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2022 year-end tax planner Canada

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2022 YEAR-END **TAX PLANNER**

Legislative changes and other tax concerns that may affect planning

With the pandemic in the rearview mirror, the Canadian government was finally able to shift focus away from COVID-19-related policies to introducing new legislation. Undoubtedly, 2022 marked the beginning of some significant changes to the tax legislation that will continue to carry into 2023 as more legislation will be tabled.

This 2022 year-end tax planner summarizes key federal, provincial and territorial tax updates that middle market taxpayers should consider when preparing for 2022 tax planning opportunities and year-end obligations.

FEDERAL BUSINESS TAX CONSIDERATIONS

Excessive interest and financing expenses limitation regime coming into effect soon

The federal government released draft legislation for the new interest deductibility rules known as the excessive interest and financing expenses limitation (EIFEL) regime. The EIFEL regime will limit a corporation's interest deduction to a fixed ratio of 30 per cent of EBITDA and 40 per cent for tax years beginning on or after Jan. 1, 2023, and before Jan. 1, 2024. The overall purpose of the rules is to restrict the amount of interest expenses claimed by large multinational enterprises to an amount of taxable income generated by their activities in Canada. The proposed rules are effective for taxation years beginning after Dec. 31, 2022.

The EIFEL rules would apply to corporations and trusts, except where the taxpayer is considered to be an "excluded entity." An "excluded entity" generally includes Canadian-controlled private corporations (CCPCs) that, together with any associated corporations, have taxable capital employed of less than $15 million in Canada. Excluded entities also include groups of Canadian taxpayers with net interest expense of $250,000 or less, groups consisting exclusively of Canadian-resident corporations, and trusts that carry on substantially all of their business in Canada (i.e., no foreign affiliates).

The EIFEL regime also lays out rules that may provide relief for eligible taxpayers:

- **Excluded interest rules:** The "excluded interest" rules provide that where there are intercompany interest payments between two related taxable Canadian corporations, a taxpayer may be able to file a joint election to exclude these payments if certain conditions are met. Similarly, the recipient corporation may also exclude the amount of such interest and financing revenues when determining their deductions.

- **Group ratio rules:** Canadian members of a multinational enterprise may be able to jointly elect the "group ratio" rules for a relevant taxation year. The group ratio rules allow a taxpayer to deduct interest and financing expenses (IFE) in excess of the ratio specified above (30 per cent or 40 per cent), provided that (i) the taxpayer is a member of a consolidated group, and (ii) the group's ratio of total net third-party interest expense to total book EBITDA exceeds the fixed ratio of 30 per cent or 40 per cent.
- **Carryforward rules and group transfer rules:** A taxpayer that is denied the interest deduction can carryforward any unused "excess capacity" and "restricted IFE" to future taxation years.

The new EIFEL rules will affect the current financing arrangements of a large number of taxpayers. It will also impact the deductibility of their IFE going forward, as well as their after-tax cash flows.

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Substantive Canadian-controlled private corporations

In the 2022 federal budget, the government introduced the new concept of substantive CCPCs (SCCPCs). SCCPCs are aimed at curbing tax planning that manipulates a corporation's CCPC status to avoid the refundable tax regime in order to qualify for a lower tax rate on investment income. The new rules are proposed to apply to taxation years that end on or after April 7, 2022.

SCCPCs are defined as private corporations resident in Canada (other than CCPCs) that are ultimately controlled (in law or fact) by Canadian-resident individuals. The de facto control test under subsection 248(1) of the *Income Tax Act* (ITA) is used to determine whether a private corporation is an SCCPC:

- The corporation is controlled directly or indirectly, in any manner, by one or more Canadian resident individuals.
- If each share of the capital stock owned by a Canadian resident individual was owned by a particular individual, the corporation was controlled by that particular individual.

The new SCCPC rules cast a wide net. Private corporations with significant Canadian resident shareholding or involvement should examine the applicability of these rules to their organizations.

A proposed corresponding anti-avoidance provision was also added under subsection 248(43) of the ITA and various proposed updates were made to integrate the new SCCPC rules throughout the ITA. Further, if a corporation is characterized as an SCCPC, it will not be entitled to benefits under the ITA reserved for CCPCs such as a lower tax rate on active business income or more beneficial treatment on scientific research and experimental development (SR&ED) investment tax credits. SCCPCs would continue to be treated as non-CCPCs for all other purposes under the ITA.

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Small business deduction

The small business deduction (SBD) provides eligible CCPCs with a reduced corporate income tax rate of 9 per cent on the first $500,000 of active business income earned in a particular taxation year. This is subject to reductions based on taxable capital or aggregate investment income, whichever reduction is greater, and is known as the corporation's "business limit." Currently, the business limit is reduced on a straight-line basis when:

- The combined taxable capital employed in Canada by the CCPC and its associated corporations is between $10 million and $15 million.
- The combined adjusted aggregate investment income of the CCPC and its associated corporations is between $50,000 and $150,000.

The 2022 federal budget extended the range over which the business limit is reduced by increasing the upper threshold to $50 million in taxable capital from the previous $15 million limit.

These proposed changes would allow more medium-sized CCPCs to benefit from the SBD and would apply to taxation years that begin on or after April 7, 2022.

Developments on cryptocurrency

As more individuals and businesses engage in crypto-asset transactions, taxation authorities around the world are growing increasingly concerned about tax compliance. Specifically, due to the inherent decentralized design of blockchain technology, governments are looking to take steps to ensure that all applicable taxes are being correctly reported and paid.

To address these shortcomings, the Canada Revenue Agency (CRA) released guidance on the taxation of cryptocurrency as follows:

- **Profit and loss tax treatment:** The CRA generally treats cryptocurrency like a commodity for purposes of the ITA. Depending on the circumstances, income from transactions involving cryptocurrency or the disposition of cryptocurrency is generally treated as business income or as a capital gain. Accordingly, losses from cryptocurrency transactions are treated as business losses or capital losses.
- **Barter transactions:** The CRA treats the payments for goods and services in cryptocurrency as a barter transaction. To determine the value of a cryptocurrency transaction where a direct value cannot be determined, the CRA advises that a taxpayer must use a reasonable method. Generally, the CRA's position is that fair market value is the highest price that a willing buyer and seller (acting independently of each other) would agree to in an open and unrestricted market. The taxpayers are advised to keep a record of how the value is determined.
- **Trading one type of cryptocurrency for another type of cryptocurrency:** Generally, when a taxpayer disposes of one type of cryptocurrency to acquire another type of cryptocurrency, the barter transaction rules apply. The taxpayer is required to convert the value of the cryptocurrency received into Canadian dollars. This transaction is considered a disposition and must be reported on the taxpayer's income tax return.

In addition, the Organization for Economic Cooperation and Development (OECD) proposed a crypto-asset reporting framework (CARF) that is intended to provide for the reporting and exchange of information with respect to crypto assets. Canada has yet to adopt the CARF because the CRA is still reviewing whether cryptocurrencies would be considered foreign property.

PERSONAL TAX CONSIDERATIONS

Measures to increase home affordability

The 2022 federal budget focused heavily on increasing home affordability through a variety of measures outlined below:

- **Tax-free first home savings account (FHSA):** Proposed to be available as of Jan. 1, 2023, the FHSA will allow qualifying taxpayers to invest a maximum of $40,000 towards the purchase of their first home. Similar to a Registered Retirement Savings Plan (RRSP), contributions to an FHSA would be deductible when calculating income. Funds can also be transferred between the FHSA and the RRSP or the Registered Retirement Income Fund (RRIF) of the same individual on a tax-free basis. Qualifying withdrawals can be made on a tax-free basis by a first-time home buyer towards the purchase of a home located in Canada. Similar to RRSP withdrawal treatment, non-qualifying FHSA withdrawals would be included as income and subject to withholding taxes.
- **First-time home buyers' tax credit (HBTC):** For 2022 and subsequent years, the first-time home buyers' tax credit has been increased from $5,000 to $10,000. First-time home buyers who acquire a qualifying home can claim a non-refundable tax credit of up to $1,500 in the year the qualifying purchase was made.

- **Underused property tax:** Under the new federal *Underused Housing Tax Act*, non-residents who directly or indirectly own residential property in Canada considered vacant or underused (except for reasons of seasonal or unsafe use) will be subject to a tax on that property. This change is effective Jan. 1, 2022. Furthermore, the *Prohibition on the Purchase of Residential Property by Non-Canadians Act* was passed on June 23, 2022, and comes into force on Jan. 1, 2023. Together with the existing non-resident speculation tax in Ontario and BC, these rules serve to reduce foreign ownership of Canadian residential real estate.
- **Multigenerational home renovation tax credit:** The multigenerational home renovation tax credit intends to make renovations needed to accommodate disabled or senior relatives living in the taxpayer's home more affordable. Taxpayers incurring qualifying renovation expenses on or after Jan. 1, 2023, can claim 15 per cent of the maximum of $50,000, amounting to a maximum refundable tax credit of $7,500.
- **Residential property flipping:** A residential property sale can be taxed as business income, or income on account of capital, the latter of which is subject to tax at a 50 per cent inclusion rate. Under the proposed changes to the residential property flipping rules, all residential properties sold within 12 months of the change in ownership would be taxed as business income. There would be an exception for residential properties sold for reasons listed on an enumerated list, such as death or divorce. Currently, the list of exceptions has yet to be finalized. Taxpayers looking to dispose of residential properties for non-business reasons should consider satisfying the 12-month period before entering into a disposition transaction. This proposal, once passed, will apply to dispositions occurring after 2022.

Luxury tax now in effect

The luxury tax was originally proposed in the 2021 federal budget and went into effect on Sept. 1, 2022. The tax is being levied on "subject items," which includes small passenger aircraft, certain passenger vehicles and recreational vessels.

For subject items sold and/or delivered, or imported on or after Sept. 1, 2022, the luxury tax is calculated as the lesser of:

(i) 10 per cent of the total taxable amount of a subject item

(ii) 20 per cent of the amount by which the taxable amount of a subject item exceeds the luxury tax threshold

The threshold for the application of the luxury tax is $100,000 for aircraft and vehicles, and $250,000 for vessels. Aircraft and vessels may be excluded from luxury tax if they are used at least 90 per cent of the time (based on total duration of time used) for purposes other than leisure, recreation, sport, or other enjoyment of the owner and their guests.

Changes to support genuine intergenerational business transfer

Subsequent to the passing of Bill C-208 in 2021, section 84.1 of the ITA was amended to support genuine intergenerational transfers of family businesses. Historically, the anti-avoidance rule converts capital gain arising on a non-arm's length sale to a dividend when certain criteria were met. This was so that vendors were unable to utilize lifetime capital gains exemption (LCGE) on such sales. The Department of Finance has indicated that once it completes its consultation process, it would bring forward legislation that could be included in a bill tabled in the fall of 2022.

The proposed amended section 84.1 provides an exclusion to its application. Section 84.1 would not apply where qualified small business corporation shares are being disposed of to a purchaser corporation controlled by children or grandchildren of the vendor (18 years or older) in a genuine intergenerational business transfer. A key condition to this exclusion is that the purchaser corporation must not dispose of the subject shares within 60 months of their purchase, except if the disposition is due to death. Those seeking to take advantage of this exemption should retain documentation that shows that it was a genuine business transfer.

Trust reporting rules

The proposed trust reporting rules will subject additional trusts—most notably bare trusts—to T3 trust return filing requirements. Those trusts required to file T3 returns will also need to provide additional disclosure about all trustees, beneficiaries, settlors and each person who has authority to make decisions about appointment of income or capital of the trust. A new penalty of $25 a day up to a maximum of $2,500 will apply for those failing to meet the new reporting requirements. These changes are still in the proposal phase and the CRA has indicated it will not implement the new requirements until they receive royal assent. To ease the administrative burden of the proposed additional trust reporting requirements, certain T3 returns can now be filed electronically.

New electronic payment requirement and electronic data delivery

In 2022, the Department of Finance introduced new legislation to require remittances and payments larger than $10,000 to the CRA be made as an electronic payment (unless the payor or remitter cannot reasonably remit or pay the amount electronically). If the CRA determines a payor or remitter can reasonably pay electronically but fails to do so, a penalty of $100 has been introduced for each failure to comply. The new rule and associated penalty apply to payments made on or after Jan. 1, 2023.

In addition, the rules have been updated so that where notices or communications are made available in electronic format (such as via CRA My Account, or by email), that communication is presumed to have been received at the time the electronic mail is made available via electronic platforms.

INTERNATIONAL TAX CONSIDERATIONS

Updated foreign affiliate reporting

Reporting entities that own shares in a foreign affiliate (FA) at any point during the year are required to file Form T1134.

The new Form T1134 is required for tax years beginning after 2020 and due within ten months of year-end.

Changes to the form are extensive and require substantial additional reporting as follows:

- Reporting related to legislative amendments to, among others, foreign affiliate dumping (FAD) rules, tracking interest rules, and upstream loan rules
- Disclosure of the amount of foreign accrual property losses (FAPLs) and foreign accrual capital losses (FACLs) incurred by control foreign affiliates (CFAs) during the current taxation year and whether such losses were carried forward and back
- Disclosure of the adjusted cost base (ACB) of both common shares and preferred shares (if applicable) of top-tier FAs, including whether any elections were made and whether any changes occurred to the ACB during the year
- Reporting of all dividends paid from one FA to another and whether any elections were made with respect to the dividend ordering rules

In light of the enhanced reporting obligations, taxpayers should be aware of some common Form T1134 pitfalls:

- Misreporting due to the complexity of the interaction between partnership rules and the FA regime
- Misreporting due to incomplete analyses—e.g., active versus passive nature of assets
- Overreporting/underreporting for lower-tier non-CFAs indirectly held through one or more non-CFAs
- Underreporting of "inactive" or "dormant" FAs due to misapplication of the test—e.g., thresholds are very low and can be inadvertently triggered
- Underreporting due to incomplete information—e.g., overlooking a minority interest FA or incomplete surplus account records
- Failure to report FAs and/or CFAs that only existed for a particular moment during the restructuring transaction

These new requirements underscore the importance of maintaining and updating surplus computations on a timely basis. The additional requirements reflect information that should already be analyzed and quantified for the reporting entities' Canadian income tax returns which are due much earlier than the T1134 form. As such, the additional reporting requirements may not be very onerous to taxpayers who are fully compliant with the current rules.

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International tax reform

On Oct. 8, 2021, the OECD announced that 136 countries, including Canada, had agreed on the elements of the landmark two-pillar plan on international tax reform.

- **Pillar One—re-allocating taxing rights:** Pillar One aims to re-allocate some taxing rights over multinationals from their home countries to the markets where they have business activities and earn profits, regardless of whether multinationals have a physical presence there. Countries are aiming to sign a multilateral treaty during 2022, with effective implementation in 2023. In the meantime, the Canadian federal government released the draft *Digital Services Tax Act* (DSTA) on Dec. 14, 2021. The DSTA would not be imposed earlier than Jan. 1, 2024, and would only apply if the treaty implementing the Pillar One tax regime under the multilateral approach has not come into force. In that event, the DSTA would be payable as of the year that it comes into force in respect of revenues earned as of Jan. 1, 2022.
- **Pillar Two—implementing a global anti-base erosion rule:** Pillar Two aims to implement a global anti-base erosion rule through the introduction of a global minimum corporate tax rate of 15 per cent that countries can use to protect their tax bases. It will apply to companies with revenue above 750 million euros and is estimated to generate around US$150 billion in additional global tax revenues annually. The OECD released the Model Rules in December 2021, and the commentary related to the Model Rules in March 2022. The rules are likely to come into effect in 2023 for the Income Inclusion Rule (IIR), which requires the parent entity to pay the top-up tax if it has foreign subsidiaries whose income is taxed below the effective minimum tax rate. Further, the rules are likely to come into effect in 2024 for the Undertaxed Payments Rule (UTPR), which provides for top-up tax on a member of the multinational group (MNE Group) if the IIR does not apply to the parent entity.

This is a significant development toward ensuring that multinationals pay a fair share of tax wherever they operate.

Substantive Canadian-controlled private corporations

As previously mentioned, the government introduced the concept of substantive CCPCs (SCCPCs) to ensure that the investment income earned and distributed by SCCPCs is taxed in the same manner as CCPCs.

On Aug. 9, 2022, the government introduced draft legislation proposing amendments to the foreign accrual property income (FAPI) rules to prevent taxpayers from gaining a tax deferral advantage by earning certain types ,of income, including investment income, through CFAs that are held by CCPCs and SCCPCs. The draft legislation proposes to apply the relevant tax factor that currently applies to individuals (i.e., 1.9) when calculating FAPI for CCPCs and SCCPCs.

CCPCs and SCCPCs that earn FAPI through CFAs should revisit their international corporate structures, as the proposed rules will eliminate the previously available tax deferral.

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

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Hybrid mismatch arrangements

Further to the government's announcement in the 2021 federal budget, the Department of Finance released the first set of draft legislative proposals to address cross-border tax avoidance arrangements known as hybrid mismatch arrangements (HMAs) on April 29, 2022.

HMAs are cross-border tax avoidance structures that use differences in the income tax treatment under Canadian tax laws and one or more other countries, in order to claim a deduction in one country for a cross-border payment. The receipt of the payment is not included in the ordinary income of the recipient in the other country. They also include arrangements where a deduction is claimed in two or more countries in respect of a single expense.

Although the final legislation has yet to be tabled, the first legislative package took effect as of July 1, 2022, with no exemptions for existing arrangements. The second legislative package will take effect no earlier than 2023.

The draft legislation identifies limited circumstances in which a hybrid mismatch amount may arise and provides operative rules to create an income inclusion or deny a deduction associated with a hybrid mismatch amount. The

limited circumstances addressed in the draft legislation primarily relate to hybrid financial instruments. Key details of the draft legislation include the following:

- **Operative rule 1:** a denial of a deduction for an entity in Canada to the extent there is a non-inclusion of a receipt in a foreign jurisdiction.
- **Operative rule 2:** an income inclusion to the extent the payment is deductible in computing the foreign income of a non-resident payer but would otherwise not result in taxable income to the Canadian recipient.
- **Dividend received from a foreign affiliate:** a denial of the dividend deduction under section 113 of the ITA for a dividend received from a foreign affiliate, to the extent there is a foreign deduction for the payment. The proposed rules for the dividend deduction limitation and the Operative rule 2 are not intended to apply to the same payment.

The application of the proposed rules is limited to taxpayers not dealing at arm's length, taxpayers who have a specified percentage of equity interest in one another, or taxpayers where the pricing of a payment reflects the hybrid mismatch. If the pricing of a payment reflects the hybrid mismatch, taxpayers may use an exception where it is reasonable to assume the taxpayer was not aware of the mismatch and derives no benefit from it.

Home offices and permanent establishment

Home offices in Canada may constitute a permanent establishment (PE) of the non-resident corporation in Canada if the employer requires their employees to work from home.

There are generally three conditions which could prove that a home office is a PE:

1. A place of business, whether owned or rented, so long as the enterprise has the legal right to use the place of business.
2. The place of business must have a degree of permanence.
3. The business must be carried on wholly or partly through the fixed place of business.

The home offices of the Canadian-resident employees are not likely to be considered PEs if they are not referred to as the non-resident corporation's Canadian address on their website, business cards or advertisement. However, the OECD Model Tax Convention provides that a home office may still constitute a PE if it is used on a continuous basis for carrying on business activities for a company, and it is clear from the facts that the company has required the individual to use that location to carry on the company's business.

TRANSFER PRICING CONSIDERATIONS

Organization for Economic Cooperation and Development update

On Jan. 20, 2022, the OECD released the 2022 edition of the Transfer Pricing Guidelines (the 2022 Guidelines), modifying its previous guidelines issued in 2017 (the 2017 Guidelines). The 2022 Guidelines reiterate the OECD's commitment to equip governments with domestic and international rules and instruments to address tax avoidance, ensuring that profits are taxed where economic activities generating the profits take place.

Key revisions made from the 2017 Guidelines to the 2022 Guidelines included revisions to Chapter II relating to the application of the transactional profit split method with significantly expanded guidance on when the profit split method may be most appropriate. Revisions to Chapter VI relating to the approach to hard-to-value intangibles, and the introduction of new guidance on financial transactions were also made.

Multinational corporations should review the 2022 Guidelines to adapt their intercompany arrangements because normally most of the OECD's recommendations are adopted in domestic tax legislation.

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Form T106 updates for 2022

The CRA has introduced several key updates to the Form T106 information return. These new measures will apply for tax years starting in 2022 and later.

For tax years or fiscal periods that begin in 2022 and later, there is no need to report transactions in Part III of the T106 slip where a reporting person or partnership's total amount of the transactions with a non-resident is below C$100,000. This should not be construed as an exception to filing the T106 information return which has a separate de minimis threshold of C$1 million (for the sum of all T106 slip reportable transactions).

Further, taxpayers are now required to report non-resident paid-up capital (PUC) in the Canadian reporting entity. This may enable the CRA to determine whether any remittance by the Canadian reporting entity to its non-resident shareholder(s) is a repayment of PUC or a deemed dividend subject to withholding tax.

Taxpayers will also have to report if a pertinent loan or indebtedness (PLOI) election is made for cross-border debt transactions, and if so, the amount is deemed to be interest income under section 17.1 of the ITA. The CRA may compare this information with the information provided in the T1134 information return, which also requires the taxpayers to indicate whether a PLOI election was made. Taxpayers should ensure they provide consistent information to the CRA on all their forms.

Changes in interest rates

In response to rising inflation, the Bank of Canada began a series of aggressive rate hikes this year, bringing its policy rate from an effective lower bound of 0.25 per cent to 3.25 per cent effective Sept. 7, 2022. Rising interest rates mean that money is no longer easy to come by, unlike at the beginning of the pandemic when the rates of borrowing were below inflation.

From a transfer pricing perspective, multinational corporations should review their intercompany loans to determine how recent increases in interest rates have impacted tax and cash flow positions. Taxpayers with intercompany loans using the Canadian overnight repo rate would need to assess the implications of rising rates on potentially higher interest payments between related parties.

Taxpayers planning to arrange new intercompany loans should consider rising interest rates when determining whether to use fixed or floating rates for intercompany loans. A holistic review of each entity's tax position would help assess the optimal method to structure future intercompany debt transactions.

Changes to the downward transfer pricing adjustment rules

The Transfer Pricing Memorandum (TPM) 03 has now been replaced with TPM-03R. The TPM-03R provides guidance on how downward transfer pricing adjustments should be directed and how they will be managed.

Downward transfer pricing adjustments are not intended to serve as a vehicle for taxpayers to implement retroactive tax planning. Nor are they intended to be used for base erosion and profit shifting strategies, or to achieve double non-taxation, because downward transfer pricing adjustments are only available in limited circumstances. Where the request involves a treaty country, downward transfer pricing adjustments will only be applied at the audit stage to the extent that they are closely linked to, and do not exceed, the upward transfer pricing adjustments.

Additionally, there are CRA established programs for taxpayers who wish to have tax certainty in their non-arm's length cross border transactions. Taxpayers may still qualify for a Mutual Agreement Procedure in situations that involve a transaction in a treaty country even if the downward transfer pricing request does not meet certain policy requirements listed in this memorandum.

Protective relief

Multinational corporations undergoing a transfer pricing audit for a particular fiscal period should consider if they need protective treaty relief for other years. For instance, under the Canada-US treaty, the taxpayer can request treaty relief for six years from the fiscal period end date. If a taxpayer is facing a transfer pricing audit and approaching the applicable relief from double taxation treaty date, the taxpayer should file a protective claim. Failure to manage and protect taxpayers' rights can result in double taxation not in accordance with tax treaties.

Please note that the Canada-US treaty is illustrated as an example above but each treaty has its own specific limits.

Goods and services tax/harmonized sales tax

- **Assignment sales:** An assignment sale is a transaction in which a person purchases a new home from a builder and subsequently sells the purchase rights and obligations under the agreement with the builder to another person. Effective May 7, 2022, all assignment sales of newly constructed or substantially renovated residential housing are taxable for goods and services tax/harmonized sales tax (GST/HST) purposes. GST/HST on new housing rebates may be affected because these rebates are generally based on the total consideration payable for a taxable supply of a home, including the consideration for a taxable assignment sale.
- **Expanded hospital rebate:** Under the current GST/HST rules, hospitals can claim an 83 per cent rebate, and charities/non-profit organizations can claim a 50 per cent rebate of the GST and the federal component of the HST. One of the conditions to be eligible for the expanded hospital rebate is that a charity or non-profit organization must deliver the health care service in a geographically remote community. This condition has been removed and the GST/HST rebate now has been extended to health care services provided by charities or non-profit organizations irrespective of geographical location. This will generally apply to rebate claim periods ending after April 7, 2022, for tax paid or payable after that date. This will allow all charities and non-profits that provide health care services to reduce their operating costs.

Excise Act

- **Taxation of vaping products:** Following consultation, the federal government introduced new a tax that will apply to vaping products including liquid or solid vaping substances with an equivalency of one millilitre of liquid to one gram of solids. The new tax is effective Oct. 1, 2022. It will not apply to those vaping products subject to cannabis excise duties or those produced by individuals for personal consumption. There will be a travel exemption for vaping products that are imported for personal use by travellers.
- **Canadian wine:** Previously, Canadian wine, defined as wine that was produced in Canada and was wholly composed of agricultural or plant products grown in Canada, enjoyed an exemption from excise duties. This exemption was repealed as of June 20, 2022, thereby increasing excise taxes on Canadian wine.
- **Beer taxation:** The *Excise Act* was amended in 2022 to reduce the existing tax on beer having no more than 0.5 per cent of alcohol by volume (ABV). This has brought beer products in line with the existing exemption for wines and spirits containing no more than 0.5 per cent ABV.

Luxury tax

As mentioned above, the luxury tax on certain high-end aircraft, vehicles and recreational vessels came into effect Sept. 1, 2022, creating new obligations for businesses.

Under the *Select Luxury Items Tax Act*, a business is required to register for the luxury tax if the business is a manufacturer, wholesaler, retailer, or importer and in the course of its business activities the business sells or imports certain vehicles and aircraft priced over $100,000 and certain boats priced over $250,000.

A business that has a luxury tax obligation must register, collect and remit luxury tax for relevant sales on or after Sept. 1, 2022. More specifically, a business is required to apply to register with the CRA as a registered vendor of aircraft, vehicles, vessels, or a combination, by the earlier of:

- The day of the first sale of aircraft, vehicles, or vessels above the respective threshold
- The day of the first importation of aircraft, vehicles or vessels above the respective threshold

For 2022, there is only one reporting period: Sept. 1, 2022, to Dec. 31, 2022. The filing/payment deadline for this period is Jan. 31, 2023.

CREDITS AND INCENTIVES CONSIDERATIONS

Interactive digital media and e-business tax credits

The provinces of Quebec, Ontario, Nova Scotia, Manitoba and British Columbia have refundable interactive digital media tax credit (IDMTC) programs in place to incentivize corporations to form permanent establishments and employ residents. The tax credit generally covers a percentage of labour costs directly attributable to product development. Companies taking advantage of IDMTCs include gaming, VR/Metaverse, and educational/edutainment-type companies.

Film and video tax credits

Canada remains a highly sought-after location for film and television companies in part due to the provincial and federal Film and Video Tax Credit incentives (FVTC) provided by the federal and various provincial governments. Similar to the IDMTCs, the tax credit covers a percentage range of labour costs and non-interactive productions. The two film and video tax credits offered by CAVCO are the Canadian Film and Video Production Tax Credit (CPTC) and the Film or Video Production Services Tax Credit (PSTC).

Scientific research and experimental development

The government of Canada offers research incentives through the Scientific Research & Experimental Development (SR&ED) program. SR&ED tax incentives encourage businesses of all sizes to perform R&D activities within Canada in the form of an earned income deduction or an investment tax credit (ITC). SR&ED ITCs are available federally as well as provincially in many of the Canadian provinces.

- **Eligibility:** Often companies incorrectly assume they need to be engaged in pure research and development to qualify for the SR&ED tax incentive even though much of the company's existing innovation and development work may already qualify. In August 2021, the CRA released new and clearer guidance on what is considered SR&ED work. The five questions which previously helped to determine SR&ED eligibility have been replaced with two questions pertaining to 'Why' and 'How' work must be carried out. The 'Why' question can be satisfied if the work is for the advancement of scientific/technological knowledge, and the 'How' of the work is through systematic investigation, experimentation, or analysis in a scientific/technological field.
- **Transfer pricing considerations:** For non-residents that control Canadian corporations eligible for SR&ED, ITCs are generally non-refundable; however, the Canadian corporation may be able to use them through transfer pricing policies. Multinational corporations may consider reviewing and updating their transfer pricing policies to use their non-refundable credits.

AUDIT AND ENFORCEMENT CONSIDERATIONS

New mandatory disclosure rules are on the horizon

In 2022, the Minister of Finance (the Minister) released two rounds of draft legislation on the mandatory disclosure rules that were originally contemplated in the 2021 federal budget. At first, the draft legislation was to be effective as of Jan. 1, 2022; however, the second revised draft legislation pushed back the effective date to Jan. 1, 2023. As a result, taxpayers should expect the increased disclosure obligations to be effective for transactions entered into (and for taxation years starting) on or after Jan. 1, 2023.

The proposed mandatory disclosure rules include three categories of disclosure obligations: (i) a reportable transaction, (ii) a notifiable transaction, and (iii) an uncertain tax treatment.

A reportable transaction is not a new concept, but the draft legislation does propose significant changes to the existing reportable transaction disclosure obligations. Currently, a reportable transaction is an avoidance transaction that has at least two out of the following three hallmarks:

- A promoter or advisor receives contingent fees related to the transaction
- An advisor (or promoter) obtains *confidential protection* in respect of the avoidance transaction
- The person entering into the avoidance transaction receives *contractual protection* against failure to achieve a tax benefit from the transaction

Moreover, under the current legislation, an avoidance transaction is a transaction (or series of transactions) that results, directly or indirectly, in a tax benefit unless there is a *bona fide* non-tax purpose for undertaking the transaction. However, under this definition, a transaction that has a tax-motivated purpose will not always be an avoidance transaction if the primary purpose is a non-tax purpose, even if there is a secondary tax purpose.

The draft legislation proposes significant changes to the existing reportable transaction disclosure obligations. The key proposed changes to the reportable transaction regime are as follows:

- The definition of avoidance transaction is revised to make it much broader. Instead of applying only when the primary purpose is to obtain a tax benefit, it will now apply if *one of the main purposes* of the transaction is to obtain a tax benefit. There can be several main purposes for a transaction or series of transactions, and if any one of them is to obtain a tax benefit, the transaction will be an avoidance transaction.
- Only one of the three hallmarks is required for the avoidance transaction to create the reporting obligation, but the scope of the confidential protection hallmark and the contractual protection hallmark will be narrowed. Specifically, (i) the confidential protection element must relate to the tax treatment of the avoidance transaction, which is meant to alleviate the concern that confidential clauses in a normal commercial context could satisfy the confidentiality protection hallmark, and (ii) the contractual protection must relate to the tax treatment of the avoidance transaction, thereby alleviating the concern that standard commercial warranties could satisfy the contractual protection hallmark.

A notifiable transaction is a new concept that will give the Minister the power to designate a specific type of transaction a "notifiable transaction," thereby creating a disclosure obligation for any substantially similar transaction. The transactions designated by the CRA are those that have been found to be abusive or a transaction of interest. So far, six types of transactions have been designated:

- Manipulating CCPC status
- Straddle creation transactions using a partnership
- Avoiding the 21-year deemed disposition rule for trusts
- Manipulation of bankrupt status to reduce debt forgiveness
- Avoidance of acquisition of control of a corporation in certain circumstances
- Back-to-back lending to avoid either thin capitalization rules or non-resident withholding tax

An uncertain tax treatment is another new concept in the mandatory disclosure rules. It applies to a planned or used tax treatment in a corporation's income tax filings where there is uncertainty over whether the courts will accept the tax treatment. Corporations will be required to file an information return in respect of each uncertain tax treatment if the following conditions exist:

- the corporation is required to file an income tax return in Canada,
- the corporation has assets of a carrying value greater than or equal to $50 million at the end of the year, and
- the corporation prepares audited financial statements in accordance with International Financial Reporting Standards or other country-specific generally accepted accounting principles (for corporations that are listed on a stock exchange outside of Canada).

A corporation that is required to disclose uncertain tax treatments is required to provide the quantum of taxes at issue, a concise description of the relevant facts, the tax treatment taken, and whether the uncertainty relates to a permanent or temporary difference in tax.

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The disclosure obligation applies to taxation years starting on or after Jan. 1, 2023.

Enhanced Canada Revenue Agency collection powers

2022 also saw the Minister release draft legislation to broaden the CRA's power to collect tax debts under section 160 of the ITA.

Section 160 states that the CRA can assess a person (the transferee) for some or all of the tax debt of another person (the transferor) when four criteria are met. The purpose of the provision is to provide the CRA with recourse when a taxpayer has not paid a tax liability and has transferred assets to a non-arm's length party for less than fair market value (FMV).

The proposed changes modify several of the criteria so that section 160 will have broader application. In addition, once passed, the changes will apply to transactions that occurred on or after April 19, 2021—meaning they will have retroactive effect. The key changes are as follows:

- **Non-arm's length dealing:** The determination of whether the transferor and transferee are not dealing at arm's length is extended. Currently, the non-arm's length assessment is made at the specific point in time that the property was transferred. The draft legislation proposes to extend the determination time to the period beginning immediately prior to, and ending immediately after, the transaction (or series of transactions), provided that one of the transaction purposes is to avoid section 160.
- **Additional rule regarding tax debt:** A rule is added that would deem a tax debt to have crystalized in a taxation year earlier than it, in fact, arose. Currently, section 160 applies when the transferor's tax liability relates to the year in which the transfer of property occurred, or any year before the transfer of property occurred. The draft legislation provides that a tax debt may be deemed to have crystalized in an earlier taxation year if one of the purposes for the transfer of property was to avoid section 160.
- **Extinguished consideration:** The section 160 regime will now apply to transactions where the consideration given by the transferee is cancelled or extinguished. Currently, a promissory note that is extinguished or cancelled as part of a transaction or series thereof that represented a *bona fide* debt at some point during the period is considered adequate consideration of the transferee, thereby avoiding the application of section 160. The draft legislation provides that if consideration given by the transferee is in a form that is cancelled or extinguished during the period beginning immediately prior to and ending immediately after a transaction or series of transactions, its FMV will be deemed to be nil (subject to certain exemptions for substituted property).

In addition, the draft legislation proposes significant penalties for taxpayers and advisors engaging in transactions where the parties know, or are reasonably expected to know, that one of the main purposes is to avoid section 160 (i.e., section 160 avoidance planning). The penalties for section 160 avoidance planning are the lesser of (i) 50 per cent of the amount payable under the ITA that was sought to be avoided with the planning and (ii) $100,000 plus the person's gross entitlements in respect of the planning. Penalties for section 160 avoidance planning can be imposed on any party involved in the planning, with a limited exception for persons solely providing clerical or secretarial services.

Modernizing the General Anti-Avoidance Rule

Unlike the mandatory disclosure rules and the enhancement of the CRA collection powers detailed above, there is no draft legislation for changes to the General Anti-Avoidance Rule (GAAR). Instead, the Minister released a lengthy consultation paper that sets out potential changes to the GAAR and seeks public input on modernizing the GAAR.

The consultation paper's proposals suggest a broadening and strengthening of the GAAR that may materially affect the willingness of taxpayers to engage in certain transactions to which the GAAR may apply. The proposals include the following changes:

- **Applying GAAR to "tax attributes":** Applying GAAR to "tax attributes" rather than just to immediate tax benefits. Currently, a tax benefit, usually defined as a reduction, deferral or avoidance of tax, is required to be considered an avoidance transaction. A transaction undertaken to change a tax attribute that could be relevant in computing tax at a subsequent time does not constitute a reduction, deferral or avoidance

of tax, since no benefit is crystalized for the taxpayer. A tax attribute may include the amount that can be withdrawn from a corporation on a tax-free basis due to the paid-up capital attached to a share or shares of a corporation.

- **Targeting mixed-purpose transactions:** The government cited that the GAAR fails to prevent abusive tax avoidance when a tax benefit is achieved in the context of a transaction with a primarily non-tax purpose or of mixed purpose. In recent court decisions, such as *Canada v. Loblaw Financial Holdings Inc.* (2021 SCC 51), taxpayers successfully cited non-tax "main purposes" for undertaking a transaction or series of transactions to defeat the CRA's GAAR claim.
- **Improving interpretive process:** Improving the interpretive process for determining the object, spirit and purpose of a transaction by including interpretive aids in legislation and improving extrinsic aids. Currently, the government and taxpayers are required to dispute the object, spirit and purpose of a provision to determine whether an avoidance transaction that gives rise to the tax benefit is abusive, or a misuse of the provision.
- **Economic substance test:** Legislating an economic substance test into the GAAR. This would override the Supreme Court of Canada's comments in *Canada Trustco Mortgage Co. v. Canada* (2005 SCC 54) that a transaction is not abusive merely because it has no economic substance.
- **Penalties:** Creating penalties and other deterrents, such as a penalty tied to the tax benefit achieved through a transaction to which GAAR may apply, an increased interest rate and a longer reassessment period.

Canada Revenue Agency's ability to demand documents in an audit

The government's power to demand the production of documents in an audit is quite broad. 2022 saw a continued trend where the Federal Court sided with the government and ordered the production of documents that a taxpayer sought to keep confidential. In *Minister of National Revenue v. BMO Nesbitt Burns Inc.* (2022 FC 157), the government sought production of a "master summary pricing model" (MSPM) that BMO had prepared as a result of input from their legal counsel. The privilege claim derived from the MSPM being translated from legal advice. BMO argued that disclosure of the MSPM would reveal the legal advice.

The CRA argued that the MSPM was an "operational document" that was an end product of legal advice and the "very legal advice given by counsel" could not be discerned.

The Federal Court ruled that the redacted portions of the MSPM were not protected by solicitor-client privilege on the basis that it was not clear how the redacted part of the MSPM implemented or conveyed that legal advice.

Even though the taxpayer has appealed this decision to the Federal Court of Appeal, this ruling carries significant ramifications for the protection afforded by solicitor-client privilege when a client acts on legal advice to prepare internal documentation or conduct any computational modelling.

Equitable remedy tax update

The Supreme Court of Canada (SCC) effectively put an end to using the equitable remedy of rescission to avoid unforeseen or unintended tax consequences. This means equitable remedies should only be available where the legal agreements do not reflect the parties' agreement and the tax impact is purely incidental.

Equity, deriving from the English court systems, generally refers to the ability of common law courts to remedy situations where the law is not flexible to deliver a fair resolution to a case. In recent years, two equitable remedies—rectification and rescission—have been addressed in the tax law context by the SCC. The SCC narrowed both remedies substantially, citing, among other things, that equitable remedies cannot be used for retroactive tax planning.

- **Rectification:** Rectification is generally considered to be available where it is required to give effect to the true intention of the parties at the time of entering a transaction. This remedy should still be available where the legal agreements do not reflect the parties' agreement. However, taxpayers should note that a general intention to avoid or minimize tax when entering a business transaction is not a sufficient basis for obtaining rectification. Furthermore, the SCC cited the case law principle that taxpayers should expect to be taxed on the basis of what they actually did, not what they could have done.
- **Rescission:** Rescission is an equitable remedy by which a transaction entered into may be retroactively cancelled, annulled or set aside. In *Canada (Attorney General) v. Collins Family Trust* (2022 SCC 26), the SCC effectively closed the door on rescission for tax matters as it would amount to retroactive tax planning.

In the decision, the taxpayer relied on a widely accepted (and CRA endorsed) interpretation of a certain provision of the ITA when structuring its affairs. Subsequently, an unrelated court decision identified that the relevant provision had been misinterpreted and established the proper interpretation. Applying the proper interpretation to the taxpayer's transaction resulted in unintended tax consequences. The taxpayer sought to rescind the transaction on the basis that it would not have completed the transaction but for the widely accepted (though incorrect) interpretation. The SCC held that the remedy of rescission was not available to the taxpayer in this case because equitable remedies are only appropriate "where it would be unconscionable or unfair to allow the common law to operate in favour of the party seeking enforcement of the transaction." In this case, there was nothing unfair about parties being taxed based on transactions they completed.

PROVINCIAL TAX CONSIDERATIONS

British Columbia

- **Scientific research and experimental development tax credit:** The provincial Scientific Research and Experimental Development tax credit program has been extended for an additional five years to Aug. 31, 2027. Providing relief for Canadian-controlled private corporations that conduct research and development, the refundable SR&ED credit can result in long-term economic growth for the province.
- **Speculation and vacancy tax:** Individual and corporate owners of strata accommodation properties (also called strata hotels) will permanently remain exempt from the British Columbia Speculation and Vacancy Tax. This exemption was previously set to expire at the end of 2021.
- **Sales tax measures—obligations for online 'marketplace facilitators':** Since July 1, 2022, marketplace facilitators have been required to collect provincial sales tax on taxable goods shipped from within Canada, taxable services (including short-term rentals and other taxable accommodation, but not including legal services), and software and leases of goods made via online marketplaces to consumers within British Columbia. Additionally, marketplace facilitators are required to charge PST on facilitation services that they provide to online sellers. Online retailers and service providers should consider whether they are required to collect and remit PST on their goods and services.

Ontario

- **Regional opportunities investment tax credit:** Budget 2021 temporarily increased the Regional Opportunities Investment Tax Credit (ROITC) from 10 per cent to 20 per cent for qualifying expenditures between $50,000 and $500,000 for properties that become available for use in the period from March 24, 2021, to Jan. 1, 2023. The government has extended the credit until Jan.1, 2024. The ROITC is a refundable corporate income tax credit available for Canadian-controlled private corporations (CCPCs) that make qualifying investments in eligible geographic areas of Ontario.
- **Strengthening the non-resident speculation tax:** Effective March 30, 2022, the Ontario government implemented several amendments in relation to the Non-Resident Speculation Tax (NRST). The NRST is a tax on the purchase or acquisition of interest in residential property located provincewide, by non-citizens or permanent residents, or by foreign entities and taxable trustees. The changes include (i) an increase to the NRST rate from 15 per cent to 20 per cent, (ii) an expansion of the NRST's application provincewide, and (iii) an elimination of two rebates specific to international students and foreign nationals working in Ontario. Agreements of purchase and sale entered into on or after March 30, 2022, will be subject to these changes. Rebates remain available for foreign nationals who become permanent residents of Canada within four years after the tax becomes payable if eligibility criteria are met.

Quebec

- **Extending the temporary increase to investment and innovation tax credits:** Quebec's 2020 Budget introduced the investment and innovation tax credits (C3i). These credits are available to businesses that acquire certain eligible properties such as manufacturing or processing equipment or certain software between March 10, 2020, and Jan. 1, 2025. The amount of the tax credit depends on the expense, the type of eligible property acquired, and the territory/zone where the eligible property is acquired and used. In the 2022 Budget, the Quebec government extended the enhanced C3i tax credit rates for another year in an

effort to continue to encourage businesses to acquire new technologies and upgrade their equipment. As a result, the tax credits are doubled for the goods acquired from March 26, 2021, until Dec. 31, 2023.

- **New tax credits to encourage environment-conscious initiatives:** The Quebec government introduced two new tax credits to promote and encourage environment-conscious initiatives: (i) a new tax credit related to the production of biofuels and (ii) a redesigned tax credit for the production of pyrolysis oil. These tax credits are available from April 1, 2023, to March 31, 2033.

The refundable tax credit for the production of biofuel in Quebec is available to a "qualified corporation" in respect of "eligible biofuels" produced in Quebec for sale and use in Quebec, up to a maximum of 300 million litres per year. The rate of the tax credit depends on various factors but, generally speaking, increases relative to the decrease in carbon intensity observed for that biofuel compared to the gasoline or diesel fuel that it replaces.

The redesigned refundable tax credit for the production of pyrolysis was initially announced in the 2018 Budget. This refundable tax credit is available for a "qualified corporation" in respect of eligible pyrolysis oil it produces in Quebec from residual forest biomass, which is sold in and intended for Quebec. The tax credit is available at a rate of $0.08 per litre, up to 100 million litres per year. The 2022 Budget extended the eligibility of the credit for another 10 years—until March 31, 2033—with certain modifications to the program effective April 1, 2023.

- **Audit and enforcement:** The Quebec government continues forward with the Tax Fairness Action Plan, designed to ensure the integrity of the tax system and combat tax evasion and tax avoidance, with the following objectives:
  - Promoting the use of efficient and modern technological tools to allow Revenu Quebec to transform its service delivery and simplify the steps taxpayers need to take in meeting their administrative tax obligations
  - Deploying project VISION, which is aimed at transforming the provision of services to individuals and businesses into a simplified, more efficient, digital tax administration model

The digitization of various compliance processes should simplify tax processes and enable taxpayers to fulfill their responsibilities themselves, with less reliance on, and intervention from, Revenu Quebec.

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