rebate and charities and non-profit organizations a 50% rebate of the GST and federal component of the HST paid on property and services used in their exempt activities. Effective April 7, 2022, for periods ending after that date in respect of tax paid or that became payable after that date, eligibility for this rebate is expanded by the elimination of the distinction between health care services rendered by physicians and nurse practitioners in non-remote areas. Charities and non-profit organizations can now claim this rebate with respect to healthcare services delivered with the active involvement of, or on the recommendation of, either a physician or a nurse practitioner, irrespective of their geographic location.

With respect to real property, assignment sales (i.e., the sale of a pre-existing purchase agreement prior to Closing) of new or substantially renovated residential housing entered into on or after May 7, 2022 are now taxable supplies of real property for GST/HST purposes. The new rules only apply with respect to single unit residential complexes or condominium units.

Cannabis Duty and Vaping Duty Amendments

Effective April 1, 2022, licensed cannabis producers who are required to remit $1,000,000 or less in excise duties in the four preceding quarters can now remit duties on a quarterly basis. Budget 2022 also announced measures which come into force upon receiving Royal Assent, including (i) newly permitted transactions between licensed producers who enter into a CRA-approved contract-for-service arrangement and (ii) licence exemptions for holders of a Health Canada-issued Research Licence or a Cannabis Drug Licence.

Further amendments were proposed in August 2022, including amendments that facilitate the stamping of cannabis products by a licensee other than the licensee who enters the cannabis product into the duty-paid market, and amendments to the transitional

rules for vaping products to address situations where a manufacturer or importer of vaping products could be incorrectly held liable for duties for vaping products that were legally sold prior to January 1, 2023.

The 2022 Fall Economic Statement proposed a variety of other amendments including those specifying whether and when the ad valorem or flat rate duty is payable for cannabis products (e.g., when the calculation of both duties was equal) and by whom the duty is payable, specifying what information must be printed on the package of a vaping product that is entered into the duty-paid market, and expanding who can possess cannabis duty stamps to include certain persons who are party to an authorized service agreement to affix the stamps to the packaged cannabis product.

QST Harmonization for Investment Limited Partnerships

Quebec is implementing changes to the QST regime to harmonize the QST rules with those enacted at the federal level on September 8, 2017 relating to investment limited partnerships. New section 345.8 of *An Act* respecting the Quebec sales tax, which is deemed to come into force on September 8, 2017, provides that the general partner of an "investment limited partnership" ("**ILP**") that renders a management or administrative service to the ILP is deemed not refundsto have done so as a member of the ILP and the supply by the general partner to the ILP of the service is deemed to have been made otherwise than in the course of the ILP's activities (Similar to subsection 272.1(8) of the Excise Tax Act). New subsection 345.3(1.1) stipulates that the management or administrative service provided by the general partner of an ILP to the ILP is deemed to have been for consideration equal to the fair market value of such service.

Other QST Proposals and Harmonization Measures

Quebec announced other legislative amendments for commodity tax matters, most notably including:

- Harmonization with the GST/HST rules on "virtual payment instruments" that were enacted on June 29, 2021 with an effective date of May 17, 2019. At a high level, cryptocurrencies that fall within the definition of "virtual payment instruments" are also considered to be financial instruments for QST purposes. The supply of a financial instrument is an exempt supply and a supplier is not required to charge and collect QST on exempt supplies of financial instruments.
- Harmonization with the GST/HST amendments relating to cryptoasset mining, assignments of residential real property and the health care rebate (Information Bulletin 2022-3 and Information Bulletin 2022-4); and
- Amendments consequential to the changes to the definition of "prescribed sleeping-accommodation establishments" in the Tourist Accommodation Regulation for the purposes of the tax on lodging (Information Bulletin 2022-5).

British Columbia Rules for Electronic Commerce and Marketplace Facilitators

In the British Columbia ("**BC**") Budget and Fiscal Plan 2022 ("**BC Budget 2022**"), released on February 22, 2022, the province announced it would amend the *Provincial Sales Tax Act* (the "**PSTA**") to expand the application of PST in digital marketplace by introducing registration requirements for online marketplace facilitators and certain out-of-province sellers. These amendments came into force on July 1, 2022 and follow changes made by other Canadian jurisdictions in prior years.

Pursuant to the PSTA amendments, "online marketplace facilitators" are required to register for, collect and remit BC provincial sales tax ("**BC PST**") on sales made through their online platforms, and the facilitators must charge BC PST on "online marketplace services" they provide to "online marketplace sellers". The tax on "online marketplace services" is the first instance of a Canadian jurisdiction imposing a non-recoverable sales tax on advertising or promoting and listing sale of goods, software and other taxable services. Notably, this tax operates contrary to the GST/HST treatment of services provided by facilitators in certain similar circumstances, where the facilitator is deemed not to have made a taxable supply to unregistered sellers such that the seller does not incur non-recoverable tax.

The application of BC PST for online marketplace services will only apply if the service is provided by an online marketplace facilitator (or by certain other persons with a relationship to the online marketplace facilitator, such as an agent) to an online marketplace seller. The definition of "online marketplace services" subject to PST is broad and includes the listing of goods, software or taxable services for sale, advertising or promotion services, storage services, or, in general, any "other services to facilitate an online marketplace seller's sale, provision, or lease" of goods, software, or taxable services through an online marketplace. As is generally consistent with the PSTA, the purchase of online marketplace services will be exempt from BC PST if purchased solely for the purpose of selling or providing the service to other persons that use the online marketplace service (i.e., a purchase for resale).

Under the amended PSTA, an online marketplace facilitator includes any person that operates an online marketplace and facilitates the provision or retail sale or lease of goods, software, or taxable services provided they also collect payment in respect of such provision, sale or lease. Similar to existing registration requirements for non-resident sellers, an online marketplace facilitator is not be required to register if the revenue from the sales it facilitates are under the threshold of $10,000 of facilitated revenues in the preceding 12 months or $10,000 of reasonably estimated facilitated revenues for the next 12 months. Additionally, if an online marketplace is jointly operated, owned or controlled by two or more online marketplace facilitators, only one is required to register for, levy and collect the BC PST.

With respect to goods sold through an online marketplace, the requirement for facilitators to register for, BC PST only applies if the goods sold through the facilitator are located in Canada when sold, provided or leased. However, in BC Budget 2022, BC indicated its intention to expand these obligations for facilitators of sales of goods shipped from outside Canada at some point in the future. Until such time, and as noted in BC PST Bulletin 142, if an online marketplace facilitator registers for BC PST it will generally be required to collect BC PST on sales of goods brought into BC from outside Canada for commercial use (even if not required to collect BC PST on similar sales to consumers of goods located outside Canada).

Other British Columbia PST Measures

In addition to the above, BC Budget 2022 announced certain climate-focused amendments to PST. These amendments (i) exempt used zero-emission vehicles from PST during the period from February 23, 2022 to February 22, 2027; (ii) effective February 23, 2022, increase the passenger vehicle surtax threshold above which surtax applies to zero-emission vehicles to $75,000 from $55,000; and (iii) effective April 1, 2022, exempt heat pumps from PST and increase the rate of PST on fossil fuel combustion heating systems from 7% to 12%.

Furthermore, BC Budget 2022 announced the expansion of PST to tobacco effective July 1, 2022, which is intended to align BC's tax policy with the majority of other provinces that, in addition to imposing a specific tobacco tax, apply either a provincial sales tax or the provincial portion of the HST to tobacco.

Other changes to BC PST announced in BC Budget 2022 include:

— Effective October 1, 2022, PST on private sales of motor vehicles is based on the greater of the reported purchase price and the average wholesale value of the vehicle.

— Effective February 23, 2022, amendments that clarify gift cards and gift certificates are not subject to PST when acquired.

— Effective retroactively to contracts entered into after April 1, 2013, amendments that override the decision of the BC Court of Appeal in *Chemainus Gardens RV Resort Ltd v BC*, 2021 BCCA 402. The amendments codify the province's pre-existing interpretation of what requirements purchase documentation must satisfy in order for a real property contractor to pass liability for PST on to a customer.

Saskatchewan Rate Adjustments and Expansion of PST Base

Saskatchewan Budget 2022-2023 introduced limited commodity tax measures, including:

— adjustments to the rate of Saskatchewan Tobacco Tax on cigarette sticks, loose tobacco, and Heat-Not-Burn Sticks, and an exemption from the Saskatchewan Vapour Products Tax for retail purchases in the City of Lloydminster; and

— the expansion of the PST to admission fees and entertainment charges (such as tickets to sporting events and concerts, admission fees for conferences, and gym memberships);

Notably, Saskatchewan Budget 2022-2023 announced that the Saskatchewan Government is developing a proposal to take over administration of, and retain all revenues from, the federal carbon tax backstop fuel charge, details of which are stated to be forthcoming.

Manitoba Status Quo

Manitoba Budget 2022 contained relatively few commodity tax measures. Among the measures, Manitoba introduced an exemption from the Manitoba Fuel Tax for fuel used in off-road operation of peat harvesting equipment, which is intended to make Manitoba fuel taxation more consistent across industries and with other Canadian jurisdictions.

Ontario Non-Resident Speculation Tax

Effective October 25, 2022, the Government of Ontario increased the Non-Resident Speculation Tax ("**NRST**") rate from 20% to 25%. This is the second rate increase of the year, following an increase from 15% to 20% in March, at which time the NRST had also been expanded to apply throughout the province.

The cumulative 10% increase to the rate means Ontario now has the highest Canadian tax of this type. Given the high rate and province-wide nature of the tax, it is difficult to see how foreign entities or taxable trustees could justify investing in smaller residential complexes in Ontario.

Part 2 - Outlook for 2023

TAX MEASURES PREVIOUSLY ANNOUNCED BY THE GOVERNMENT

Significant tax measures announced by the Government in Budget 2022 remained outstanding at the close of the 2022 year. We expect that the Government will seek to advance these tax measures in 2023.

EIFEL Rules

As mentioned in the 2022 legislative review section of this publication, the consultation period for the EIFEL Rules ended on January 6, 2023. We expect further revisions to the draft legislation as a result of the ongoing consultation.

Hybrid Mismatch Arrangements

In the Fall Economic Statement, the Government confirmed its intent to proceed with implementing the Hybrid Mismatch Rules but in a manner that takes "into account consultations and deliberations since their

release". As of the date of this publication, the amended proposed legislation for Part I of the Hybrid Mismatch Rules were stated to be effective with respect to payments made on or after July 1, 2022. even though we expect to see revised legislation sometime in 2023.

It is also quite possible we will see the first draft of second part of the Hybrid Mismatch Rules in 2023.

Mandatory Disclosure Rules

We expect additional updates to the draft legislation implementing the new mandatory disclosure rules in response to the feedback provided to the Government through the public consultation processes on these rules.

Transfer Pricing Consultation

Budget 2022 confirmed the Government's intention to proceed with the previously announced transfer pricing consultation. In Budget 2021, the Government announced its intention to begin a consultation process on Canada's transfer pricing rules with a view to protecting the integrity of the tax system while preserving Canada's attractiveness for foreign investment. This announcement was a response to the Supreme Court of Canada's decision on February 18, 2021 to dismiss the Government's application for leave to appeal the Federal Court of Appeal's decision in Canada v. Cameco Corporation (2020 FCA 112), which affirmed the Tax Court of Canada's decision not to apply Canada's domestic transfer pricing rules to certain long-term uranium purchase contracts between the corporate taxpayer and its Swiss subsidiary. The Government believes that the *Cameco* decision may encourage the inappropriate shifting of corporate profits outside of Canada (thereby reducing the Canadian tax base), and stated that the intention of the consultation process would be to allow stakeholders to comment on possible measures to improve Canada's domestic transfer pricing rules. Further commentary from our Firm on the *Cameco* decision can be found here.

As at the date of preparing this publication, the public consultation process on Canada's transfer pricing rules has not commenced.

Digital Services Tax

There has been no significant update to the digital services tax ("**DST**") that was proposed in Budget 2021 as an interim measure until an acceptable multilateral approach to the taxation of the digital economy (i.e., Pillar 1) comes into effect. The Government's aim is to ensure that the revenue earned by large businesses, whether foreign or domestic, from engagement with online users in Canada is subject to Canadian tax. Generally, the DST will apply at a rate of 3% of revenue earned from certain digital services that rely on engagement, data and content contributions of Canadian users. The DST will apply to an entity that has (or is part of a business group that has) global revenue from all sources of at least €750 million in the previous calendar year and in-scope revenue associated with Canadian users of more than $20 million in the particular calendar year.

The DST proposal was subject to a public consultation process, which

ran from April 19, 2021 to June 18, 2021. On December 14, 2021, the Government released draft legislation regarding the DST. The draft legislation provides that the DST will be imposed as of January 1, 2024, but only if the OECD/G20 Inclusive Framework's multilateral approach has not come into force by that date, and will apply retroactively to revenues earned as of January 1, 2022. In Budget 2022, the Government stated that it was prepared to advance legislation for the DST, but that it was "Canada's sincere hope that the timely implementation of the new international system will make this unnecessary."

Update on International Tax Reform

There were numerous developments in respect of the OECD's two-pillar solution to address the tax challenges arising from the digitalization of the economy, although the fundamentals remain the same: one regime will reallocate some portion of the taxing rights on the profits of large multinational enterprises ("**MNEs**") to countries where the MNEs' customers are located ("**Pillar One**") and a second regime will implement a global minimum effective tax rate of 15% ("**Pillar Two**").

Budget 2022 did not mention any potential implementation date for Pillar 1 while stating that Canada would work to implement portions of Pillar 2 in 2023 and 2024. Budget 2022 also launched a consultation on Pillar 2, although given the extensive international work developing the model rules, the consultation was expressly limited to adaptations to the model rules necessitated to allow them to work in the Canadian legal and income tax context. The consultation was open until July 7, 2022.

In the Fall Economic Statement the Government noted the OECD and the Inclusive Framework hope to complete multilateral negotiations on Pillar 1 and sign the required treaty in the first half of 2023 and have that treaty come into force in 2024. The Fall Economic Statement reiterated Canada's commitment to Pillar 2, but did not set out an implementation timeline, possibly in implicit recognition that many other countries have announced a delay in their implementation of Pillar 2 and the significant amount of work that remains to be done on many aspects of the model rules.

GAAR Consultation Process

Although the formal consultation period on the GAAR Paper ended September 30, 2022, we expect the Government to engage in further consultation regarding any dramatic legislative changes to the GAAR.

Tax on Share Buybacks

We expect to see further detail regarding the new tax on share buybacks announced in the Fall Economic Statement.

DECISIONS EXPECTED TO BE ISSUED IN 2023

Deans Knight Income Corporation – What to Expect from the Supreme Court?

On November 2, 2022, the SCC heard the appeal in *Deans Knight Income Corporation* and will have the opportunity to address the uncertainty created by the FCA.[39] The FCA

[39] *Deans Knight Income Corporation v. Canada, 2021 FCA 160, rev'g 2019 TCC 76 ("**Deans Knight**").*

reversed the TCC's decision and relied on a novel concept of "actual control" to conclude there was an abuse of the loss restriction rules in subsection 111(5) of the Act. The FCA did not define this concept of actual control in the decision, nor is it found anywhere in the Act or other jurisprudence.

The issues before the SCC are to determine the object, spirit, and purpose of subsection 111(5) and whether its underlying rationale is based on "actual control" (and, if it is, what does "actual control" mean)?

During the SCC hearing, there were many clarifying questions asked to both the Appellant's and the Respondent's counsels with regards to the meaning of "actual control" as an attempt to arrive at a resolution on how to reconcile the FCA's decision. The tax community is hopeful that the SCC will provide guidance.

Summary of Facts and Judicial History

The appeal in *Deans Knight* represents the first judicial consideration of whether the GAAR applies to the acquisition of control element in subsection 111(5) of the Act. Subsection 111(5) can prohibit a company from utilizing non-capital losses after its acquisition of control. For purpose of subsection 111(5), can prohibit a company from utilizing non-capital losses after its acquisition of control. For purposes of subsection 111(5), it is de jure control that is relevant which means the control by the shareholders who carry sufficient votes to elect the board of directors means the control by the shareholders who carry sufficient votes to elect the board of directors.[40]

Deans Knight involved a corporation that incurred significant losses. The taxpayer entered into a "corporate restart" transaction, which sought to monetize accumulated tax losses from a discontinued business while staying on side of the limits and rules of the Act. In a unanimous ruling, the FCA concluded that these transactions constituted an abuse of the relevant provision in the Act, thereby causing the acquisition of control loss restrictions to apply.

The FCA analysis examined the object, spirit, and purpose of subsection 111(5). The FCA found "the object, spirit and purpose of subsection 111(5) as follows: it is to restrict the use of specified losses, including non-capital losses, if a person or group of persons has acquired actual control over the corporation's actions, whether by way of de jure control or otherwise".[41] Accordingly, the FCA emphasized that for the purposes of the abuse analysis in applying the GAAR, the relevant control test under subsection 111(5) is "actual control". The FCA did not define "actual control" in the decision, but provided the following guidance:

> *the actual control test is different than the statutory de facto control test in subsection 256(5.1) of the Act. […] I see nothing inconsistent with the conclusion that the object, spirit and purpose of subsection 111(5) take into account different forms of control even though the text of the provision is limited to de jure control.*[42]

[40] *Duha Printers*, para. 36.
[41] *Deans Knight*, para. 72.
[42] *Deans Knight*, para. 83.

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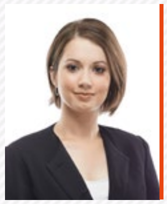

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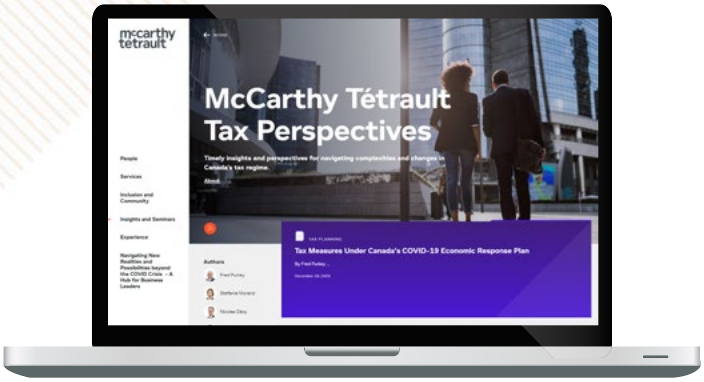

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