TAX MANAGEMENT PORTFOLIOS™

FOREIGN INCOME

Business Operations in Canada

by

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This Portfolio revises and supersedes previous versions of 7050-2nd T.M., *Business Operations in Canada*.

ISBN 978-1-63359-385-5

ISBN 978-1-63359-385-5

TAX MANAGEMENT
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Business Operations in Canada

PORTFOLIO DESCRIPTION

Tax Management Portfolio, *Business Operations in Canada*, No. 7050-2nd, contains general information and tax rules to enable United States and other foreign businesses to understand the commercial and tax law likely to be of concern to them in their business dealings with Canada.

Among the non-tax matters covered in this Portfolio are the formation and operation of Canadian business entities, anti-trust (or combines) law, the United States-Mexico-Canada Agreement, and legislation dealing with review of foreign investment in Canada.

The rules of income taxation are covered with particular emphasis on problems likely to be encountered by foreign businesses. The discussion of individual and corporate income taxes is based upon the federal Income Tax Act. The discussion of income taxes is directed toward a basic explanation of the Canadian tax system, special rules applicable to corporations, and the taxation of nonresidents. Other sections deal with tax avoidance, the computation of income, and administration of the income tax legislation.

Among the Worksheets are links to the forms commonly used in connection with the Income Tax Act.

This Portfolio may be cited as Marley and Ludwin, 7050-2nd T.M., *Business Operations in Canada*.

ISBN 978-1-63359-385-5

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DETAILED ANALYSIS

I. Canada: The Country, Its Government and Legal System

A. Canada — The Country and Its Government

Canada is a federal state in which legislative authority is constitutionally divided between the federal and provincial governments. Jurisdiction over some areas and activities is exclusively that of either the federal government or the provincial governments, while jurisdiction over other areas is shared. In addition, the provincial governments normally delegate specific powers to the municipal governments. As a result, a business may be regulated at each of the three levels: federal, provincial and municipal.

1. The Country

Canada consists of 10 provinces and three territories with a total population of over 40 million. The three largest metropolitan areas are Toronto, Montreal and Vancouver. The capital city, Ottawa, is located in Ontario, the most populous province.

Canada is officially bilingual, with English and French having equal status in all institutions of the federal government.

2. Political Organization/Government

Canada is a constitutional monarchy with the King of the United Kingdom as the official head of state. In practice, however, it is a completely independent sovereign state having full international status. Governments are democratically elected at each of the federal, provincial and municipal levels. The titular head of state is the Governor General. Although technically the representative of the King in Canada, the Governor General is chosen based on the recommendation of the Prime Minister. The government is indicated in the style of cause for most tax cases as "The King" (or, for decisions issued during the reign of Queen Elizabeth II, "The Queen").

As a federal state, legislative authority in Canada is constitutionally divided between the federal and provincial governments under enumerated heads of powers. Jurisdiction over some areas and activities is exclusively that of either the federal government or the provincial governments, while jurisdiction over other areas is shared. The federal government has jurisdiction over "the raising of money by any mode or system of taxation," while provinces have jurisdiction over the broad category of "property and civil rights in the province" as well as "direct taxation within the province in order to the raising of a revenue for provincial purposes." Any residual powers falling outside the enumerated heads of power fall to the federal government. In addition, the provincial governments normally delegate specific powers to the municipal governments, which have no constitutional status and are instead created by the provinces. As a result, a business may be regulated at each of the three levels: federal, provincial and municipal.

The federal government consists of three branches: legislative, executive, and judicial. The legislature consists of the House of Commons, members of which are democratically elected; the Senate, members of which are appointed by the Governor General based on the recommendation of the Prime Minister; and the King, as represented by the Governor General. The executive, by convention, comprises members of the House of Commons and, rarely, Senators. Legislation is enacted by means of a bill, which can originate in either chamber of the legislature (the House of Commons or the Senate). Tax bills must, however, originate in the House of Commons. The bill must pass both chambers.

Further details of the judiciary are found in section I.B.2., below.

B. Sources of Law

1. Statutes

The federal legislative process in Canada begins with a proposed law being introduced as a bill in Parliament, either in the House of Commons or the Senate. After a first reading in either house, the bill is printed. During the second reading (in the same house), members debate and vote on the principle of the bill. It may then be referred to a legislative, standing or special committee that will report the bill back to the house and indicate any proposed amendments. During the third reading, members will debate and vote on the bill (as amended); it then passes to the other house for consideration. Finally, it is presented to the Governor General (as representative for the King in Canada) for royal assent; once royal assent is granted, the bill becomes law.

Statutes may come into force upon either royal assent or proclamation, or on a day specified in the act. Although tax amendments follow this same legislative process, they are often released as draft legislation prior to being introduced as a bill. This allows members of the public to comment on the proposals and identify concerns at an early stage. Upon receiving royal assent, in many cases draft tax amendments apply retroactively to the date on which they were first introduced in draft form.

The legislative process of the provincial governments is structured similar to that of the federal government.

2. Court System

With the exception of Quebec, all the provinces of Canada are common law jurisdictions, deriving their private law and many public institutions from British precedents. Quebec is a civil law jurisdiction and derives its private law generally from the body of French law that led to the Napoleonic Code in France. Although the common law provinces have strong historical ties to U.K. common law, U.S. jurisprudence and legislative developments are also influential with Canadian courts and legislators, particularly with respect to commercial matters.

The judiciary includes both courts of inherent jurisdiction created by the Constitution and federal courts created by statute with specified jurisdictions. The Tax Court of Canada is a statutory court that has exclusive jurisdiction over appeals on

ISBN 978-1-63359-385-5

matters arising under the Income Tax Act,[1] the Excise Tax Act (which includes the goods and services tax),[2] and other specified federal statutes.[3] Each statute further sets out the Tax Court's powers; for example, the Income Tax Act specifies that the court may dispose of an appeal by dismissing or allowing it and either vacating or varying the assessment at issue or referring it back to the Minister of National Revenue for reconsideration and reassessment.[4] The Minister of National Revenue has formal responsibility over administering and enforcing the Income Tax Act, though in practice the administration and enforcement is carried out by the Canada Revenue Agency.

Another statutory court is the Federal Court of Canada, which has "concurrent original jurisdiction in all cases in which relief is claimed against the Crown," as well as "exclusive original jurisdiction" to grant certain relief in respect of "any federal board, commission or other tribunal" in response to an application for judicial review.[5] The Federal Court of Canada's jurisdiction accordingly includes judicial review of decisions made by governmental or quasi-governmental authorities in exercising their statutory powers.

Disputes between taxpayers and the government regarding which court, the Tax Court of Canada or the Federal Court of Canada, has jurisdiction over a particular tax matter occasionally arise. In *Canada (National Revenue) v. JP Morgan Asset Management (Canada) Inc.,* the Federal Court of Appeal struck a notice of application to the Federal Court of Canada for judicial review, holding that taxpayers cannot seek relief from the Federal Court if "an appeal to the Tax Court is available, adequate and effective in giving the taxpayer the relief sought."[6] Such appeals include those concerning the validity of an assessment ("the Federal Court is not allowed to vary, set aside or vacate assessments"), the admissibility of evidence supporting an assessment, and abuses of the Tax Court's own processes.[7] In *Canada v. Dow Chemical Canada ULC*, the taxpayer appealed to the Tax Court to challenge the Minister's refusal to make a downward transfer pricing adjustment, which under the Income Tax Act is discretionary.[8] The Supreme Court upheld the Federal Court of Appeal's decision that the Federal Court of Canada and not the Tax Court has jurisdiction over how the Minister of National Revenue chooses to exercise statutorily granted discretion powers such as those concerning downward transfer pricing adjustments.[9]

Appeals from both the Tax Court and the Federal Court of Canada are heard by the Federal Court of Appeal.[10] A further appeal may then be available to the Supreme Court of Canada, which has jurisdiction over virtually any legal proceeding arising in Canada, though in most cases (and virtually all cases concerning the tax system) parties must seek leave from the Supreme Court for their appeal to be heard.

3. *Arbitration System*

Arbitration is available in Canada as a private dispute resolution mechanism. Parties must agree to have their dispute heard by one or more arbitrators. The agreement can occur before or after the dispute arises, including by entering into an arbitration agreement (either as a standalone contract or as part of a broader contract). Parties usually have significant flexibility in choosing the arbitrator(s), the procedure, the applicable law, and the forum for the arbitration.

The decision of the arbitrator(s) can be generally be enforced by a court. The arbitration agreement can restrict the parties' right to appeal the arbitrator's decision to a court.

Domestic provincial and territorial arbitration statutes set out a default procedure for domestic arbitration, establish minimum requirements, and specify when a court can intervene (including circumstances where a party can appeal or apply to set aside an arbitrator's decision). Separate rules govern international arbitration.

Arbitration is not currently an option for resolving Canadian tax disputes between taxpayers and tax authorities other than arbitration under a tax treaty, which is most notably available under the Canada-U.S. tax treaty (discussed below in XII.G.5.). A number of Canada's other tax treaties have an arbitration provision in their mutual agreement procedure (MAP) article. In addition, Canada elected to apply the arbitration provisions in Part VI of the Multilateral Instrument (MLI).

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[1] R.S.C. 1985, c. 1 (5th Supp.).
[2] R.S.C. 1970, c. E-15, as amended.
[3] Tax Court of Canada Act, R.S.C. 1985, c. T-2, s. 12.
[4] R.S.C. 1985, c. 28 (1st Supp.), s. 171(1).
[5] Federal Courts Act, R.S.C. 1985, c. F-7, ss. 17, 18.
[6] 2013 FCA 250 at para. 82.
[7] *Ibid.* at paras. 82, 93.
[8] 2022 FCA 70.
[9] *Dow Chemical Canada ULC v. Canada*, 2024 SCC 23. See also a related decision regarding the availability of declaratory relief relating to the conduct of a tax appeal released by the Supreme Court at the same time: *Iris Technologies Inc. v. Canada*, 2024 SCC 24.
[10] Federal Courts Act, R.S.C. 1985, c. F-7, s. 27.

ISBN 978-1-63359-385-5

II. Operating a Business in Canada

A. *Foreign Investment Control — Investment Canada Act*

1. *In General*

The Investment Canada Act[11] (ICA) applies to an investment in an existing Canadian business or the establishment of a new Canadian business by a non-Canadian investor. In general, a "non-Canadian" investor is an individual who is neither a Canadian citizen nor a permanent resident of Canada, or an entity that is controlled, or deemed to be controlled, by one or more non-Canadians. The ICA applies regardless of whether the Canadian business being acquired is Canadian-controlled.

The ICA sets out certain rules regarding when an acquisition of control has occurred. The acquisition of a majority of the voting interests of an entity, including a corporation, is deemed to be an acquisition of control. The acquisition of between one-third and one-half of the voting shares of a corporation is presumed to be an acquisition of control unless it can be shown that the investor has not in fact acquired control of the corporation. The acquisition of less than one-third of the voting shares of a corporation is deemed not to be an acquisition of control. In the case of entities other than corporations, such as partnerships, trusts or joint ventures, an acquisition of less than a majority of the voting interests is deemed not to be an acquisition of control. The ICA also provides for Ministerial discretion regarding the acquisition of control where the non-Canadian investor is a state-owned enterprise (SOE) or where the Canadian business is a "cultural business" as defined in the ICA.

Under the ICA, acquisitions of control where certain monetary thresholds are exceeded by the Canadian business are subject to pre-closing Ministerial review and approval. In such circumstances, the non-Canadian investor must demonstrate that its investment is likely to be of "net benefit to Canada." Acquisitions by non-Canadian investors that fall below these thresholds and establishments of new Canadian businesses by non-Canadian investors must be notified to the Canadian government.

Any level of investment by a non-Canadian investor in a Canadian business may be subject to a national security review if the government determines that the investment may be "injurious to national security." This includes establishments of new businesses and investments that do not involve an acquisition of control of a Canadian business.

In March 2024, the federal government enacted Bill C-34, the *National Security Review of Investments Modernization Act*, bringing a significant suite of changes to the ICA. While some of these amendments came into force in September 2024, others will come into force on a date to be fixed by Cabinet (as these changes will require drafting new regulations or interpretation notes). Once in force, the remaining Bill C-34 amendments will, among other things, establish a mandatory pre-closing notification regime for certain types of investments in sensitive sectors by non-Canadian investors and provide for a discretionary net benefit review for acquisitions of control by SOEs from non-trade agreement jurisdictions.

2. *Reviewable Transactions*

a. *Thresholds*

Acquisitions of control by non-Canadian investors of Canadian businesses that meet the following review thresholds are subject to pre-closing Ministerial review and approval:

(i) For a direct acquisition of control of a publicly-traded entity, privately-held entity, or of substantially all of the assets used in carrying on a Canadian business (outside of the cultural sector):[12]

- Can. $2.079 billion (for 2025) in enterprise value if the investor or the current controller of the Canadian business is a national of a country with which Canada has a free trade agreement (currently Australia, Brunei, Chile, Colombia, Honduras, Japan, Malaysia, Mexico, New Zealand, Panama, Peru, Singapore, South Korea, Ukraine, the United Kingdom, the United States, Vietnam and the European Union); or
- Can. $1.386 billion (for 2025) in enterprise value if the investor or the current controller of the Canadian business is not a national of a country with which Canada has a free trade agreement but is a national of a WTO member state.

(ii) For a direct acquisition of control of a cultural business — book value of assets of the Canadian business is Can. $5 million or more.

(iii) For a direct acquisition of control by a non-WTO investor of a non-WTO controlled target — book value of assets of the Canadian business is Can. $5 million or more.

(iv) For a direct acquisition of control by a state-owned enterprise (SOE) investor — book value of the assets of the Canadian business is Can. $551 million or more (for 2025).

Indirect non-WTO investment or indirect investment in the cultural sector is subject to a post-closing review where the book value of assets of the Canadian business is Can. $50 million or more, although if the Canadian assets acquired represent more than 50% of the value of all assets acquired through the transaction, then the threshold is Can. $5 million or more.

The manner in which enterprise value and book value of assets are to be calculated is prescribed by statute.

Direct acquisitions of Canadian businesses where the thresholds are not met, and indirect trade agreement/WTO investments, including by SOEs, are currently subject to notification only (although national security review could still apply — as discussed below).

b. *The Substantive Test — Net Benefit to Canada*

For an investment to secure Ministerial approval under the ICA, the investor must demonstrate that the investment is like-

[11] R.S.C. 1985, c. 28 (1st Supp.).

[12] The acquisition thresholds are adjusted annually to reflect changes to the Gross Domestic Product (GDP).

ISBN 978-1-63359-385-5

ly to be of "net benefit to Canada" with reference to the prescribed statutory factors set out in section 20 of the ICA, namely:

(i) The effect of the investment on the level and nature of economic activity in Canada;

(ii) The degree and significance of participation by Canadians in the Canadian business;

(iii) The effect of the investment on productivity, industrial efficiency, technological development, product innovation and product variety in Canada, including the effect of the investment on any rights relating to intellectual property whose development has been funded, in whole or in part, by the Government of Canada;

(iv) The effect of the investment on competition within any industry or industries in Canada;

(v) The compatibility of the investment with national industrial, economic and cultural policies, taking into consideration industrial, economic and cultural policy objectives enunciated by the government or legislature of any province likely to be significantly affected by the investment, including the effect of the investment on the use and protection of personal information about Canadians; and

(vi) The contribution of the investment to Canada's ability to compete in world markets.

To demonstrate net benefit, the investor generally must enter into undertakings with the responsible Minister relating to matters such as employment, Canadian management and head office capital expenditures, research and development, and charitable and community contributions.

There are special policies that apply to acquisitions of certain cultural businesses and acquisitions by SOEs. In particular, once in force, the Bill C-34 amendments will grant federal Cabinet the discretion to order a net benefit review of any direct or indirect acquisition of control of a Canadian business where the investor is a SOE that is not a trade agreement investor.

c. *Review Process and Timeline*

Once the investor has filed an application for review with the responsible Minister, there is a review period of 45 days, which may be (and typically is) extended by the Minister for an additional 30 days. Any further extensions are agreed to between the investor and the Minister. In circumstances in which the application is required to be filed prior to closing (which is typically the case), the transaction may not be completed until approval or deemed approval is received under the ICA.

The review and approval of investments falls under the authority of the Minister of Industry, other than investments in cultural businesses, which are reviewed and approved by the Minister of Canadian Identity and Culture.

3. *Notification*

The federal agency, Innovation, Science and Economic Development Canada or, in the case of cultural businesses, the Department of Canadian Heritage must be notified whenever a non-Canadian establishes a new Canadian business that is unrelated to any business already being carried on in Canada by that investor or acquires an existing Canadian business in a transaction that is not reviewable because it does not reach the thresholds discussed above. In such cases, the investor must give notice in the prescribed manner any time before implementing the investment or within 30 days after completing the investment. The investment will then proceed without further government intervention on a "net benefit review basis," unless it is in a "cultural business" and the federal Cabinet exercises its jurisdiction to order a review of the transaction in the public interest. Notice generally is not required where the investment is simply an expansion of the investor's existing Canadian business or is related to a business already operated in Canada by the investor, except in the case of cultural businesses, where notification is required even for expansion into related businesses that are not already carried on by the investor. The federal government has published guidance to assist investors in determining whether new activities carried on in Canada would be treated as "related" to an existing business.[13] A "related business" under this guidance is generally a business whose central purpose is the more effective operation of the existing business.

As stated above, recent amendments to the ICA will establish a mandatory pre-closing notification regime for investments in sensitive sectors by non-Canadian investors and provide for a discretionary net benefit review for investments by SOEs from non-trade agreement jurisdictions. While these amendments have been enacted, the federal Cabinet has not yet fixed the entry into force date for either of these new provisions.

4. *National Security Review*

The ICA also provides for the review of any foreign investment on national security grounds. An investment is subject to national security review if the Minister considers that the investment could be "injurious to national security" and a review is ordered. In particular, even establishments of new businesses and investments that do not involve an acquisition of control of a Canadian business may be subject to national security review.

While the standard for what is considered "injurious to national security" is not defined in the ICA, the federal government has published guidelines for the national security review process.[14] Pursuant to these guidelines, in assessing the national security implications of a proposed investment, the Minister will consider the nature of the asset or business activities and the parties, including the potential for third party influence (including that of foreign countries). The guidelines further provide the following non-exhaustive list of factors it will consider when assessing whether an investment poses a national security risk:

(i) The potential effects of the investment on Canada's defense capabilities and interests, including but not limited to the defense industrial base and defense establishments.

(ii) The potential effects of the investment on the transfer of sensitive technology or know-how outside Canada, including consideration of whether the investment provides

[13] https://ised-isde.canada.ca/site/investment-canada-act/en/investment-canada-act/guidelines/all-guidelines#p1.

[14] https://ised-isde.canada.ca/site/investment-canada-act/en/investment-canada-act/guidelines/guidelines-national-security-review-investments.

ISBN 978-1-63359-385-5

access to information not in the public domain related to the research, design or manufacture of sensitive technologies. The federal government's Sensitive Technology List identifies the following 11 broad technology areas with national security implications that the Government of Canada considers to be sensitive:

- Advanced Digital Infrastructure Technology;
- Advanced Energy Technology;
- Advanced Materials and Manufacturing;
- Advanced Sensing and Surveillance;
- Advanced Weapons;
- Aerospace, Space and Satellite Technology;
- Artificial Intelligence (AI) and Big Data Technology;
- Human-Machine Integration;
- Life Science Technology;
- Quantum Science and Technology; and
- Robotics and Autonomous Systems.[15]

(iii) Involvement in the research, manufacture or sale of goods/technology identified in Section 35 of the Defence Production Act.

(iv) The potential impact of the investment on the supply of critical goods and services to Canadians, or the supply of goods and services to the Government of Canada.

(v) The potential impact of the investment on critical minerals and critical mineral supply chains. For further details regarding what constitutes a critical mineral, see Canada's Critical Minerals List.[16]

(vi) The potential impact of the investment on the security of Canada's critical infrastructure. Critical infrastructure refers to processes, systems, facilities, technologies, networks, assets and services essential to the health, safety, security or economic well-being of Canadians and the effective functioning of government.

(vii) The potential of the investment to undermine Canada's economic security through the enhanced integration of the Canadian business with the economy, or any sector of it, of a foreign state.

(viii) The potential of the investment to enable foreign surveillance or espionage.

(ix) The potential of the investment to hinder current or future intelligence or law enforcement operations.

(x) The potential impact of the investment on Canada's international interests, including foreign relationships.

(xi) The potential of the investment to involve or facilitate the activities of illicit actors, such as terrorists, terrorist organizations, organized crime or corrupt foreign officials.

(xii) The potential of the investment to enable access to sensitive personal data that could be leveraged to harm Canadian national security through its exploitation, including, but not limited to:

- Personally identifiable health or genetic (for example, health conditions or genetic test results);
- Biometric (for example, fingerprints);
- Financial (for example, confidential account information, including expenditures and debt);
- Communications (for example, private communications);
- Geolocation; or
- Personal data concerning government officials, including members of the military or intelligence community.

The federal government has also published policy statements on the application of the ICA to certain sectors, such as interactive digital media[17] and critical minerals.[18]

A national security review occurs in stages. A full review may take up to the 200 days set out in the National Security Regulations or longer as the investor often has no option but to agree to an extension of the review period or abandon the investment. During the course of a national security review, the Minister may impose interim conditions on an investment to address the risk of national security injury that could arise before the review is complete.

To resolve the government's concerns that an investment may be injurious to national security and conclude the review, the investor may enter into undertakings with the Minister (e.g., requiring prior approval for proposed business locations, implementing specific security protocols for safeguarding data, granting access to sites for inspections, etc.) or, alternatively, the federal Cabinet may take any measures to protect national security, including issuing a prohibition order (or divestiture order if the investment was previously implemented) or imposing conditions on the investment.

B. *Antitrust — Competition Act*

1. *In General*

The Competition Act[19] (CA) is a federal law that is intended, among other things, to "maintain and encourage competition in Canada" and "provide consumers with competitive prices and product choices." The Commissioner of Competition and the staff of the Competition Bureau, which is an independent federal law enforcement agency, are primarily responsible for the administration and enforcement of the CA. The Attorney General prosecutes violations of the criminal provisions of the CA on referral from the Commissioner.

[15] https://www.canada.ca/en/services/defence/nationalsecurity/sensitive-technology-list.html.

[16] https://www.canada.ca/en/campaign/critical-minerals-in-canada/critical-minerals-an-opportunity-for-canada.html.

[17] https://ised-isde.canada.ca/site/investment-canada-act/en/home/policy-statement-foreign-investment-review-interactive-digital-media-sector.

[18] https://ised-isde.canada.ca/site/investment-canada-act/en/policy-regarding-foreign-investments-state-owned-enterprises-critical-minerals-under-investment; https://www.canada.ca/en/innovation-science-economic-development/news/2024/07/ministerial-statement-on-net-benefit-reviews-of-canadian-critical-minerals-companies.html.

[19] R.S.C. 1985, c. C-34.

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2. *Criminal Offenses*

The CA establishes a number of competition-related criminal offences, including conspiracies between actual or potential competitors to fix prices, restrict output or allocate markets in Canada (as well as the implementation in Canada of such collusive arrangements entered into outside of Canada), bid-rigging, multi-level marketing, and certain misleading advertising and telemarketing practices. In June 2023, amendments to the CA came into force criminalizing wage-fixing and no-poach agreements entered into between unaffiliated employers. Penalties for violations of the criminal provisions of the CA are fines, imprisonment or both.

The CA also permits civil actions in the ordinary courts for the recovery of damages suffered and resulting from conduct contrary to a criminal offence provision of the CA.

3. *Reviewable Practices*

The CA reviewable practices provisions deal with business conduct that is generally legal but may be prohibited in certain circumstances. The principal reviewable practices are:

(i) Mergers;

(ii) Abuse of dominance;

(iii) Anti-competitive civil agreements or arrangements;

(iv) Price maintenance;

(v) A variety of vertical non-price restrictions, such as tied selling, refusal to deal, exclusive dealing and market restriction; and

(vi) Certain misleading advertising practices, known as deceptive marketing practices.

The reviewable practices provisions provide that the Competition Tribunal, which is a specialized, independent adjudicative body with expertise in law, economics and business, may review a practice on application by the Commissioner. In addition, private parties may, with leave of the Competition Tribunal, seek remedies for breaches of most civil provisions. Where appropriate, the Competition Tribunal may issue remedial orders (such as a prohibition order). For certain provisions, a form of monetary relief (payable to a private applicant and any persons affected by the conduct) and administrative monetary penalties (payable to the government) are also available.

4. *Merger Notification and Substantive Review*

a. *Notification Thresholds*

While the Bureau has the authority to review any merger (which is a broadly defined term in the CA), only certain mergers are subject to mandatory notification. For a transaction to be subject to mandatory notification, the transaction must exceed both of the following financial thresholds:

(i) "Party size:" the parties to the transaction, together with all of their affiliates have:

- Assets in Canada the aggregate gross book value of which exceeds Can. $400 million; or
- Aggregate gross revenues from sales in, from or into Canada that exceed Can. $400 million; and

(ii) "Transaction size:"

- For an acquisition of assets in Canada of an operating business, the aggregate book value of those assets, or the gross revenues from sales in, from or into Canada generated from those assets, exceeds Can. $93 million (for 2025); or
- For an acquisition of voting shares of a corporation that carries on an operating business or controls a corporation that carries on an operating business, the aggregate book value of the assets of the operating business in Canada of the corporation and corporations controlled by it (other than assets that are shares of any of those corporations), or the gross revenue from sales in, from or into Canada generated from those assets exceeds Can. $93 million (for 2025).

Similar "transaction size" thresholds apply in the case of:

(i) A proposed acquisition of an interest in a combination that carries on an operating business through an unincorporated entity; and

(ii) A proposed combination of two or more persons to carry on business through an unincorporated entity if one or more of the persons proposes to contribute to the combination assets that form all or part of an operating business carried on by those persons, or corporations controlled by those persons.

However, in the case of a proposed amalgamation of two or more corporations where one or more of those corporations carries on an operating business or controls a corporation that carries on an operating business, at least two of the amalgamating corporations, together with their affiliates, must each have assets in Canada, or gross revenues from sales in, from or into Canada in excess of Can. $93 million (for 2025).

If the transaction is an acquisition of shares or an acquisition of an interest in a combination, there is an additional threshold that must be met. For a share acquisition, notification is required if the transaction exceeds the monetary thresholds above and, as a result of the acquisition, the buyer would control more than 20% of the outstanding voting rights in respect of a publicly-listed target, or if it already owns more than 20%, as a result of the acquisition it would own more than 50% of that target. If the target is a private corporation, then the initial threshold rises to more than 35% of the voting shares. Similarly, if the transaction is an acquisition of an interest in a combination, notification is required if the transaction exceeds the monetary thresholds above and, as a result of the acquisition, the buyer would be entitled to more than 35% of the profits or assets on dissolution, or if more than 35% is already held, to more than 50% of the profits or assets on dissolution.

b. *The Substantive Test — Substantial Lessening or Prevention of Competition*

In reviewing a merger, the Competition Tribunal must determine whether the transaction "prevents or lessens, or is likely to prevent or lessen, competition substantially" in a market. To this end, the Competition Tribunal may consider the following non-exhaustive list of factors:

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(i) Whether foreign products or competitors will provide competitive discipline to the merging parties;

(ii) Whether the business or part of the business of a party to the merger has failed or is likely to fail;

(iii) The extent to which there are acceptable substitutes for the products of the merging parties;

(iv) Barriers to entry and the effect of the merger on such barriers;

(v) Whether there will be effective remaining competition following the merger;

(vi) Whether the merger will eliminate a vigorous and effective competitor;

(vii) The nature and extent of change and innovation in the relevant market in which the merging parties operate;

(viii) Network effects within the market;

(ix) Whether the merger would contribute to the entrenchment of market position held by the leading incumbents;

(x) Any effect of the merger on price or non-price competition, including quality, choice or consumer privacy;

(xi) Any change in concentration or market share that the merger has brought about or is likely to bring about;

(xii) Any likelihood that the merger will or would result in express or tacit coordination between competitors in a market; and

(xiii) Any other factor that the Competition Tribunal deems relevant.

Recent amendments to the CA have also introduced a rebuttable structural presumption of anti-competitive effects for a merger where certain concentration and market share thresholds are exceeded.

The Bureau has supplemented these statutory factors with its Merger Enforcement Guidelines that set out in detail its approach to merger review.

c. Review Process and Timeline

Where notification is required, the parties are not permitted to complete the transaction until a 30-day statutory waiting period has expired. Prior to the expiry of this initial period, the Commissioner may initiate a second-stage review through the issuance of a supplementary information request (SIR). Where a SIR is issued, the waiting period is stopped until the parties comply with the SIR, after which a second 30-day waiting period commences. Following expiry of the second 30-day waiting period, the parties may proceed to complete the transaction, unless challenged or enjoined by the Commissioner.

There is also a procedure that allows the Commissioner to require a target to make a filing in response to an unsolicited offer. The timing of the Bureau's review in such a case is driven by the date of the buyer's filing.

In circumstances where there are no or very limited competitive overlaps between the parties, the parties can request that the Commissioner issue an advance ruling certificate (ARC). An ARC, which can be obtained in approximately two or three weeks where there are no material competitive issues, would exempt the acquisition from the formal notification provisions of the CA.

d. Remedies

The Commissioner retains the right to challenge any transaction (other than transactions with respect to which the Commissioner has issued an ARC) within either: (i) one year after its completion in the case of mergers that were subject to notification or for which an ARC request was filed; or (ii) three years after its completion in the case of any other merger.

Where the Commissioner believes that a completed merger substantially prevents or lessens competition (or in the case of a proposed merger, is likely to have that effect), he or she may bring an application to the Competition Tribunal for a remedial order, such as a divestiture of assets or shares, or a prohibition order. Where the Commissioner and the merging parties agree to a remedy to address the Commissioner's concerns, they typically document it in a consent agreement that is registered with the Competition Tribunal. Upon registration, the consent agreement has the same effect as an order of the Competition Tribunal.

C. Trade and Commerce Regulation

1. Import-Export

a. In General

Both importers and exporters are subject to numerous regulations in Canada. Customs legislation imposes a variety of administrative requirements regarding the reporting and entry of goods into Canada. Other import regulations are designed to implement government policies on international trade, to protect the Canadian environment from potentially injurious imports, to collect revenue, or to regulate the import of certain classes of goods such as food, drugs and agricultural products.

Export control legislation implements Canada's international obligations under various international agreements requiring the control of certain goods and technology. The export permit system is primarily governed by the Export and Import Permits Act,[20] which governs goods and technology including those used in the military and nuclear sectors, United States originating goods and technology, encryption technology, and dual-use goods having both military and conventional applications.

b. Import Regulations

Most statutes regulating the importation of goods into Canada are administered in conjunction with the federal Customs Act.[21] Under the Customs Act, imported goods must be reported to Canada Border Services Agency (CBSA) officers, and any applicable duties and taxes paid. Where imported goods are subject to controls under legislation other than the Customs Act, CBSA officers also have the authority to enforce such regulations. A wide range of enforcement provisions are available to CBSA officers, including criminal sanctions and civil penalties, which may involve the seizure and forfeiture

[20] R.S.C. 1985, c. E-19.

[21] S.C. 1985, c. 1 (2d Supp.).

ISBN 978-1-63359-385-5

of goods and the imposition of fines. CBSA officers also have substantial audit powers to ensure compliance with import controls, and importers are required to keep extensive books and records.

The Customs Tariff[22] imposes duties on a wide range of imported goods. Rates of duty depend on the country of origin and the nature of the product. Country of origin is determined under a series of rules found in the Customs Tariff, the United States-Mexico-Canada Agreement (USMCA) and other free trade agreements entered into by Canada, and may also reflect the WTO Agreement on Rules of Origin. Generally, goods originating in countries that have a free trade agreement with Canada benefit from the lowest tariff treatment, often attracting no duty. Many non-agricultural imports, including manufacturing equipment, machinery and inputs, are also duty-free for WTO Members under Canada's most-favoured nations tariff rate.

In addition to the USMCA, Canada has free trade agreements with Chile, Colombia, Costa Rica, Honduras, Israel, Jordan, Panama, Peru, South Korea, the European Union (provisionally applied only), the European Free Trade Association (which includes Iceland, Liechtenstein, Norway and Switzerland), Ukraine and the United Kingdom. Canada is also a party to the Comprehensive and Progressive Agreement for Trans-Pacific Partnership (CPTPP), which is a plurilateral trade agreement that is currently in force between Canada and each of Australia, Brunei, Chile, Japan, Malaysia, Mexico, New Zealand, Peru, Singapore and Vietnam. The United Kingdom is also a party to the CPTPP but because Canada has not yet ratified its accession, the CPTPP does not yet apply to Canada-U.K. trade.

Goods are classified according to the Harmonized Commodity Description and Coding System, which is the standard tariff classification structure used by most countries in international trade. The Harmonized Code classifies goods using six digits. Canada's Customs Tariff then adds four digits, the first two for more accurate classification and the latter two for statistical purposes. The Canadian system for determining value of goods for duty purposes is based on the international Customs Valuation Code.

In Canada, a goods and services tax (GST) or harmonized sales tax (HST), which is similar to a value added tax (VAT), is imposed on most goods imported into Canada. The rate of tax that applies depends on the province into which the goods are imported and whether they are commercial goods. Generally, goods imported for commercial purposes are only subject to the 5% GST even if imported into an HST province. GST/HST is imposed on the value for duty of imported goods, plus any applicable duties.[23] Special excise taxes and duties are also levied on certain goods (such as tobacco products, vaping products, alcohol and cannabis (which was legalized in Canada on October 17, 2018)).[24]

Regulations under the Customs Tariff[25] provide for relief from import duties in certain situations. This relief, in the form of drawbacks or exemptions, may be available where goods are imported and subsequently exported, used in the manufacture of products that are ultimately exported, used in the production of goods sold in Canada if an equal amount of a similar Canadian material is used in manufacturing the product for export, or used in Canada for prescribed purposes or in specified industries. It should be noted, however, that the USMCA limits the availability of drawbacks on duties (custom, anti-dumping and countervailing) for exports to USMCA parties. Duty relief may also be available where certain imported machinery is not available in Canada. The Customs Tariff also provides for the discretionary remission of duties. The Financial Administration Act[26] permits the remission of duties and taxes where the Canadian government considers their collection unreasonable, unjust or not in the public interest.

Various statutes regulate the importation of goods into Canada with respect to product standards or potential health and safety concerns. The following list is illustrative:

(i) The Consumer Packaging and Labeling Act[27] prescribes information required on pre-packaged consumer products imported into Canada, including rules regarding bilingual labeling (see also III.F., below).

(ii) The Textile Labeling Act[28] prescribes information required in both English and French on imported consumer textile articles.

(iii) The Food and Drugs Act[29] protects consumers from fraud, injury and deceptive practices by imposing labeling and packaging standards for imported foods, drugs, cosmetics and medical devices.

(iv) The Canadian Environmental Protection Act[30] prohibits the importation of substances new to Canada until specified information regarding potential toxicity has been provided and determined, and necessary controls identified. The importation of sufficiently toxic substances may be prohibited entirely.

(v) The Hazardous Products Act[31] provides lists of products that may not be advertised, sold or imported into Canada, as well as products that may be imported only if authorized by the Regulations. Related restrictions apply under the Explosives Act,[32] the Pest Control Products Act[33] and the Nuclear Energy Act.[34]

(vi) Other controls are imposed on the importation of agricultural products, specific food products, grains, alcoholic beverages, radiation emitting devices, offensive weapons, and oil and gas. Environmental protection and language legislation (see III.F., below) may also regulate the importation and labeling of many products.

[22] S.C. 1997, c. 36.
[23] Customs Act, R.S.C. 1985, c. 1 (2d Supp).
[24] Excise Tax Act, R.S.C. 1985, c. E-15.
[25] S.C. 1997, c. 36; *see* Goods Imported and Exported Refund and Drawback Regulations, SOR/96-42.
[26] R.S.C. 1985, c. F-11.
[27] R.S.C. 1985, c. C-38.
[28] R.S.C. 1985, c. T-10.
[29] R.S.C. 1985, c. F-27.
[30] S.C. 1999, c. 33.
[31] R.S.C. 1985, c. H-3.
[32] R.S.C. 1985, c. E-17.
[33] S.C. 2002, c. 28.
[34] R.S.C. 1985, c. A-16.

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(vii) The entry of certain goods (especially supply-managed agricultural goods such as wheat, poultry products and dairy products) into Canada may be quantitatively limited by quotas or tariff-rated quotas if the goods appear on the Import Control List established under the Export and Import Permits Act.[35]

(viii) Special measures apply where import practices have adverse effects on Canadian industry. These are designed to protect Canadian domestic industries from unfair trade practices such as injurious dumping by foreign exporters and injurious subsidization by foreign governments. For example, potentially significant anti-dumping and/or countervailing duties are imposed under the Special Import Measures Act[36] if the CBSA determines that a foreign good has been dumped and/or subsidized and the Canadian International Trade Tribunal (CITT) determines that this has caused or is threatening to cause material injury to a Canadian domestic industry producing like goods. Safeguard remedies also exist to deal with rapid increases in the volume of imported goods that are a significant cause of serious injury to domestic industries producing like goods. If the CITT determines that a safeguard measure is warranted, it may recommend to the Governor in Council that one of three remedies be imposed: a tariff; a tariff rate quota that applies one tariff rate to subject goods until a predetermined volume of goods is imported, following which a higher tariff rate is imposed; or a quota that establishes a limit on the volume of subject goods that may be imported.

Under the authority of section 53 of the Customs Tariff, Canada imposed a 100% surtax on electric vehicles produced in China and a 25% surtax on steel and aluminum goods produced in China, effective October 1, 2024 and October 22, 2024, respectively. The stated purpose of the surtaxes, which are similar in scope and rates to U.S. "Section 301" tariffs that were finalized on September 13, 2024, is to address unfair Chinese trade practices.

The surtaxes are payable by the importer of record. They are imposed on the "value for duty" of the imported goods, which, generally, is the purchase price paid or payable, subject to certain additions or deductions.

The determination of whether goods are produced in China for purposes of the surtax is based on a "substantially manufactured" test under the Determination of Country of Origin for the Purpose of Marking Goods (Non-CUSMA Countries) Regulations.

According to the Canada Border Service Agency (CBSA), per Memorandum D-11-3-1, the CBSA considers the country where goods are "substantially manufactured" to be "the country where the major part of production or manufacturing took place". This will be determined, according to the Memorandum, by a cost of production test that will consider "the accumulated costs of material, labour, and overhead".

Remission of the surtaxes may be granted, in exceptional circumstances, by order-in-council pursuant to section 115 of the Customs Tariff. These circumstances are:

- Where goods used as inputs, or substitutes for those goods, cannot be sourced either domestically or reasonably from non-Chinese sources;

- Where there are contractual requirements, existing prior to August 26, 2024, requiring Canadian business to purchase Chinese inputs into their products or projects for a specified period of time; or

- Other exceptional circumstances, on a case-by-case basis, that could have significant adverse impacts on the Canadian economy.

Remission under section 115 may be granted with or without conditions, in respect of the whole or any portion of the surtaxes. Remission may be granted not only in respect of surtaxes already paid by an importer but also prospectively before any surtaxes are, in fact, levied and paid.

Comment: On October 10, 2024, Canada concluded a 30-day public consultation on similar potential surtaxes on Chinese-produced goods in what it has deemed "critical manufacturing sectors" for renewable electricity generation and storage. These surtaxes, which at the time of writing have not been enacted, would apply to lithium-ion batteries and battery parts; semiconductors and integrated circuits, solar products (photovoltaic cells, modules and panels), and a range of critical metals and minerals.

Comment: Canada has imposed 25% retaliatory tariffs on imports of certain U.S.-originating goods in response to tariffs imposed by the second Trump Administration on imports from Canada. These goods include various consumer goods (such as food products, apparel, appliances) and building materials;[37] steel and aluminum products;[38] and non-CUSMA compliant vehicles imported from the United States, and the non-Canadian and non-Mexican content of CUSMA-compliant vehicles.[39]

Canada's retaliatory tariffs are subject to a remission application process, as well as various general remission orders. In particular, Canada has implemented a remission order for certain goods imported into Canada before October 16, 2025, including: input goods for manufacturing or processing; goods for packaging of food products or beverages; goods for use by public health, public safety and national security agencies and organizations and health care entities; and infant and nutrition formulas and certain medical goods.[40] For autos, remission is available to a certain number of businesses for a specified number of imported vehicles.[41]

c. *Export Regulations*

Unless exceptions apply, exporters, carriers and customs service providers must report exports using an Export Declaration in prescribed form detailing the product to be exported from Canada. Exceptions are found in the Customs Act Reporting of Exported Goods Regulations.

[35] R.S.C. 1985, c. E-19.

[36] R.S.C. 1985, c. S-15.

[37] *United States Surtax Order (2025)*, SOR/2025-66.

[38] *United States Surtax Order (Steel and Aluminum 2025)*, SOR/2025-95.

[39] *United States Surtax Order (Motor Vehicles 2025)*, SOR/2025-118.

[40] *United States Surtax Remission Order (2025)*, SOR/2025-122.

[41] *United States Surtax Remission Order (Motor Vehicles 2025)*, SI/2025-60. Canada has kept confidential the businesses and volume of imported vehicles covered by this order.

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Pursuant to the Export and Import Permits Act,[42] controlled goods and technology are placed on the Export Control List. Examples include: dual use goods and technology with military and conventional applications; munitions and related goods and technology; military goods and technology; nuclear goods and technology; missile launching goods and technology; U.S. origin goods and technology; and chemicals and biological materials used to produce chemical and biological weapons and weapons of mass destruction. Notwithstanding the requirements for export permits, in some cases the Canadian government will issue a General Export Permit (for example, for U.S. origin goods), which will cover the export of those goods if certain conditions are met. Exports to certain countries, organizations and individuals also may be restricted by virtue of the Area Control List,[43] the Special Economic Measures Act and its regulations[44] and economic sanctions pursuant to the United Nations Act.[45]

The Wild Animal and Plant Protection and Regulation of International and Interprovincial Trade Act[46] requires a permit, issued by the Minister of the Environment, to export or import most animals and plants from or into Canada.

Certain cultural property — including archaeological artifacts, decorative objects, art, books and photographs — listed under the Cultural Property Export and Import Act[47] requires an export permit to leave Canada.

An exporter of goods and technology included on the Export Control List or the Area Control List, or subject to economic sanction, is required to apply to Foreign Affairs and International Trade Canada for an export permit prior to export. Only Canadian residents may apply for such permits.

The export of energy products, including oil, natural gas and electricity, requires exporters to obtain export licenses or orders from the National Energy Board, which also regulates the importation and domestic distribution of energy goods.

The export of certain goods or substances is also regulated on the basis of potential environmental risk, often arising as a result of obligations under international treaties. For example, the export of substances specified on the Export Control List under the Canadian Environmental Protection Act[48] is prohibited unless notice to the Minister of the Environment is provided and the export is for narrow specified purposes. In some cases, exportation is totally prohibited.

d. Government Programs

There are a number of federal government programs designed to provide services to Canadian exporters and foreign importers. For example:

(i) Export Development Canada (EDC) was established by the federal Export Development Act[49] to facilitate and develop trade between Canada and other countries by providing financial services to Canadian exporters and foreign buyers. The principal services offered by EDC are insurance, guarantees and export financing.

(ii) The federal Canadian Commercial Corporation promotes trade between Canada and other nations on a government-to-government basis and generally helps Canadians import and export goods and commodities.

(iii) The federal Global Commerce Support Program (GCSP) aids Canadian companies with a view to improving Canadian capacity to compete effectively in the global economy. Established in 2008, GCSP is an amalgamation of three existing funding programs: Invest Canada Community Initiatives (ICCI); Going Global Innovation (GGI); and Global Opportunities for Associations (GOA). GOA provides funding to national associations expanding or seeking new business development in strategic sectors and markets. ICCI assists Canadian communities in the attraction, retention, and expansion of foreign direct investment. GGI supports collaborative international research and development (R&D). The legislative authority through which funding is dispensed is the Department of Foreign Affairs and International Trade Act.[50]

In addition, provincial governments have export-related promotion programs, ranging from loans and insurance programs to incentives for participation in trade fairs abroad.

2. United States-Mexico-Canada Agreement

Trade liberalization in the Americas began with the free trade agreement between Canada and the United States (the "Canada-United States FTA"), which came into effect on January 1, 1989.

Shortly after implementation of the Canada-United States FTA, the United States and Mexico started bilateral free trade negotiations. To avoid the erosion of the trade preferences that it enjoyed under the Canada-United States FTA and to achieve better access to the Mexican market, Canada joined these negotiations. The result was the North American Free Trade Agreement (NAFTA), which came into force on January 1, 1994.[51]

In 2018, the governments of Canada, the United States, and Mexico began the process of renegotiating and modernizing NAFTA. The result was the USMCA, which replaced NAFTA and came into effect on July 1, 2020.

The USMCA consists of a core or umbrella agreement that resembles the prior NAFTA agreement in terms of its overall objectives and individual provisions. Throughout the core agreement are separate bilateral commitments between Canada and Mexico, and the United States and Mexico, on specific issues with respect to which multilateral agreement was not achieved.

Significant USMCA provisions cover:

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[42] R.S.C. 1985, c. E-19.
[43] At the time of writing only North Korea is listed.
[44] At the time of writing, regulations adopted under the Special Economic Measures Act (S.C. 1992, c. 17) place restrictions on certain exports to Belarus, Myanmar, China (though extremely limited), Haiti, Iran, Moldova, North Korea, Nicaragua, Russia, South Sudan, Sri Lanka, Syria, Ukraine, Venezuela and Zimbabwe.
[45] R.S.C. 1985, c. U-2.
[46] S.C. 1992, c. 52.
[47] R.S.C. 1985, c. C-51.
[48] S.C. 1999, c. 33.
[49] R.S.C. 1985, c. E-20.
[50] R.S.C. 1985, c. E-22.
[51] Enacted in Canada by the North American Free Trade Agreement Implementation Act, S.C. 1993, c. 44.

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(i) Trade in goods (including tariff elimination, rules restricting drawbacks and duty deferral, and provision for the special treatment of certain goods like alcoholic goods), rules of origin and uniform customs procedures. Tariff elimination for Canada and the United States under the Canada-United States FTA was incorporated into NAFTA. All goods meeting the rules of (U.S.) origin tests in the Canada-United States FTA became duty-free on entry into Canada on January 1, 1999. Canadian tariffs on most goods originating from Mexico have been eliminated. Exceptions on imports from both NAFTA partners include agricultural products, such as eggs, sugar, dairy and poultry.

(ii) Special treatment in the energy and agricultural sectors.

(iii) Technical barriers to trade.

(iv) Government procurement.

(v) Foreign investment protections (including an investor-state dispute mechanism).

(vi) Services (including special rules for the telecommunications and financial services sectors competition policy, and the temporary entry of businesspersons).

(vii) Basic harmonization of intellectual property rules.

(viii) Special rights of judicial review in trade remedy cases.

(ix) State-to-state dispute settlement rules and procedures.

D. Immigration

1. In General

While the federal government has primary jurisdiction over matters of immigration, the Constitution Act[52] allows each provincial government to make laws in relation to immigration into the province to the extent that such laws are not repugnant to any federal legislation.

Immigration is largely governed by the provisions of the Immigration and Refugee Protection Act,[53] which is administered by Citizenship and Immigration Canada.[54]

Generally, non-citizens and nonresidents of Canada may be granted admission into Canada as visitors or immigrants. The category of visitor includes anyone seeking admission for a temporary purpose. The provisions relating to visitors apply, therefore, to a nonresident wishing to come to Canada for a temporary period as a visitor or as an employee of a business enterprise. The term “immigrant” refers to a person seeking admission for purposes of establishing permanent residence.

2. Temporary Entry

Although, in principle, a visitor to Canada is required to obtain a visitor’s visa prior to entry into Canada, nationals of 60 countries are exempt from this requirement. These include the United States, Mexico, and most European countries. Most people who seek admission as visitors for purposes of attending a post-secondary academic institution or engaging in employment must apply to a Canadian visa officer and obtain student or work permits to enter Canada for that purpose, either before appearing at a port of entry or at the port of entry itself. Exceptions are made for certain individuals, including, for example, a representative of a foreign business or government, who may enter Canada to consult with employees of a Canadian parent company, subsidiary or branch office, or for purchasing goods or services or selling goods (other than to the general public) without obtaining a work permit.

For visa-exempt foreign nationals travelling to Canada by air, an electronic travel authorization (“eTA”) is required for entry to Canada. The eTA is linked to the traveler’s passport and is valid for up to five years or until the passport expires. A valid eTA allows the traveler to travel to Canada as often as desired and for up to six months at a time. However, an eTA does not guarantee entry into Canada, so upon arrival at the border, the border service officer will still require the traveler’s passport and other documents.

Special procedures may apply under the USMCA to U.S. and Mexican businesspersons. U.S. and Mexican citizens who are categorized as “business visitors,” “traders and investors,” “professionals” or “intra-company transferees” can gain quick access to Canada for temporary business or investment reasons. A Labour Market Impact Assessment is not needed, and Canadian employers of such persons do not need to have a job offer approved by Employment and Social Development Canada. Under the USMCA, these categories are generally defined as follows:

(i) “Business visitors” are persons seeking to engage temporarily in the trade of goods or services, or in investment activities within Canada as specified in the USMCA.

(ii) “Traders and investors” are businesspersons seeking to (I) carry on substantial trade in goods and services between the United States or Mexico and Canada or (II) establish, develop, administer or provide advice or key technical services to the operation of an investment to which the businessperson or the businessperson’s enterprise has committed a substantial amount of capital. A trader or investor must be carrying out the above activities in a capacity that is supervisory, executive or that involves essential skills. Traders and investors must have a work permit to work in Canada.

(iii) “Professionals” are individuals in specified fields who will continue to work in their professions while temporarily in Canada. Professionals must have a job offer from a Canadian business in their particular field and have a work permit to work in Canada.

(iv) “Intracompany transferees” are persons who have been employed by the same or related employer on an ongoing basis, for at least one year in the last three years, and work as a manager, executive, or in a job that requires specialized knowledge. Intra-company transferees must have a work permit to work in Canada.

[52] Sched. B to the Canada Act 1982 (U.K.), 1982, c. 11.

[53] R.S.C. 1985, c. I-2.

[54] General information is available on the web site of that department, at http://www.cic.gc.ca/.

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3. Permanent Residents

The first step in immigrating to Canada is to apply for, and obtain, permanent residency. Individuals applying for permanent resident status in Canada are assessed according to selection standards designed to determine an immigrant's ability to become successfully established in Canada. The six major selection factors are education, language skills, work experience, age, arranged employment, and adaptability. Different selection criteria are prescribed for different classes and subclasses of immigrants. The major classes are express entry, family class sponsorship, business class, caregiver, humanitarian, and refugee protection. The Provincial Nomination Program is another class that gives provinces discretion in nominating applicants for permanent residency based on the labor market and economic needs of the province.

For those in the Express Entry program, which covers skilled works, the Immigration and Refugee Protection Act requires prospective immigrants to submit an online profile. The new Express Entry program allows candidates from any occupation to submit an application for consideration. Prospective immigrants eligible for the Express Entry program will be accepted into a pool of candidates and then ranked on a points-based system using the information from the profile. Invitations to apply for permanent residency will only be sent to those with the highest scores in the pool. Once an invitation has been received, an applicant can apply for permanent residency. The decision on the application will be made based on the eligibility criteria for the program and the results of the medical exam, police certificates and background checks. In the case of an individual who intends to immigrate to Quebec, the province requires that the applicant apply for a certificate of selection through the Government of Quebec's online portal. The permanent selection application process in Quebec is based on the expression of interest principle.

The Immigration and Refugee Protection Regulations[55] set out specific selection criteria for each class of applicant. The criteria are applied by way of a points system under which the applicant is awarded units of assessment based on factors designed to measure both the short-term and long-term ability of the applicant to become successfully established in Canada. The factors for which points are awarded include education, proficiency in English and French, work experience, age, arranged employment, and adaptability. The manner of applying the points system and the number of points required differ for each class and subclass of applicant. The Regulations provide for administrative discretion to deviate from the points system in appropriate cases.

Canada's Start-Up Visa Program is designed to target immigrant entrepreneurs who are seeking to build businesses in Canada that:

(i) Are innovative;

(ii) Can create jobs for Canadians; and

(iii) Can compete on a global scale.

To qualify as an entrepreneur, an applicant must have the financial ability and proven expertise to become involved in a Canadian business enterprise that will create or maintain employment and contribute to the Canadian economy and must intend to participate actively in the management of that business. An applicant must also obtain a letter of support from a designated organization which is a business group that has been approved to invest in or support start-ups. Designated organizations include venture capital funds, angel investor groups, and business incubators. Such an applicant is assessed under a modified version of the points system.

A "self-employed" immigrant is defined as an immigrant who has taken part in cultural activities or athletics at a world-class level or been a self-employed person in cultural activities or athletics. The relevant experience in either of these areas must have been for at least two years, and the prospective immigrant can obtain more points if they have three to five years of experience. The two years of experience must occur during the period commencing five years before the day the potential immigrant applies and ending on the day the decision is made on the application.

E. Privacy

1. Legal Structure

Legislative reform is currently the focal point in the dynamic Canadian privacy arena. Canada has an established and extensive privacy law framework, including over 30 federal, provincial and territorial privacy statutes governing the public, private and health sectors. The federal private-sector privacy law, the *Personal Information Protection and Electronic Documents Act* (PIPEDA),[56] applies unless there is provincial legislation that is deemed by the federal government to be "substantially similar" to PIPEDA (i.e., the private-sector privacy laws in Alberta, British Columbia and Quebec).[57]

In 2022, the federal government introduced a new private sector privacy law framework to replace PIPEDA.[58] If passed, the *Consumer Privacy Protection Act* (CPPA) would expose companies across Canada to severe financial penalties for privacy breaches, enhanced litigation risk and significant compliance costs (as discussed in II.E.2. to 5., below).

Quebec's private-sector privacy law was substantially amended in September 2021 through the passage of *An Act to modernize legislative provisions as regards the protection of personal information* (Law 25).[59] Law 25 introduced sweeping

[55] SOR/2002-227.

[56] Personal Information Protection and Electronic Documents Act (PIPEDA), 2000 S.C., ch. 5 (Can.).

[57] PIPEDA §26; See Organizations in the Province of Quebec Exemption Order, SOR/2003-374 (Can.); Organizations in the Province of Alberta Exemption Order, SOR/2004-219 (Can.); Organizations in the Province of British Columbia Exemption Order, SOR/2004-220 (Can.). The health privacy laws in Newfoundland and Labrador, New Brunswick, Nova Scotia, and Ontario also have been deemed substantially similar. *See* Health Information Custodians in the Province of Ontario Exemption Order, SOR/2005-399 (Can.); Personal Health Information Custodians in New Brunswick Exemption Order, SOR/2011-265 (Can); Personal Health Information Custodians in Newfoundland and Labrador Exemption Order, SI/2012-72 (Can.); and Personal Health Information Custodians in Nova Scotia Exemption Order, SOR/2016-62 (Can.).

[58] Bill C-27, An Act to enact the Consumer Privacy Protection Act, the Personal Information and Data Protection Tribunal Act and the Artificial Intelligence and Data Act and to make consequential and related amendments to other Acts, 1st Session, 44th Parl, 2021–2022.

[59] R.S.Q., c. P-39.1.

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changes, including accountability obligations, breach reporting, notification and record-keeping provisions, and data localization restrictions. As of September 2023, failure to comply with Quebec's private-sector privacy law will expose organizations to potentially severe financial penalties and fines (as discussed in II.E.2., below).

Companies doing business in Quebec and across Canada must have a thorough understanding of their personal information practices and their privacy obligations. Companies will need to identify and mitigate the expanding array of privacy, legal and reputational risks associated with the collection, use and disclosure, as well as other processing, of personal information.

2. Enhanced Enforcement Regimes

Currently, the private sector privacy regulatory process is largely complaint-based and the regulatory authorities have no significant enforcement powers. However, if Bill C-27 is passed, failure to comply with the CPPA could expose companies to fines of up to the greater of Can. $25 million or the amount corresponding to 5% of worldwide turnover for the preceding fiscal year. Companies could also be exposed to administrative monetary penalties of up to the greater of Can. $10 million or the amount corresponding to 3% of worldwide turnover for the preceding fiscal year.

As of September 22, 2023, companies violating the provisions of the Quebec private-sector privacy law may face fines of up to the greater of Can. $25 million or 4% of worldwide turnover for the preceding fiscal year, and administrative monetary penalties of up to the greater of Can. $10 million or 2% of worldwide turnover for the preceding fiscal year.

3. Data Breach Notification

Three private-sector privacy statutes in Canada contain express breach notification requirements. PIPEDA requires notification to the Privacy Commissioner of Canada in the event of the loss of, unauthorized access to or the unauthorized disclosure of, personal information resulting from a breach of an organization's security safeguards or from a failure to establish those safeguards if it is reasonable in the circumstances to believe that the breach creates a real risk of significant harm to an individual.[60] In addition, under PIPEDA, an organization is required to "keep and maintain a record of every breach of security safeguards involving personal information under its control."[61] Notably, this obligation applies to "every breach of security safeguards," not just to breaches that are deemed to create a "real risk of significant harm."

Alberta's private sector privacy law requires notification to Alberta's Information and Privacy Commissioner in the event of an incident involving the loss of, unauthorized access to or the disclosure of, personal information where a reasonable person would believe there is a real risk of significant harm.[62]

Effective September 22, 2022, the Quebec private sector privacy law provides for a mandatory security breach notification regime consisting of regulatory and individual notice obligations.[63] The statute also now includes security incident response requirements to reduce the risk of injury and to prevent new incidents of the same nature, as well as new record-keeping requirements.[64]

4. Individual Rights

PIPEDA requires that, on request, an organization inform any individual "of the existence, use, and disclosure of his or her personal information and [the individual] shall be given access to that information," subject to limited exceptions.[65] Alberta and British Columbia's private-sector privacy legislation also provide access and correction rights.[66]

Amendments under Quebec's Law 25 introduce new individual rights, including a right to data portability, rights with respect to automated decision-making, and a right of cessation of dissemination, de-indexing and re-indexing (i.e., an analog to the GDPR's "right to be forgotten"). These additions supplement individual rights already available under Quebec law such as rights to deletion, access and rectification (correction).[67]

If federal Bill C-27 is passed, the CPPA would also provide enhanced individual rights for data subjects.

5. International Data Transfers

PIPEDA does not contain substantial restrictions on the international transfer of data. Notably, the European Commission has confirmed PIPEDA provides adequate protection for personal data.[68]

Under PIPEDA, organizations are responsible for personal information in their custody or control, including personal information transferred to a third party for processing. Organizations are expressly required to use contractual or other means to provide a comparable level of protection while personal information is being processed by a third party. In general, PIPEDA permits the transfer of personal information to a third-party service provider for data management or processing purposes where the transferring organization remains in control of the personal information in the custody of the third-party service provider. PIPEDA also contains notice and openness requirements that would be applicable in the service provider context (i.e., it requires notice to be given about the use of service providers, particularly foreign-based service providers).

In addition to PIPEDA, provincial statutes in Alberta and Quebec contain express references to trans-border data flows. Alberta's private sector privacy law generally requires organizations to provide notice when using a foreign-based service provider for the collection, use, disclosure or storage of personal information.[69] As of September 22, 2023, personal information transfers outside of Quebec will require:

[60] PIPEDA §§10.1, 10.2.

[61] PIPEDA §10.3(1).

[62] PIPA, S.A. 2003, c. P-6.5, §34.1(1) (PIPA Alberta).

[63] *Act respecting the protection of personal information in the private sector,* CQLR c. P-39.1, §3.5 (Quebec Privacy Act).

[64] Law 25 §§3.5, 3.8.

[65] Law 25 §§3.5, 3.8.

[66] PIPA Alberta, S.A. 2003, c. P-6.5 §24-5; PIPA, S.B.C. 2003, c. 63 §23-4 (PIPA BC).

[67] Quebec Privacy Act §28; Civil Code of Quebec, c. CCQ-1991 art. 40.

[68] See Commission Decision 2002/2, 2002 O.J. (L 2) 13 (EC), http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:32002D0002:EN:NOT (last visited March 28, 2023).

[69] PIPA Alberta, S.A. 2003, c. P-6.5 §6.

ISBN 978-1-63359-385-5

(i) Privacy impact assessments finding that personal information transferred outside of Quebec would enjoy "adequate protection;" and

(ii) Written agreements to mitigate risks identified in these assessments.[70]

[70] Quebec Privacy Act §17.

ISBN 978-1-63359-385-5

III. Establishing a Business

A. *Types of Business Organizations*

1. In General

There are various forms of business organization through which persons may carry on business in Canada. They range from individuals carrying on business in their personal capacity (sole proprietorships) through partnerships, joint ventures, and licensing/franchising arrangements (which are generally established through contracts) to corporations of various types, including foreign corporations carrying on business through a branch in Canada and unlimited liability companies. Typically, the key factors to be considered in selecting a form of business organization are tax and liability issues.

2. Sole Proprietorships

This form of business organization is typically selected for small businesses in which personal liability is not an important factor. Sole proprietorships do not involve the creation of a legal person separate and distinct from the individual carrying on the business. Although sole proprietorships are not subject to the same formalities as applicable to partnerships and corporations, certain registration requirements, which vary from province to province, may apply. For example, an individual who carries on business or who identifies his or her business to the public under a name other than the individual's own name is generally required to register the business name or style under applicable provincial legislation.

3. Partnerships, Joint Ventures and Licensing/ Franchising

Persons may carry on business in Canada through a partnership or limited partnership formed in Canada or formed under the laws of another jurisdiction. The use of a partnership form may be attractive in particular circumstances, primarily for tax reasons, because partnerships and limited partnerships do not constitute entities or legal persons separate and apart from the partners. The fact that partners in a general partnership are generally jointly and severally liable for the obligations of the partnership may be a reason to select another form of business organization.

Partnership law in Canada is a matter of provincial jurisdiction, with each province having legislation governing the formation of general or ordinary partnerships and limited partnerships. In most cases, in the absence of an agreement to the contrary, the rights and obligations of partners are governed by the applicable provincial legislation with the result that partners typically reduce their arrangements to writing. Persons associated in business in partnership that identify themselves to the public under a firm name are usually required to register the firm name under applicable provincial legislation.

Each province has legislation that permits the formation of limited partnerships. Limited partnerships are partnerships that consist of one or more persons who are general partners and one or more persons who are limited partners. While the formalities to be observed in establishing a limited partnership are more onerous than those relating to a general partnership, it has the advantage of offering limited partners the opportunity to limit their exposure to the liabilities of the partnership business provided they comply with the requirements of the legislation. Provinces also permit the establishment of limited liability partnerships, which are different from limited partnerships and are generally available only to persons who practice a profession that is governed by legislation in the province concerned.

Persons may also carry on business in Canada through joint ventures or co-ownership arrangements. These arrangements typically are established by contract, commonly involve one or more corporations, and may be advantageous as an alternative to a partnership, particularly as they avoid the unlimited joint and several liability that is applicable to partners.

In appropriate circumstances, persons may also carry on business in Canada through licenses or franchises granted to others. The licenses or franchises may be entered into directly by a nonresident in favor of Canadian licensees or franchisees or through a Canadian business organization established for purposes of granting the licenses or franchises. The choice of business organization involves many of the same considerations as are applicable to establishing a branch operation in Canada or a Canadian subsidiary. In either case, it is important to ensure that the licensor's or franchisor's intellectual property, such as trademarks and patents, is properly protected in Canada.

4. Corporations

The federal government and all provincial governments have enacted general legislation providing for the incorporation and regulation of business corporations. In addition, legislation also exists providing for the incorporation and regulation of specific types of corporations, such as banks, trust companies, insurance companies and credit unions. Federal and provincial legislation also provides for the incorporation of non-share capital and not-for-profit corporations that are more typically used by charities, trade associations, clubs and the like.

Corporations incorporated in Canada, whether federally or provincially, are legal entities that have an existence separate and apart from their shareholders and directors. As a result, they are subject to taxation at the corporate level and shareholders are not typically individually responsible for the liabilities of the business.

Canadian statutes governing business corporations are generally modern and provide considerable flexibility in formation and structuring of the corporation and in undertaking fundamental corporate transactions. Although a few of the statutes continue to adhere more closely to English company law, most Canadian statutes reflect U.S. corporate law principles. There are, however, some differences that may be important in specific circumstances. For example, most Canadian corporations are not empowered to own their own shares and several Canadian corporate statutes (including federal statutes and certain provincial statutes) include Canadian residency requirements for at least part of the board of directors. Certain specified industries, such as regulated media and telecommunications businesses, may also be subject to Canadian share ownership and board residency requirements.

Because the requirements, formalities and restrictions of federal and provincial legislation relating to business corporations are similar in many respects, the decision to incorporate

ISBN 978-1-63359-385-5

federally or in a particular province will depend upon a variety of factors, including requirements as to the residency of directors, the ease and timeliness of incorporating and making subsequent changes to the constating documents of the corporation, flexibility in carrying out corporate proceedings, licensing requirements, fees, taxes, etc. Generally, a federal corporation has the capacity and the power of a natural person (unless restricted by its incorporating documents) and may carry on business anywhere in Canada without having that capacity and power restricted by a province. It may also use its name in any province, although it will still be required to register the business within the relevant provinces. While provincial corporations may also have the capacity and power of a natural person, the rights they acquire on incorporation to use their corporate name apply only in their province of incorporation. If a provincial corporation wishes to carry on business in another province, it may find that it is required to have an extra-provincial license in that province and that the license is not available because the name of the corporation is the same as or substantially similar to that of another corporation carrying on business in that province.

5. Unlimited Liability Companies

An unlimited liability company (ULC) is generally a separate legal entity that is similar to a corporation except that its shareholders are responsible (or partially responsible) for the liabilities of the company's business. ULCs may currently be formed only in the provinces of Alberta, British Columbia, Nova Scotia, and Prince Edward Island.

From a Canadian tax perspective, there is generally no benefit to a nonresident doing business in Canada through a ULC since ULCs are treated as regular corporations for Canadian federal income tax purposes. However, ULCs are generally eligible to be treated as disregarded entities or partnerships under the "check the box" rules[71] for U.S. federal income tax purposes and thus may provide certain benefits to U.S. persons from a U.S. tax perspective. A U.S. person that intends to invest in Canada through a ULC should also consider the potential application of the hybrid entity rules in the Canada-United States tax treaty, which could deny the benefits of the treaty in certain instances. In this respect, see the discussion below at XII.G.9.

B. Financing

1. Securities Legislation

The issuance and sale of securities are subject to the securities laws enacted by each of the provinces. There is no federal securities law or federal securities commission in Canada, although the securities regulatory authorities in each province and territory of Canada generally work together to produce unified rules across the country through an umbrella organization called the Canadian Securities Administrators (CSA). The federal government proposed a national securities regulator, but the Supreme Court of Canada held in 2011 that such regulation was properly within the jurisdiction of the provinces.

Regulatory standards imposed by the CSA and Canadian stock exchanges are generally similar to U.S. standards, such as the requirement for distributions of securities to be qualified by a prospectus or rely on an exemption from the prospectus requirement and for dealers and advisors in securities to be registered, or rely on an exemption from registration, to carry on business in Canada.

Provincial securities laws, as well as the federal and certain provincial corporate laws, regulate the conduct of takeover bids made to security holders within the relevant jurisdiction. Exemptions from takeover bid rules are available where a bid is made through the facilities of, and in accordance with the policies of, certain Canadian stock exchanges, is a private agreement purchase, or is with respect to a nominal number of outstanding securities. Bids made by issuers to purchase their own shares are generally regulated and subject to disclosure and timing requirements similar to those applying to takeover bids.

Insider trading and tipping are statutory offenses carrying criminal penalties. Civil remedies are also available to the purchaser and seller of securities, and the issuer, where the trade involves such activity. Securities legislation in Canada also contains a regime for civil remedies for investors against public issuers, their directors and officers and certain others where disclosure in the secondary market concerning the issuer is misleading. Private issuers are also subject to civil liability for misrepresentation in offering documents.

The CSA and the U.S. Securities and Exchange Commission (SEC) permit distributions and rights offerings in Canada to be made by certain U.S. issuers based on disclosure documents prepared in accordance with the U.S. Securities Act of 1933 and the Securities Exchange Act of 1934 rather than requiring compliance with Canadian provincial securities legislation. These rules, which are referred to as the Canada/U.S. Multi-Jurisdictional Disclosure System (MJDS), apply to certain securities offerings rights and exchange offers, takeover bids, issuer bids and business combinations, and extend to the recognition of certain home jurisdiction continuous reporting obligations.

As with the rest of the world, Canadians are participating in the new blockchain-driven cryptocurrency economy. A number of blockchain-based issuers are headquartered in Canada and/or have obtained listings on Canadian stock exchanges, generally through reverse takeover bids.

The CSA has published guidance consistent with the SEC's position that digital tokens are considered "investment contracts" and therefore subject to securities regulation when they are issued to raise capital from investors in a common enterprise with the expectation of profit primarily based upon the efforts of others. The CSA has recognized that bitcoin, ether and certain other crypto-assets are more appropriately characterized as commodities when the blockchain networks supporting them are sufficiently decentralized that there is no identifiable management team or group responsible for the development or success of the asset concerned.

With respect to the regulation of crypto trading platforms, Canada has registered a relatively large number as securities dealers, while the United States has not. As of March, 2023, over a dozen crypto trading platforms have been registered as securities dealers in Canada with the CSA and the Canadian In-

[71] See U.S. Treas. Regs. §301.7701-2.

ISBN 978-1-63359-385-5

vestment Regulatory Organization.[72] As of the same date, none of the major crypto trading platforms were registered with the SEC as securities dealers.[73] This reflects a major policy difference between the United States and Canada; while the SEC has commenced a much larger number of enforcement actions against domestic and foreign platforms[74] as compared to the CSA, the CSA has provided clear instructions for platforms on how existing securities laws can be adapted to apply to their trading activities. For example, in March 2021, the CSA published guidance indicating their intention to regulate crypto trading platforms that hold crypto-assets on behalf of their clients as dealers and/or marketplaces under securities laws, and areas where there may be flexibility in how those securities laws apply to the industry.[75]

Since that time, 11 crypto trading platforms have obtained registration as restricted dealers, one has obtained registration as an investment broker-dealer with the Canadian Investment Regulatory Organization (formerly the Investment Industry Regulatory Organization of Canada), two have been granted permission to operate a marketplace, and another 10 have filed pre-registration undertakings with the CSA, undertaking to become registered as securities dealers within a 12-month period following March 24, 2023. A small number of additional dealer trading platforms in Canada have been granted permission by the CSA to trade crypto-assets that are securities, under strict, time-limited terms and conditions. The rest are prohibited from offering crypto-assets that are themselves securities and/or derivatives.

Both domestic and global trading platforms are prohibited from offering crypto-asset custodial services to Canadians unless they are properly registered as dealers and/or marketplaces.

In February 2023, the CSA published guidance confirming their view that stablecoins (or "Value Referenced Crypto Assets" per the CSA's terminology) or stablecoin arrangements may constitute securities and/or derivatives. Any crypto trading platform proposing to offer stablecoins to Canadians must abide by stringent terms and conditions imposed by the CSA, and must obtain their prior written consent, which consent will not be granted unless the stablecoin concerned is backed by fiat.

In addition to securities laws, crypto-asset trading platforms are regulated as money services businesses under federal anti-money laundering/anti-terrorist financing laws.

2. *Personal Property Security*

Each of the common law provinces and territories in Canada has enacted personal property security legislation that governs the creation, perfection, priority and enforcement of security on personal property. In the common law Canadian provinces and territories, this legislation has a framework that is similar in many respects to Article 9 of the Uniform Commercial Code (UCC) in the United States, with a public registry system, perfection of security interests by registration and priority generally determined by time of registration.

Under Quebec's civil law system, the Civil Code of Quebec (CCQ) governs the creation, publication (similar to the concept of perfection), priority and enforcement of security on personal property (referred to as "movable property"), which is generally constituted by way of a movable hypothec, with or without delivery. Registration of an application for registration in Quebec's central Register of Personal and Movable Real Rights (RPMRR) is required to publish (perfect) and render opposable against third parties movable hypothecs without delivery, as well as other registrable rights in movable property (for example, a reservation of ownership under an installment sale contract and a right of ownership of the lessor under a contract of leasing). However, a hypothec with delivery (referred to as a "pledge") can be created and published (perfected) by the secured creditor obtaining physical possession of the pledged property or, in the case of securities, security entitlements and certain monetary claims (for example, a claim relating to the credit balance on a deposit account), by the secured creditor obtaining control of such pledged property (without having to make a registration at the RPMRR).

Each of the Canadian provinces and territories has also enacted uniform legislation regarding the transfer of securities. Such legislation generally accords with Articles 8 and 9 of the UCC and affects the law governing the perfection and priority of security interests in investment property, including securities. In Quebec, the securities transfer legislation generally accords with Articles 8 and 9 of the UCC and the securities transfer legislation of the other provinces and supplements the rules in the CCQ governing the creation, publication, priority and enforcement of movable hypothecs on securities and security entitlements to financial assets.

The federal government has passed legislation dealing with personal property security in areas of federal authority, in particular, relating to special forms of security that may be taken by banks under the Bank Act. The Bank Act enables banks to receive security in collateral such as raw materials, work-in-progress, and finished goods inventory, as well as agricultural, aquacultural, and forestry products, by-products and equipment, and hydrocarbons and minerals and related equipment.

C. *Employment Legislation*

1. *In General*

Most Canadian employers are regulated by provincial labor and employment laws. Federal labor and employment laws apply to a smaller group of employers who are engaged in federally regulated activities, such as shipping, railways, broadcasting, airlines, banking and inter-provincial trucking.

2. *No "At Will Employment"*

There is no "at will employment" in Canada. Unless there is a written employment contract dealing with termination, Canadian common law requires employers to provide employees with "reasonable" notice of termination or pay in lieu of notice, if employment is terminated without cause. Courts approach each case on an individual basis taking into account such employment factors as the employee's years of service,

[72] https://www.osc.ca/en/industry/registration-and-compliance/registered-crypto-asset-trading-platforms.

[73] https://www.sec.gov/oiea/investor-alerts-and-bulletins/exercise-caution-crypto-asset-securities-investor-alert#:~:text=In%20particular%2C%20no%20crypto%20asset,currently%20trades%20crypto%20asset%20securities.

[74] https://www.sec.gov/spotlight/cybersecurity-enforcement-actions.

[75] https://www.osc.ca/sites/default/files/2021-03/csa_20210329_21-329_compliance-regulatory-requirements.pdf.

ISBN 978-1-63359-385-5

position, level of compensation, age, and likelihood of finding reasonably comparable employment. Courts will also consider whether the employee had been lured away from secure employment. While there is no formula or calculation that can determine any employee's reasonable notice period, they typically fall within a range of three to 24 months.

3. Minimum Standards Legislation

Each province and the federal government have enacted legislation regulating the basic terms and conditions of employment. The legislation generally guarantees employees minimum rights with respect to the terms and conditions of their employment, which may not be waived by contract. Such statutory terms and conditions include minimum wage, hours of work, overtime pay, daily and weekly rest periods, vacations, statutory holidays, pregnancy and parental leave, and minimum periods of notice of termination or termination pay.

Provincial legislation also commonly provides that, where a sale of a business or a part of a business has taken place and the purchaser hires employees of the vendor, the employees' length of service with the vendor is treated as service with the purchaser for purposes of a number of statutory entitlements, including vacations with pay, and pregnancy and parental leave, and in calculating both the qualification for and the minimum amount of the employee's entitlement to notice of termination or termination pay.

4. Workers' Compensation

Workers' compensation legislation in each province establishes entitlement as a matter of right to compensation with respect to injuries or illnesses occurring in the course of an employee's employment, notwithstanding the presence or absence of any negligence on the part of the employer, the employee or other employees. This system is designed to replace the common law right of an employee to sue an employer for losses arising as a result of an accident in the workplace by providing the employee with the right to claim compensation from a statutorily established accident fund. Employers are required to contribute to the fund and compensation and medical expenses for injured workers are paid by an administrative tribunal out of the fund. No contribution to the fund by employees, either directly or indirectly, is permitted. The legislation may provide for continuation of benefits and the mandatory reinstatement of injured workers in certain circumstances.

5. Human Rights Legislation

Human rights legislation in Canada has had a profound impact on the employer-employee relationship. The most significant right guaranteed with respect to the employment relationship is the right to equal treatment and the corresponding prohibition against discrimination in employment. Generally, the prohibited grounds of discrimination include race, ethnic origin, ancestry, religion, sex, sexual orientation, marital status, family status, disability and age. The specific prohibited grounds of discrimination differ somewhat from province to province and within the federal sphere.

6. Privacy

A number of jurisdictions, including the federal government, British Columbia, Alberta and Quebec, have adopted privacy legislation covering employment relationships in the private sector. In Alberta, British Columbia and Quebec, employees in provincially regulated private sector industries are subject to Alberta's Personal Information Protection Act, British Columbia's Personal Information Protection Act, and Quebec's Act Respecting the Protection of Personal Information in the Private Sector, respectively. Canada's federal private sector statute, the Personal Information Protection and Electronic Documents Act, is only applicable to employees of federal works, undertakings or businesses (banks, airlines, railways, etc.). All other employees in Canada are not subject to private sector privacy legislation (although other privacy rights may exist).

While there is no private sector privacy legislation in Ontario that applies to provincially regulated employees, in 2022, Ontario amended its employment standards legislation, requiring employers of 25 employees or more to provide employees with a notice describing electronic monitoring practices, together with descriptions of purposes. This amendment does not provide such employees with any new right not to be monitored.

Employers operating in jurisdictions with privacy legislation are required to establish policies for the collection, use and disclosure of employee information, such as an employee privacy policy or notice (although it is recommended that employers in all provinces adopt policies regarding the collection, use and disclosure of employee personal information). Employee-facing privacy policies or notices, if properly drafted, often function as an employee-specific exception to the general obligation to obtain consent in order to collect, use or disclose personal information. The collection, use and disclosure of employee personal information must still be reasonable (or in Quebec, necessary) to the hiring, management or termination of the employee's employment.

Depending on the jurisdiction, private sector privacy legislation effectively limits the circumstances in which employers may conduct surveillance and employee monitoring for purposes of discovering employee wrongdoing or poor performance. Employers must also be aware that, under private sector privacy legislation, they are accountable for any employee personal information transferred to any third parties, including affiliates, service providers, suppliers and vendors; therefore, precautions should be taken to ensure the confidentiality and security of such information.

7. Labor Law

The basic policy of both federal and provincial labor laws is to grant employees the right to join a union of their choice. In addition, these laws impose an obligation on the employer to bargain in good faith and recognize the exclusive bargaining rights of a union following certification. Legislation in each jurisdiction provides for employee and employer protection against unfair labor practices, on the part of either the union or the employer. The legislation also establishes a system of certification of trade unions as bargaining agents, compulsory collective bargaining, compulsory postponement of strikes and lockouts during the bargaining process, government intervention by way of a conciliation process when the parties have been unable to negotiate a collective agreement, the right of employees to strike, and the right of employers to lockout. Most

ISBN 978-1-63359-385-5

jurisdictions provide for the imposition of a collective agreement by way of arbitration and, in some cases, there may be first contract arbitration where parties have been unable to negotiate an agreement and have been in a lawful strike or lockout position for more than a specified period. Some jurisdictions, such as Quebec, limit an employer's right to use replacement workers during a strike or lockout.

Where there is a sale of all or part of a business and the vendor's employees are represented by a trade union, the buyer of the business is automatically considered to be a successor employer with respect to unionized employees and will be bound by the vendor's collective agreement and subject to the bargaining rights of the vendor's union.

8. *Employment and Pay Equity*

Employment equity legislation is intended to promote the representation of certain historically disadvantaged groups in the workplace. It applies, subject to certain workplace size thresholds, to employers under federal jurisdiction. The federal government has mandatory employment equity requirements that apply to provincially regulated employers who bid on government contracts above a certain amount.

In Canada, "pay equity" refers to wage parity between male and female workers to redress systemic discrimination. Ontario's Pay Equity Act, the most far-reaching legislation of its kind in any Canadian jurisdiction, requires existing employers to make upward adjustments in compensation to female-dominated job classes to achieve pay equity. The Act provides for a proactive enforcement mechanism under which employers can be found liable for noncompliance, even if no employee lodges a complaint. Legislation in most other provinces provides for a complaint-driven process under which an employer may be held accountable only if an employee or union files a complaint.

9. *Occupational Health and Safety*

Occupational health and safety legislation across Canada require employers to provide workers with a safe workplace by taking every precaution reasonable in the circumstances for the protection of a worker. Most provinces also impose specific duties (i.e., preparation of a written occupational health and safety plan and establishment of a joint health and safety committee, certified members of which may order a work stoppage where dangerous circumstances exist). Recently, occupational health and safety legislation in many Canadian jurisdictions has added a duty to take every reasonable precaution to protect employees from harassment and violence in the workplace. In most jurisdictions, a worker has the right to refuse unsafe work. Fines for violations of health and safety legislation can be significant and are rising. Canada's Criminal Code provides for the prospect of criminal charges and potential imprisonment for senior managers, officers and directors of corporations that direct the work of others but fail to take all reasonable steps to ensure the safety of workers and the public.

10. *Unemployment, Pension and Healthcare Contributions*

Both employers and employees are required to pay premiums under the Employment Insurance Act[76] and the Canada Pension Plan.[77] Employers may also be subject to taxes imposed to fund the Canadian public health insurance system. These levies are discussed in greater detail at VI.F., below.

D. Environmental Legislation

1. *In General*

Jurisdiction to regulate environmental matters in Canada is divided between the federal government and the provinces (and municipalities through the provinces). Both provincial governments and the federal government have become increasingly active in recent years, particularly regarding air pollution and releases to water, as have municipalities, particularly with respect to the use of pesticides and toxic substances. Overlapping jurisdiction can sometimes result in confusing and duplicative but not identical requirements, as well as constitutional challenges. Efforts by all three levels of government to minimize duplication and overlap are continuing.

Environmental legislation in Canada can be broadly divided into three separate categories: the first relating to protection of the environment through the imposition of requirements to assess and consider environmental impacts before commencing new projects; the second relating to the protection of the environment through the imposition of controls on the operation of facilities and businesses after they are established; and the third relating to protection of the environment through the implementation of a greenhouse gas pricing system.

2. *Environmental Assessment of Proposed Projects*

Environmental assessments, also known as impact assessments, can be required under federal or provincial legislation, and sometimes both. In some jurisdictions in Canada, a distinction is made between public projects and private projects, with public projects being generally subject to the requirement to conduct an assessment and private projects being required to do so only when they are designated as being subject to the process. In other Canadian jurisdictions, all projects may be subject to the requirement to complete an assessment at the discretion of the government and, in still other Canadian jurisdictions, only those projects meeting certain criteria are required to undergo assessment.

In most Canadian jurisdictions, projects with no substantial or significant potential impacts are subject to less rigorous procedures than projects that are likely to have significant impacts. At times, projects with no substantial or significant potential impacts may not require environmental assessment at all. Environmental assessments of projects that may have a significant adverse environmental impact are usually submitted to an administrative agency for a structured review.

The process is similar in most Canadian jurisdictions. The proponent is required to complete a report providing a description of the project, a statement of the need for the project, identification of possible alternatives to the project and means of achieving the objective of the project, an analysis and prediction of how the alternatives will affect the environment, a comparison of the environmental benefits and costs of the alternatives, a selection of the preferred alternative, and an identifica-

[76] S.C. 1996, c. 23.

[77] R.S.C. 1985, c. C-8.

ISBN 978-1-63359-385-5

tion of measures to mitigate any adverse effects. The report is submitted to the government for review. The government may approve the project, impose conditions and, in some cases, require a public hearing. The government will typically also delegate to the project proponent certain obligations to consult with Indigenous peoples which must be fulfilled prior to a project being approved. In cases where the environmental costs exceed the benefits, the government may prohibit the project from proceeding.

In 2019, the federal government enacted the Impact Assessment Act, S.C. 2019, c. 28, s. 1, replacing the previous Canadian Environmental Assessment Act, 2012, S.C. 2012, c. 19, s. 52. Unlike the previous federal environmental assessment legislation, the Impact Assessment Act requires that proponents of designated projects carry out a planning process before deciding on project specifics and before the federal regulator determines that an assessment is required. When required, assessments consider both project benefits and adverse effects, with respect to the environment and socio-economic effects.

On May 10, 2022, the Alberta Court of Appeal declared the Impact Assessment Act unconstitutional. The Supreme Court of Canada heard the appeal of this decision on March 21–23, 2023. As of June 15, 2023, the Supreme Court had not yet rendered its decision on the constitutionality of the Impact Assessment Act.

3. *Environmental Control of Established Facilities*

Environmental protection legislation typically regulates the discharge or release of substances to land, air and water; the reporting, clean-up or control of substances in the environment after they are discharged or released; the use and control of potentially harmful substances; the transportation and storage of dangerous goods; and the collection, transportation, treatment and disposal of wastes. Regulatory instruments and powers include:

(i) Licensing or approval requirements (which may impose conditions, such as, for example, the installation of control equipment or monitoring devices and reporting requirements) for undertaking activities that may result in the discharge or release of contaminants;

(ii) The prohibition of certain actions (such as discharges of contaminants);

(iii) Orders requiring the recipient to take actions to comply with applicable environmental regulatory requirements and administrative penalties for particular types of noncompliance; and

(iv) Investigations, prosecution or charges (which may result in significant fines and, in severe cases, imprisonment) for breach of environmental regulatory requirements.

In most Canadian jurisdictions, the directors and officers of a corporation have a duty to take all reasonable care to prevent the corporation from contravening environmental regulatory requirements or to not participate or acquiesce in such a contravention. If they fail to take such care or they so acquiesce or participate, they may be personally charged and, if convicted, fined and, in severe cases, imprisoned. In some Canadian jurisdictions, directors and officers may also be obliged to effect compliance with orders if the corporation fails to comply.

A lender will not generally be exposed to environmental regulatory liability in Canada for merely making a loan and taking security over assets with respect to the loan. However, if a lender exerts a sufficient degree of management or control over a borrower's operations, business or property, the lender may be exposed to such liability. For example, a lender could be exposed if the lender imposes controls over a borrower's operations in the loan conditions. Also, if a lender realizes on its security and takes possession and control of the assets subject to the security instrument, the lender may be exposed to environmental regulatory liability, which could exceed the value of the debtor's assets. Recent jurisprudence has indicated that environmental obligations could effectively function as a super priority in insolvency or bankruptcy circumstances, as the courts currently require a trustee in bankruptcy or other insolvency professional to use the assets of the estate to satisfy the regulatory obligations, including environmental reclamation or clean-up requirements, imposed on the bankrupt. The trustee, monitor or receiver is generally protected from personal environmental regulatory liability for any environmental condition or damage that arose or occurred before its appointment or after its appointment, the exception for the latter being with respect to liability resulting from conditions or damage that occurred as a result of its gross negligence or willful misconduct.

4. *Implementation of a Greenhouse Gas Pricing System*

Since 2018, a federal greenhouse gas pricing system has been operating in Canada that is comprised of two elements:

(i) A regulatory charge on fossil fuels, such as gasoline and natural gas, known as the "fuel charge," payable by fuel producers and distributors; and

(ii) A performance-based regulatory trading system for industrial facilities with high emissions levels, known as the "Output-Based Pricing System."

The fuel charge applies at rates equivalent to Can. $65 per tonne of carbon dioxide-equivalent emissions for 2023 with an increase of Can. $15 per tonne per year until the rate reaches Can. $170 per tonne with effect from January 1, 2030. Industries in the Output-Based Pricing System will pay a charge on the amount of greenhouse gases they emit above a specified level at rates similar to the fuel charge rates.

The federal greenhouse gas pricing system does not apply in provinces that have imposed their own greenhouse gas pricing system, provided the provincial system meets or exceeds the federal benchmark. As of June 15, 2023, the fuel charge applies in Alberta, Manitoba, Nunavut, Ontario, Saskatchewan and the Yukon. As of July 1, 2023, it will also apply in New Brunswick, Newfoundland and Labrador, Nova Scotia and Prince Edward Island. The Output-Based Pricing System applies in Manitoba, Nunavut, Prince Edward Island, the Yukon and, partially, in Saskatchewan. A Notice of Intent was published on December 23, 2022, indicating the Government of Canada's intent to remove Saskatchewan from the Output-Based Pricing System, as Saskatchewan's provincial plan meets the requirements for the 2023–30 federal benchmark. All other provinces and territories are implementing their own pricing systems.

Businesses that have activities in these provinces, such as fuel producers, distributors, importers, certain users of com-

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bustible waste, and persons that are air, marine, rail or road carriers, may have to apply for registration with the Canada Revenue Agency (CRA) for purposes of the fuel charge and will be subject to monthly reporting requirements. The Alberta, Ontario and Saskatchewan provincial governments have challenged the constitutionality of the federal greenhouse gas pricing system. On March 26, 2021, the Supreme Court of Canada rejected the challenges of Alberta, Ontario and Saskatchewan, upholding the federal greenhouse gas pricing system as constitutionally valid.

E. Notifications and Information Returns

As discussed in II.A., above, while the Investment Canada Act (ICA)[78] provides for governmental review primarily in the case of significant foreign investment and with respect to national security considerations, non-Canadians must file a notice regarding all acquisitions of control of Canadian businesses and the establishment of new Canadian businesses. The information obtained in the course of the administration of the ICA is protected under the confidentiality protections set out in the ICA and is exempt from disclosure under the Access to Information Act. Similarly, any information obtained in the course of the administration of the CA is protected under the confidentiality protections set out in the CA and is exempt from disclosure under the Access to Information Act.

Other federal information returns include those filed pursuant to the Income Tax Act,[79] the Employment Insurance Act,[80] and the Canada Pension Plan.[81] In addition, financial and other information is collected under federal and applicable provincial law from certain corporations, primarily to enable the government to evaluate the extent and effects of nonresident ownership and control of corporations in Canada. Federally-incorporated corporations are required to file an annual return in prescribed form and other notices in certain circumstances.

Provincial incorporation or corporate information statutes generally require the filing of an annual or other return by all corporations doing business in the province concerned. The information required may vary depending on whether the corporation is incorporated under the laws of the province or is merely registered to do business there.

All corporations that are "reporting issuers," or that distribute their securities to the public within the definitions contained in provincial securities laws and stock exchange rules, are required to make regular filings, including the filing of their financial statements and copies of materials sent to security holders in accordance with applicable continuous and timely disclosure requirements.

F. Language Legislation

Canada is officially a bilingual (English and French) country. As of 2021, approximately 30% of its population was French speaking, the majority of whom reside in Quebec, where nearly 95% of residents speak French. When doing business in Canada, a nonresident must, therefore, take into account various federal and Quebec laws and regulations designed to protect language rights and promote the French language and culture.

For example, regulations passed under the Consumer Packaging and Labeling Act,[82] in conjunction with the Official Languages Act,[83] require that, as a general rule, the product identity and the net quantity identification be in both French and English. The dealer identification declaration may be in either English or French but, as a general rule, if the product is being sold in the Province of Quebec, both languages must appear. It is, therefore, common to provide all the mandatory information in both languages. These requirements apply to all consumer products marketed and sold in Canada, whether locally manufactured or imported, subject to very limited exceptions. Goods marketed or sold in contravention of these requirements are subject to seizure and potential destruction by federal authorities.

When doing business in Quebec, it is necessary also to consider the requirements of the Quebec Charter of the French Language (the "French Language Charter"),[84] which is designed to make French the everyday language of work, instruction, communication, commerce and business in Quebec. There are a number of important aspects of this legislation, affecting everything from signage to labor relations and contracts. Some of the more noteworthy provisions are as follows:

(i) All public signs as well as poster and commercial advertising in Quebec must be in French, although another language is permitted subject to certain restrictions on the prominence of the other version. A number of exceptions to this requirement are included in the regulations. For example, with respect to trademarks, the Regulation respecting the language of commerce and business[85] has been amended to provide that when a trademark in another language is used on exterior-facing signage, sufficient presence of French must be ensured in the same visual field as the trademark, by way of either a generic term or description of the products or services concerned, a slogan or any other term or indication in French. On June 1, 2025, additional requirements will come into force, such as a requirement for a non-French trademark to be registered in Canada to be used on signage and increasing the prominence of French on exterior-facing signage, so that the French is markedly predominant in relation to a non-French trademark.

(ii) Every inscription on a product, on its container or wrapping, or on a document or object supplied with it, including the directions for use and the warranty certificates, must be drafted in French. Another language is also permitted provided that the other language is not given greater prominence over the French version. There are various exceptions to the French labeling, inscription, and signage requirements. For example, exceptions exist for products intended for use exclusively for a market outside of Quebec, for trademarks, for greeting cards, and for cal-

[78] R.S.C. 1985, c. 20 (1st Supp.).
[79] R.S.C. 1985, c. 1 (5th Supp.).
[80] S.C. 1996, c. 23.
[81] R.S.C. 1985, c. C-11.
[82] R.S.C. 1985, c. C-38.
[83] R.S.C. 1985, c. 31 (4th Supp.).
[84] R.S.Q. 1987, c. C-11.
[85] C.Q.L.R. c. C-11, r. 9.

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endars and agendas not for purposes of advertising. On June 1, 2025, additional restrictions will come into force regarding the use of non-French trademarks on product inscriptions. These restrictions will require that such trademarks be registered in Canada and will further require the translation of any generic or descriptive terms that are included in the trademark.

(iii) All computer software, including game software and operating systems, whether installed or uninstalled, must be available in French unless no French version exists. Software may also be available in languages other than French, provided the French version may be obtained on terms that are no less favorable, except with regard to price where it reflects higher production or distribution costs, and provided it has technical characteristics that are at least equivalent. This requirement has had an impact on the release of new software products in Quebec.

(iv) Contracts predetermined by one party, as well as contracts containing printed standard clauses and the related documents, must be in French. These may also be in another language, at the express request of the parties. However, as of June 1, 2023, most contracts that are predetermined by one party will have to be systematically provided to the Québec counterparty in French before that counterparty can express a willingness to contract in English. Failure to comply with this new requirement can result in the annulment of the contract in question. While it has become common for English language contracts (even for negotiated contracts) to include a clause (in bilingual form) stating that the parties wish the contract and related documents to be in English, this practice should not be relied on to negate liability under the Charter of the French Language for failing to provide standard-form contracts in French in Quebec, particularly given the new requirement to provide a French version of non-negotiable contracts in most cases, even if the Québec counterparty prefers to contract in English, and the fact that annulment of such a contract is now possible if it is not provided in French.

(v) The names of firms doing business in Quebec are required to be in French, subject to exceptions to accommodate circumstances in which the statute under which they are incorporated does not permit it. The specific component of a French name may be a word, or an expression taken from another language (like a trademark), provided its generic component is in French.

(vi) A firm with 50 or more employees in Quebec must obtain a "francization certificate" stating that it has properly applied and implemented a francization program at each level of the organization. As of June 1, 2025, this requirement will apply to firms with 25 or more employees in Québec.

Non-Quebec corporations that do business in Quebec are required to comply with most of the provisions of the French Language Charter, such as those relating to the labeling of products and communicating with their Quebec employees and customers in French. However, the day-to-day common business language in the largest city in Quebec, Montreal, remains English in many enterprises and approximately 20% of Montreal residents do business mainly in English.

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IV. General Private and Commercial Law

A. Real Property

The sale and development of real property is under the jurisdiction of the provincial governments. In every province except Prince Edward Island, a nonresident is generally entitled to take, acquire, hold, and dispose of commercial real property in the same manner as a Canadian citizen or resident. Prince Edward Island, however, has enacted the Lands Protection Act, P.E.I.,[86] which restricts the amount of land that may be held by persons or corporations not resident in the province. There are also restrictions on the ownership of land outside of cities, towns and villages in Alberta, and on the ownership of farmland in Saskatchewan, Manitoba and Quebec. In addition, some provinces require corporations to meet licensing or registration requirements to hold land. Notwithstanding that real property is under the jurisdiction of the provincial governments, the federal government has introduced a restriction on the ownership of residential real property in certain designated areas by non-Canadians, including corporations and other business interpretations that do not satisfy the criteria for being considered Canadian. That restriction became effective January 1, 2023, and is expected to be in place until January 1, 2027.

Although provincial governments are responsible for land use planning, various planning functions are delegated to the municipalities. The degree of control exercised by the provincial governments over municipal action varies considerably. Much of the regulation of real property is in the form of zoning and building by-laws. Zoning by-laws regulate virtually all aspects of the use of land, the nature of buildings and structures thereon, the size of parcels of land and the permissible development of land among other things. Building by-laws, including building permit requirements and building code standards, govern such matters as building materials, heating and ventilation systems, electrical systems, sewage and water systems, access, and inspection.

Other provincial legislation may also be relevant to real property ownership and development, such as laws relating to environmental protection, residential rent control, historical designations, and the regulation of real property and mortgage brokers.

Each province administers a system for the registration of interests in land, both with respect to title and with respect to encumbrances. To this end, in various parts of the country one finds a registry system and/or a land titles (or "Torrens") system. A registry system provides for the public registration of instruments affecting land but does not make any qualitative statement as to the status of title. A land titles system provides for more than the registration of documents and, in some cases, title is (subject to certain exceptions) effectively guaranteed by the province.

Taxes on real property constitute a major source of revenue in Canada. Most of these taxes are levied at the municipal level and used to fund municipal services. Some provinces also levy taxes on the purchase of land and impose various other taxes on mines, timber property and similar property.

[86] R.S.P.E.I. 1988, c. L-5, s. 4 and 5.

In several Canadian provinces, the purchaser of land is required to pay provincial and/or municipal land transfer tax or property purchase tax. The specifics of the legislation differ significantly from province to province and are discussed in VI.G., below.

Income taxes are normally payable on profits or gains from the disposition of land. Reference should be made to the discussion at VIII.B.3.c., below, of gains realized by nonresidents of Canada and the related compliance requirements. Depending on the province, goods and services tax (GST), or harmonized sales tax (HST), discussed at VI.D.3., below, may be imposed on the sale or lease of real property.

Additional rules apply to certain residential properties considered to be vacant or underused. The federal Underused Housing Tax imposes an annual tax on non-residents who own Canadian residential real estate considered to be vacant or underused that is equal to 1% of the value of the property. Vacant Home Taxes are also imposed by certain municipal governments, including Toronto, Ottawa, and Vancouver.

Comment: In Budget 2024, the federal government announced that it was considering imposing a tax on residentially zoned vacant land. The government held a consultation for the potential tax from October 8 to December 31, 2024.

B. Intellectual Property

1. Patents

In Canada, the federal Patent Act[87] grants a statutory monopoly over new and useful inventions for a fixed period of time. The Canadian Patent Act was fundamentally changed in 1989 from a first-to-invent system to a first-to-file system, with a qualified absolute novelty requirement. Any publication or enabling public disclosure of the invention prior to the effective filing date by someone other than the inventor, or a person who obtains knowledge of the invention directly or indirectly from the inventor, will bar the application. Generally, a one-year grace period, measured from the date of filing of the patent application in Canada, will be allowed for disclosures originating from the inventor. Canadian patents are granted for a term of 20 years from the date of filing in Canada.

Where a court finds a patent has been infringed, it may order an injunction restraining further infringement, an award of the patentee's damages or an accounting of the infringer's profits, and the delivery up or destruction of infringing articles.

2. Copyrights

In Canada, copyright subsists in every original literary, dramatic, musical or artistic work, including computer software. Subject to exceptions set out in the Copyright Act,[88] the term of protection of a copyrighted work is the life of the author plus 50 years. Canada, like the United States, is a signatory to international copyright conventions. Thus, under the federal Copyright Act, the author of an original literary, musical, dramatic or artistic work (including computer software) automatically has copyright in the work in Canada upon its creation, provided the author is a citizen or subject of a treaty country

[87] R.S.C. 1985, c. P-4, as amended.
[88] R.S.C. 1985, c. C-42, as amended.

ISBN 978-1-63359-385-5

(i.e., a country that is a member of the World Trade Organization (WTO) or a party to the Berne Convention or the Universal Copyright Convention), or provided the work, if published, was first published in a treaty country.

The owner of the copyright in a work has the exclusive right to produce or reproduce the work, or any substantial part of the work, to perform the work in public, to transmit the work to the public by telecommunication, to publish an unpublished work, and to authorize any such act. Pursuant to the Copyright Act, the copyright in a work is infringed when any third party, without the permission of the copyright owner, does anything that only the owner has the right to do.

Generally, the author of a work is the first owner of the copyright, although an employer is the first owner of the copyright in material created by its employees in the course of employment (absent an agreement to the contrary). Works created by an independent contractor belong to the contractor. There is no equivalent in Canada to the "work for hire" doctrine. Note that where a work is "prepared or published by or under the direction or control of" a Canadian government entity, Crown copyright issues will arise and will require specific consideration.

Copyright subsists in original works whether or not a work is registered. Although registration is not necessary in Canada, it provides certain advantages. First, it provides certain presumptions regarding the subsistence and ownership of copyright. Second, the existence of a registration is deemed to be grounds for suspecting that copyright subsists in a work and prevents any person from relying on the defense of "innocent infringement." This defense is available when a protected work is copied but the infringer has no actual knowledge that copyright subsists in a work, and no reasonable grounds for suspecting it does. In this case, the only remedy for infringement available to the copyright owner is injunctive relief.

Where a court finds that a copyright has been infringed, it may order an injunction restraining further infringement, an award of damages or an accounting of the infringer's profits, and the delivery up or destruction of infringing articles. In the alternative to actual damages or profits, the plaintiff may elect to receive statutory damages. Criminal sanctions may also be available.

3. Trademarks

Trademarks in Canada may be registered or unregistered. The federal Trademarks Act[89] allows for the registration of a trademark, which is granted for an initial term of 10 years. The registration may be renewed for successive 10-year periods on payment of renewal fees and does not require proof of use of the trademark by the registrant. Registration of a trademark provides the registrant with the exclusive right to use the trademark in Canada in association with the goods and services identified in the registration. The owner of an unregistered trademark will need to establish, if its mark is challenged or infringed, that its trademark is recognized in the relevant marketplace as identifying its goods or services.

A trademark will not be valid, enforceable or registrable if the trademark is not distinctive with respect to the goods or services with which it is associated. Under Canadian law, a trademark is not distinctive where there has been concurrent or prior use of the mark by others (unless the others are licensees). A trademark will also be unenforceable when it is clearly descriptive, or where it is deceptively misdescriptive.

The owner of a registered trademark may bring an action for infringement under Sections 19 and 20 of the Trademarks Act if the mark is being used by an unauthorized third party. The owner of an unregistered mark may commence an action in passing off if a third party is using its trademark.

To prevail in an infringement suit, the owner of a trademark must show that the defendant is using a mark in association with its goods or services that is confusingly similar to the owner's trademark and creates confusion as to the true source of the goods or services.

When a court finds that a trademark has been infringed, it may order an injunction restraining further infringement, an award of the owner's damages or an accounting of the infringer's profits, and the delivery up or destruction of infringing articles.

4. Industrial Designs

The provisions of the federal Industrial Design Act[90] protect a product's unique appearance, allowing the owner of a novel design to obtain a monopoly on the use of that design, provided an application for registration is filed within one year after publication of the design in Canada or elsewhere. An industrial design is the Canadian equivalent of a U.S. design patent. The design must not be solely utilitarian and must be one that "appeals to and is judged solely by the eye." An industrial design registration endures for the longer of 10 years from the date of registration and 15 years from the Canadian filing date (i.e., the exclusive rights will be between 10 and 15 years). The owner of an industrial design that has been infringed is generally entitled to an award of damages or an accounting of profits, injunctive relief, and the disposal of infringing products. If the infringer was not aware, and had no reasonable grounds to suspect, that the design was registered, the plaintiff is limited to injunctive relief. This defense of innocent infringement is not available if the articles to which the registration pertains, or the labels or packaging associated with those articles, were properly marked as a registered industrial design, and were distributed in Canada by or with the consent of the owner of the industrial design at the time of the infringing act.

5. Semiconductor Chips

The federal Integrated Circuit Topography Act[91] gives registrants an exclusive 10-year term of protection for the design or topography of integrated circuits, such as semiconductor chips, after the earlier of the first commercial exploitation of the topography or the filing date of the application. Registration is available to creators of topographies who are nationals of Canada, legal entities that create topographies or manufacture integrated circuit products in Canada, nationals and residents

[89] R.S.C. 1985, T-13.

[90] R.S.C. 1985, c. I-9, as amended.

[91] S.C. 1990, c. 37, as amended.

ISBN 978-1-63359-385-5

of foreign countries who offer sufficient protection to Canadian topographies, and nationals of WTO member countries.

The application for registration must be filed in Canada within two years of the first commercial exploitation of the topography anywhere in the world. Registration gives the exclusive right to reproduce, manufacture, import or commercially exploit the topography, and any integrated circuit that incorporates the topography or a substantial part thereof. Reverse engineering is lawful for purposes of evaluation, research or teaching, but not for commercial purposes.

6. *Trade Secrets and Confidential Information*

While there is federal legislation pertaining to the protection of personal privacy and personal information held by public bodies and private corporations in Canada, commercial confidential information and trade secrets are protected by the common law, rather than by statute.

Confidential information will be protected if the information has not been publicly disclosed. Any disclosure of confidential information must have been made in such a manner as to protect its confidentiality, and the recipient of the information must know, or ought to have known, that the information was confidential.

A trade secret is a type of confidential information that typically consists of technical information, or knowhow, that is kept secret and provides a competitive advantage to its owner. Where the court finds a misuse of confidential information, the remedies available are flexible and include an injunction, damages or an accounting of profits, and equitable remedies such as the imposition of a trust.

C. *Bankruptcy Law*

1. *Restructurings*

An insolvent Canadian company may choose to implement a formal restructuring using the proposal provisions in the Bankruptcy and Insolvency Act (BIA)[92] or by commencing an application under the Companies' Creditors Arrangement Act (CCAA).[93] Each of these processes is similar to Chapter 11 of the Bankruptcy Code of the United States, although proposal proceedings under the BIA are more codified than CCAA proceedings. Both of these processes are generally overseen by the relevant provincial court in which the bankruptcy proposal or CCAA application is made.

Under the BIA, an insolvent person may file a notice of intention to make a proposal, which automatically initiates a 30-day stay period against most creditors. During the stay period, the business is monitored by a trustee, while the debtor attempts to negotiate an acceptable proposal with its creditors. The BIA also provides that, during this period, contractual terms providing for the termination, amendment or acceleration of payment under a contract simply by reason of the fact that a person is insolvent or has filed a notice of intention or a proposal are unenforceable. A similar rule applies to clauses in leases or licensing agreements that are triggered by the nonpayment of rent or royalties. Any further supply of goods and services may, however, be on a cash basis and need not be on credit terms.

The debtor may seek individual extensions of the stay period not exceeding 45 days up to a maximum of five months following the expiry of the initial 30-day period for formulating a viable proposal. A debtor that does not file a proposal within the allowed time will be deemed to have made an assignment in bankruptcy (akin to commencing a Chapter 7 proceeding in the United States).

The proposal may be made to unsecured creditors only or to both secured and unsecured creditors. Creditors with proven claims are entitled to vote on the proposal and are divided into classes based on commonality of interest, with all of the unsecured creditors normally comprising one class. The approval of a proposal by a particular class requires a favorable vote by creditors representing a majority in number and two-thirds in value of those voting. The BIA requires that all classes of unsecured creditors (other than equity claimants, unless the court orders otherwise) must vote for acceptance of a proposal by such threshold. Some significant differences between the Canadian law and the U.S. Chapter 11 regime are the absence in Canadian law of a "cram down" to force a reorganization scheme on classes of dissenting secured creditors, and the fact that the company must first be insolvent to seek such relief and that the initiation of such relief does not create a new estate interest.

Once the court sanctions the proposal as approved by a class of creditors, it will then be binding on all members of that class. The BIA provides that a court may not sanction a proposal unless it provides for the payment of source deductions for income tax, unemployment insurance and Canada Pension Plan contributions. Apart from such source deductions and subject to certain exceptions, the BIA generally treats government claims as ordinary unsecured claims. In the case of an employer, the BIA also provides that the court may not sanction a proposal unless it provides for the payment of unpaid wages and disbursements up to a maximum amount per employee, as well as for the payment of unremitted employee pension contributions, unpaid employer defined benefit pension contributions and unpaid normal cost payments.

Like the proposal provisions of the BIA, the CCAA may, in certain circumstances, permit a financially troubled company to continue its business through a reorganization by providing for a stay of proceedings against secured and unsecured creditors during a reorganization period. Such proceedings are available only to a debtor company or affiliated debtor companies with more than Can. $5 million of total debt (i.e., larger companies involved in more complicated restructurings). However, being less codified than the BIA, the CCAA is a more flexible restructuring tool allowing, for example, broader and longer stays of proceedings. If a restructuring under the CCAA fails, there is no automatic bankruptcy as there would be under a failed BIA proposal. Voting thresholds, the classification of creditors, plan approval and the court sanction process are largely similar in nature to BIA proposal proceedings.

2. *Liquidations*

The BIA also provides for voluntary assignments into formal bankruptcy or involuntary creditor applications to have a company adjudged bankrupt. Such proceedings are similar to

[92] R.S.C. 1985, c. B-3.
[93] R.S.C. 1985, c. C-36.

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Chapter 7 proceedings in the United States. In a bankruptcy, all assets of the debtor, subject to existing security interests, vest in a trustee in bankruptcy who liquidates them for the general benefit of all unsecured creditors. Aside from the BIA, various liquidation regimes apply to entities doing business in Canada, including liquidation proceedings commenced under the CCAA. In addition, certain financial institutions, such as banks, loan and trust companies, and insurance companies, as well as other corporations subject to exclusive federal jurisdiction, must be liquidated pursuant to the Winding-up and Restructuring Act.[94] This Act also applies to Canadian branches of foreign banks.

D. Conflict of Laws

Each of the Canadian provinces and territories is a separate jurisdictional entity with its own conflict of laws rules. The conflict rules of the common law provinces are similar, although not identical. The conflict rules of the civil law Province of Quebec differ from the common law conflict rules. In addition, there is a federal legal system that applies to matters within federal legislative competence that encompasses the entire country. Canada is a member of the Hague Conference on Private International Law.

This discussion reflects Canadian common law conflict of laws rules, which are principally developed by case law.

In general, a Canadian court will apply the *lex causae* (the system of law that Canadian conflict of laws rules indicate is applicable to the question) to matters of substance and the *lex fori* (the law of the forum, in this case the law of a Canadian province or territory) to matters of procedure. Therefore, in matters involving foreign legal elements it is crucial to determine whether a given rule of law is substantive or procedural in nature.

A Canadian court will generally apply a foreign choice of law clause in a contract provided the choice is bona fide and legal and is not contrary to public policy. However, a Canadian court will not apply a foreign law that deals with the enforcement of foreign tax or expropriatory or penal laws. In addition, a Canadian court will not apply a foreign law if its application would be contrary to public policy.

Unless foreign law is pleaded and proven in a case, a Canadian court will apply Canadian law based on a presumption that the Canadian law is the same as the foreign law.

A Canadian court will generally enforce a final foreign money judgment if the foreign court had jurisdiction over the defendant according to Canadian law. A foreign court may have jurisdiction in different ways, including if the defendant attorned to or previously agreed to submit to the jurisdiction or if there is a real and substantial connection between the defendant and the foreign jurisdiction in relation to the matter before the foreign court.

A Canadian court will not normally enforce a foreign judgment if the judgment:

(i) Was obtained by fraud;

(ii) Would be characterized as based on foreign tax, expropriatory or penal law;

(iii) Was obtained in breach of the rules of natural justice; or

(iv) Is contrary to public policy.

The laws of evidence and admissibility are, for the most part, procedural and are governed by Canadian law as the law of the forum. This rule is subject to the qualification that not every rule that Canadian law would consider part of the law of evidence is classified as procedural for conflict of laws purposes, but only rules of a technical or procedural character. It is now generally accepted that questions as to the remoteness of damages are substantive and governed by the *lex causae*, whereas questions as to the quantification of damages are procedural and thus governed by Canadian law as the law of the forum.

Questions of the priority of creditors are matters for Canadian law as the law of the forum in relation to bankruptcies, windings-up and the administration of insolvent estates.

[94] R.S.C. 1985, c. W-11.

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V. Regulated Sectors

Several sectors of the Canadian economy are strictly regulated because of their perceived importance to national economic policy, including certain financial services (banking in particular), communications and energy.

A. *Financial Services*

In Canada's system of government, there is a division of powers between the federal and provincial governments. The federal government has exclusive legislative authority over banking and incorporation of banks, while the provinces retain jurisdiction over contract law, property and civil rights. Accordingly, both federal and provincial laws shape the regulation of financial institutions in Canada.

At the federal level, the legislation provides for the incorporation and regulation of three categories of financial institutions: banks, which include federal credit unions and foreign bank branches; trust and loan companies; and insurance companies. The legislation in provinces permits the establishment of and regulates non-bank deposit-taking institutions, such as credit unions and trust and loan companies, non-bank finance companies and insurance companies. As a result, credit unions (*caisse populaires* in Quebec), insurance companies, trust companies and loan companies may be incorporated under either federal or provincial laws.

In 1992, a revised framework of federal legislation governing federal financial institutions took effect. At that time, the Bank Act,[95] the Trust and Loan Companies Act,[96] the Insurance Companies Act,[97] and the Cooperative Credit Associations Act[98] introduced changes designed, among other things, to broaden competition among financial institutions and to increase their lending and investment powers, all within the context of enhanced consumer protection. The legislation also revised the rules relating to the ownership and acquisition of Canadian financial institutions. In addition to being subject to the federal legislation referred to above, federally incorporated trust companies, loan companies, and insurance companies are subject to provincial legislation that regulates these types of entities, and which varies from province to provinces. Most provinces impose a licensing or registration regime for each of these types of companies, as well as market conduct rules.

Banks incorporated in Canada under the Bank Act are designated as Schedule I or Schedule II banks depending upon whether they are controlled by a foreign bank. Foreign banks that have been authorized under the Bank Act to establish branch operations in Canada are designated as Schedule III banks.

Banks incorporated in Canada that have equity of Can. $12 billion or more may not have any major shareholders, with some limited exceptions. A major shareholder is defined as a person who would beneficially own, either directly or through entities that the person controls, more than 20% of the outstanding voting shares of the bank or more than 30% of any class of nonvoting shares of the bank. Any person wishing to exceed 10% of any class of shares will also require the prior approval of the Minister. One exception to this rule exists pertains to banks that are controlled by a foreign bank at the time that they reach the Can. $12 billion threshold.

Canadian banks that have between Can. $2 billion and $12 billion of equity are subject to a public float requirement. Subject to obtaining an exemption from the Minister of Finance, these banks are required to have at least 35% of their voting shares listed on a Canadian stock exchange and widely distributed.

Ownership constraints are also imposed on federally regulated insurance companies, trust companies, and loan companies, including public float requirements for companies with Can. $2 billion or more of equity.

Foreign banks and entities associated with them are not empowered to undertake any business in Canada except as expressly permitted by the Bank Act, although they are permitted to conduct business with Canadians from outside of Canada on a cross-border basis. Historically, foreign banks were permitted to perform banking activities in Canada only through a subsidiary. However, branch banking was introduced pursuant to amendments to the Bank Act made in 1999.[99] Representative offices are permitted solely to promote the services of the foreign bank and act as a liaison between the foreign bank and its clients.

Quebec and British Columbia, with the cooperation of the federal government, have enacted legislation creating "International Financial Centres" in Montreal and Vancouver and providing tax and other advantages to qualifying corporations and their employees where their activities consist of certain eligible international financial transactions.

B. *Energy and Natural Resources*

Responsibility for the regulation of energy and natural resources in Canada is shared by the federal and provincial or territorial governments. The principal federal regulatory body is the Canada Energy Regulator (CER) created by the Canadian Energy Regulator Act (CER Act).[100] In addition, each province or territory has one or more comparable bodies whose statutory mandates relate to energy and natural resources. Whether the jurisdiction of a project is federal, provincial/territorial or both depends on several factors including the scope of the undertaking and the nature of the energy development and its location. The federal government is typically the relevant authority for energy projects crossing inter-provincial or international boundaries, or in frontier areas.

The general responsibility of the CER is to regulate defined aspects of the inter-provincial and international transportation of oil, gas and electricity in the public interest. The CER has the power to grant certificates of public convenience and necessity for the construction of inter-provincial and international pipelines and power lines, to issue licenses and/or or-

[95] S.C. 1991, c. 46.
[96] S.C. 1991, c. 45.
[97] S.C. 1991, c. 47.
[98] S.C. 1991, c. 48. The creation of the concept of retail associations as a form of a federal cooperative financial institution was not successful. In 2012, the Bank Act was amended to permit the incorporation and continuance of federal credit unions. As of April 2020, only two provincial credit unions have entered into the federal credit union regime.

[99] S.C. 1999, c. 28.
[100] S.C. 2019, c. 28.

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ders for exports of oil, gas or electricity, and to approve tolls and tariffs for inter-provincial and international pipelines. The CER also has the authority to hold inquiries into any aspect of energy matters under its jurisdiction, and to issue reports for the information of the government and the general public. The CER does not regulate hydrocarbon exploration, drilling or exploitation, or the generation of electric power within any of Canada's 10 provinces or the Yukon, but it does regulate aspects of hydrocarbon exploration and extraction within Canada's other two northern territories (namely, Nunavut and part of the Northwest Territories) and within some areas offshore.

Many decisions of the CER require federal cabinet approval. Such decisions include the issuance of certificates for pipelines and of licenses for the export of oil or gas, designated applications to export electricity, and the construction and operation of designated international power lines. Licenses for the export of oil or gas require approval of the Minister of National Resources under the CER Act, in addition to the federal cabinet approval required under the regulations.

The approval of CER is required for the establishment of inter-provincial and international pipelines and power lines. The approval process normally includes a public hearing process, whether written or oral, and involves consideration of the technical and financial feasibility and the environmental and socio-economic impact of the proposed project. The international export of oil, gas or electricity also requires CER approval.

The USMCA has a significant impact in protecting the trade of energy from regulatory intervention, particularly between Canada and the United States. Although the USMCA does not have a specific section dealing with energy goods, such goods are subject to USMCA's general trade provisions. These provisions largely reflect the rights and obligations provided for in the General Agreement on Tariffs and Trade (GATT) and NAFTA. In general, no taxes, duties or charges will be imposed on the export of any energy goods from the United States to Canada, or vice-versa, unless such taxes, duties or charges are also imposed on such energy goods when destined for domestic consumption.

Provincial governments in Canada have the basic responsibility for energy and natural resources within their boundaries and, in most cases, are the owners of the resources. Several provincial governments have also negotiated with the federal government to obtain the rights to energy and natural resources in the offshore areas. The role of the provincial governments in energy and natural resources is, therefore, fundamental.

ISBN 978-1-63359-385-5

VI. Principal Taxes

A. Sources of Authority in Taxation

1. Legislative

a. Organization of the Tax Law

Under the Constitution of Canada, the federal government has jurisdiction over "the raising of money by any mode or system of taxation," while the provinces may legislate in relation to "direct taxation within the province in order to raise revenue for provincial purposes."[101] Thus, both levels of government have the power to impose taxes, but certain constitutional strictures are placed on the form that provincial taxation may take.

The federal income tax is imposed under the Income Tax Act (ITA),[102] with certain prescribed rules contained in the corresponding Income Tax Regulations.[103] A federal multi-stage goods and services tax (GST) is also imposed under the Excise Tax Act (ETA).[104] The Canada Revenue Agency (CRA) administers both the income tax under the ITA and the GST under the ETA.

Each Canadian province has its own income tax statute or statutes that impose provincial income taxes, and each such statute is generally modelled on the ITA. Each province other than Alberta and Québec (the agreeing provinces) have also entered into a memorandum of understanding with the federal government pursuant to which the agreeing provinces and the federal government agree that the CRA will administer provincial income tax on behalf of each agreeing province. In contrast, the Alberta Tax Revenue Administration administers the provincial income tax in Alberta and Revenu Québec administers the provincial income tax in Québec.

Each province other than Alberta also imposes a provincial sales tax, although the form and administration of these taxes varies from province to province. Some of the provinces have agreed to replace the federal GST and their respective provincial sales tax with a single harmonized value-added tax known as the harmonized sales tax (HST) that is administered by the CRA. Other provinces have elected to retain a separate provincial sales tax that is administered by the particular province. A more detailed discussion of the GST/HST and provincial sales tax regimes can be found at VI.D.3. and 5., below.

b. Other Legislative Documents That Can Be Used to Interpret the Law

Most amendments to the ITA and the ETA are typically proposed in the annual Federal Budget introduced in the spring (though recent years have also seen significant draft legislation released outside of the Federal Budget process — such as in a Fall Economic Statement — and there was no spring Federal Budget in 2025 due to the election held on April 28, 2025). The Federal Budget may also include an explanation of the purpose and intended application of the tax proposals. In this respect, the Federal Budget documents may be helpful in interpreting a particular provision of the ITA or the ETA. In addition, the Department of Finance routinely publishes "Technical Notes" (more recently called "Explanatory Notes") that accompany proposed amendments to the ITA or ETA, whether such proposals are part of the Federal Budget or not. These Technical Notes typically provide some additional context with respect to the purpose of the proposed amendments and, in some cases, examples of how the proposed amendments apply.

Although the Federal Budget documents and Technical Notes can be of assistance in interpreting tax legislation, it is important to note that such interpretive aids do not have the force of law. Thus, while a court may rely on such documents to assist in determining the legislative intention in respect of a tax provision, the court is not bound by statements found within such documents.

The CRA also publishes certain guides and similar documents that provide the CRA's interpretation of certain provisions in the ITA or the ETA. These CRA documents are discussed in further detail under VI.A.2., below.

c. Legislative Process

The Tax Policy Branch of the federal Department of Finance is generally responsible for developing and evaluating Canada's taxation policies and legislation, in many cases in consultation with or at the direction of the Minister of Finance (currently a joint position with the Minister of National Revenue, as noted below in VII.A.) and/or the Federal Cabinet. The Tax Policy Branch is divided into five divisions:

(i) Personal Income Tax Division;

(ii) Sales Tax Division;

(iii) Business Income Tax Division;

(iv) Intergovernmental Tax Policy, Evaluation and Research Division; and

(v) Tax Legislation Division.

Each of these divisions is responsible for undertaking analysis and developing policy proposals and recommendations with respect to their specific areas of responsibility.

The Tax Legislation Division is primarily responsible for the drafting of income tax legislation and the Sales Tax Division is primarily responsible for the drafting of sales and excise tax legislation. Both of these Divisions rely on support and consultation from the federal Department of Justice and the CRA.[105]

Draft legislation must be introduced in Parliament in the form of a government bill. Draft tax legislation is prepared in a Notice of Ways and Means Motion and is introduced in the House of Commons[106] by the Minister of Finance, in most cases as part of the annual Federal Budget. In certain cases, draft tax legislation may be publicly released prior to being introduced

[101] The Constitution Act, 1867, subsecs. 91(3) and 92(2).

[102] R.S.C. 1985, c. 1 (5th Supp.), as amended (ITA).

[103] C.R.C., c. 945 (ITA Regulations).

[104] Part IX, R.S.C. 1970, c. E-15, as amended (ETA).

[105] Department of Finance Canada — Tax Policy Branch website: https://www.canada.ca/en/department-finance/corporate/transparency/transition-binders/2019/how-finance-works/tax-policy-branch.html.

[106] See discussion in I.A.2., above, regarding the legislative process in Canada.

ISBN 978-1-63359-385-5

in Parliament so that the public may review and comment. The Department of Finance will then consider the public comments and, if necessary, revise the draft tax legislation prior to its introduction into Parliament.

Following its introduction into Parliament, draft tax legislation first undergoes three readings in the House of Commons. The first reading generally involves an introduction and brief summary of the bill. The second reading provides an opportunity for the members of the House of Commons to debate the general principles of the bill and to vote on whether to refer the bill to a committee for a more detailed review of the text. If sent to a committee, the bill will be reviewed on a clause-by-clause basis and the committee may recommend amendments to the text of the bill. The committee will then report the bill back to the House of Commons for further study, debate and amendments. Following the report stage, the House of Commons will complete a third and final reading of the bill after which the bill is voted on.[107] Following adoption in the House of Commons, a bill is forwarded to the Senate. The Senate follows the same general procedure (i.e., three readings) as the House of Commons. The Senate can either adopt the bill as drafted or make amendments and communicate such amendments to the House of Commons. If the Senate proposes amendments to the bill, the House of Commons can either accept or reject these amendments. The Senate can technically reject the House of Common's refusal to accept the Senate's amendments, in which case the bill will either fail to pass or the two bodies would hold a conference to resolve the issues. However, in practice, the Senate will generally accept the refusal of the democratically elected House of Commons to accept the Senate's amendments to the bill.[108]

Once both the House of Commons and the Senate have adopted a bill with identical language, that version must be given royal assent by the Governor General (i.e., the King's representative in Canada) or a deputy before it becomes an official act of Parliament. Royal assent can be granted either through a ceremony in the Senate or by a written declaration. After royal assent has been granted, the subject matter of the bill (now a law) will come into force either on the date of royal assent or on the "in-force" date specified in the particular bill.[109] In the context of tax legislation, the in-force date will typically be the date on which the particular tax measure was first publicly proposed. In many cases, this will be the date of the Federal Budget in which the tax measure was first proposed.

d. *Constitutional Challenges*

The constitutionality of legislation can be challenged in the courts by any person that has standing, which is generally the case where the person is directly affected by the legislation or is threatened by sanctions for any alleged violation of the legislation.[110] Certain common law exceptions to this general principle permit a party to bring a constitutional challenge even though the person is not directly affected by the legislation or threatened by sanctions. Challenges to the constitutionality of federal tax legislation (i.e., the ITA or the ETA) are typically brought in the Tax Court of Canada, either as a separate action or as part of an appeal of an assessment or reassessment. Challenges to the constitutionality of provincial tax legislation are typically brought in the relevant provincial courts.

Under the Tax Court of Canada Act, a party that wishes to challenge the validity, applicability or operability of an Act of Parliament or its regulations in the Tax Court of Canada must first serve a Notice of Constitutional Question on the Attorney General of Canada and the attorney general of each province at least 10 days prior to the date upon which the constitutional question will be heard, unless the court orders otherwise.[111] Without a valid Notice of Constitutional Question having been served, the Tax Court is not permitted to rule on the validity, applicability or operability of the legislation or regulation in question.[112] The Attorney General of Canada or any attorney general of a province that is served with a Notice of Constitutional Question is entitled to introduce any evidence or make submissions relating to the constitutional question, and if they do so, they will become a party to the proceedings in respect of that constitution question.[113] Similar rules are generally applicable to constitutional challenges that are brought in provincial courts.

A decision of the Tax Court of Canada relating to a constitutional issue can be appealed to the Federal Court of Appeal in the same manner as the appeal of any other Tax Court of Canada decision.[114] Appeals of decisions of the Federal Court of Appeal can be made to the Supreme Court of Canada with leave.[115] In addition, the Federal Court of Appeal and the Supreme Court of Canada have the discretion to consider a constitutional issue that was not raised at a lower level provided that the party seeking to argue the constitutional issue has complied with all notice requirements.[116]

2. *Administrative*

The CRA's Income Tax Rulings Directorate is generally responsible for the interpretation of and establishing CRA policy with respect to the ITA, the ITR, income tax treaties and other related statutes. The CRA also provides interpretation services in respect of the ETA through its Excise and GST/HST Rulings and Interpretations Service.

The CRA has various explanatory and technical publications, including:

(i) Information circulars (ICs): provide information about administrative, enforcement, or procedural matters relating to income tax law.

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[107] Barnes A. and Virgint E., Parliamentary and Information Research Service, Legal and Social Affairs Division, *The Legislative Process: From Government Policy to Proclamation*, (October 1, 2019), Publication No. 2019-31E; Parliament of Canada, House of Commons website, *Our Process: Legislative Process*, https://www.ourcommons.ca.

[108] Parliament of Canada, House of Commons website, *Our Process: Legislative Process*, https://www.ourcommons.ca.

[109] Parliament of Canada, House of Commons website, *Our Process: Legislative Process*, https://www.ourcommons.ca.

[110] *Minister of Justice (Can) v. Borowski*, [1981] 2 SCR 575.

[111] Tax Court of Canada Act, R.S.C. 1985, c. T-2, s. 19.2(1) and (2).

[112] Tax Court of Canada Act, R.S.C. 1985, c. T-2, s. 19.1(1).

[113] Tax Court of Canada Act, R.S.C. 1985, c. T-2, s. 19.1(4) and (5).

[114] Federal Courts Act, R.S.C. 1985, c. F-7, s. 27; Tax Court of Canada Act, R.S.C. 1985, c. T-2, s. 17.6.

[115] Supreme Court Act, R.S.C. 1985, c. S-26, s. 40.

[116] *Guindon v. Canada*, 2015 SCC 41 at para 5.

ISBN 978-1-63359-385-5

(ii) Income Tax Technical News (ITTNs): issued on an ad hoc basis and provide the CRA's technical interpretation of various provisions of income tax law. The newsletter format allows a new or revised interpretation to be released quickly.

(iii) Interpretation bulletins (ITs): provide the CRA's technical interpretation and position on certain provisions contained in income tax law. Income tax ITs will eventually be replaced by relevant income tax folios.

(iv) Income tax folios: provide the CRA's technical interpretation and position on certain provisions contained in the ITA. Income tax folios contain updated versions of the technical content currently found in ITs and the ITTNs. When new folios chapters are published, the relevant ITs and ITTNs are cancelled.

(v) Advance tax rulings (ATRs/Rulings): written statements confirming how the CRA's interpretation of specific provisions of Canadian income tax law apply to a definite transaction that a taxpayer is contemplating. Rulings are generally requested by tax professionals on behalf of their clients and a fee is charged for an ATR. Subject to any qualification, caveats, disclaimers, or comments stated in a Ruling, a Ruling is binding on the CRA with respect to the recipient taxpayer and the described transactions to the extent that there is no material omission or misrepresentation in the statement of relevant facts, proposed transaction(s), or other information described in the Ruling and/or the related request, and provided that the proposed transactions are implemented within the time limit specified in the Ruling.

(vi) Conference roundtables: written answers to questions initially presented by the CRA at a roundtable session at certain conferences, including the annual meetings of the Canadian Tax Foundation (CTF), *Association de planification fiscal et financière* (APFF), International Fiscal Association (IFA), and Society of Trust and Estate Practitioners conferences (STEP).

3. Courts

A taxpayer can appeal an assessment, reassessment, or loss determination by filing a Notice of Objection. Loss determinations are issued by the Minister on request by a taxpayer to set out the amount of a loss arising in taxation years in which no income tax is otherwise owing. Following the filing of a Notice of Objection, the CRA's Appeals Division will review the taxpayer's objections and either confirm, vary or vacate the assessment, reassessment, or loss determination. If the taxpayer is not satisfied with the Appeals Division's determination of the issue, the taxpayer may file a Notice of Appeal with the Tax Court of Canada appealing the assessment, reassessment, or loss determination. Judgments of the Tax Court of Canada can be appealed to the Federal Court of Appeal and then ultimately to the Supreme Court of Canada.

These procedures are discussed in further detail under VII.I., below.

B. Income Tax

In general, Canada taxes the worldwide income of every person resident in Canada at any time during the year and certain income sourced in Canada and earned by nonresidents. Two distinct taxes are imposed on nonresidents. First, ordinary income tax is payable with respect to business or employment income and certain capital gains that are regarded, under Canadian laws, as having their source in Canada. Second, a special nonresident withholding tax applies to certain payments received by a nonresident from a Canadian resident payor.

C. Inheritance and Gift Taxes

Other than certain provincial probate fees, Canada and its provinces do not impose estate tax, gift taxes or succession duties.

D. Commodity Taxes

In Canada, the federal and provincial governments impose an amalgam of retail and wholesale sales taxes, value-added taxes (VAT) such as the goods and services tax (GST), commodity taxes, customs duties, etc.

1. Federal Customs Duty

All goods imported into Canada must be declared and customs duty paid if applicable. The customs duty varies according to the item imported and its country of origin.

2. Anti-Dumping Duty

Like many countries, Canada has a system to investigate and address dumping and subsidization of imported goods, which is governed by the Special Import Measures Act[117] and Special Import Measures Regulations and subject to Canada's WTO obligations. Investigations into dumping and subsidization are usually triggered by a complaint filed by the aggrieved domestic industry in Canada, but it can also be self-initiated by the Canada Border Services Agency (CBSA).

In an investigation, the CBSA determines whether the subject goods are dumped and/or subsidized while the Canadian International Trade Tribunal (CITT) determines whether those goods, if dumped or subsidized, have caused or threaten to cause material injury to the domestic industry. Where both the CBSA and the CITT have made affirmative determinations, the CBSA will impose anti-dumping and/or countervailing duties (AD/CVD) on the subject imports. Timelines for Canadian AD/CVD investigations are short: typically, it takes seven months from the initiation of an investigation to the issuance of an AD/CVD order.

Under the Canadian system, definitive duty rates are established when the subject goods are imported. Cooperative exporters of goods subject to a dumping order can receive prospective "normal values" for their goods, which establish floor prices for their sales of subject goods that, in principle, will eliminate the importer's liability for AD duties. However, the CBSA has increasingly been resorting to an administrative review process for normal values, which can result in retroactive duty liability for importers where the CBSA finds that the

[117] Special Import Measures Act, R.S.C. 1985, c. S-15.

ISBN 978-1-63359-385-5

exporter, notwithstanding being issued prospective floor prices by the CBSA, did not sufficiently price above its floor prices to reflect changes over time to costs of production and other market conditions.

3. *Goods and Services Tax and Harmonized Sales Tax*

At the federal level, Canada has implemented a multistage goods and services tax (GST) that is currently assessed at a rate of 5%.

The provinces of British Columbia, Manitoba and Saskatchewan maintain a separate provincial sales tax regime, while the provinces of New Brunswick, Newfoundland and Labrador, Nova Scotia, Ontario and Prince Edward Island (the HST-participating provinces) have harmonized their provincial sales taxes with the federal GST to form the harmonized sales tax (HST). Quebec has maintained its own VAT regime, which is generally harmonized with the federal GST. Unlike the HST-participating provinces, however, Quebec maintains its own Quebec sales tax (QST) legislation (which generally mirrors the GST/HST legislation, including any changes the federal government makes to this legislation) and retains administration of the provincial component of the tax. Unlike the HST, which uses the same registration number as the GST, and is filed on the same return as the GST, Quebec has a separate registration number and filing for the QST. Neither Alberta nor the territories have a provincial sales tax.

Outside of the HST-participating provinces, the GST rate of 5%, plus any applicable provincial sales tax, applies to taxable supplies made, or deemed made, in those provinces. For taxable supplies made, or deemed made, in an HST-participating province, the rate of tax is 13% in Ontario, 14% in Nova Scotia (as of April 1, 2025), and 15% in New Brunswick and Newfoundland and Labrador, which is comprised of a 5% federal component and a specified provincial component (currently 8% in Ontario, 9% in Nova Scotia, and 10% in New Brunswick and Newfoundland and Labrador). Goods and services that are zero-rated or exempt from GST generally retain the same status under the HST regime.

The GST/HST is very broadly based, although certain goods (e.g., basic groceries, prescription drugs, residential rents, health and dental services, and day care) are not taxed. The GST/HST is modeled on a VAT. More specifically, the GST/HST is imposed on recipients of "taxable supplies made in Canada," as well as on recipients of certain imported goods and "imported taxable supplies."[118]

"Supply" is defined in relevant part as "the provision of property or a service in any manner, including sale, transfer, barter, exchange, license, rental, lease, gift or disposition"[119] and a "taxable supply" is a supply that is made in the course of a commercial activity. "Commercial activity" in turn is broadly defined to include, in relevant part, any business carried on by a person or any adventure or concern in the nature of trade, but it excludes the making of an "exempt supply."

Supplies are generally considered to be "made in Canada" in the following circumstances:

(i) Tangible personal property supplied by way of sale is delivered or made available in Canada;

(ii) The use or possession of tangible personal property supplied otherwise than by way of sale is given or made available in Canada;

(iii) Intangible personal property supplied may be used in Canada, or the property relates to real property situated in Canada, tangible personal property ordinarily situated in Canada or a service to be performed in Canada;

(iv) Real property is situated in Canada (which is also the test for a related service); or

(v) Any other service is performed, at least in part, in Canada.[120]

However, special rules apply to supplies of personal property or services made by nonresidents. Such supplies are deemed made outside Canada unless made in the course of a business carried on in Canada or made by a nonresident person registered for GST/HST, or the supplies are admissions to a place of amusement, seminar, activity or event where the nonresident did not acquire the admission from another person.[121]

An "imported taxable supply" is, generally, a taxable supply of intangible property or services made outside of Canada to a resident of Canada for use in Canada otherwise than exclusively in a commercial activity.[122]

The GST/HST is a multi-stage tax imposed at each link in the chain of production (importing, manufacturing, wholesaling and retailing), with an "input tax credit" system[123] operating at those same stages to eliminate the temporary imposition of tax. The intended effect is to exact the full amount of the tax from the ultimate consumer without the cascading tax effect of a consumption tax imposed at any level other than the final consumer. The GST/HST system results in a net tax being levied on the value added at each stage of commercial activity. Persons engaged in a commercial activity pay GST/HST on their purchases of goods and services (generally on the earlier of when the consideration is paid or becomes due), collect GST/HST on their sales of goods and services, deduct any GST/HST previously paid, and remit the difference to the CRA. If the tax paid exceeds the tax collected, the difference is refunded as there is no requirement to wait until the purchased supply is sold before claiming an input tax credit. From the perspective of most businesses, GST/HST paid is not an ultimate cost of doing business (except to the extent of administrative costs and any costs of funding cash flow deficiencies that may result owing to the time lag between payment of GST/HST on inputs and receipt of a refund).

The GST/HST levied on most supplies is based on the "value of the consideration" for the supply. This generally refers to the cash consideration paid or the fair market value of noncash consideration. In the case of imported goods, GST/HST is calculated based on the value of the goods (generally, the value for duty purposes).

[118] Excise Tax Act, Part IX R.S.C. 1970, c. E-15, as amended, secs. 165, 212 and 218.

[119] Excise Tax Act, subsec. 123(1).

[120] Excise Tax Act, sec. 142.

[121] Excise Tax Act, sec. 143.

[122] Excise Tax Act, sec. 217.

[123] Excise Tax Act, sec. 169.

ISBN 978-1-63359-385-5

As stated above, GST is generally calculated at a rate of 5% and HST at a rate of 13%, 14%, or 15% (depending upon the province in which the supply is made). However, the rate of GST/HST is 0% in the case of certain supplies that are classified as "zero-rated," including most:

(i) Prescription drugs;

(ii) Medical devices;

(iii) Basic groceries;

(iv) Agricultural and fishery products; and

(v) Exports.

Zero-rated exports, however, include goods supplied in Canada to persons other than consumers that are intended for immediate export by common carrier. "Exports" also include most supplies of services made to nonresidents (with some exceptions, including services with respect to real property or tangible personal property situated in Canada).[124] Nonresidents (other than consumers) purchasing goods while in Canada for use outside Canada, where such goods are removed from Canada within 60 days from purchase, may generally claim a rebate for the GST/HST paid by them.

GST/HST is not imposed on "exempt supplies," which include most of the following items:

(i) Long-term and some short-term residential leases, and used housing;

(ii) Health and dental services;

(iii) Educational services;

(iv) Childcare services;

(v) Legal aid services;

(vi) Domestic financial services (including making loans and selling shares of corporations);[125] and

(vii) Many supplies made by charities, nonprofit organizations, and government bodies.[126]

The essential difference between exempt and zero-rated supplies arises because of the multi-stage nature of the GST/HST and has to do with the treatment of the persons making such supplies. A supplier of goods or services classified as exempt supplies pays GST/HST on purchases related to the making of such supplies but is not entitled to claim input tax credits with respect to such GST/HST. The supplier must absorb the GST/HST it pays or recover it through an increase in the sale price. This is the case, for example, for Canadian financial institutions that, for the most part, are engaged in the business of supplying exempt financial services. For these institutions, GST/HST is a real cost that must either be absorbed or passed on to their customers through higher fees or rates.

[124] Excise Tax Act, Schedule VI, Part V.

[125] Some cryptocurrencies, such as bitcoin, fall within the definition of "virtual payment instruments" and are treated as "financial instruments" such that vendors would not be obligated to charge and collect GST/HST on supplies of such digital assets. For further discussion of the characterization and treatment of cryptocurrencies under Canadian federal law, see the discussion at VI.D.6., below.

[126] Excise Tax Act, Schedule V.

In the case of a zero-rated supply, the supplier is entitled to claim input tax credits with respect to GST/HST paid on purchases related to the making of such supplies. Thus, zero-rated goods and services pass through the production chain and to the ultimate consumer entirely free of GST/HST. The inclusion of exported goods and services in the "zero-rated" category permits exports to leave Canada on an entirely GST/HST-free basis, with no unrecovered GST/HST having been imposed at any point in the production chain.

In the case of domestic supplies, liability for GST/HST is imposed on the purchaser; however, the onus for collecting the tax is usually on the vendor. GST/HST is generally payable when payment for the supply is made or becomes due (e.g., the time at which an invoice is issued).[127] The vendor collects the tax as an agent for the Crown and remits it to the tax authorities. GST/HST on imported goods and imported taxable supplies is paid directly by the purchaser.

Only persons that are "registrants" under the GST/HST system may claim input tax credits. Every person (including a nonresident) who makes a taxable supply in Canada in the course of a commercial activity engaged in by the person in Canada, except for a nonresident not carrying on business in Canada, must generally apply for registration within 30 days from the making of the first taxable supply in Canada.[128] One exception from registration is for small suppliers (generally suppliers with annual revenue of less than Can. $30,000). However, generally only a small supplier who elects to register can claim input tax credits. Nonresidents who enter Canada for purposes of selling admissions to places of amusement, seminars, activities or events must also register. Nonresidents without a permanent establishment (PE) in Canada are generally required to post security when applying to be registered.

Effective July 1, 2021, the federal government created a second GST/HST regime (the "Simplified Regime") that requires certain persons to register (including non-residents) even where they are not carrying on business in Canada. Generally, this registration requirement applies to persons making or facilitating certain kinds of supplies (including, very generally, supplies of intangible personal property and services to consumers in Canada or other parties not registered under the regular regime, and supplies of short-term accommodation in Canada).

Registrants under both GST/HST regimes are required to collect and remit GST/HST, and file periodic returns with the CRA. Remittances and reporting may be on a monthly, quarterly or annual basis depending on the amount of revenue earned by the registrant. All registrants, other than charities and certain financial institutions, are required to file their returns electronically for reporting periods that begin after December 31, 2023.

To alleviate the regressivity inherent in sales taxes, modest GST/HST credits are provided through the income tax system for individuals with income of less than a threshold amount.

The Excise Tax Act parallels the Income Tax Act in many respects. There are specific provisions that deal with such aspects as the GST/HST consequences of corporate reorganizations, asset sales of businesses and supplies within a corporate

[127] Excise Tax Act, subsec. 168(1).

[128] Excise Tax Act, subsec. 240(1).

ISBN 978-1-63359-385-5

group. There is also a general anti-avoidance rule that is similar to the rule in the income tax legislation.

For further research on Canada's GST system, see also the VAT Navigator.

4. Federal Excise Tax and Excise Duty

In addition to the GST, the federal government levies special taxes and, in some cases, duties on certain goods and commodities. These include "luxury items," such as cosmetics, jewelry, vaping products and tobacco, as well as insurance premiums and air transport. Special taxes also apply to cannabis and certain products containing cannabis, which was legalized in Canada on October 17, 2018.

5. Provincial Retail Sales and Commodities Taxes

Once goods have been subjected to the federal taxes described above, they face provincial levies at the retail level. All provinces except Alberta levy either an HST or a sales or consumption tax. In addition, specific commodity taxes are imposed on a variety of goods and services, such as motor fuel oil, tobacco, meals, amusements, etc. As is the case with federal sales tax, certain types of goods are exempt under various provincial laws, which vary from province to province.

The collection of provincial sales tax in British Columbia, Manitoba and Saskatchewan is generally accomplished through a system of permits whereby sellers collect the tax from purchasers on behalf of the province in question. Because of constitutional limitations, the tax is imposed only on the ultimate consumer of the property, though there can be requirements on nonresident vendors to register for and collect the applicable sales tax. In the case of purchases outside the scope of the licensing jurisdiction, for example purchases outside the province for use therein, the purchaser is responsible for assessing the tax.

6. Digital Assets and Cryptocurrencies

Generally, the income tax treatment of transactions relating to digital assets and cryptocurrencies is substantially similar to the treatment of commodities.[129] Whether a particular transaction involving digital assets or cryptocurrencies gives rise to income from a business or property (taxed at ordinary income rates) or capital gains (taxed at capital gains rates) will depend on the facts and circumstances. In this respect, see VIII.C.2. and VIII.C.3., which discuss the factors that are relevant in determining whether particular activities result in income from a business or property or capital gains.[130]

Similar to other commodities, the CRA considers any transaction for goods or services paid for using digital assets or cryptocurrencies to be a barter transaction.[131] In this respect, the purchase price for the relevant goods or services is generally considered to be the fair market value of the digital asset or cryptocurrency at the time of the transaction.

From a GST/HST perspective, since the Excise Tax Act deems "virtual payment instruments" to be "financial instruments," the purchase and sale of virtual payment instruments will generally be exempt from GST/HST. Virtual payment instruments are generally defined to be property that is a digital representation of value that functions as a medium of exchange (i.e., like money, it is an instrument that is accepted as payment in transactions for property and services and is recognized as a measure of value) and exists only at a digital address of a publicly-distributed ledger (i.e., blockchain). Certain property is specifically excluded from the definition, including property that confers a right of any kind to be exchanged for money or specific property or service, and property that is primarily for use within, or as part of, a gaming platform, an affinity or rewards program or a similar platform or program. As such, the definition will cover many, but not all, types of cryptocurrency.

The mining of cryptocurrencies or other digital assets would not generally be considered a supply for GST/HST purposes. Subject to certain limited exceptions, persons engaged in mining activities relating to crypto-assets do not have to charge any GST/HST on any mining activity. However, they are also generally not able to claim any input tax credits with respect to their costs of performing the mining activities (such as the cost of computers, rent, electricity, etc.). The cost of mining activities relating to crypto-assets effectively includes unrecoverable GST/HST, and crypto miners in Canada will need to factor in these additional costs when determining whether to continue to do business in Canada (and in which province to carry on such business).

E. Corporate Capital Taxes

A federal capital tax (the large corporations' tax or LCT) of 1.25% is levied on the taxable capital of a corporation that is a financial institution, subject to a Can. $1 billion exemption. The taxable capital of the corporation generally includes not only the amount received on the issuance of shares of the corporation, but also surplus, long-term debt of a capital nature and reserves (other than reserves for depreciation, depletion and doubtful debts).[132] Some provinces also impose a capital tax on large financial institutions, ranging from 4–6% and with varying exemptions.

F. Payroll Taxes

1. Canada and Quebec Pension Plans

The Canada Pension Plan applies to individuals employed in Canada other than in the province of Quebec. Employees in Quebec are governed by the Quebec Pension Plan. The employer and employee rates of contribution are established each year as a percentage of an employee's pensionable earnings, subject to a maximum contribution amount. The maximum contribution amounts are also adjusted annually. For 2025, the CPP contribution rate is 5.95% of pensionable earnings (up to a maximum amount of Can. $4,034.10 each) whereas the QPP contribution rate is 6.40% of pensionable earnings up to a spec-

[129] See the previous discussion under VI.D.

[130] See also CRA, "Information for crypto-asset users and tax professionals," online: https://www.canada.ca/en/revenue-agency/programs/about-canada-revenue-agency-cra/compliance/digital-currency/cryptocurrency-guide.html.

[131] See the CRA's Guide for cryptocurrency users and tax professionals accessible at: https://www.canada.ca/en/revenue-agency/programs/about-canada-revenue-agency-cra/compliance/digital-currency/cryptocurrency-guide.html.

[132] ITA, Part VI.

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ified limit, and 4% of additional maximum pensionable earnings (up to a maximum amount of Can. $4,735 each).

2. *Employment Insurance*

The employment insurance scheme in Canada is also contributory for both employers and employees, and applies with respect to employment in Canada, unless such employment is specifically exempted by the Income Tax Act or Regulations. The employee and employer rates of contribution (which may differ) are established each year as a percentage of an employee's maximum yearly insurable earnings, subject to maximum contribution amounts. The maximum contribution amounts are also adjusted annually. For 2025, the federal employee contribution rate is 1.64% of insurable earnings (up to a maximum of Can. $1,077.48) and the federal employer contribution rate is 2.296% of insurable earnings (up to a maximum of Can. $1,508.47) for non-Quebec employees. For Quebec employees, the 2025 federal employee contribution rate is 1.31% of insurable earnings (up to a maximum of Can. $860.67) and the federal employer contribution rate is 1.834% of insurable earnings (up to a maximum of Can. $1,204.94) for Quebec employees.

3. *Provincial Payroll and Health Fund Taxes*

Some Canadian provinces require employers to pay payroll, health or other similar taxes with respect to remuneration paid to their employees. The rates vary depending on the province, and some have exemptions or significantly reduced rates for employers whose total remuneration payments fall below a certain threshold.

G. *Land Transfer Taxes*

1. *Ontario Land Transfer Tax*

Ontario imposes a tax on transfers of land at the time of registration of a conveyance and on most unregistered conveyances of beneficial interests in land located in Ontario.[133] "Land" is broadly defined to include the interest of an optionee or of a purchaser under an agreement for sale, and goodwill attributable to the location of land, fixtures and leaseholds (only if the term, including renewals, may exceed 50 years).[134]

The amount of land transfer tax payable in respect of a conveyance depends on the value of the consideration paid for the property and applies at the following rates:

(i) 0.5% on the first Can. $55,000;

(ii) 1% on the value of the consideration between Can. $55,001 and $250,000;

(iii) 1.5% on the value of the consideration between Can. $250,001 and $400,000;

(iv) 2% on the value of the consideration in excess of Can. $400,000; and

(v) 2.5% on the value of the consideration in excess of Can. $2 million if the property is a residential property with one or two single-family units.

Certain dispositions of beneficial interests in land between related corporations may qualify for a deferral of land transfer tax and subsequent cancellation of the tax otherwise payable.[135] Also, certain dispositions of beneficial interests in land arising as a result of particular divisive reorganizations of corporations may qualify for exemption from land transfer tax.[136] The vesting of land owned by predecessor corporations in an amalgamated corporation is generally not considered a conveyance for land transfer tax purposes.[137] Certain limited exemptions from land transfer tax are available for some transfers between spouses,[138] transfers to family farm corporations, and transfers to family business corporations.[139]

For purchases of properties within the city of Toronto, an additional Municipal Land Transfer Tax applies. The amount of tax is calculated in a manner substantially similar to the Ontario Land Transfer Tax. However, as of September 6, 2023, consideration in excess of Can $3 million payable on the acquisition of residential properties with one or two single-family units will be subject to an additional tax at a rate of 3.5%–7.5%.

Furthermore, as of March 25, 2022, an additional "nonresident speculation" property transfer tax of 25% is levied on purchases of certain residential property located in Ontario by nonresidents. It also applies in situations where a nonresident purchases an interest in a property along with residents.

2. *Quebec Land Transfer Tax*

The Province of Quebec also levies a duty on land transfers. The Act Respecting Duties on Transfers of Immovables (ADTI)[140] applies to the transfer of real property (and attachments thereto) situated in Quebec. The duty payable depends on the amount of consideration paid for the real property and is indexed to the consumer price index in Quebec. For 2025, the following rates apply:

(i) 0.5% for the first Can. $61,500 of consideration;

(ii) 1% on the consideration between Can. $61,500 and $307,800;

(iii) 1.5% on the consideration in excess of Can. $307,800;

(iv) 2% on the consideration between Can. $552,300 and $1,104,700 if the property is situated in Montreal;

(v) 2.5% on the consideration between Can. $1,104,700 and $2,136,500 if the property is situated in Montreal;

(vi) 3.5% on the consideration between Can. $2,136,500 and $3,113,000 if the property is situated in Montreal; and

(vii) 4% on the consideration in excess of Can. $3,113,000 if the property is situated in Montreal.

The ADTI is paid by the transferee of the property and collected by the municipality in which the real property is situated.

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[133] Land Transfer Tax Act, RSO 1990, c. L. 6, as amended, subsecs. 2(1), 3(1).

[134] Land Transfer Tax Act, subsecs. 1(1), 1(6).

[135] Land Transfer Tax Act, subsecs. 3(9), 3(11).

[136] Regulation 70/91, subsec. 2.

[137] Land Transfer Tax Bulletin LTT 3-2000 (published April 2000, content last reviewed September 2009).

[138] Regulation 696, R.R.O. 1990.

[139] Regulation 697, R.R.O. 1990.

[140] RSQ c. D-15.1.

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3. British Columbia Property Purchase Tax

A property purchase tax is levied in British Columbia on most conveyances of title of real property at of the following rates:

(i) 1% on the first Can. $200,000 of fair market value of the property conveyed;

(ii) 2% on the portion of the fair market value of the property conveyed between Can. $200,001 and Can. $2 million;

(iii) 3% on the portion of the fair market value of the property conveyed in excess of Can. $2 million; and

(iv) An additional 2% on portion of the fair market value of the property conveyed in excess of Can. $3 million, if the property is a residential property.[141]

Furthermore, a tax of 20% of the fair market value of the property is also imposed on the acquisition of residential real property located in specified areas of the province, including the Metro Vancouver Regional District (the city of Vancouver and its surrounding areas) by a foreign national, a foreign corporation or a taxable trustee.

4. Manitoba Land Transfer Tax

A land transfer tax applies on the transfer of real property in Manitoba. The tax is imposed on the fair market value of the property conveyed at the following rates:

(i) 0% on the first Can. $30,000 of fair market value;

(ii) 0.5% on the portion of the fair market value between Can. $30,001 and $90,000;

(iii) 1% on the portion of the fair market value between Can. $90,001 and $150,000;

(iv) 1.5% on the portion of the fair market value between Can. $150,001 and $200,000; and

(v) 2% on the portion of the fair market value in excess of Can. $200,000.[142]

5. New Brunswick Real Property Transfer Tax

A real property transfer tax applies on the transfer of land in New Brunswick at a rate of 1% of the greater of the consideration paid for the property transferred or its assessed value.[143]

6. Nova Scotia Deed Transfer Tax

Nova Scotia municipalities may, through by-law, tax the transfer of land situated within their boundaries. The rate (generally up to 1.5%) depends on the municipality in which the land is situated. An additional 10% tax (increased from 5% as of April 1, 2025) is levied on certain residential properties acquired by nonresidents of Nova Scotia.

[141] Property Transfer Tax Act, R.S.B.C. 1996, Chapter 378.

[142] The Tax Administration and Miscellaneous Taxes Act, C.C.S.M. c. T2, S. 112(1).

[143] Real Property Transfer Tax Act, S.N.B. 1983, Chapter R-2.1. subsec. 2(1.03).

7. Other Provinces and Territories

Other provinces and the three territories also levy similar land transfer taxes. Alberta has a property registration fee based on Can. $50 plus 0.1% of the value of the land[144] and a mortgage registration fee based on Can. $50 plus 0.1% of the mortgage amount.[145]

H. Municipal Taxes

Property taxation in Canada is generally imposed at the municipal level rather than the provincial level. Though some provinces have taken over the taxation of schools and businesses, municipalities are generally empowered by provincial governments to levy such taxes as a fixed percentage of value. Several provinces do levy similar taxes in unorganized areas not under the jurisdiction of a municipality. The authority for property taxation and its modalities is governed by various provincial statutes, and in some cases the charters of municipalities.

Generally, the tax base includes land and buildings, and, in some provinces, extends to machinery, equipment and fixtures attaching to a building. In each province certain classes of property are exempt from taxation, such as schools and public properties.

Real property taxes are based on assessed value; however, the method by which the value is assessed, and the relationship between assessed value and market value are not uniform across the country. In some cases, attempts have been made to revalue property for purposes of assessment but, in general, assessed value lags behind market value.

I. Natural Resource Taxation

The taxation of Canada's various natural resource industries, such as mining, logging, and oil and gas, is based on special and varied rules that must be examined in each particular situation.

J. Select Luxury Items Tax

A luxury items tax on certain luxury goods was introduced in 2022 under a separate statute, the Select Luxury Items Tax Act (SLITA). The tax applies to the purchase of certain aircraft, sea vessels and motor vehicles that have a purchase price in excess of Can. $100,000 (in the case of aircraft and motor vehicles) or Can. $250,000 (in the case of sea-going vessels).

The tax is computed as the lesser of:

(i) 10% of the total "taxable amount" (generally, the consideration paid plus any consideration paid for certain "improvements") of the luxury item; and

(ii) 20% of the amount by which the taxable amount exceeds Can. $100,000 (for aircraft or motor vehicles) or Can. $250,000 (for sea-going vessels).

The SLITA includes rules for assessments, objections, appeals, audit, collection, enforcement, penalties, offences and all other aspects for the administration of the SLITA. It also contains an anti-avoidance provision similar to the general anti-avoidance rule of the Income Tax Act (Canada). A separate an-

[144] Alta. Reg. 120/2000, s. 3.

[145] Alta. Reg. 120/1200, s. 4.

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ti-avoidance provision applies to certain transactions between non-arm's length persons. This provision does not require that there be a misuse or abuse of the SLITA to apply.

K. Digital Services Tax

Canada has been working with the OECD, the G20 and the members of the Inclusive Framework (representing over 140 countries) to reach a consensus on a new taxing right under the OECD's Pillar One proposals to reallocate certain amounts of taxable income to market jurisdictions. While Canada has indicated a strong preference for a multilateral approach, the federal government has nevertheless gone ahead with enacting a Canadian digital services tax (DST) in the meantime.

In this respect, legislation to implement a DST was enacted on June 20, 2024 and brought into force as of June 28, 2024. The legislation provides that the DST applies at a rate of 3% on revenues in excess of Can. $20 million from digital services that rely on the engagement, data and content contributions of Canadian users, as well as on certain sales or licensing of Canadian user data.

On June 29, 2025, the Minister of Finance issued a press release stating that the DST would be rescinded. The decision to rescind the DST was taken after the U.S. indicated that the continuation of trade negotiations was conditional on such a rescission. Legislation to formally repeal the DST is expected to be introduced in Parliament in the Fall of 2025. The remainder of this section describes the DST legislation in its current form (as enacted).

The DST is generally modelled after similar DSTs in other jurisdictions, such as France. The legislation provides that the DST applies in a calendar year to an individual entity or members of a consolidated group that, in a prior calendar year not earlier than 2022, had global revenue of at least Can. $750 million and, in the calendar year concerned, had more than Can. $20 million of in-scope revenue from Canadian users. In-scope revenue from Canadian users is generally comprised of revenue from four categories of activities:

(i) Online marketplace services;

(ii) Online targeting advertising services;

(iii) Social media services; and

(iv) The sale of or provision of access to user data.

Revenue from each category is sourced to Canada using several methods depending on how the particular revenue is earned, including whether: the service concerned facilitates the delivery of services in physical form within Canada (for example, by providing transportation) or the exchange of goods and services between users at least one of which is located in Canada (for example, an online marketplace); a particular online advertisement is displayed to users located in Canada; or a social media platform's users are located in Canada. Revenue from each category is based on a formula that takes into account the proportion of users located in Canada versus outside of Canada (as determined based on user data such as billing, delivery/shipping address, phone number and other available information).

The DST legislation also includes certain administration and enforcement provisions that generally mirror those found in the ITA, with some exceptions. In particular, to simplify the compliance burden associated with the DST, members of consolidated groups will be allowed to designate one entity within the group to fulfill their filing obligations, pay any DST liability and otherwise comply with all of the administrative obligations in relation to the DST. Each entity within the consolidated group remains jointly and severally liable for the DST payable by any other group member. The legislation also includes a general anti-avoidance provision that is similar to the general anti-avoidance rule in the ITA. While the DST liability is not creditable against income taxes payable under the ITA, the Department of Finance has indicated that DST liability payments may be deductible in computing taxable income based on general principles relating to deductibility (i.e., whether the payment is made for purposes of earning income from a business or property).

The DST legislation gives the Canadian government the ability to change many key aspects of the DST, including the implementation date, the relevant thresholds and the applicable rate of the DST, by regulations, which is a faster process that does not involve Parliament. This structure allows the Canadian government to change those key aspects quickly, including effectively reversing the DST entirely by changing its applicable rate to 0%. The first payment was due on June 30, 2025 and was intended to be with respect to relevant revenue earned from January 1, 2022 onward. The DST was not intended to apply if a multilateral agreement is reached on the OECD/G20 Inclusive Framework's Pillar One prior to its coming into force. Delays in reaching a multilateral agreement, and Canada's rejection of the OECD's extension of the DST moratorium to 2024, resulted in the federal government choosing to have the DST come into force. The press release announcing the rescission of the DST was issued the night before the first payment was due. The press release confirmed that the "June 30, 2025 collection will be halted". The CRA subsequently announced that taxpayers that already paid DST before the press release was issued will not have their payments returned until relevant legislation is enacted by Parliament.[146]

L. Streaming Tax

Separately to the (now-halted and expected to be rescinded) DST as discussed at VI.K., online streaming services that are not affiliated with a Canadian broadcaster and that generate at least $25 million of annual Canadian gross (broadcasting) revenue are now required to make "base contributions" totaling 5% of their in-scope annual revenue (in the broadcasting context, "annual" refers to the September 1 to August 31 period). The first base contributions must be made by August 31, 2025, based on in-scope revenue earned between September 1, 2023 and August 31, 2024. The contributions are applied to specified government funds that are intended to support Canadian and Indigenous content.

This new payment obligation was imposed by the Canadian Radio-television and Telecommunications Commission (CRTC) under authority granted by the Broadcasting Act (as amended by the Online Streaming Act, which received royal

[146] CRA, "Digital services tax", online: https://www.canada.ca/en/services/taxes/excise-taxes-duties-and-levies/digital-services-tax.html.

ISBN 978-1-63359-385-5

asset in April 2023).[147] The CRTC is an administrative tribunal with a mandate entrusted to it by the Canadian Parliament. It regulates and supervises broadcasting and telecommunications in the public interest.

[147] Canadian Radio-television and Telecommunications Commission, “Broadcasting Regulatory Policy CRTC 2024-121-1 and Broadcasting Order CRTC 2024-194” (August 29, 2024), online: https://crtc.gc.ca/eng/archive/2024/2024-121-1.htm. *See also* CRTC Broadcasting Orders 2023-330 and 2023-332, online: https://crtc.gc.ca/eng/archive/2023/2023-329.htm#bm1 and https://crtc.gc.ca/eng/archive/2023/2023-331.htm#bm1, respectively.

ISBN 978-1-63359-385-5

VII. Tax Administration

A. Administrative Framework

The collection of federal income tax is administered by the Canada Revenue Agency (CRA). As an agency, rather than another department of the federal government, the CRA has greater flexibility in making tax administration arrangements, particularly with respect to the administration of provincial tax laws and programs. The CRA is under the purview of the Minister of National Revenue and its day-to-day operations are ultimately overseen by the Commissioner of Revenue, who reports to and advises the Minister of National Revenue.

Until 2025, the Minister of National Revenue was a standalone position. In the current federal cabinet, appointed on May 13, 2025, one minister is serving concurrently as the Minister of Finance and National Revenue. This chapter will continue to refer to the Minister of National Revenue. While the CRA also has a Board of Management and several Committees that are generally responsible for certain strategic and governance matters, these entities have no authority over the administration or enforcement of tax legislation.

The CRA has its head office in the capital of Canada, the city of Ottawa, and offices in all major Canadian centers. The division of duties between the head office in Ottawa and the district offices is not precise but, in general, the districts confine their activities to the examination of taxpayers' books and records with a view to ensuring compliance. The Ottawa office is primarily concerned with questions of policy, uniformity and supervision.

B. Income Tax and Information Returns

1. Income Tax Returns

Every corporate taxpayer is required to file an income tax return annually, and an individual must file for years when tax is payable, or in which the individual had a taxable capital gain or disposed of capital property. A trust is generally required to file an income tax return if the trust has tax payable or if it distributes all or part of its income or capital to its beneficiaries in the year.

A corporation must file its return within six months of its year-end. An individual must file on or before April 30 of the year following the applicable taxation year. A trust must file its return on or before March 30 of the year following the applicable taxation year.[148]

The Income Tax Act provides that a nonresident corporation must file a tax return if it carries on business in Canada or realizes a taxable capital gain, irrespective of whether the income or gains of the corporation are exempt from Canadian tax under one of Canada's tax treaties. To claim a treaty exemption for a particular taxation year, a corporation must complete a special form with its tax return for the year in which treaty protection is sought.[149]

[148] ITA, sec. 150.

[149] Schedule 91, Information Concerning Claims for Treaty-Based Exemptions. More information is available in the T2 Guide (T4012). Unlike the situation under the U.S. Internal Revenue Code, however, failure to file the form does not result in the disallowance of expenses.

The following rules apply to electronic documents and electronic filing requirements:

(i) From January 1, 2024, tax preparers must file tax returns electronically if they accept consideration for the preparation of more than five individual returns, more than five corporate returns, or more than five trust returns. The threshold was previously more than 10 returns and it did not apply to trust returns. Tax preparers can still submit a maximum of five returns in each category by non-electronic means.

(ii) For tax years commencing on or after January 1, 2024, all companies (except for insurance, nonresident and tax-exempt companies as well as companies reporting in a functional currency other than the Canadian dollar) are required to submit their tax returns electronically. Previously, electronic filing was not mandatory for corporations with gross revenues not exceeding Can. $1 million.

(iii) For tax years commencing on or after January 1, 2024, taxpayers required to file more than five prescribed information returns of any type in a calendar year must file the returns electronically. The previous threshold was 50 information returns. (See VII.B.2., below, for a discussion of information returns.)

(iv) For reporting periods commencing on or after January 1, 2024, most GST/HST registrants are required to file their returns electronically. Previously, there was a Can. $1.5 million threshold governing which registrants had to file their returns electronically.

(v) As from January 1, 2024, the Minister of National Revenue may send notices of assessment electronically to individual taxpayers who consent to electronic notification. Non-individual taxpayers that file electronically do not need to consent to allow the Minister to issue notices of assessment electronically.

(vi) Various amendments to permit the use of electronic signatures, effective on the date of royal assent.

(vii) Various amendments regarding payments being mandatorily electronic or made at a financial institution.

2. Information Returns

In an effort to prevent erosion of the Canadian tax base, information returns must be filed with respect to certain interests in foreign property. This reporting requirement applies to residents of Canada with interests in, or transactions with, offshore entities. In particular, the following areas have been identified for reporting purposes:[150]

(i) Interests in foreign affiliates.

(ii) Distributions from and indebtedness to offshore trusts and other nonresident entities.

(iii) Transfers or loans to offshore trusts and corporations.

(iv) Interests in foreign property that cost in the aggregate more than Can. $100,000.

[150] ITA, secs. 233.1 to 233.8.

ISBN 978-1-63359-385-5

(v) Country-by-country (CbC) reports in accordance with the OECD's Base Erosion and Profit Shifting (BEPS) Action 13. Canadian taxpayers that are part of a multinational group that has group consolidated revenue in excess of 750 million euros are required to file CbC reports. Generally, a CbC report can be filed by the Canadian taxpayer as a constituent entity, or in another jurisdiction if done by the ultimate parent entity or surrogate parent entity provided that Canada has a qualifying competent authority agreement with the other jurisdiction.[151]

(vi) Certain transactions that are considered "reportable transactions" or "notifiable transactions," and certain "uncertain tax positions" reflected in financial statements.[152]

Financial institutions that are required to report international electronic fund transfers in excess of Can. $10,000 under the under the Proceeds of Crime (Money Laundering) and Terrorist Financing Act are also required to report such transfers to the CRA under the Income Tax Act.

On June 22, 2023, the federal government made significant amendments to the existing "reportable transaction" rules and introduced two new categories of disclosure with respect to "notifiable transactions" and "uncertain tax positions." The three categories of changes are collectively referred to as the "mandatory disclosure rules."

First, the existing "reportable transaction" rules in section 237.3 were amended effective June 22, 2023 in several ways, including:

(i) Amending the definition of "reportable transaction" so that only one of the three generic "hallmarks" needs to be present for a transaction to be reportable;

(ii) Amending the definition of "avoidance transaction" so that only one of the main purposes needs to be to obtain the tax benefit, as opposed to the current requirement that the primary purpose be to obtain the tax benefit;

(iii) Increasing the penalties for failing to meet the disclosure requirements;

(iv) Accelerating the deadline for filing an information return with respect to a reportable transaction, as well as making it more complicated to determine the deadline for filing an information return;

(v) Requiring all relevant persons to file an information return with respect to a reportable transaction (previously, the obligation of each person to file an information return would be satisfied if one person filed the relevant information return); and

(vi) Amending the definition of the "contractual protection" hallmark to exclude certain types of protections that are offered in the context of normal commercial transactions to a wide market, such as representation and warranty insurance and certain types of transactional tax insurance, but that do not offer contractual protection for a tax treatment with respect to an avoidance transaction.

Second, a new "notifiable transaction" regime was added as section 237.4 effective June 22, 2023. The rules provide that the Minister of National Revenue (with the concurrence of the Minister of Finance — though, as noted above in VII.A., as of May 13, 2025 one minister is serving concurrently as Minister of Finance and National Revenue) may designate certain types of transactions as "notifiable transactions," which will trigger a requirement for certain persons to file information returns with respect to such transactions. The first list of designated transactions and series of transactions was released on November 1, 2023.[153] The new rules provide that any transaction that is expected to achieve the same or similar types of tax consequences and that is either factually similar to a designated notifiable transaction, or based on the same or a similar tax strategy, is considered to be substantially similar to a designated notifiable transaction and thus constitutes a notifiable transaction subject to a notification requirement. Quebec already has a similar regime in place.

Third, a new reporting requirement was enacted with respect to "uncertain tax positions" for any corporation (or a consolidated group of which a corporation is a member) that has audited financial statements prepared in accordance with IFRS (or other country-specific GAAP in the case of a corporation listed on a non-Canadian stock exchange) if the carrying value of the corporation's assets is Can. $50 million or more at the end of the taxation year and the corporation is required to file a Canadian income tax return for the year. Such a reporting corporation is required to report with respect to any tax treatment of a transaction or series of transactions that the corporation uses (or plans to use) in an income tax return or information return with respect to which uncertainty is reflected in the audited financial statements of the corporation (or consolidated group) for the year. Prior to the enactment of the new rules, the government indicated that the prescribed information that must be provided by a taxpayer would include information such as the quantum of taxes at issue, a description of the relevant facts, and the specific provisions relied on by the taxpayer for determining the tax payable under the ITA. These rules will be effective for taxation years beginning after 2022.

Certain additional rules support the new mandatory disclosure rules. In particular, new penalties apply to taxpayers that fail to disclose any reportable transactions, notifiable transactions or uncertain tax treatments as and when required, and advisors or promoters with respect to reportable or notifiable transactions will be subject to penalties for failure to report such transactions. Furthermore, the normal reassessment period with respect to a particular transaction will not commence until the taxpayer concerned has complied with all mandatory reporting requirements with respect to that transaction. Thus, if a taxpayer failed to report a transaction as and when required by

[151] For a complete discussion of Canada's transfer pricing documentary requirements, including CbC reporting, see Chapter 30 of 6945 T.M., *Transfer Pricing: Rules and Practice in Selected Countries (C–D)*. See also CRA, RC4651, "Guidance on Country-By-Country Reporting in Canada" (March 1, 2024), online: https://www.canada.ca/en/revenue-agency/services/forms-publications/publications/rc4651/guidance-on-country-country-reporting-canada.html.

[152] ITA, secs. 237.3, 237.4 and 237.5 respectively.

[153] CRA, "Notifiable transactions designated by the Minister of National Revenue" (November 1, 2023), https://www.canada.ca/en/revenue-agency/programs/about-canada-revenue-agency-cra/compliance/mandatory-disclosure-rules-overview/notifiable-transactions-designated-by-minister-national-revenue.html.

ISBN 978-1-63359-385-5

the new rules, the reassessment of the year with respect to that transaction would not become statute-barred.

Lawyers and other legal professionals acting in their capacities as legal advisors are currently exempted from the application of the mandatory disclosure rules in respect of reportable and notifiable transactions. The Federation of Law Societies of Canada obtained an injunction from the British Columbia Supreme Court pending the outcome of its challenge to the constitutionality of the mandatory disclosure rules in respect of their application to persons acting as legal professionals.

As of January 1, 2024, new rules for digital platform operators based on the OECD model rules require additional reporting by certain online platforms to facilitate the compliance activities of the CRA with respect to sellers using such platforms. The European Union has accepted that Canada's digital platform operators rules are equivalent to those of the European Union for purposes of automatic exchanges of information under a related multilateral competent authority agreement between Canada and certain EU members.[154] The administrative guidance on the new rules published by the CRA notes that the guidance "was developed with the international context in mind and will be updated when necessary to align with the international consensus on the [OECD model rules]."[155]

Legislative Note: On December 15, 2022, the rules governing income tax filing and reporting requirements for certain trusts were expanded for taxation years of trusts that end after December 30, 2023 (i.e., the 2023 taxation year). In particular, the amendments include the following:

(i) A trust resident in Canada (including a bare trust) will be required to file a T3 trust income tax and information return every year regardless of whether the trust has tax payable or distributes any portion of its income. No guidance has been provided regarding how the residency of a bare trust might be determined.

(ii) A trust resident in Canada and a non-resident trust that is required to file a T3 return will be required to list in the return each person who at any time in the year was a trustee, beneficiary or settlor, or had the ability to exert control over trustee decisions over the allocation of trust income or capital, and to provide certain personal information about those persons (name, address, date of birth [for individuals], jurisdiction of residence and social insurance number or other applicable taxpayer identification number) (Beneficial Ownership and Control Information). Information that is subject to solicitor-client privilege will not be required to be reported.

(iii) New penalties apply to a failure to file a T3 return containing trust Beneficial Ownership and Control Information — including, notably, a penalty of no less than 5% of the highest fair market value of the trust property during the year where the failure to file was done knowingly, or due to gross negligence.

The expanded filing and reporting requirements generally do not apply to certain types of trusts including mutual fund trusts, segregated funds, master trusts, trusts governed by registered plans or any trust all of whose units are listed on a designated stock exchange.

The first returns due under the amended rules were due on April 2, 2024. On March 28, 2024, one business day before the due date, the CRA issued a press release stating that "[i]n recognition that the new reporting requirements for bare trusts have had an unintended impact on Canadians, the [CRA] will not require bare trusts to file a [T3 return] for the 2023 tax year, unless the CRA makes a direct request for these filings." Further amendments were released as draft legislation on August 12, 2024. The prior expansion of reporting rules to bare trusts were proposed to be repealed effective for taxation years ending after December 30, 2024 (which, combined with the CRA's administrative decision, would mean the prior expansion was never effective). The new proposed rules apply to taxation years ending after December 30, 2025 and are intended to increase the number of bare trusts that are exempted from the new reporting rules. Bare trusts that do not qualify for one of the exemptions will still have to comply with the expanded reporting obligations. On October 29, 2024, the CRA issued a press release stating that bare trusts will not be required to file a T3 return for the 2024 taxation year unless the CRA requests them to do so (this statement being necessary given that the August 12, 2024 amendments have not yet been enacted).

C. Books and Records

Every taxpayer is required to keep and maintain business records. These must be kept at the Canadian place of business or residence in such form and containing such information as will enable the assessors to verify the taxpayer's estimate of the tax payable.[156]

D. Inspections

The tax authorities have fairly wide powers to enter premises or places of business to examine the books and records of a taxpayer, although those powers were reduced to some extent as a result of amendments introduced in 1986 in response to taxpayer challenges to the prior legislation based on the Canadian Charter of Rights and Freedoms. CRA officials must have a warrant to enter a dwelling-house without the consent of the occupant. A warrant must also be obtained to seize documents or other evidence. The CRA may require any person to provide information or documents; however, where such information or documents relate to unnamed persons, prior judicial authorization is required.[157] The CRA was successful in two cases at the Federal Court of Appeal in which the CRA has made such "unnamed persons" requests to two companies. The court required these companies to disclose information regarding their respective customers to the CRA, including busi-

[154] EU, "Commission Implementing Regulation (EU) 2024/432 of February 2, 2024 determining that the information to be automatically exchanged pursuant to the agreement signed by the competent authorities of Canada and certain Member States is equivalent to the information specified in certain provisions of Council Directive 2011/16/EU," online: https://eur-lex.europa.eu/eli/reg_impl/2024/432/oj.

[155] CRA, "Guidance on the Reporting Rules for Digital Platform Operators" (Sept. 5, 2024), online: https://www.canada.ca/en/revenue-agency/programs/about-canada-revenue-agency-cra/compliance/reporting-rules-digital-platforms/guidance-on-reporting-rules.html.

[156] ITA, sec. 230.

[157] ITA, secs. 231–231.5.

ISBN 978-1-63359-385-5

ness names and numbers, transaction details, invoices, methods of payment and the customers' banking information.[158] Thus, companies that do business in Canada should be aware that the CRA has broad powers to request disclosure of information about a company's customers for the purpose of conducting audits on those customers.

Communications between a taxpayer and a solicitor for purposes of obtaining legal advice are considered to be privileged and need not be produced for the tax authorities on compliance with a prescribed procedure for claiming the privilege.[159] Similar communications between a taxpayer and an auditor are generally not privileged.

Although the CRA's powers with respect to administration are broad, they are not unlimited. In *Canada (National Revenue) v. Cameco Corporation,*[160] the CRA sought an order to compel certain employees of the Cameco group to attend oral interviews, but the Federal Court of Appeal held that an auditor does not have the power to compel such interviews. The CRA did not seek leave to appeal the decision in *Cameco.* However, the CRA has indicated that it will continue to seek interviews where necessary and expects that the vast majority of taxpayers will continue to comply with their requests. If a taxpayer declines an interview request, the CRA may use alternative means to verify the taxpayer's level of compliance and may make assessments based on assumptions about the nature of a taxpayer's business activities and tax planning.

Legislative Note: In response to the Federal Court of Appeal's decision in *Cameco* relating to the CRA's audit powers, Parliament amended the general audit powers in section 231.1 with effect from December 15, 2022, to redefine the category of persons required to provide reasonable assistance and answer questions orally as a "taxpayer or any other person" and not just the "owner or manager" or persons who are on the business premises. The federal government proposed to further amend the CRA's audit powers in Budget 2024 to:

(i) impose a significant penalty if the CRA successfully obtains a compliance order against the taxpayer concerned under subsection 231.7(6) (where the penalty applies to the total amount of tax payable with respect to the tax years to which the order relates, even if the compliance order is wholly unrelated to that amount and even if the compliance order does not result in the assessment of any additional taxes);

(ii) allow the CRA to issue a "notice of non-compliance" with consequences, including potential penalties and the suspension of the normal reassessment period; and

(iii) allow the CRA to require information (written and oral) and documents produced by taxpayers during an audit to be provided under oath or affirmation.

In addition, the amendment authorizes an auditor to:

(i) Compel the attendance of a taxpayer or any other person (at a place designated by the auditor or by video-conference or other form of electronic communication) to answer proper questions relating to the administration or enforcement of the ITA;

(ii) Compel the answer to proper questions relating to the administration and enforcement of the ITA in writing in any form specified by the auditor; and

(iii) Require a taxpayer or any other person to provide "all reasonable assistance" with anything the auditor is authorized to do under the ITA.

Taxpayers have had some success in obtaining from the courts not merely a rebuke as to the manner in which the powers of search and seizure are executed,[161] but relief as well, where the technical requirements of the law have been found not to have been complied with.[162]

While the CRA's powers to examine books and records is generally very broad, the Federal Court of Appeal held in *BP Canada Energy Company v. Minister of National Revenue,*[163] that the Minister could not routinely compel a taxpayer to disclose the uncertain tax positions reflected in its tax accrual working papers. However, in *MNR v. Altas Tube Canada,*[164] the Federal Court allowed the Minister's request for a draft due diligence report (where some of the information in the report could have been characterized as tax accrual working papers) prepared by an accounting firm in connection with a transaction involving a taxpayer. Despite this, the CRA has indicated in its communique entitled "Obtaining Information for Audit Purposes," that it will continue to request taxpayer tax accrual working papers "where CRA officials determine there is a higher risk of non-compliance." The CRA, however, will not seek these documents if they are subject to solicitor-client privilege. Therefore, it is important for taxpayers to seek legal advice early on when preparing their tax accrual working papers.

Furthermore, to target instances of international tax avoidance, the Offshore Tax Informant Program (OTIP) was established. The OTIP allows the CRA to reward individuals who provide specific information regarding major international noncompliance that leads to the assessment and collection of Canadian taxes in excess of Can. $100,000. The award to the informant under OTIP ranges between 5% to 15% of the tax collected.

E. Inquiries

The CRA may institute an inquiry into the affairs of any taxpayer. Such an inquiry is held before a hearing officer appointed by the Tax Court of Canada. The taxpayer may be present and represented by counsel throughout the inquiry, unless the hearing officer orders otherwise on application by the Minister of National Revenue and the supply of proof that the taxpayer's presence or representation would be prejudicial to the conduct of the inquiry.[165]

[158] *MNR v. Rona Inc.*, 2017 FCA 118 and *Roofmart Ontario Inc. v. Canada,* 2020 FCA 82.

[159] ITA, sec. 232.

[160] 2019 FCA 67.

[161] As in *Granby Construction & Equipment Co. Ltd. v. Milley,* [1974] CTC 562, 701.

[162] *See Royal American Shows, Inc. v. MNR,* [1977] CTC 52; *Kruger Inc. v. MNR,* [1983] CTC 319; *see also James Richardson & Sons Ltd. v. MNR,* [1982] CTC 239, *Canadian Bank of Commerce v. A.G. of Canada,* [1962] SCR 729, *MNR v. Parion, Courey, Cohen & Houston,* [1980] CTC 131.

[163] 2017 FCA 61.

[164] 2018 FC 1086.

[165] ITA, sec. 231.4.

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F. Assessments

The Minister of National Revenue examines each income tax return and assesses the tax payable by the issuance of a Notice of Assessment or a notice that no tax is payable (often referred to as a "nil assessment"). This notice may or may not agree with the taxpayer's own calculation; however, in practice, the original Notice of Assessment would generally differ only as to relatively obvious or mechanical errors detected, or existing disagreements as to the quantum of losses available to be carried forward from prior taxation years. The Minister is also required to issue a notice of determination of losses where the taxpayer so requests.[166]

In the absence of fraud or misrepresentation due to neglect, carelessness or willful default, the CRA may generally reassess tax, interest or penalties only within three years of the date of mailing of an original Notice of Assessment or nil assessment. The reassessment period is extended to four years for mutual fund trusts and all corporations except "Canadian-controlled private corporations" (CCPCs).[167] The reassessment period is extended to six or seven years, as the case may be, in several circumstances.[168]

For example, the normal reassessment period may be extended:

(i) Where a reassessment is required to give effect to a deduction carried back to a prior year;

(ii) As a consequence of a transaction involving the taxpayer and a non-arm's-length nonresident;

(iii) Where a nonresident carries on a business in Canada and the reassessment is a consequence of:

a. The nonresident allocating revenues or expenses with respect to the Canadian business; or

b. A notional transaction between the nonresident and its Canadian business that is recognized for purposes of the ITA or an applicable tax treaty; or

(iv) In respect of income arising in connection with a foreign affiliate.

Extensions are also available with respect to loss carrybacks or with respect to any period in which a taxpayer is contesting the CRA's attempt to access information through a requirement order or compliance order.

The Minister of National Revenue also has discretion to reassess beyond the three-year period, at the request of an individual or testamentary trust, to give the taxpayer a refund or to reduce taxes payable. This extension also applies with respect to any other tax year of the particular taxpayer or another taxpayer, where there is reason, as a consequence of a carryback deduction, to reassess such other year.[169]

The rules for assessing outside the standard limitation periods are not clear. The Minister of National Revenue may reassess at any time if a taxpayer makes a misrepresentation that is attributable to neglect, carelessness, or willful default, or commits fraud.[170] The onus of demonstrating misrepresentations or fraud is on the Minister of National Revenue. Within the normal reassessment period, the taxpayer may also file a waiver to extend the reassessment period with respect to the issues set out in the waiver. This technique is useful where negotiations between the taxpayer and the tax authorities are in progress, but the deadline for reassessing is approaching. The waiver may forestall a particularly negative assessment and permit the parties to continue discussing more palatable solutions.

Where a reassessment is made, the increased tax payable bears interest at a prescribed rate from the date on which the tax should have been paid. The prescribed rate varies quarterly based on the Bank of Canada Treasury Bill rate, plus 2%. Interest is also charged on any outstanding tax payable. Such interest paid is not deductible by the taxpayer in computing income.

G. Tax Payments

Generally, corporations are liable to pay installments on account of tax. Corporate installments are generally paid monthly. An individual is required to make installment payments on a quarterly basis, where the individual's total tax payable for the year or for each of the two preceding tax years not subject to source withholding exceeds Can. $3,000 (or Can. $1,800 if the individual is resident in Quebec). The balance of tax owing is generally to be remitted by corporations within two months after the close of their tax years. Individuals remit any balance with their annual returns due April 30.[171]

In the case of an individual deriving remuneration from employment, a system of withholding applies whereby the employer deducts an amount with respect to the employee's tax liability, computed in a prescribed manner, and remits it on the employee's behalf to the appropriate authorities.[172] An exception applies for certain "qualifying nonresident employers" that make payments to "qualifying nonresident employees." To qualify for this exemption, a nonresident employer is required to obtain a certification from the CRA and must be a resident of a country with which Canada has an income tax treaty. Once a certification has been obtained, a qualifying nonresident employer is relieved from the obligation to make source withholdings on payments to qualifying nonresident employees. Qualifying nonresident employees are those employees that (i) are resident of a country with which Canada has an income tax treaty, (ii) are not required to pay tax under the Income Tax Act because of the application of such income tax treaty, and (iii) work in Canada for less than 45 days in a calendar year that includes the time of payment or is present in Canada less than 90 days in any 12-month period that includes the time of payment.

Generally, no withholding tax is required with respect to an employee who is neither employed nor resident in Canada.[173] Where remuneration is paid to a nonresident with respect to services rendered in Canada, the payer is obligated to withhold 15% of the payment.[174] Where the nonresident is exempt from

[166] ITA, subsecs. 152(1)–(1.3).
[167] ITA, subsecs. 152(3.1).
[168] ITA, para. 152(4)(b).
[169] ITA, para. 152(4)(b), subsec. 152(6).
[170] ITA, subpara. 152(4)(a)(i).
[171] ITA, secs. 156, 157. Income Tax Regulations (ITR), Part I.
[172] ITA, subsec. 153(1); ITR, Part I.
[173] ITR, subsec. 104(2).
[174] ITR, sec. 105. An additional 9% must be withheld and remitted to Revenu Québec if the service is rendered in Quebec.

ISBN 978-1-63359-385-5

Canadian tax under the terms of a tax treaty, there is no general exemption from the required withholding. In such a case, however, relief may be obtained on application to the CRA for permission not to withhold.[175]

The government is generally precluded from collecting amounts of tax that are in dispute until the dispute is resolved. However, a corporation is required to pay 50% of the amount in dispute when assessed, if the corporation, or a related corporation, is a "large corporation" (i.e., generally a corporation that has taxable capital employed in Canada in excess of Can. $10 million)[176] with respect to the year in dispute. Similarly, 50% of the amount in dispute must be paid in respect of certain charitable donation deductions or other tax shelter credits while the matter is under appeal.

H. Penalties

1. Generally & Failure to File

In addition to the fines or imprisonment that may be imposed on prosecution (see XI.A., below), the Income Tax Act provides for penalties levied administratively by assessment.

The failure to file annual returns of income carries with it a possible penalty of 5% of the tax unpaid plus 1% per month (up to an aggregate maximum of 17%). On a second or further occurrence, an increased penalty of 10% of the unpaid tax plus 2% per month (up to an aggregate maximum of 50%) will apply. Failure to furnish the prescribed information brings a penalty of Can. $100 for each failure.[177]

2. Evasion

Most discussion of penalties deals with attempts to evade tax. Failure to include an amount in income (for a minimum amount of Can. $500), where a similar failure has occurred in any of the preceding three tax years, attracts a penalty of 10% of the unreported amount. A person who unknowingly or by gross negligence has made or participated in the making of a false statement or omission in a return or other required statement is liable to a penalty equal to 50% of the tax attributable to the false statement or omission.[178]

3. Negligence

A number of penalty cases involve determining whether gross negligence has occurred where responsibility to file a return was left to the taxpayer's accountant. Generally, mere negligence of the accountant is not imputed back to the taxpayer if the taxpayer was not a party to it, though the courts will consider the capabilities and experience of the specific taxpayer. In a case where a taxpayer delivered a blank signed return to his accountant and the latter filled it in, not complying with the professional standard of conduct that is to be expected, the penalty was not imposed.[179] Similarly, the penalty did not apply where a taxpayer made faithful entries in his books of account but employed a public accountant who made a number of inexplicable transposition errors in preparing the tax returns.[180] A contrary result occurred, however, where a company employed an accountant to prepare and file financial statements and income tax returns, using his discretion as to what was to be contained in those documents without any reference to the taxpayer for approval in advance of filing. In those circumstances, the Federal Court of Appeal found that the acts of the accountant were the acts of the taxpayer.[181] Similarly, in 2011, the Federal Court of Appeal upheld multiple penalties against a group of related corporations where an accountant did not prepare requisite foreign reporting forms, even though all taxes were paid, and the Minister had all of the relevant information through other tax reporting.[182]

4. Burden of Proof

The onus is on the Minister of National Revenue to prove the facts justifying imposition of the penalty. In addition to the penalties that may be levied on taxpayers, the Income Tax Act contains rules governing the conduct of third parties involved in providing tax advice or preparing tax returns and similar documents. Information Circular 01-1 outlines the administrative guidelines established by the CRA that are intended to ensure a fair and reasonable application of the third-party civil penalties. In general, the third-party civil penalties are directed at ensuring tax compliance by imposing penalties on tax practitioners and others who provide false or misleading information relating to tax matters.

5. Promoters of Tax Shelters

Tax shelter promoters may be caught when they make a "false statement," knowingly or in circumstances amounting to "culpable conduct,"[183] in holding presentations to provide information with respect to a specific tax shelter.[184] The term "culpable conduct" is defined as conduct that is tantamount to intentional conduct, shows an indifference as to whether the Income Tax Act is complied with, or shows a willful, reckless or wanton disregard of the law. It generally refers to conduct that is not simply an honest error of judgment or failure to exercise reasonable care. A tax shelter promoter providing a "false statement" in the course of a "planning" or a "valuation" activity is liable to pay a penalty equal to the greater of Can. $1,000, or the amounts that the tax shelter promoter is entitled to receive with respect to the "planning" or "valuation" activity. In any other case, a tax shelter promoter will be liable to pay a penalty of Can. $1,000.[185]

6. Tax Advisors

Tax advisors may also be liable to penalties when they make or participate in the making of a "false statement," knowingly or in circumstances amounting to "culpable conduct," in providing tax advice or preparing a tax return for a specific taxpayer.[186] A tax advisor or a tax return preparer making a "false

[175] *See* Information Circular 75-6R2 — Required Withholding from Amounts Paid to Non-Residents Providing Services in Canada (Feb. 23, 2005).

[176] ITA, subsec. 225.1(8).

[177] ITA, sec. 162.

[178] ITA, sec. 163.

[179] *See Decore v. The Queen*, [1974] CTC 791.

[180] *Udell v. MNR*, [1969] CTC 704.

[181] *The Queen v. Columbia Enterprises Ltd.*, [1983] CTC 204.

[182] *Stemijon Investments Ltd. v. A.G. of Canada*, 2011 FCA 299.

[183] ITA, subsec. 163.2(1).

[184] ITA, subsec. 163.2(2).

[185] ITA, subsec. 163.2(3).

[186] ITA, subsec. 163.2(4).

ISBN 978-1-63359-385-5

statement" will be subject to a penalty equal to the greater of Can. $1,000, and the lesser of the penalty the particular taxpayer would be liable to pay under subsection 163(2) of Income Tax Act or the total of Can. $100,000 and the compensation paid to the tax advisor or tax return preparer with respect to the "false statement."[187]

The subsection 163(2) penalty provides that a taxpayer who:

(i) Knowingly or under circumstances amounting to gross negligence; and

(ii) Has made a false statement in a tax return or other prescribed document.

Is liable to a penalty of the greater of:

(i) Can. $100; or

(ii) 50% of the excess of the tax that would otherwise be payable under the Income Tax Act if the taxpayer's understatement of income for the year was added to that person's taxable income over the amount of tax paid based on the information originally provided by the taxpayer.

Thus, where a lawyer assisted in issuing donation receipts as part of a tax sham in circumstances in which she knew or was reasonably expected to have known that other taxpayers would use those receipts to claim unwarranted tax credits, the penalty applied.[188]

The CRA has the burden of proving that an advisor or preparer knowingly made a "false statement" that constitutes "culpable conduct." The standard of proof used for third-party penalties is the balance of probabilities, with the benefit of the doubt being given to the advisor or tax return preparer.

Conventional tax planning strategies that do not involve making "false statements" knowingly or evidencing "culpable conduct" should not trigger the application of the third-party civil penalties. Similarly, differences of interpretation should not attract penalties if a reasonable argument exists as to the application of the law. Moreover, the rules provide that an advisor or a tax return preparer is not considered to have acted in circumstances amounting to "culpable conduct" solely because the advisor relied, in good faith, on information provided by a taxpayer.[189] Generally, the good faith reliance exception can be used when the information used by the advisor is not, on its face, clearly false or obviously unreasonable. However, it will not apply to a statement made by an advisor in the course of an activity the main purpose of which is to provide a specific taxpayer with a "tax benefit," or when an advisor develops a tax plan that is subsequently sold to clients in consideration for a fee.[190]

In addition, failure by a tax advisor or promoter to provide an information return with respect to a "reportable transaction" or a "notifiable transaction" will also attract a penalty that is generally equal to the amount of the fee that the tax advisor or promoter is entitled to receive from its customer, plus Can. $10,000 and Can. $1,000 per day the return is late, up to a maximum of Can. $100,000.[191]

I. Objections and Appeals

Disputes with the tax authorities usually arise first at the pre-assessment level. It is a matter of discretion for the CRA whether the taxpayer will be permitted to make representations at this stage. In practice, the CRA nearly always informs the taxpayer of a proposed reassessment if it is substantial and allows the taxpayer a reasonable period of time within which to make representations.

After an assessment or reassessment has been made, a taxpayer who disagrees with the CRA's findings may file a Notice of Objection with the CRA within 90 days setting forth the reasons why the taxpayer feels the additional tax is not payable.[192] An individual or "graduated rate estate" trust can file a Notice of Objection on or before the later of 90 days after the date of the assessment or reassessment and one-year after the filing due date for the taxpayer's return. A Notice of Objection is processed at the local tax services office level, but in certain cases, representations may also be made to head office officials in Ottawa. CRA officers in the appeals division of the Agency review all objections and are supposed to act independently of the CRA auditors who performed the assessment or reassessment that gave rise to the objection. If the taxpayer is a large corporation,[193] then the taxpayer's objection must reasonably describe each issue; specify the relief sought with respect to each issue; and provide facts and reasons with respect to each issue.[194] A large corporation should exercise care in ensuring that each of these requirements is satisfied, as failure to do so can preclude the large corporation from being able to appeal an assessment to the Tax Court of Canada.[195] A large corporation should be able to introduce additional facts and reasons, and, in limited circumstances, may be able to introduce new issues on appeal that were not reasonably described in the Notice of Objection. This might occur if the taxpayer can demonstrate that the Minister otherwise became aware of, and accepted, the alternative issues during the objection stage.[196]

Following a Notice of Objection, if the assessment is confirmed or varied without granting all the relief sought, the taxpayer may appeal to the Tax Court of Canada within 90 days.[197] Taxpayers can also appeal to the Tax Court of Canada before the CRA renders its decision, provided that 91 days have passed after filing the Notice of Objection. A special informal procedure applies to cases involving amounts of tax and penalties at issue of Can. $25,000 or less. The taxpayer, or the CRA, if unsuccessful before the Tax Court, may appeal to the Federal Court of Appeal. Where the informal procedure has applied, review by the Federal Court of Appeal is limited to questions of law and jurisdiction. A further appeal lies from the Federal Court of Appeal to the Supreme Court of Canada. Leave to appeal to the Supreme Court of Canada is required for tax cases and can be difficult to obtain.

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[187] ITA, subsec. 163.2(5).
[188] *Guindon v. Canada*, 2015 SCC 41.
[189] ITA, subsec. 163.2(6).
[190] ITA, subsec. 163.2(7); Information Circular 01-1, para. 38.
[191] ITA, subsec. 237.3(8).
[192] ITA, sec. 165.
[193] A large corporation is defined in ITA, subsec. 225.1(8).
[194] ITA, subsec. 165(1.11).
[195] ITA, subsec. 169(2.1). See also *Bakorp Management Ltd.*, 2014 DTC 5063 (FCA).
[196] *Devon v. The Queen*, 2015 FCA 214.
[197] ITA, sec. 169.

ISBN 978-1-63359-385-5

It is possible for the taxpayer, with the agreement of the CRA, to refer a question of general importance arising under the Income Tax Act to the Tax Court for determination. It is not clear in what situations the tax authorities will be willing to utilize this procedure and it has not been resorted to very frequently.[198]

J. Advance Rulings

A system of advance income tax rulings was established in 1970. Due to the complexity of various provisions of the law, taxpayers have become wary of falling foul of the official interpretation. Advance rulings may be useful to determine whether the tax authorities will view a proposed transaction favorably. For example, an advance ruling may be sought concerning the applicability of the General Anti-Avoidance Rule (GAAR) to a specific transaction. The primary requirement for an advance ruling is that the transaction be neither hypothetical nor accomplished, but "seriously contemplated." Further, no ruling will be made on a question of fact, where the transaction is part of a tax avoidance scheme or has no business purpose, and in various other situations. Although rulings will not be issued with respect to draft legislation, the CRA may nevertheless offer their opinion on the potential applicability of draft legislation.

The fee for an advance ruling or a pre-ruling consultation is determined on an hourly basis. The hourly fee is indexed to inflation. For April 1, 2025 to March 31, 2026, the hourly fee is Can. $301.50.[199] To request a pre-ruling consultation, an advance deposit of Can. $2,500 or undertaking to pay the requisite fees is required. The deposit is refundable to the extent it exceeds the fee for the consultation.

Rulings are binding on the Minister of National Revenue (subject to changes in the facts or amendments to the law) with respect to the particular taxpayer and facts addressed in the sense that the Minister has publicly agreed to be so bound, although, technically, the legal effect of rulings is uncertain. Non-binding, informal interpretations of the law may also be obtained, though in view of changes in CRA thinking, their value is limited in comparison to that of an advance ruling.

K. Fairness Rules

The fairness rules deal largely with administrative matters under the Income Tax Act. These rules allow for common sense in dealing with taxpayers who, because of personal misfortune or circumstances beyond their control, are unable to comply with certain provisions of the Income Tax Act. The fairness legislation covers three main areas.

First, the Minister of National Revenue has the discretion to waive or cancel all or any portion of any penalty or interest payable within 10 years from the end of the taxation year with respect to which the penalty or interest was imposed.[200] Penalties and interest may be waived where they arise from circumstances beyond a taxpayer's control, such as natural disasters, disruption in civil services, serious accident, illness or emotional distress. They can also be waived if the interest or penalties arose principally because of actions of CRA officials or where the taxpayer is financially unable to pay the amounts of tax owing. The factors that may be considered by the CRA in determining whether to waive the interest or penalties are set out in Information Circular 07-1R1 (although the Federal Court of Appeal has held that the Minister's discretion may extend beyond any factors listed in the CRA's published guidance).[201]

The waiver of interest and penalties must be distinguished from the voluntary disclosure program (VDP), which is intended to promote voluntary compliance with the tax system.[202] In effect, the VDP only provides taxpayers with relief from penalties in limited circumstances, as outlined in Information Circular 00-1R6 and consists of a two-track system. The first track is the General Program in which applicants will be eligible for penalty relief and partial interest relief. The second track is the Limited Program in which applicants will be eligible for a form of limited penalty relief and no interest relief is available. The VDP's General Program is not available to corporations with gross revenue in excess of Can. $250 million in at least two of its last five tax years. In addition, applications related to transfer pricing adjustments or penalties will be referred to CRA's Transfer Pricing Review Committee for their consideration (rather than being addressed under the voluntary disclosure program).

Second, the Minister has the discretion to extend the time for making an election for tax years if the taxpayer makes an application for an extension within 10 years after the end of the taxation year in which the election was required to have been made.[203] The Minister also has the discretion to permit an amendment to, or a revocation of, certain elections previously filed. Information Circular 07-1R1 describes the factors that may be considered by the CRA in determining whether to extend the time for making an election, or otherwise amend or revoke a prescribed election.

Third, the Minister has the discretion to make a reassessment beyond the "normal three-year period" to provide an individual or a testamentary trust with a refund if the taxpayer makes an application within 10 years from the end of the tax year to which the application applies.[204] Information Circular 07-1R1 sets out the factors that may be considered by the CRA in exercising this discretion.

When a request for relief under the fairness legislation is denied by the CRA, the taxpayer's only remedy is to apply for a judicial review of the decision under section 18.1 of the Federal Courts Act.[205] In that regard, the Federal Court will generally not interfere with the Minister's decision, unless it is established that the Minister's statutory discretion was not exercised

[198] ITA, sec. 173.

[199] IC70-6R12, "Advance Income Tax Rulings and Technical Interpretations" (April 1, 2022). The fees are adjusted annually to reflect inflation: https://www.canada.ca/en/revenue-agency/services/tax/tax-professionals/income-tax-rulings-interpretations/fees-for-advance-income-tax-rulings-pre-ruling-consultations.html. Partial remission of the fee is available in some circumstances.

[200] ITA, subsec. 220(3.1).

[201] *Stemijon Investments Ltd. v. A.G. of Canada*, 2011 FCA 299.

[202] For further information on the VDP, including the application, see https://www.canada.ca/en/revenue-agency/programs/about-canada-revenue-agency-cra/voluntary-disclosures-program-overview.html.

[203] ITA, subsec. 220(3.2).

[204] ITA, subsec. 152(4.2).

[205] R.S.C. 1985, c. F-7.

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in good faith or in accordance with the principles of natural justice.[206]

L. Functional Currency Reporting

Generally, a taxpayer must determine its Canadian tax results under the ITA in Canadian dollars.[207] Amounts that are otherwise computed in a foreign currency must generally be converted into Canadian dollars using the relevant spot rate on the date of the transaction (being the rate quoted by the Bank of Canada on the particular day or, in certain cases, another rate of exchange that is acceptable to the CRA).

However, the ITA contains a special functional currency reporting regime in section 261 which permits a corporation to elect to report its Canadian tax results using a different currency if certain requirements are met.[208] The functional currency must be the primary currency in which the corporation maintains its books and records, and must be a "qualifying currency."[209] At present, the only official qualifying currencies for purposes of section 261 are the U.S. dollar, the euro, the pound Sterling, the Japanese Yen and the Australian dollar.[210]

A functional currency reporting election must be made in prescribed form and manner on or before 60 days after the first day of the particular tax year in which the election is made. Once a corporation elects to report using a functional currency, subsections 261(5) to (22) provide detailed rules for calculating various amounts and the currency conversion dates that must be used. A taxpayer may revoke a function currency election after the first year in which the election is made in prescribed form and manner. A revocation becomes effective for each tax year that begins six months after the revocation has been filed. Certain anti-avoidance rules may apply to limit the application of the rule. For example, certain losses may be denied in respect of transactions between related taxpayers with different functional currencies.[211]

[206] *Maple Lodge Farms v. Government of Canada*, [1982] 2 SCR 2, 7–8 (SCC). See also *Stemijon Investments Ltd. v. A.G. of Canada*, 2011 FCA 299.

[207] ITA, subsec. 261(2).

[208] ITA, subsec. 261(3).

[209] "Functional currency" definition in ITA, subsec. 261(1).

[210] "Qualifying currency" definition in ITA, subsec. 261(1).

[211] ITA, subsecs. 261(18) to (21).

ISBN 978-1-63359-385-5

VIII. Income Taxation

A. Provincial Income Taxation

All of the Canadian provinces impose an income tax on individuals and use a tax-on-income structure so that these provinces have their own tax rate structure and income brackets. With the exception of Quebec, each province uses federal taxable income as the tax base to which the provincial marginal tax rates apply. With a few exceptions, for example, in their treatment of tax credits against provincial tax with respect to municipal property taxes and provincial resource royalties, the provincial income tax acts are brief and incorporate by reference the rules of federal income tax. Quebec has enacted its own income tax statute,[212] modeled generally on the federal act, but differing with respect to some personal tax credits. A few provinces also impose a surtax on higher income individuals. To simplify tax administration and collection, the federal government administers and collects provincial income taxes on individuals (other than in Quebec). Generally, an individual is subject to tax in a province if the individual carries on business in the province or is resident there on December 31. The highest combined federal and provincial marginal income tax rates for individuals are set out in the table shown below. Provincial individual income tax is not deductible for purposes of federal income taxation.

Combined Federal and Provincial Individual Tax Rates (highest marginal rates)

	Ordinary Income	Dividends (Eligible)	Dividends (Non-Eligible)	Capital Gains
Alberta	48%	34.3%	42.3%	24%
British Columbia	53.5%	36.5%	48.9%	26.7%
Manitoba	50.4%	37.8%	46.7%	25.2%
New Brunswick	52.5%	32.4%	46.8%	26.3%
Newfoundland	54.8%	46.2%	49%	27.4%
Northwest Territories	47.1%	28.3%	36.8%	23.5%
Nova Scotia	54%	41.6%	50%	27%
Nunavut	44.5%	33.1%	37.8%	22.3%
Ontario	53.5%	39.3%	47.7%	26.8%
Prince Edward Island	52%	36.5%	47.9%	26%
Quebec	53.3%	40.1%	48.7%	26.7%
Saskatchewan	47.5%	29.6%	41.3%	23.8%
Yukon	48%	28.9%	44%	24%

All Canadian provinces also impose a tax on corporate income, which is also nondeductible for determining federal tax. However, in each case, the provincial tax should be considered in view of the abatement from federal tax of 10 percentage points. The effective federal and provincial corporate income tax rates are set out in the table below.

Combined Federal and Provincial General Corporate Tax Rates (non-CCPC)

	Active Business/ Investment Income
Alberta	23%
British Columbia	27%
Manitoba	27%
New Brunswick	29%
Newfoundland	30%
Northwest Territories	26.5%
Nova Scotia	29%
Nunavut	27%
Ontario	26.5%
Prince Edward Island	31%
Quebec	26.5%
Saskatchewan	27%
Yukon	27%

All provinces have a split-rate structure, with the lower rate applying to income subject to the small business deduction under the federal Income Tax Act (see VIII.E.3.b., below). Some provinces stipulate a higher threshold for the application of the higher rate than does the federal ITA.

Currently, all provinces, except Quebec and Alberta,[213] have agreed that the federal government should administer and collect their corporate income tax.

Corporate income is allocated among the provinces on a relatively uniform basis.[214] Corporate income is generally allocated based on a formula reflecting salaries paid and gross revenue received. Special rules apply to particular businesses, such as transport companies and financial institutions. A corporation usually becomes subject to tax in a province based on a permanent establishment (PE) test set out in the provincial tax statute. Generally speaking, a PE will be considered to exist in a province where the corporation has a fixed place of business, including an office, branch, mine, oil well, farm, timberland, factor, workshop, or warehouse. Where a corporation does not have any fixed place of business, a PE will exist in the principal place in which the corporation's business is conducted. In addition, several deeming rules can deem a corporation to have a PE in a particular province, such as where the corporation car-

[212] Taxation Act, LRQ 1977, c. I-3.

[213] Quebec: Taxation Act, LRQ 1977, c. I-3. Alberta: Corporate Tax Act, RSA 2000, c. A-15.

[214] See Income Tax Regulations (ITR), Part IV.

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ries on business through certain agents or employees that have a general authority to contract on behalf of the corporation.[215]

Administratively, there is some duplication under the provincial tax system where tax collection is not performed by the federal government. Thus, all individuals subject to tax in Quebec and all corporations subject to tax in Quebec and/or Alberta must file provincial income tax returns and face provincial assessments and possible appeals separate from any federal returns, assessments and appeals.

B. The Canadian Tax Net

1. Tax Residency

Canada taxes the worldwide or global income of every person (individual, trust or corporation) resident in Canada at any time during the year.[216] Thus, the criterion of residence is central to the liability to tax in Canada. Citizenship is not a basis for taxation in Canada.

a. Individuals

Under Canadian law, an individual is resident in Canada if, in fact, he or she resides in Canada under the criteria established by case law. Further, under the Income Tax Act, a reference to a person resident in Canada includes a person who was "ordinarily resident."[217] It has never been clear precisely what the word "ordinarily" adds to the word "resident." It has been suggested that "ordinarily resident" may be slightly broader than "resident,"[218] but the leading Canadian authority on the subject merely contrasts "ordinarily resident" with "casually resident."[219] The best way to appreciate what constitutes residence under the common law test is to consider some examples:

(i) An unmarried Canadian lawyer lived with his parents before World War II. He enlisted in 1939 and went to England in 1940, retaining a bank account and safety deposit box in Canada and continuing as a nonactive partner of his law firm. He married a British resident in England in 1941 and set up house there. He returned to Canada in May of 1946 and claimed to have become resident in Canada at that time. The trial court ruled that he was ordinarily resident throughout the year, but the decision was reversed by the Supreme Court of Canada, which found him neither resident, nor ordinarily resident, until the month of May.[220]

(ii) A U.S. citizen transferred to Canada by his U.S. employer moved to Canada with his family. Three years later he was transferred back to the United States. He resigned from his Canadian club, put his house on the market and physically moved to the United States. He reestablished residence and club membership in the United States. His wife and children remained in Canada for approximately five months to sell the house, during which time he visited the family on several occasions. Notwithstanding the presence of the family in Canada, as well as a car and bank account left with them, the court ruled that the taxpayer was not resident after he physically left the country. The sole reason for the family remaining in Canada, it held, was to sell the house and this was not sufficient to cause the taxpayer to retain Canadian residence.[221]

(iii) A taxpayer left Canada in 1923 to live in a rented house in Bermuda. He spent little time in Bermuda, however, and subsequently built a home in North Carolina in 1939, into which his Canadian belongings were moved. In subsequent years he spent a considerable period of time, but less than 183 days each year, in Canada, first in a rented house and then in one he had built. The Canadian house was staffed by servants year-round. The courts found this taxpayer to be resident in Canada throughout. A constant personal presence was found not to be necessary to establish residence. Though every person must reside somewhere, a person can have more than one residence. The taxpayer was not a mere casual visitor to Canada, but rather ordinarily resided there.[222]

(iv) A U.S. citizen resided in Canada with his wife and children. Following a divorce, he returned to the United States. In subsequent years, he spent up to five months annually in Canada visiting the children and managing certain real property investments there, owned by a Canadian corporation. During his Canadian visits he resided in a storage suite in an apartment building owned by the company. The Court found the case "close to the line," but held the taxpayer not to be resident in Canada during the years in question.[223]

A temporary absence from Canada by a person resident in Canada would not normally break the residential tie where the purpose of the taxpayer's departure was by its nature not permanent (e.g., a holiday). In other cases, the question of continued residence during a relatively short physical absence will depend on an assessment of the taxpayer's intent to return, and the strength and number of residential links with Canada. While establishment of residence abroad is not decisive, the lack of a foreign residence will often, as a matter of practice, be a strong factor in a finding of continued residence in Canada. For example:

(i) A taxpayer was absent from Canada for only eight months. He left for France to participate in a training program run by the French parent company of his new employer. Although he maintained no home in Canada in the interim, his furniture remained in storage in Canada and the absence was clearly temporary. Other ties were retained as well, such as a bank account. The court found the taxpayer had never ceased to reside in Canada, considering his ties to Canada and to France, his style of living, and the temporary purpose of his stay abroad.[224]

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[215] ITR, s. 400(2).
[216] ITA, subsec. 2(1).
[217] ITA, subsec. 250(3).
[218] See, e.g., *Midyette v. MNR*, [1985] 2 CTC 362 (FCTD).
[219] *Thomson v. MNR*, [1946] CTC 51 (SCC).
[220] *Beament v. MNR*, [1952] CTC 327 (SCC).
[221] *Schujahn v. MNR*, [1962] CTC 364 (Ex. Ct.).
[222] *Thomson v. MNR*, [1946] CTC 51 (SCC).
[223] *Erikson v. The Queen*, [1975] CTC 624 (FCTD).
[224] *The Queen v. Reeder*, [1975] CTC 256 (FCTD); *see also Erickson v. MNR*, [1980] CTC 2117 (TRB).

ISBN 978-1-63359-385-5

(ii) A series of cases has been decided dealing with academic sabbatical leave. Generally, taxpayers have been found to be ordinarily resident in Canada where the stay abroad, expressly of a temporary nature, was of only about a year's duration.[225]

(iii) On the other hand, a taxpayer was found to have ceased to be resident even though his absence from Canada was less than one year. He moved to the United States to take up employment for a U.S. subsidiary of a Canadian corporation. Although it appeared that he intended to take up full residence in the United States, in fact his house in Canada was never sold and his family never moved. After a few months, due to a change in the parent company's accounting set-up, the taxpayer was offered a new position in Canada on a "take it or leave the organization" basis, and he chose to return to Canada.[226]

The CRA has set out its administrative practices in an Income Tax Folio with respect to the factors for determining whether an individual has ceased to reside in Canada or has established residence in Canada.[227] The CRA takes the approach that residence status in any particular case must be determined on the specific facts under consideration. However, an individual will be considered to continue residence if he or she fails to sever what are considered significant ties with Canada. In the CRA's view, the significant residential ties are the location of a dwelling, and the location of a spouse and any dependents. There is no specific length of absence from Canada that establishes non-residence. Instead, the focus is on the number and type of the individual's residential ties with Canada and the individual's intention to sever those ties. In addition, secondary ties with Canada include the individual's personal property, social connections, economic ties, medical insurance arrangements, and immigration or work status. Income Tax Folios do not have the force of law, but they are intended to reflect administrative practice and the CRA's view of the law.

In addition to the common law test of residence, the Income Tax Act provides an alternative test: A person will be deemed to have been resident in Canada throughout a year if he or she "sojourned" in Canada for an aggregate of 183 days or more in the year.[228] Other conclusive presumptions of residence are also made, for example, regarding members of the Canadian forces and certain diplomatic or other personnel,[229] but the sojourning rule is by far the most important case of deemed residence as applied to individuals. The word "sojourned" is not a common one and its meaning has not often been elaborated on by the courts. It would appear, however, that sojourning involves a casual or transient physical presence. Thus, though there is some authority to the contrary,[230] it would appear that where, for example, an immigrant arrives in Canada before the end of June and thereupon establishes permanent residence, the sojourning rules do not apply so as to deem him resident throughout the year, but rather he will be resident under the common law test for the balance of the year starting at the time of arrival. This is the approach taken by the CRA.[231]

An individual must be resident somewhere, and one may be resident in more than one place at the same time. The potential problems arising out of dual or multiple residence may be solved by way of bilateral tax treaties. For example, the Canada-United States tax treaty[232] provides rules for attributing residence to one or the other territory, but not both, based on factors such as location of a permanent home, center of vital interests (personal and economic relations), habitual abode or citizenship. This is the approach of the Organization for Economic Co-operation and Development (OECD) model treaty and it is found in most of Canada's more recent tax treaties. In some cases, it may be that a dual resident can invoke the treaty as a resident of either state or that the competent authorities of both contracting states are to settle the question by mutual agreement.

The issue of dual residence is addressed by the Income Tax Act in a rule aimed at preventing individuals and corporations from becoming dual residents. Where a "person" (which includes an individual and a corporation) would otherwise be resident in Canada but is, under a tax treaty, resident in another country and not resident in Canada, that person is deemed not to be resident in Canada.[233] One effect of this rule is to curtail plans to acquire residence in a treaty partner country without giving up Canadian residence and, therefore, avoid the Canadian departure tax.

b. Corporations

As in the case of individual residence, the residence of a corporation in Canada may rest on the application of a common law test or special statutory deeming provisions. A corporation is resident in Canada at common law if its "central control and management" is in Canada. The following examples illustrate this test:

(i) In a leading English decision, a company incorporated in South Africa and having its head office there was held to be resident in the United Kingdom in view of the fact that its board of directors regularly met in London, and that real control was exercised there. This was the case even though no business other than such meetings was carried on in the United Kingdom, because the "real business" is carried on where "the central management and control actually abides.[234]

[225] See, e.g., *Saunders v. MNR*, [1980] CTC 2436 (TRB); *Magee v. MNR*, [1980] CTC 2450 (TRB); *Lancaster v. MNR*, [1980] CTC 2448 (TRB). But see also *Silburn v. MNR*, [1985] 2 CTC 2071 (TCC).

[226] *Bergelt v. MNR*, [1986] 1 CTC 212 (FCTD).

[227] Income Tax Folio S5-F1-C1, online: https://www.canada.ca/en/revenue-agency/services/tax/technical-information/income-tax/income-tax-folios-index/series-5-international-residency/folio-1-residency/income-tax-folio-s5-f1-c1-determining-individual-s-residence-status.html.

[228] ITA, para. 250(1)(a).

[229] ITA, paras. 250(1)(b)–(g).

[230] *Truchon v. MNR*, [1970] Tax ABC 440.

[231] Income Tax Folio S5-F1-C1 at paras. 1.30 and 1.32.

[232] Convention between Canada and the United States with Respect to Taxes on Income and on Capital, signed on September 25, 1980 (the "Canada-U.S. tax treaty"). On September 21, 2007, Canada and the United States signed a long-awaited protocol (the "Fifth Protocol") to amend the Canada-U.S. tax treaty. The Fifth Protocol entered into force on December 15, 2008, though the effective date of the Fifth Protocol's provisions generally varies from January 1, 2008 to up to January 1, 2010.

[233] ITA, subsec. 250(5).

[234] *DeBeers Consolidated Mines v. Howe*, [1906] A.C. 455. The Supreme Court of Canada endorsed this test in *Fundy Settlement v. The Queen*, 2012 SCC 14, discussed further below.

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(ii) A wholly owned subsidiary of an English company was registered in Kenya. All directors' meetings were held in Kenya and, indeed, under the company's constitution, its business was to be managed in Kenya. In fact, however, because of the situation of the company, it had been determined that management should be taken over by the parent and from that time important decisions that concerned the business were made in London by the directors of the parent. The Court found that the seat of the central management and control of the subsidiary passed from Kenya to the United Kingdom.[235] A similar result occurred in a case in which the central management and control of a Dutch corporation was found to reside with its shareholders in Canada, rather than with its Dutch resident director. In particular, the Tax Court of Canada found that the Dutch director had no prior business experience, received limited remuneration, routinely acted on the instructions of the shareholders, and did not participate in the decision-making process (generally not even being copied on the relevant correspondence).[236]

(iii) A Bahamian re-insurance subsidiary of a Canadian public company was 49% owned by U.K. residents. Four of its nine directors resided in Canada and five in the Bahamas. The business activity of the subsidiary was modest, but whatever had to be done (largely record keeping, reporting and corporate acts) was done in the Bahamas. Board meetings were also held in the Bahamas. The Tax Review Board found a sufficient "independence of action" and "sense of permanence" to conclude that management and control were not in Canada.[237]

Beyond this test, the Income Tax Act provides that any corporation incorporated in Canada after April 26, 1965, is deemed to be resident in Canada.[238] Further, in the case of a corporation incorporated in Canada on or before that date, Canadian residence will be conclusively presumed if, at any time in the taxation year or in any preceding taxation year ending after that date, it was resident in Canada or carried on business in Canada.[239] That is to say, subject to the potential application of a tax treaty, companies incorporated in Canada after April 26, 1965 are conclusively presumed to be resident in Canada, while those incorporated in Canada before that time will acquire perpetual and irrebuttable Canadian residence if, in any taxation year ending after that date, the corporation carries on business in Canada or is resident in Canada under the common law test.

In a case where the application of the latter deeming rule to a pre-1965 corporation was considered, the Federal Court of Appeal ruled that a corporation was resident on the basis that it had carried on business in Canada. The taxpayer had been inactive for approximately 20 years before 1966, when it was used by the international group of which it was a member to enter into contracts with Middle Eastern purchasers. The taxpayer's Canadian incorporation and head office were used to disguise the fact that those purchasers were actually doing business with a corporation resident in the United States. Sales promotion and manufacturing were performed by other corporations in the group, and the product was shipped directly to the purchaser by the manufacturer. The Court, overturning the trial judge's decision, concluded that although central management and control of the taxpayer was exercised in the United States, the taxpayer carried on business in Canada and was therefore resident there. The court seemed influenced by the fact that the success of the scheme used to deceive the Middle Eastern purchasers required the carrying on of a business in Canada. Although this decision may be dependent upon the particular factual circumstances, it illustrates the care that one must exercise in this area.[240]

A further transitional rule applies to the special case of corporations that qualified as "foreign business corporations" under the former Income Tax Act.[241]

Like individuals, corporations may have dual residence. The matter is sometimes resolved by tax treaties, although in many cases not definitely or with the appropriate results from a domestic tax perspective.

To ensure that a taxpayer's residence status in Canada reflects the taxpayer's residence status under an applicable tax treaty, the Income Tax Act treats a taxpayer who is otherwise resident in Canada as a nonresident for purposes of the Income Tax Act where the taxpayer is considered to be a resident of another country and not to be a resident of Canada under a tax treaty.[242] This situation may arise where the taxpayer is resident in both countries under their respective domestic laws and thus the determination resorts to the tax treaty "tie-breaker" rule, which deems the taxpayer to be, for purposes of the treaty, resident in only one jurisdiction. The Canada-U.S. tax treaty has a tie-breaker rule based on place of incorporation. Many other tax treaties have a tie-breaker rule based on location of place of effective management or the matter is left for the relevant competent authorities to resolve. Also, where a corporation is granted articles of continuance in a particular jurisdiction, it is deemed to have been incorporated in the jurisdiction into which it has been continued and not in any other jurisdiction.[243] The Canada-U.S. tax treaty provides that a corporation formed in one country and continued into another is considered to be resident in the jurisdiction to which it has been continued. This ensures generally that a U.S. corporation that has continued to Canada and is thenceforth governed solely by Canadian law is resident in Canada for both domestic and treaty purposes. The Fifth Protocol amended the Canada-United States tax treaty to deny dual residence status where a continued corporation is not discontinued in its original jurisdiction. Under that rule, a dually chartered corporation is not considered to be a resident of either country and, unless the competent authorities determine otherwise, is not entitled to any benefits under the Canada-United States tax treaty.[244]

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[235] *Unit Construction Co. Ltd. v. Bullock,* [1960] A.C. 351.

[236] *Landbouwbedrijf Backx B.V. v. The Queen,* 2018 TCC 142; *rev'd on other grounds* 2019 FCA 310.

[237] *Victoria Insurance Co. Ltd. v. MNR,* [1977] CTC 2443 (TRB).

[238] ITA, para. 250(4)(a).

[239] ITA, para. 250(4)(c).

[240] *The Queen v. Gurd's Products Co. Ltd.*, [1985] 2 CTC 85 (FCA).

[241] ITA, para. 250(4)(b).

[242] ITA, subsec. 250(5).

[243] ITA, subsec. 250(5.1).

[244] This rule, which was originally announced in a Department of Finance News Release on September 18, 2000, applies to corporate continuances that occur after September 17, 2000.

ISBN 978-1-63359-385-5

c. Trusts

There is no statutory provision that determines the residence of a trust, except in certain circumstances dealing with foreign trusts. A trust is generally taxed as an individual and identified with its trustees under the Income Tax Act. It may not, however, follow inexorably that the residence of the trust is the place of residence of the trustees; indeed, in the case of multiple trustees resident in different parts of the world, such a test cannot apply without a more sophisticated analysis of trustee powers, etc.

Until 2012, the leading case in Canada on this issue was *Thibodeau Family Trust v. The Queen*, where the Federal Court of Canada had to consider whether a trust was a resident of Canada or Bermuda.[245] In *Thibodeau*, a trust originally formed in Canada had three trustees: one was resident in Canada and two were resident in Bermuda. The jurisdiction of the trust was moved to Bermuda, as well as the books and records, and the trust's administration. The trust required at least one Bermuda trustee to decide any trust matters. All trustee decisions were made in Bermuda. The Federal Court held that the residence principles applicable to individuals and corporations were not applicable. It held that the trust was resident in Bermuda as a majority of the trustees resided in Bermuda and administered the trust there. As a result of this case, the prevailing view in Canada was that the residence of a trust is determined by reference to the residence of the trustees and the place where the trust is managed. These and other factors are enumerated by the CRA in an Income Tax Folio.[246]

The Supreme Court of Canada's decision in *Fundy Settlement v. The Queen*[247] rejects the principle espoused in *Thibodeau* that the residence of a trust is determined by reference to the residence of the trustees and the place where the trust is managed. *Fundy Settlement* instead adopted the test for residence used for corporations — the central management and control test — which looks to where the trust's central management and control are located to determine residence. The Supreme Court stated "[a]s with corporations, residence of a trust should be determined by the principle that a trust resides for the purposes of the Act where 'its real business is carried on,' which is where the central management and control of the trust actually takes place."[248] This will generally be the place where the trustees meet and make their decisions (unless, as was the case in *Fundy Settlement*, someone else is exercising the central management and control of the trust).

Certain foreign trusts are deemed to be resident in Canada by virtue of having a Canadian resident contributor or beneficiary under detailed foreign trust rules.[249]

[245] [1978] CTC 539 (FCTD).

[246] Income Tax Folio S6-F1-C1.

[247] 2012 SCC 14, *aff'g St. Michael Trust Corp. v. The Queen*, 2010 FCA 309 and *Garron v. The Queen*, 2009 DTC 1287 (TCC). *Fundy Settlement* was referred to by the names "*St. Michael Trust Corp.*" and "*Garron*" in the lower courts.

[248] *Fundy Settlement* at para. 15, citing *De Beers Consolidated Mines, Ltd. v. Howe*, [1906] A.C. 455.

[249] ITA, sec. 94.2.

2. Tax Base of Residents

The Canadian tax net extends to worldwide income from any source inside or outside Canada including, but not restricted to, income from an employment, business or property.[250] Income also includes taxable capital gains, i.e., one-half of the gain realized from the disposition of capital property anywhere in the world. The income of a Canadian resident may also include certain foreign income earned by offshore affiliates. The computation of income and taxable income is addressed at length below.

3. Tax Base of Nonresidents

Subject to the provisions of an applicable tax treaty, nonresidents of Canada are liable to ordinary income tax payable with respect to business or employment income that is regarded, under domestic laws, as having its source in Canada. Nonresidents are also liable to tax on taxable capital gains arising on the disposition of "taxable Canadian property." Corporations that do not qualify as "Canadian corporations" and that carry on business in Canada are subject to a further "branch tax." Furthermore, nonresident withholding tax is imposed with respect to what is essentially Canadian-source property or investment income. For the rates of source country taxation applying to investment income, services income and capital gains under Canada's domestic law and tax treaties and the context for the application of those rates, see the Withholding Tax Chart.

a. Business Income

(1) Carries on Business in Canada

A nonresident who carries on business in Canada in a given year or any previous year is taxable on income from such business.[251] The reference to a previous year ensures that income from carrying on business in Canada cannot escape tax merely by its being deferred until such time as the nonresident no longer carries on business in Canada. "Business" is broadly defined to include a profession, calling, trade, manufacture or undertaking of any kind whatever, and an adventure in the nature of trade.[252] An isolated transaction that constitutes an adventure in the nature of trade does not necessarily amount to carrying on business where it is not the corporation's sole activity.[253] As to whether a business conducted by a nonresident is being carried on in Canada, the courts look to where the contracts are formed,[254] as well as to the place in which the operations take place from which the profits in substance arise.[255] A nonresident who holds an interest in a partnership that carries on a business in Canada may be considered to be carrying on

[250] ITA, para. 3(a).

[251] ITA, para. 2(3)(b), subpara. 115(1)(a)(ii).

[252] ITA, subsec. 248(1).

[253] *Tara Exploration and Development Co. Ltd. v. MNR*, [1970] CTC 557 (Ex. Ct.), *aff'd for other reasons* [1972] CTC 328 (SCC). *Compare Birmount Holdings Ltd. v. The Queen*, [1977] CTC 34 (FCTD), *aff'd* [1978] CTC 358 (FCA).

[254] *Geigy (Canada) Ltd. v. Comr. Social Services Tax*, [1969] CTC 79 (BCSC); *GLS Leaseco Inc. v. MNR*, [1986] 2 CTC 2034 (TCC).

[255] *Firestone Tyre & Rubber Co. Ltd. v. Lewellin*, (1957), 37 T.C. 111; *London Life Insurance Co. v. Canada*, [1990] 1 CTC 43 (FCA).

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business in Canada, even if the nonresident is a silent or limited partner.[256]

Furthermore, the Income Tax Act provides that a nonresident is deemed to have been carrying on business in Canada where the nonresident:[257]

(i) Produces, grows, mines, creates, manufactures, fabricates, improves, packs, preserves or constructs, in whole or in part, anything in Canada whether or not the person exports that thing without selling it before exportation;

(ii) Solicits orders or offers anything for sale in Canada through an agent or servant, whether the contract or transaction is to be completed inside or outside Canada, or partly in and partly outside Canada; or

(iii) Disposes of certain Canadian resource property, timber resource property or real property situated in Canada that is held as inventory, including options or interests therein.

It has been held, however, that even under this extended definition, mere advertising does not constitute carrying on business in Canada.[258] Nor does the mere making of loans to Canadians constitute the soliciting of orders or offering anything for sale in Canada where the loans are completed outside Canada.[259]

(2) Exemption for Certain Investment Management Services

A special rule in section 115.2 of the Income Tax Act provides that a nonresident person will not be considered to be carrying on business in Canada solely due to the engagement by that person of certain investment management or advisory services of a Canadian resident. This rule was introduced because of the concerns of the Canadian investment services industry that a nonresident pension fund, mutual fund or other collective investment vehicle would be considered to be carrying on business in Canada where the nonresident uses the services of a Canadian resident to provide asset management services, advisory functions or back-office investment administration. Generally, the rule applies provided the nonresident fund (if organized as a corporation or a trust) does not itself (or through its agents) sell or promote the sale of its units to investors in Canada, does not itself (or through its agents) file any documents with a government or public regulatory body in Canada, and, after the fund's first year of existence, persons and partnerships affiliated with the Canadian service provider (other than certain designated entities) do not own more than 25% of the fair market value of investments in the fund. In the case of a fund organized as a partnership of which a nonresident person is a member, the rule will apply for the fund's first year of existence, after which the 25% ownership test must be met. The rule applies to nonresident individuals as well. If the services are provided to a nonresident individual, other than a trust, the nonresident individual must not be affiliated with the service provider to avail itself of the deeming rule. If the rule does not apply, the normal rules for determining whether a particular nonresident person is carrying on business in Canada will apply.

(3) Treaty Exemption

A nonresident who is carrying on business in Canada may nevertheless be exempt from Canadian tax due to the operation of one of Canada's tax treaties. Though the structure of these treaties varies somewhat, the general rule is that a treaty-protected nonresident is subject to Canadian tax on business profits only to the extent that these are attributable to a "permanent establishment" in Canada. "Permanent establishment" is defined in each treaty. Each treaty must be carefully examined to determine its applicability (e.g., the definition of residence) and effect.[260]

For example, several cases under a prior version of the Canada-U.S. tax treaty have drawn subtle distinctions in connection with the availability of protection to U.S. resident individuals who speculated in Canadian real property. Under most of Canada's treaties, Canadian federal tax may be levied on the profits of the Canadian operation if the nonresident operates through a factory, office or other fixed place of business in Canada. The income for Canadian purposes is computed as if the Canadian business were separate from any other business carried on by the taxpayer with a determination of the income earned from the Canadian business less applicable deductions.[261] In some treaties, a deemed arm's-length or other transfer pricing formula is established with respect to branch operations. In any event, the question of pricing and particularly the deduction of "head office expenses" will often prove difficult and a potential source of conflict between the taxpayer and the Canadian taxation authorities.

Tax treaties do not apply per se to provincial tax, since a federal treaty does not bind the provinces' ability to levy provincial tax. Nevertheless, similar provincial treatment generally arises pursuant to the tax collection agreement with the provinces or by virtue of provincial law.

(4) Branch Tax

There is no Canadian tax per se on the repatriation of earnings by a Canadian branch of a foreign corporation. However, a corporation other than a "Canadian corporation" carrying on business in Canada may be subject to an additional tax on branch profits. A "Canadian corporation" is a corporation resident in Canada and either incorporated in Canada or continuously resident since June 18, 1971. Very generally, the branch tax is imposed at the rate of 25% on after-tax profits of the foreign corporation's branch that are not reinvested in specified Canadian assets.[262] Canada's tax treaties may have an effect on the rate of, and the quantum of profits subject to, the imposition of this tax. Some of the more recent treaties protect the jurisdiction of Canada to impose the tax, but they limit the rate to 15%. Furthermore, where a tax treaty does not specifically limit the rate of branch tax, but specifies a maximum rate on divi-

[256] *Randall v. The Queen,* [1985] 1 CTC 268 (FCTD); *Grocott v. The Queen,* [1996] 1 CTC 2311 (TCC); *Robinson Trust v. Canada,* 98 DTC 6065 (FCA).

[257] ITA, sec. 253.

[258] *Sudden Valley Inc. v. The Queen,* [1976] CTC 297 (FCTD), *aff'd* [1976] CTC 775 (FCA).

[259] *Pullman v. The Queen,* [1983] CTC 52 (FCTD).

[260] *See, e.g., Rutenberg v. MNR,* [1979] CTC 459 (FCA); *Abed v. The Queen,* [1982] CTC 115 (FCA).

[261] ITA, subsec. 4(1).

[262] ITR, sec. 808 and ITA, subsec. 219(1).

ISBN 978-1-63359-385-5

dends, the branch tax rate is reduced to that dividend rate.[263] Under the Canada-United States tax treaty, the rate of branch tax applicable to U.S. corporations carrying on business in Canada through a PE is 5%, and the first Can. $500,000 of profits are exempted from its application. The CRA's view is that certain hybrid entities (such as U.S. limited liability companies that are disregarded or treated as partnerships for U.S. federal income tax purposes) may be liable for 25% branch profits tax with no relief under the Canada-United States tax treaty. However, that position may not be upheld by the courts having regard to the Tax Court of Canada's decision in *TD Securities LLC v. The Queen*,[264] which held that a U.S. LLC with U.S. members could be entitled to treaty benefits (albeit for years prior to the Fifth Protocol coming into force).

In computing a nonresident's taxable income earned in Canada for a year, a loss from carrying on a business in Canada is only taken into account where the income of the business would not be exempt from Canadian income tax under the terms of a tax treaty.[265] Thus, income taxable in Canada cannot be offset with a loss from a treaty-protected business or property.[266]

b. Employment Income

A nonresident who was employed in Canada in the year or in a previous year is subject to tax on his or her income from the duties of offices and employment performed in Canada.[267] The reference to a prior year prevents avoidance of tax through deferred compensation arrangements.

Further, a nonresident individual who receives remuneration with respect to employment paid directly or indirectly by a Canadian resident and who had, in any previous year, been resident in Canada, may be subject to Canadian tax on such remuneration.[268] This is the case unless the remuneration is attributable to duties performed anywhere outside Canada and either:

(i) Is subject to income tax in a foreign country; or

(ii) Is paid in connection with the selling of property, the negotiation of contracts or the rendering of services for the employer (or a related person) in the ordinary course of the employer's business.

The rule extends as well to certain contract signing bonuses.

An illustration of this rule involves a U.S. resident who was taxed with respect to the exercise of a stock option he had received as an employee of a Canadian company. The taxpayer attempted, unsuccessfully, to demonstrate that the employment income generated by exercise of the option was not related to Canadian employment and, therefore, not subject to Canadian tax. Alternatively, he claimed an exemption under Articles VII (Business Profits) and VIII (Transportation) of the then applicable Canada-United States tax treaty. It was held that the benefit was realized as an employee of the Canadian company, although not received until after the employee was no longer a resident, and the amount was properly subject to tax.[269]

The provisions of a tax treaty can affect the taxation of nonresident employment income. Typically, such protection depends upon the duration of the employee's stay in Canada, the level of remuneration, and the source of the payments. For example, under Article XV (Dependent Personal Services) of the Canada-United States tax treaty, Canada will not tax a U.S. resident if the remuneration does not exceed Can. $10,000 in a calendar year, or the U.S. resident is present in Canada for less than 183 days in any 12-month period commencing or ending in the fiscal year concerned, and the remuneration is not paid by, or on behalf of, a person who is resident in Canada (and is not borne by a Canadian PE of the employer).

c. Capital Gains

A somewhat unusual feature of the Canadian income tax system is that nonresidents are also liable for Canadian tax if they dispose of "taxable Canadian property."[270] Thus, a disposition of the following types of property (or an option to acquire such property or an interest in such property) raises a potential liability to tax on capital gains:

(i) Real property situated in Canada;

(ii) Any other capital property used or held by a nonresident in a business carried on in Canada;

(iii) If the nonresident is an insurer, its designated insurance property for the year;

(iv) A share of a Canadian resident corporation or nonresident corporation that is not listed on a designated stock exchange, a partnership interest or an interest in a trust (other than a unit of a mutual fund trust or an income interest in a trust resident in Canada) if, at any time during the preceding 60-month period, more than 50% of the fair market value of such share or interest was derived, directly or indirectly, from one or any combination of: (I) real or immovable property situated in Canada; (II) Canadian resource property; (III) timber resource property; and (IV) options or interests in respect of the foregoing (the Value Requirement);

(v) A share of a Canadian corporation or a nonresident corporation that is listed on a designated stock exchange, a share of a mutual fund corporation or a unit of a mutual fund trust if, at any time during the 60 months preceding the disposition, the nonresident, alone or together with persons with whom the nonresident did not deal at arm's length, owned at least 25% of any class of the corporation's shares or the trust's issued units (the Ownership Requirement) and the Value Requirement is satisfied; and

(vi) An option with respect to, or an interest in, or for civil law a right in, a property described in (i) to (v), whether or not the property exists.

A nonresident is not liable to capital gains taxation on the disposition of "taxable Canadian property" that is excluded

[263] ITA, sec. 219.2.
[264] 2010 TCC 186 (TCC).
[265] ITA, para. 115(1)(c).
[266] Definitions in ITA, subsec. 248(1).
[267] ITA, para. 2(3)(a), subpara. 115(1)(a)(i).
[268] ITA, paras. 115(2)(c), (c.1), (d), (e).
[269] *Hurd v. The Queen*, [1981] CTC 209 (FCA).
[270] ITA, para. 2(3)(c), subparas. 115(1)(a)(iii) and 115(1)(b). The definition is in ITA, subsec. 248(1).

ISBN 978-1-63359-385-5

from Canadian tax under the provisions of an applicable tax treaty, which is referred to as "treaty-protected property." "Treaty-protected property" is defined as property, the income or gain from the disposition of which would be exempt from tax under Part I (Income Tax) of the Income Tax Act because of a Canadian tax treaty.[271]

Also, the disposition of certain property that, under Canadian principles, gives rise to ordinary income rather than capital gains also falls within the tax net applicable to nonresidents. For instance, the disposition by a nonresident of Canadian resource property, timber resource property, income interests in Canadian resident trusts and certain rights to the income of partnerships may generate income taxable in Canada.[272] The same applies to certain life insurance policies that give rise to income on disposition.[273] Recapture of capital cost allowance previously claimed, to the extent it is not already caught by the reference to business income, may also be taxed.[274]

To support the system of taxing nonresidents on "Canadian" capital gains, the Income Tax Act requires nonresidents who dispose of taxable Canadian property to send a notice containing certain information to the Canadian tax authorities.[275] Upon receipt of the notice and payment of an amount equal to 25% of any gain arising on the disposition (or provision of security acceptable to the Minister), the Canadian tax authorities issue a certificate indicating that payment on account of the nonresident's tax liability (or the provision of sufficient security) has been made.[276] If the certificate is not obtained, or if the limit set out in the certificate is less than the cost of the taxable Canadian property to the purchaser (which should generally equal the purchase price paid by the purchaser), the purchaser is entitled to withhold 25% of such cost (or, if a certificate with an insufficient limit has been issued, of the difference between the cost and the certificate limit), and is required to remit this amount to the Canadian tax authorities within 30 days after the end of the month in which the property was acquired. The purchaser is liable for this amount should he or she fail to withhold and remit, and may recover from the nonresident any amount paid by him or her on account of the tax.[277] Where a certificate has not been obtained and the proper withholding was not performed, the purchaser may be liable to a penalty equal to 10% of the amount that should have been withheld in addition to the amount that should have been withheld.[278] The process for obtaining a certificate is often times a lengthy one, so it may be advisable for a nonresident to apply for one well in advance of any proposed disposition of taxable Canadian property. Alternatively, in circumstances where the CRA is not able to timely review a request for a certificate the CRA may provide an informal "comfort letter" stating that penalties will not apply if the requisite withholding is not remitted within the 30-day period (particularly in circumstances where there may not be a taxable gain on the sale). In some cases, the nonresident vendor may not have the proceeds to pay the 25% tax prior to the completion of the disposition (and thus cannot obtain a certificate). In such cases, the CRA may provide an informal "comfort letter" to the nonresident which advises the purchaser to withhold and remit an amount equal to 25% of the nonresident vendor's gain from the disposition of the taxable Canadian property (rather than 25% of the total purchase price).

The certificate procedure extends, with some modifications, to dispositions of depreciable property, Canadian resource property and timber resource property, and of real property (other than capital property) situated in Canada. In these cases, the tax liability is less mechanically determined. Therefore, if Canadian tax is owing on the disposition, a certificate is obtained on payment of an amount "acceptable to the Minister [of National Revenue]."[279] Absent a certificate, the purchaser must withhold and remit 50% of the purchase price.[280]

In any case, a certificate may be obtained without payment if acceptable security is provided.[281] What is considered acceptable security is within the discretion of the CRA. Where treaty protection applies, suitable undertakings and representations by the vendor may be treated as acceptable security for this purpose. A nonresident vendor must generally demonstrate that it is resident in a tax treaty jurisdiction and is entitled to the benefits of the treaty. Thus, in some cases where treaty protection is available, certificates are obtained without payment on the provision of adequate evidence that no tax is ultimately owing due to a treaty exemption, coupled with an undertaking to pay any tax that is levied.

The jurisdiction of Canada to tax capital or other gains of nonresidents may be reduced by a tax treaty. Many recent treaties allow Canada to tax gains from the disposition of real property and business assets used in connection with a PE in Canada. Under some treaties, this jurisdiction also includes shares of corporations the principal asset of which is real property, or even shares of any Canadian corporation, if the nonresident owns 25% or more of the shares.

As noted in the discussion of capital gains at VIII.C.3.d., below, Canada deems a disposition of capital property to occur with the result that capital gain may be realized when a person ceases to be a resident of Canada. Where the taxpayer is an individual, certain property is excluded from the deemed disposition. Many of Canada's tax treaties preserve Canada's jurisdiction to tax residents of the treaty country who formerly resided in Canada. This prevents a former Canadian resident from avoiding tax on gains accrued on taxable Canadian property while he or she was resident in Canada by becoming a nonresident and then selling the property under protection of a tax treaty.

The cumulative lifetime capital gains exemption, discussed at VIII.C.3.b., below, is not available to nonresidents of Canada.

[271] Defined in ITA, subsec. 248(1).
[272] ITA, subparas. 115(1)(a)(iii.1), (iii.3), (iv) and (iv.1).
[273] ITA, subpara. 115(1)(a)(vi).
[274] ITA, subpara. 115(1)(a)(iii.2). See also ITA, subsec. 216(5).
[275] ITA, subsecs. 116(1) and 116(3).
[276] ITA, subsecs. 116(2) and 116(4).
[277] ITA, subsec. 116(5).
[278] ITA, subsec. 227(9).
[279] ITA, subsec. 116(5.2).
[280] ITA, subsec. 116(5.3).
[281] ITA, subsecs. 116(4), 116(5.2).

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d. Nonresident Withholding Tax

Certain other sources of income are subject to a flat rate tax on the gross amount of payments made to nonresidents, the collection of which is assured by withholding at source. Generally, this tax applies to property or investment income, and certain income from services that is regarded as having its source in Canada for these purposes (which may broadly apply to payments made to a nonresident in respect of services rendered in Canada).[282] For a more detailed discussion of this tax, see XI.F., below. Generally, however, the following payments, as well as amounts paid or credited "in lieu of" such payments, are subject to nonresident withholding tax:[283]

(i) Management or administration fees or charges;[284]

(ii) Interest;

(iii) Estate or trust income;

(iv) Rents, royalties, and, in certain cases, payments for information or services of an industrial, commercial or scientific character;

(v) Timber royalties;

(vi) Patronage dividends;

(vii) Pension and death benefits, retiring allowances, and similar payments;

(viii) Certain payments under a restrictive covenant (including noncompete payments);

(ix) Certain grants;

(x) Certain annuity payments; and

(xi) Dividends.

e. Part-Time Residents

In the case of an individual only, a special rule applies where the taxpayer is resident in Canada for one part of the year and during some other part of the year is not resident, employed or carrying on business in Canada.[285] In this case, the taxpayer's income for the period during which he or she was resident, employed or carrying on business is determined under the usual rules applicable to Canadian residents, and for the rest of the year, his or her income is determined under the rules applicable to nonresidents. Deductions such as personal exemptions are prorated based on the period of Canadian residence.

4. Global Minimum Tax

a. Global Minimum Tax Act

As a member of the G20/OECD Inclusive Framework, Canada has committed to implementing a 15% global minimum tax, which is the keystone of the G20/OECD's Pillar Two initiative. On June 20, 2024, Canada enacted the Global Minimum Tax Act (GMTA), which introduces two tax measures of the Pillar Two initiative: a 15% global minimum tax (a "top-up amount") under the income inclusion rule (IIR)[286] and a 15% domestic minimum top-up tax,[287] which are intended to be qualified IIR and qualified domestic minimum top-up tax (QDMTT) regimes, respectively.

The global minimum tax under the IIR and domestic minimum top-up tax applies for fiscal years of qualifying multinational enterprise (MNE) groups[288] beginning on or after December 31, 2023, provided that those MNE groups have:

(i) Consolidated revenue of at least 750 million euros that are reported in the consolidated financial statements[289] of the ultimate parent entity (UPE) in at least two of the four fiscal years immediately preceding fiscal years; and

(ii) Business presence in two or more jurisdictions.

The consolidated financial statements of the UPE should normally be prepared in accordance with an acceptable financial accounting standard,[290] meaning either the international financial reporting standards (IFRS) or the generally accepted accounting principles (GAAP) of the members of the European Union and the European Economic Area as well as the 14 leading economies, including Canada and the United States. Where the UPE does not apply an acceptable financial accounting standard, the consolidated financial statements must be adjusted to prevent material competitive distortions.[291] A material competitive distortion arises where an application of a specific principle or procedure results in an aggregate variation in excess of 75 million euros relative to the amounts that would have been determined if the corresponding IFRS principle or procedure were applicable.[292]

Governmental entities, international organizations, nonprofit organizations, and certain funds are excluded from the scope of the GMTA.[293] A qualifying MNE group can also be exempted from paying a tax under the GMTA with respect to its members or jurisdictions in which those members are located, as the case may be, if those MNE members or jurisdictions qualify for the *de minimis* exclusion[294] or a safe harbor, and the relevant elections are made on a timely basis.

On August 12, 2024, the Department of Finance released legislative proposals that encompass, among other things, the first set of amendments to the GMTA, including the undertaxed profit rule (UTPR) and the UTPR safe harbor.

The UTPR is the third tax measure under the G20/OECD's Pillar Two initiative that is intended to serve as a back-stop rule for the other two tax measures (i.e., a global minimum tax under the IIR and the QDMTT).

The UTPR safe harbor deems the top-up tax of the relevant entities located in the jurisdiction in which the ultimate parent entity (UPE) of the qualifying MNE group is located

[282] ITR, sec. 105.
[283] ITA, sec. 212.
[284] Usually exempted under Article VII of Canada's tax treaties as business profits.
[285] ITA, sec. 114.
[286] Part 2 of the GMTA.
[287] Part 3 of the GMTA.
[288] GMTA, sec. 9.
[289] GMTA, subsec. 2(1).
[290] *Ibid.*
[291] GMTA, subsec. 2(1), "consolidated financial statements", para. (c).
[292] GMTA, subsec. 2(1).
[293] GMTA, subsec. 13(1).
[294] GMTA, sec. 33.

  ISBN 978-1-63359-385-5

(UPE jurisdiction) to be nil, provided that the following conditions are fulfilled:

(i) An election for the UPE jurisdiction is made;

(ii) The corporate income tax rate of the UPE jurisdiction is at least 20%; and

(iii) The fiscal year begins before January 1, 2026 and ends before December 31, 2026.

The transitional UTPR safe harbor mitigates the impact of the Pillar Two rules with respect to jurisdictions that do not implement those rules but have high statutory income tax rates and are home to headquarters of large MNE groups (most notably, the United States).

The UTPR and UTPR safe harbor rules are proposed to apply to fiscal years of qualifying MNE groups that begin on or after December 31, 2024.

The GMTA is a standalone statute that conceptually follows the Global Anti-Base Erosion (GloBE) Model Rules released by the OECD on December 20, 2021, the related GloBE commentary and three sets of administrative guidance that were released before 2024.[295] In contrast to certain jurisdictions that have opted to incorporate the rules of the GloBE source documents by reference, Canada has re-designed the structure and text of the rules from the GloBE source documents to better align them with Canadian legal conventions and practices.

Although the approach adopted has many inherent advantages, it inevitably complicates cross-referencing of the GMTA provisions to the rules in the GloBE source documents that the GMTA intends to implement and is prone to inadvertent inconsistencies with those rules that can pose challenges in applying and interpreting the GMTA rules.

b. Interpretation

To facilitate the cross-referencing and interpretation of the GMTA rules, the Explanatory Notes released by the Department of Finance for the GMTA include a table of concordance for cross-referencing the relevant GMTA provisions with the GloBE source documents, as well as the usual provision-by-provision comments of the Department of Finance on the GMTA.[296] Generally, the commentary is limited to mere statements that the relevant GMTA provisions implement an analogous provision from a GloBE source document. The Explanatory Notes are helpful for connecting the "Canadianized" provisions in the GMTA with the model rules in the GloBE source documents on which those provisions are based, but otherwise have a limited value for in-scope MNEs and their advisors.

The GMTA includes an interpretation provision in subsection 3(1) that may assist in addressing the textual divergencies and inevitable inconsistencies between the GMTA and the GloBE source documents. Subsection 3(1) requires the provisions of Part 1 (Interpretation and Application), Part 2 (Global Minimum Tax) and relevant provisions of Part 5 (General Provisions, Administration and Enforcement) to be interpreted consistently with the GloBE source documents unless the context otherwise requires. Part 3 (Domestic Minimum Top-up Tax) is required to be interpreted consistently with the GloBE Commentary rather than all GloBE source documents. Part 4, which provides that Canada's domestic general anti-avoidance rule (GAAR) applies to the GMTA, does not have an interpretation provision.

c. The Income Inclusion Rule

A global minimum tax under the IIR is paid by UPEs, partially-owned parent entities (POPEs) and certain intermediate parent entities (IPEs) of qualifying MNE groups that are located in Canada[297] if and to the extent that:

(i) The effective tax rate (ETR) for a jurisdiction in which their directly or indirectly owned constituent entities, including permanent establishments (PEs), are located is less than 15%; and

(ii) There is an excess profit for that jurisdiction.

Although the ETR and global minimum tax are typically determined on a jurisdictional basis, in the case of certain entities or groups of entities the ETR is computed and a global minimum tax is determined on a standalone or group basis, as the case may be. Subject to some exceptions, no global minimum tax is payable if there is a loss for the jurisdiction or the relevant entity or group of entities, as the case may be.

The jurisdictional ETR[298] is determined by dividing the adjusted covered taxes of all constituent entities located in the jurisdiction by the net GloBE income of those constituent entities for that jurisdiction. The net GloBE income[299] is the positive difference between GloBE income and GloBE loss of the constituent entities located in the jurisdiction.

GloBE income or loss of a constituent entity is its after-tax financial accounting net income or loss as adjusted under the GMTA.[300] The financial accounting net income or loss is generally based on the constituent entity's financial accounts that are prepared under the acceptable financial accounting standard used to prepare the consolidated financial statements of the UPE of the qualifying MNE group. An exception from this general rule exists where it is reasonably practical to apply another acceptable financial accounting standard or an authorized financial accounting standard that is used to prepare financial accounts with reliable information, subject to adjustments for permanent differences in excess of one million euros to account for the use of an accounting standard that is different from the financial accounting standard used by the UPE.[301]

The term "authorised financial accounting standard" is defined in GMTA subsection. 2(1) as a set of generally acceptable accounting principles permitted by the body responsible for prescribing, establishing or accepting accounting standards for financial reporting purposes in the jurisdiction where the entity is located. Consolidation adjustments are ignored in determining the constituent entity's financial accounting net in-

[295] The GloBE Model Rules, GloBE Commentary and administrative guidance that OECD releases from time to time are hereinafter jointly referred to as the "GloBE source documents."

[296] Explanatory Notes Relating to the *Global Minimum Tax Act* (May 2024), online: https://fin.canada.ca/drleg-apl/2024/nwmm-amvm-0424-n-3-eng.html.

[297] GMTA, sec. 14.

[298] GMTA, subsec. 29(1).

[299] GMTA, subsec. 29(2).

[300] GMTA, sec. 16.

[301] GMTA, para. 17(1)(a).

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come or loss except where a tax consolidated group election is made.[302]

Net income or loss of a permanent establishment is normally determined in the financial accounts that are separate from the financial accounts of the main entity and are prepared (or should have been prepared) in accordance with an acceptable financial accounting standard, or an authorized financial accounting standard (as adjusted to prevent material competitive distortions).[303] It should include only income and expenses that are attributable to the permanent establishment and regardless of whether such income is subject to tax and expenses are tax deductible in the jurisdiction where the permanent establishment is located.[304]

Noteworthy adjustments to the after-tax financial accounting net income or loss to arrive at the GloBE income or loss include:[305]

(i) Excluded dividends and excluded equity gains or losses;

(ii) Certain anti-avoidance adjustments relating to transfer pricing and intra-group financing arrangements;

(iii) Certain tax credits;

(iv) Purchase price accounting adjustments;

(v) Revaluation method gains or losses;

(vi) Reorganization adjustments;

(vii) Asymmetric foreign currency gains or losses;

(viii) Stock-based compensation expenses; and

(ix) Prior period errors and changes in accounting principles.

The GloBE income or loss computations can also be impacted by various elections.

Adjusted covered taxes[306] is the second variable of the ETR calculations. Adjusted covered taxes include covered taxes[307] and deferred taxes (defined as the "total deferred tax adjustment amount,"[308] TDTAA) that are adjusted under the GMTA.

Covered taxes include income (profit) taxes and substitutes for such taxes that are allocated to constituent entities on the basis that covered taxes follow and match the income with respect to which they are incurred. Based on this general principle, covered taxes that are paid or withheld by one constituent entity can be attributed to another constituent entity for purposes of the GMTA. For example, covered taxes of the main entity that are paid with respect to the income of a PE are allocable to the PE. Likewise, covered taxes of a parent entity with respect to the income of a direct or indirect controlled foreign affiliate are allocable to that affiliate.

Covered taxes include neither a QDMTT nor a tax under the IIR or UTPR and are subject to numerous adjustments. For example, it is necessary to exclude taxes or a portion thereof that relate to income items excluded from GloBE income (for example, excluded dividends or excluded equity gains), or conversely to include eligible tax credits (for example, qualified refundable tax credits).

The TDTAA represents an adjusted or recast deferred tax expense that is taken into account in computing the adjusted covered taxes to eliminate the impact of temporary differences on the current income tax position of the relevant constituent entity. Doing so is necessary to prevent unintended GloBE outcomes where timing differences can produce an abnormally high ETR that inappropriately reduces or eliminates a global minimum tax, or an abnormally low ETR that gives rise to a global minimum tax in circumstances in which no tax would be due from a GloBE policy perspective.

If the jurisdictional ETR is less than 15%, a global minimum tax is typically due for the jurisdiction only if there is an excess profit for the jurisdiction. The excess profit for the jurisdiction[309] is a positive difference between the net GloBE income and the substance-based income exclusion (SBIE) amount, which is determined with reference to eligible payroll costs and the averaged carrying value of eligible tangible assets in the jurisdiction multiplied by the rate of 5%. Transitional rates apply for a period of 10 years, during which time they will gradually decrease from 10% for payroll and 8% for eligible tangible assets until they reach the regular 5% rate for fiscal years that begin in or after 2033.[310]

Even if there is a global minimum tax for the relevant jurisdiction under the IIR, it can be reduced or eliminated to the extent of a QDMTT that is paid in that jurisdiction.

d. Domestic Minimum Top-up Tax

A domestic minimum top-up tax is payable in Canada by constituent entities of qualifying MNE groups that are located in Canada[311] if:

(i) The ETR for Canada is less than 15%; and

(ii) There is excess profit for Canada.

The Canadian domestic minimum top-up tax is intended to be a qualified domestic minimum top-up tax with qualified domestic minimum top-up tax safe harbor status, and the Canadian rules on that tax are to be interpreted consistently with the GloBE Commentary.[312] The GloBE Commentary outlines special rules and requirements for a "qualified domestic minimum top-up tax"[313] that can be computed with reference to financial accounting income in the financial accounts that are prepared in accordance with either an acceptable financial accounting standard or an authorized financial accounting standard (as adjusted to prevent any material competitive distortions). This possibility is embedded in the "qualified domestic minimum top-up tax" definition in Article 10.1 of the GloBE Model Rules and is discussed further in the GloBE Commentary.

[302] GMTA, sec. 18(24).
[303] GMTA, para. 17(1)(b).
[304] GMTA, subsec. 17(2).
[305] GMTA, Part 2, Subdivision B.
[306] GMTA, subsec. 22(1).
[307] GMTA, subsec. 23(1).
[308] GMTA, subsec. 25(1).
[309] GMTA, subsec. 30(4).
[310] GMTA, sec. 49.
[311] GMTA, subsec. 51(1).
[312] GMTA, sec. 50.
[313] As determined per GMTA, subsec. 2(1), and Article 10.1 of the GloBE Model Rules.

ISBN 978-1-63359-385-5

The methodology for computing a domestic minimum top-up tax is consistent with the methodology for computing a global minimum tax under the IIR, as outlined above, subject to some minor adjustments prompted by the GloBE commentary, in particular Chapter 3 (QDMTT Safe Harbour) of Annex A thereto.[314]

The adopted approach is necessary to ensure that the Canadian domestic minimum top-up tax:

(i) Is functionally equivalent to and produces outcomes that are consistent with (or more onerous than) the global minimum tax under the IIR (which is necessary for a domestic minimum top-up tax to qualify as a QDMTT); and

(ii) Meets a set of additional standards necessary to qualify as a QDMTT with a safe harbor status.

e. *Safe Harbors*

The GMTA includes one transitional Country-by-Country Report (CbCR) safe harbor and three permanent safe harbors that are modelled with reference to the rules in Annex A to the GloBE commentary.

The transitional CbCR safe harbor[315] deems a top-up amount for the jurisdiction to be nil provided an election is filed[316] and certain requirements are met, including satisfaction of at least one of three simplified tests:

(i) *De minimis* test: the total revenue in the jurisdiction is less than 10 million euros and the pre-tax profit is less than 1 million euros (or there is a loss);[317]

(ii) Simplified ETR test: the simplified ETR is not lower than 15% (2023–2024), 16% (2025) or 17% (2026);[318] and

(iii) Routine profits test: the profit before income tax is equal to or less than the SBIE amount (or there is a loss).[319]

To access the transitional CbCR safe harbor, a qualifying MNE group must file either a CbCR with respect to the jurisdiction, or, where there is no obligation to file a CbCR, a GloBE information return (GIR, described below) for the relevant fiscal year provided section 2.2.1.3(a) is completed using the data from qualified financial statements.[320] The latter generally means the financial accounts that are either used to prepare the consolidated financial statements of the UPE, or prepared in accordance with an acceptable financial accounting standard or authorized financial accounting standard provided that the information in those accounts is maintained based on that accounting standard and is reliable.[321]

The transitional CbCR safe harbor applies to fiscal years that begin before January 1, 2027 and end before July 1, 2028.[322]

Of the three permanent safe harbors in the GMTA, the QDMTT safe harbor is the most important.

The QDMTT safe harbor deems a top-up amount of a constituent entity or a joint venture entity located in the jurisdiction with a qualified domestic minimum top-up tax to be nil provided an election is filed with respect to the relevant entity.[323] To be able to rely on the QDMTT safe harbor, the jurisdiction's QDMTT must have safe harbor status (which includes transitional qualified status) and be included in the list of jurisdictions with the QDMTT safe harbor status that is posted on the OECD's website. Finally, the constituent entity must be permitted under the GloBE source documents to elect to use the QDMTT safe harbor, which includes the requirement that the "switch-off rule" set out in Chapter 3 of Annex A to the GloBE commentary does not apply to the entity concerned.[324]

In contrast to the transitional CbCR safe harbor that applies to each jurisdiction and covers all entities located therein, the QDMTT safe harbor operates on an entity-by-entity basis.

The two other permanent safe harbors are the simplified calculations safe harbor[325] and the non-material constituent entity (simplified calculations) safe harbor.[326]

f. *General Anti-Avoidance Rule*

The Canadian GAAR in section 245 of the ITA applies to the GMTA, subject to "any modifications that the circumstances require."[327]

The 25% GAAR penalty in subsection 245(5.1) of the ITA applies to transactions that occur on or after June 20, 2024.

The mandatory disclosure rules in the ITA are also extended to the GMTA with respect to the voluntary filing of an information return under the mandatory disclosure rules (as discussed in XI.C.1., below).[328] Where such a voluntary disclosure is made, the GAAR penalty will not apply to the disclosed transaction or series of transactions.[329]

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[314] GMTA, sec. 52.
[315] GMTA, sec. 47.
[316] GMTA, subsec. 47(2).
[317] GMTA, subsec. 47(3).
[318] GMTA, subsesc. 47(4) and 47(5).
[319] GMTA, subsec. 47(6).
[320] GMTA, para. 47(2)(b).
[321] GMTA, subsec. 47(1).
[322] GMTA, para. 47(2)(a).
[323] GMTA, sec. 44.
[324] GMTA, sec. 44.
[325] GMTA, sec. 45.
[326] GMTA, sec. 46.
[327] GMTA, subsec. 54(1).
[328] GMTA, para. 54(2)(a).
[329] GMTA, para. 54(2)(b).

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g. Reporting and Compliance

A GloBE information return (GIR) must be filed in Canada by:[330]

(i) The UPE of an MNE group that is located in Canada;

(ii) A designated filing entity (in lieu of the UPE) located in Canada; or

(iii) If neither circumstance (i) nor (ii) applies (for example, because the UPE and designated filing entities are not located in Canada), each constituent entity located in Canada (or a designated local entity).

Where a GIR is filed by a qualifying foreign filing entity with a foreign tax authority, the CRA must be notified of such filing by each constituent entity located in Canada,[331] or by the designated notification entity located in Canada,[332] as the case may be.

GIRs must be filed within 15 months after the end of the fiscal year, with the exception of the first GIR, which is due within 18 months but not earlier than June 30, 2026.[333]

Taxpayers must file tax returns with estimates of their tax liabilities under Part 2 (Global Minimum Tax)[334] and Part 3 (Domestic Minimum Top-up Tax)[335] on or before the GIR due date.

All top-up amounts are paid in Canadian dollars.[336] Currency conversion is normally effected using the average for the fiscal year of the daily rates of exchange as quoted by the Bank of Canada.[337]

h. Assessments and Appeals

The assessment limitation period is seven years starting on the latter of the following two dates:[338]

(i) The date on which the relevant return is filed; and

(ii) The date on which the Minister receives the GIR.

The assessment limitation period does not apply if there is:[339]

(i) Misrepresentation attributable to neglect, carelessness or willful default; or

(ii) Fraud in filing a return, applying for a refund or providing any information under the GMTA.

Taxpayers have 90 days to object to a notice of assessment.[340] A one-year extension is allowed at the discretion of the Minister of National Revenue if a notice of objection is not filed on a timely basis.[341] A taxpayer can ask the Tax Court of Canada to grant the extension if the Minister of National Revenue has refused the extension application, or 90 days have elapsed following that application and the Minister fails to notify the taxpayer of her decision.[342]

A taxpayer can appeal to the Tax Court of Canada if the Minister of National Revenue:

(i) Confirms the assessment or reassesses in response to the objection; or

(ii) 180 days have passed since the objection was filed and the Minister has not notified the taxpayer of her decision.[343]

i. Enforcement

A penalty of Can. $25,000 per month (up to a maximum of Can. $1,000,000, being 40 months) applies for:

(i) Failing to file a GIR on a timely basis;

(ii) Filing a substantially incomplete GIR; or

(iii) Failing to notify the CRA of the GIR if it was filed in a foreign jurisdiction.[344]

A penalty of 5% of unpaid tax (plus an additional 1% per month late for a maximum of 12 months) applies for late-filing of Part 2 (Global Minimum Tax) and Part 3 (Domestic Minimum Top-up Tax) returns.[345]

A penalty of up to 10% of the disputed amount applies where the taxpayer files an "unreasonable appeal," meaning:[346]

(i) The court concurs with CRA that one of the main purposes for instituting or maintaining the appeal was to defer a GMT payment; and

(ii) The court determines there were no reasonable grounds for the appeal.

Finally, the GMTA includes onerous consequences in the form of both imprisonment (ranging from 12 months to five years) and fines[347] for various offences under the GMTA. A due diligence defense is available under the GMTA,[348] presumably in addition to any common-law due diligence defense that might otherwise be available against criminal charges.

C. Computation of Income

Under the Income Tax Act, tax payable is computed by applying a percentage rate or, in the case of an individual, a series of progressive marginal rates, to the taxpayer's "taxable income" (or, in the case of a nonresident, the nonresident's "taxable income earned in Canada"). "Taxable income" is determined by making certain deductions from "income." The computation of the latter is, therefore, the starting point for the determination of tax. In this section, the computation of income is considered by examining the more common sources of income. It should be recalled, however, that Canadian residents are liable to tax on income from all sources worldwide, subject to the foreign tax credits[349] and Canada's tax treaties with oth-

[330] GMTA, subsec. 60(1).
[331] GMTA, subsec. 60(4).
[332] GMTA, subsec. 60(5).
[333] The definition of "GIR due date" in GMTA, subsec. 55(1).
[334] GMTA, subsec. 61(1).
[335] GMTA, subsec. 61(2).
[336] GMTA, subsec. 68(1).
[337] GMTA, subsec. 68(2).
[338] GMTA, sec. 85(1).
[339] GMTA, subsec. 85(2).
[340] GMTA, subsec. 87(1).
[341] GMTA, sec. 88.
[342] GMTA, subsec. 89(1).
[343] GMTA, subsec. 90(1).
[344] GMTA, subsec. 98(1).
[345] GMTA, subsec. 99(1).
[346] GMTA, sec. 101.
[347] GMTA, secs. 106–110.
[348] GMTA, sec. 111.
[349] ITA, sec. 126.

ISBN 978-1-63359-385-5

er countries. Tax on nonresidents is limited to Canadian-source income.[350]

1. *Employment and Similar Income*

Income from an office or employment is defined as the salary, wages and other remuneration, including gratuities, received by the taxpayer in the year.[351] "Office" means the position of an individual entitling the individual to a fixed or ascertainable remuneration, while "employment" means the position of an individual in the service of some other person (including a government).[352] For greater certainty, the statute itemizes various categories of benefits or forms of remuneration that are specifically included in computing income from an office or employment. Only certain specific statutory deductions are allowed in computing income from an office or employment.[353]

Because of the severe limitation on deductions available in computing income from employment, there has been a fair amount of litigation instigated by taxpayers seeking to classify their revenue as income from a business rather than salary. The leading case on this issue states that a determination of whether a taxpayer is an employee or independent contractor must be made taking into account all the facts surrounding the relationship between the taxpayer and the persons receiving the taxpayer's services.[354] In examining this relationship, the Court developed a four-part test that looks at the level of control over the taxpayer, and the taxpayer's ownership of tools, chance of profit and risk of loss.

Regarding the withholding requirements imposed on employers, see VII.F., above.

a. *Benefits and Remuneration*

(1) *In General*

Included in computing income from employment is the value of board, lodging and other benefits of any kind (excluding certain pension, insurance or other plans, specifically addressed in VIII.C.1.c., below) received or enjoyed by a taxpayer in the year with respect to, in the course of or by virtue of, an office or employment.[355] This broad inclusion of benefits has been used to reach the many possible "fringe benefits," all of which could not possibly have been specifically dealt with. Notwithstanding the breadth of this provision, however, the CRA has exercised a certain degree of restraint in its application. It has done so by interpreting what, administratively, will be considered a "benefit." The following list reflects the views of the tax authorities:[356]

Taxable Benefit	Non-Taxable Benefit
Board and lodging	Discounts on merchandise
Rent-free and low-rent housing	Transportation passes
Gifts (other than certain undeducted gifts under a threshold amount)	Uniforms and special clothing
Holiday trips and other prizes	Subsidized school services
"Frequent flyer" program credits	Subsidized meals
Premiums under government health plans	Transportation to the workplace
Employer paid educational costs	Recreational facilities
Traveling expenses of employee's spouse	Moving expenses
Reimbursement of cost of tools	Premiums under private health plans
Certain wage loss replacement plans	Health counselling services
Financial counselling fees	Professional membership fees

The Income Tax Act covers some of these items, while others have been drawn from the case law. For example, holiday trips have been considered in a number of cases and a benefit equal to the value thereof included in the employee's income; indeed, this is the case even where the benefit flows not from the direct employer but from a manufacturer.[357] On the other hand, the courts have held that the reimbursement of moving expenses does not give rise to income. In one case, a reimbursement for the loss incurred on the sale of a house necessitated by a transfer was held non-taxable.[358]

(2) *Automobile Use*

In view of the difficulty of valuing the benefit of an employer-supplied vehicle, statutory rules replace the general employee benefit principles.

Where an employer makes an automobile available to an employee or a related person, an amount as a reasonable standby charge for the number of days in the year during which it was so available is included in computing income. This amount, however, is reduced by amounts actually paid by the employee to the employer for use of the automobile.[359] Essentially, the minimum reasonable standby charge is, where the employer owned the automobile, its capital cost multiplied by 2% per month of ownership, and where the automobile is leased, two-thirds of the lease cost.[360]

A reasonable allowance paid to an employee for the use of a motor vehicle for traveling in the performance of his or her employment duties is not included in the employee's income as

[350] ITA, subsec. 2(3), secs. 212 and 216–219.
[351] ITA, sec. 5.
[352] ITA, subsec. 248(1).
[353] ITA, sec. 8.
[354] *Wiebe Door Services Ltd. v. MNR,* 87 D.T.C. 5025.
[355] ITA, para. 6(1)(a).
[356] T4130(E) Rev. 22, "Employers' Guide: Taxable Benefits and Allowances" (November 24, 2022), is applicable while Income Tax Folio S2-F3-C2, "Benefits and Allowances Received from Employment" is being reviewed.
[357] *Waffle v. MNR,* [1968] CTC 572.
[358] *Ransom v. MNR,* [1967] CTC 346.
[359] ITA, para. 6(1)(e).
[360] ITA, subsec. 6(2).

ISBN 978-1-63359-385-5

a taxable benefit. To be considered "reasonable," an allowance must be based on the number of business kilometers driven.[361] Similarly, the employer may deduct such an allowance in calculating his or her income in accordance with annually adjusted prescribed rates per kilometer driven.[362]

(3) Interest-Free and Low-Interest Loans

An employee must include in income an amount as an employment benefit deemed received where he or she receives a low-interest or interest-free loan by virtue of one's employment. The benefit takes the form of deemed income equal to a prescribed rate of interest less any interest actually paid by the employee.[363]

The benefit is deemed to be an amount paid as interest by the employee on borrowed money.[364] Accordingly, a balancing deduction may be available where the borrowed funds are used to earn income, for example, to purchase shares under employee stock participation plans.

(4) Lump-Sum Payments

Income from employment includes an amount received by one person from another while the former was employed by the latter or in satisfaction of an obligation arising out of an agreement made immediately before, during or immediately after a period of employment. An exception is made if it can be shown that the payment cannot be reasonably regarded as having been received wholly or partly as consideration for accepting employment, as remuneration for services rendered, or in consideration for a covenant to do (or not to do) something before or after the termination of employment.[365]

This provision ensures taxation of all employment-related benefits whenever paid. Taxpayers have attempted to circumvent this rule by clothing such payments with the marks of an acquisition of capital assets. For example, one of two brothers sold his shares in a family business of which he was an employee to the other for a lump sum payable over 10 years, seeking to attribute the full amount to the purchase price of the shares rather than a covenant not to compete. He was unsuccessful. The amount payable was treated as employment income.[366]

(5) Stock Options

A popular incentive is the stock option plan whereby an employee receives a right to purchase shares of the employer company, or a parent or affiliate, at a fixed price. For many years the Income Tax Act has taxed the value of the benefit received with respect to such an option as employment income.[367]

The general rule is that the difference between the value of shares when acquired and the option price is deemed to have been received by virtue of employment in the year in which the shares are acquired on the exercise of the option (whether or not the taxpayer is an employee at that time). Similarly, where the option rights are transferred, the consideration received is taxed as employment income. In certain cases, the recognition of the benefit may be deferred until the tax year in which the employee disposes of or exchanges the shares.

Where the stock option is granted by a "Canadian-controlled private corporation" (CCPC — defined at VIII.E.3.b., below) to an arm's-length employee, the inclusion of the benefit in the employee's income is deferred until the tax year in which the employee disposes of or exchanges the shares.[368]

A deduction equal to one-half of the benefit required to be included in the employee's income is permitted in certain circumstances. In effect, this deduction gives the employee capital gains treatment with respect to the deemed benefit. Arm's-length employees are generally entitled to deduct one-half of the deemed benefit provided the share is a "prescribed share" (essentially, a common share) and the option price was not less than the fair market value of the share at the time the relevant agreement was entered into.[369]

Where the employee surrenders an option for cash in lieu of exercising it, the paragraph 110(1)(d) deduction may be available in certain circumstances. An employee will generally be prevented from claiming the deduction under paragraph 110(1)(d) unless the employer elects in the prescribed form to forgo a corporate deduction for the cash payment.

However, based on the 2011 decision of the Federal Court of Appeal in *Imperial Tobacco Canada Ltd. v. The Queen*,[370] cash payments made on the surrender of options in the context of a corporate takeover may not be deductible (leave to appeal the case further to the Supreme Court of Canada was denied, so the Court of Appeal decision is final for this case). An employer may reduce the exercise price stipulated in the original agreement without prejudicing the employee's right to the deduction if certain conditions are fulfilled.[371]

Thus, to take advantage of these provisions, care should be taken to ensure that options issued to employees are not "in the money" at the time of issuance. Similarly, an employee of a CCPC deemed to have received a benefit in the year he or she disposes of or exchanges a share can deduct one-half of the deemed benefit, provided the employee does not dispose of or exchange the share within two years of acquiring it.[372]

Withholding and remittance of income tax must be made in respect of stock option benefits to the same extent as if the amount of the benefit had been paid to the employee as a cash bonus.[373] Subsection 153(1.31) precludes the Minister of National Revenue from waiving a withholding requirement in respect of a stock option benefit solely because it is received as a non-cash benefit. However, the employer's withholding and remittance obligations do not generally extend to any portion of the benefit that is deductible by the employee under paragraph 110(1)(d) of the ITA (in which case, the amount of the benefit subject to withholding may be reduced by one-half) or to a benefit resulting from stock options granted by CCPCs.

[361] ITA, para. 6(1)(b).
[362] ITA, para. 18(1)(r); ITR, sec. 7306.
[363] ITA, sec. 80.4.
[364] ITA, sec. 80.5.
[365] ITA, subsec. 6(3).
[366] *Richstone v. MNR*, [1974] CTC 155.
[367] ITA, subsec. 7(1).
[368] ITA, subsec. 7(1.1).
[369] ITA, para. 110(1)(d).
[370] 2012 DTC 5003 (FCA).
[371] ITA, subsecs. 110(1.7), (1.8).
[372] ITA, para. 110(1)(d.1).
[373] ITA, subsection 153(1.01).

ISBN 978-1-63359-385-5

For capital gains tax purposes, the full value of the benefit taxed to the employee is added in computing the employee's adjusted cost base of the shares.[374]

Effective as of July 1, 2021, employee stock options granted by an employer that is not a Canadian-controlled private corporation (CCPC) and has annual gross revenue of more than Can. $500 million ("non-qualified options") will be subject to a Can. $200,000 annual cap in respect of the employee stock option deduction based on the fair market value of the underlying shares at the times the option is granted.[375] The cap will apply to non-qualified options that become vested in the same calendar year to the extent that the fair market value of the optioned shares under those options at the time of their grant is more than Can. $200,000. This is similar to the U.S. $100,000 annual cap that applies to incentive stock options under the U.S. Internal Revenue Code.[376] To the extent that the option benefit realized in a tax year exceeds the Can. $200,000 annual cap, the employer that granted the options may be entitled to deduct the amount of such excess. No annual limit is contemplated for employee stock options granted by a CCPC or a non-CCPC with annual gross revenue of less than Can. $500 million.

b. Deductions

Employees often consider themselves the least favored of Canadian taxpayers due to the paucity of deductions available to them in computing income. Unlike those whose income is derived from a business or property, employees generally cannot deduct expenses incurred to earn their income.[377] Rather, employees are limited to certain statutory deductions. Deductions permitted include legal expenses incurred to collect any amount owed to the employee that, if received, would be included in his or her income from an office or employment,[378] and certain expenses of salesmen, transportation employees and others who must travel in connection with their employment.[379]

Other deductions available to all taxpayers include deductions for alimony and maintenance payments,[380] and expenses of objections or appeals from income tax assessments.[381] Deductions are also allowed for moving expenses incurred by employees (and students) in certain cases and for a limited amount with respect to childcare expenses.[382]

All taxpayers with "earned income" (essentially, employment or business income or income from renting real property) may make deductible contributions up to certain specified limits to private pension plans, known as registered retirement savings plans (RRSPs).[383]

c. Deferred and Special Compensation and Tax-Free Savings Accounts

Subject to a number of conditions established by the CRA, employers may establish registered pension plans to which deductible employer and employee contributions may be made.[384] The employee contribution is deductible up to an annual limit that, combined with any employer contribution, cannot exceed the prescribed comprehensive limit for the particular year, discussed in more detail below. Benefits received from the plan, whether lump sum or periodic, are taxable.[385] Among the more important administrative requirements is the refusal to register most foreign plans. This often entails a tandem Canadian fund for Canadian employees within a multinational group.

The Income Tax Act also recognizes certain profit-sharing plans, either ordinary or deferred. An employee profit-sharing plan is an arrangement whereby profits are allocated to specific employees, either contingently or absolutely, and are taxable as allocated.[386] A deferred profit-sharing plan may be registered if certain conditions are met, and the taxability of benefits is deferred until receipt.[387]

An integrated system of tax assistance for retirement savings has been in place since 1991. Under this system, a uniform comprehensive "contribution limit" is imposed. Employers sponsoring registered pension plans or deferred profit-sharing plans are annually required to report a pension adjustment for each plan member, reflecting the benefits accruing to the member for the year. The pension adjustment is subtracted from the plan member's comprehensive limit to determine the deductible RRSP contribution that the plan member may make for the following year. The comprehensive annual limit is the lesser of 18% of the previous year's earned income and a stated limit, which is Can. $32,490 for 2025.[388]

The rules dealing with deferred compensation plans are fairly strict and intended to prevent any tax assistance on deferred compensation outside the limits set by the statute.

Certain anti-avoidance rules exist to deal with issues associated with the use of RRSPs in tax planning schemes. These rules include taxing certain advantages received under RRSPs at their fair market value and subjecting certain "prohibited investments" and "non-qualified investments" to a tax of 50% when they are acquired or held by the plan.

The rules restrict an employer's ability to defer the recognition of employment income through the use of a "salary deferral arrangement" (SDA). An SDA is, essentially, a plan (funded or unfunded) under which an employee has a right to receive an amount in a later year, if that right exists to postpone tax on an amount that effectively is salary or wages of the employee for services rendered in the current year or an earlier year. The rules generally require the "deferred amount" to be included in the employee's income as a benefit received in the current year[389] and permit the employer to deduct that amount

[374] ITA, para. 53(1)(j).
[375] ITA, subsecs. 110(1.3)–(1.44).
[376] I.e., I.R.C. §422.
[377] ITA, subsec. 8(2).
[378] ITA, para. 8(1)(b).
[379] ITA, paras. 8(1)(e), (f), (g), (h).
[380] ITA, para. 60(b), sec. 60.1.
[381] ITA, para. 60(o).
[382] ITA, secs. 62, 63.
[383] ITA, para. 60(i), sec. 146.
[384] ITA, paras. 8(1)(m), 20(1)(q).
[385] ITA, subpara. 56(1)(a)(i).
[386] ITA, sec. 144.
[387] ITA, sec. 147.
[388] ITA, subsecs. 146(1) and 147.1(1).
[389] ITA, subsec. 6(11), para. 6(1)(a).

ISBN 978-1-63359-385-5

currently.[390] However, the SDA rules do not apply to certain deferred amounts under plans established primarily for the benefit of nonresident employees with respect to services to be rendered outside Canada.

The SDA rules have severely restricted the use of the once common non-statutory deferred compensation plans, under which employers undertook to make future payments to employees if certain conditions were met. The Income Tax Act now provides that a "deferred amount," for purposes of the SDA rules, includes an amount that an employee has a right to receive where that right is subject to one or more conditions, unless there is a substantial risk that the condition(s) will not be satisfied.

A special tax regime deals with funded "retirement compensation arrangements" (RCAs). An RCA is a plan under which an employer makes payments to a custodian in connection with benefits that are to be, or may be, paid to an employee on, after, or in contemplation of his or her retirement or termination. Employer contributions are currently deductible.[391] Contributions and income earned thereon are subject to a special 50% refundable tax.[392] As benefits are paid out of the plan, the employee is taxed on those he or she receives,[393] and the special 50% tax is refunded. An RCA is defined to exclude a plan maintained primarily for the benefit of nonresidents with respect to services rendered outside Canada. However, a special rule deems a separate "resident's arrangement" to exist (to which the RCA rules apply) where contributions under such a plan are made with respect to services rendered by an employee who was resident in Canada at the time the services were rendered and, if the employee was a member of the plan before becoming so resident, for more than 60 of the 72 months before the time the services were rendered.

An employee benefit plan is an arrangement under which an employer makes contributions to a custodian and under which payments are to be made to or for the benefit of employees. SDAs and RCAs are excluded from this definition. Generally, an employer may make unlimited non-deductible contributions to an employee benefit plan. The employee is taxed and the employer obtains a deduction when amounts are paid out of the plan.[394]

Canada also has a special registered savings account referred to as the "Tax Free Savings Account" (TFSA), which generally permits taxpayers to invest after-tax dollars, with any income or capital gains earned within the TFSA not being subject to tax.[395] As of 2025, a taxpayer may contribute up to Can. $7,000 per year to this plan, with any unused contribution room carrying over to a future year. Prior yearly contribution limits have ranged from $5,000 to $10,000. In addition, unlike the RRSP, any withdrawals from a TFSA increase the taxpayer's unused contribution room, although the increase does not take effect until the taxpayer's next tax year following the withdrawal.

The "Tax-Free First Home Savings Account" is a new tax-free savings account specifically designed to assist first-time Canadian homebuyers with saving the down payment for purchasing a new home. This account permits up to Can. $40,000 of tax-deductible contributions and the tax-free withdrawal of funds (including any earned investment income on contributions) to make qualifying first home purchases.

d. Termination of Employment

Death benefits and retirement allowances are taxable when received.[396] The definition of "death benefit"[397] is such that, effectively, up to Can. $10,000 or the amount received by the beneficiary, whichever is less, is not taxed.

"Retiring allowances" include amounts received on or after retirement in recognition of long service, as well as any payment for loss of office.[398] The latter inclusion effectively reverses a line of cases that held that certain termination payments were non-taxable. Retiring allowances may, to a limited extent, be rolled over tax-free to a RRSP.[399]

2. Income from Business or Property

Though on occasion it may be important to know whether income is from a business, from property, from both or from some other source, in view of the taxation of worldwide income under the Income Tax Act, the distinction is generally of less importance than the breadth of the concepts themselves. The difference between income from such sources as these and capital gains remains important due to the different regime of taxation that applies to the latter. Capital gains are discussed in greater detail in VIII.C.3., below.

a. Accounting for Profit

A taxpayer's income for the year from a business or property is the profit therefrom for the year.[400] Profit from a business or property is the result of reducing gross profit, i.e., sales less cost of goods sold, by various outlays and expenses incurred to earn the income. The Supreme Court of Canada has indicated that in ascertaining profit, taxpayers are free to adopt any method that is not inconsistent with the provisions of the Income Tax Act, established case law principles and well-accepted business principles.[401] Generally accepted accounting principles (GAAP) are not rules of law and, more generally, GAAP is simply one of the interpretative aids that can be used to determine income for tax purposes. Further, the goal in computing profit is defined to be the presentation of an accurate picture of the taxpayer's profit.

The precise scope of the generally accepted commercial practice has long been a subject of debate. Certain well-recognized and accepted accounting principles have been rejected by the courts, such as last-in-first-out (LIFO) accounting.[402] However, while a number of clearly reasoned early cases made a sharp distinction between commercial principles and the codi-

[390] ITA, para. 20(1)(oo).
[391] ITA, para. 20(1)(r).
[392] ITA, Part XI.3.
[393] ITA, para. 56(1)(x).
[394] ITA, para. 6(1)(g), sec. 32.1.
[395] ITA, sec. 146.2.
[396] ITA, subpara. 56(1)(a)(ii), (iii).
[397] ITA, subsec. 248(1).
[398] ITA, subsec. 248(1), definition of "retiring allowance."
[399] ITA, subsec. 60(j.1).
[400] ITA, sec. 9.
[401] *Canderel Ltd. v. The Queen*, 98 DTC 6100 (SCC).
[402] *MNR v. Anaconda American Brass Ltd.*, [1954] CTC 319.

ISBN 978-1-63359-385-5

fied practices of the accounting profession, i.e., GAAP, the precise scope for GAAP in the computation of income remained for many years a subject of dispute. For example, while courts sometimes firmly rejected any "matching principle,"[403] in other cases matching appeared to be raised almost to the status of a legal principle.[404]

In a trilogy of cases, the Supreme Court of Canada classified the status of GAAP and outlined the guiding principles for the computation of income for tax purposes.[405] The cases all concerned tenant inducement payments, and the timing of the deduction and inclusion in income for both the landlord and the tenant. The Court decided that an immediate deduction and income inclusion were appropriate, but of more importance were comments made regarding the essential basis of tax accounting in such circumstances. The analysis led to the enunciation of certain principles or guidelines that may be useful in other cases:

> (i) The determination of profit is a question of law. Since the word "profit" is used in the statute, its meaning must be determined by the court in any particular circumstance and cannot be proven by facts, including evidence of GAAP or other accounting treatment.
>
> (ii) The profit of a business for a tax year is the revenue from the business less the expenses incurred to earn it.
>
> (iii) In seeking to ascertain profit, the goal is to obtain "an accurate picture" of the taxpayer's profit for the given year.
>
> (iv) In ascertaining profit, the taxpayer is free to adopt any method that is not inconsistent with the provisions of the statute, established case law principles that may apply to a particular type of income or income-earning process, and well-accepted business principles.
>
> (v) Such well-accepted business principles, which include but are not limited to GAAP, are not rules of law but interpretive aids. They can influence the calculation of income only on a case-by-case basis.
>
> (vi) On reassessment, once the taxpayer has shown that he or she has provided an accurate picture of income for the year, consistent with the Income Tax Act, case law and well-accepted business principles, the onus shifts to the Minister of National Revenue to show either that the figure provided does not represent an accurate picture, or that another method of computation would provide a more accurate picture.

In response to concerns with avoidance through tax shelter arrangements, the matching principle has been incorporated in the Income Tax Act in the context of defined "matchable expenditures."[406] In essence, the matchable expenditure rules are designed to prevent the immediate deduction of payments made in consideration for a right to receive other payments in the future from another person's business or property. The transactions that gave rise to the perceived need for such a rule involved advance funding of deferred commissions of mutual fund distributions.

In the case of business income, the accrual basis of computing profit is generally mandated by the Income Tax Act. More precisely, the Act provides that in computing income from a business for the year, any amount receivable with respect to property sold and services rendered in the course of the business in the year must be included, notwithstanding that the amount may not be due until a subsequent year. Similarly, amounts are taxable in the year if received in the year in the course of a business even if on account of services not rendered or goods not yet delivered before the end of the year (subject to a reserve requirement, discussed below).[407]

Thus, as a rule, amounts are included in computing income if received or receivable. The inclusion of receivables is, however, subject to the caveat that where the method adopted by the taxpayer for computing income from the business, and accepted by the tax authorities, does not require one to include such a receivable in computing income for a year unless it has been received, then this system will govern.

This exception to accrual accounting is, in fact, a concession to commercial practice. In certain industries, a method of accounting other than the accrual basis has been accepted over the years and continues to govern. Thus, for example, the CRA has recognized that certain taxpayers in the construction industry may more accurately compute their profit on a completed contract or other basis.[408] Similarly, a limited number of taxpayers continue to bring their profits to account under a cash method, reporting revenue and expenses as received and disbursed.

The cash basis is recognized under the Income Tax Act, but only for taxpayers carrying on a farming or fishing business.[409] Special rules apply to prevent those in farming from changing their accounting basis. Where the business is carried on jointly by several persons, each must have elected to have his or her income computed on a cash basis if any are to do so.

b. Tax Year

Income is reported based on a "taxation year," which, in the case of a corporation, is a fiscal period; in the case of an individual, a calendar year; and, in the case of a testamentary trust, the period for which the accounts of the trust are made up for purposes of assessment under the ITA.[410] Though an individual always reports income on a calendar year basis, a business of which he or she is the sole proprietor, or that is carried on by a partnership of which he or she is a member, may have a different fiscal period.

Generally, the fiscal period of a business means the period for which its accounts have been ordinarily made up and accepted for purposes of assessment and, in the absence of an established practice, the fiscal period is that adopted by the taxpayer, subject to the restriction that no fiscal period may exceed, in the case of a corporation, 53 weeks or, in the case

[403] *The Queen v. Oxford Shopping Centres Ltd.*, [1981] CTC 128.

[404] *West Kootenay Power and Light Co. v. The Queen*, (1991) 92 DTC 6023.

[405] *Canderel Ltd. v. The Queen*, 98 DTC 6100 (SCC); *Toronto College Park Ltd. v. The Queen*, 98 DTC 6088; *Ikea Limited v. The Queen*, 98 DTC 6092.

[406] ITA, sec. 18.1.

[407] ITA, paras. 12(1)(a), (b).

[408] Interpretation Bulletin IT-92R2 (12/29/83).

[409] ITA, sec. 28.

[410] ITA, sec. 249.

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of any other taxpayer, 12 months.[411] Also, the fiscal period of an individual, *inter vivos* trust, certain partnerships or a professional corporation must not end after the end of the calendar year in which the period began (other than in the case of a business carried on outside Canada and certain other limited exceptions). Once a fiscal period is established, it may not be changed for tax purposes without the concurrence of the Minister of National Revenue.

As an adjunct to certain loss streaming and stop loss rules discussed in VIII.D.6.e., below, a corporation has a deemed year-end immediately before the acquisition of control of the corporation by a person or group of persons.[412] Control generally means ownership of a sufficient number of shares to elect a majority of the board of directors and extends through a chain of corporations. Thus, the acquisition of control of a corporation constitutes the acquisition of control of all of the direct and indirect subsidiaries of that corporation.

c. Inventory

Inventory is valued at the lower of cost or market value. Opening inventory must be valued at the same amount as closing inventory of the preceding year.[413] Certain adjustments are made to the inventory valuation of land with respect to interest and property taxes that are disallowed as current expenses. Where the business is an adventure in the nature of trade, the inventory must be valued at the cost at which the property was acquired.[414]

The determination of value for inventory accounting may raise a number of issues — such as obsolescence and use of replacement cost. "Cost" can also present difficulties. The Income Tax Act seeks to resolve the matter of full absorption costing, as regards depreciation, by requiring an annual income adjustment.[415]

As to the method of inventory valuation (e.g., lower of cost or market), there remain areas of dispute despite the statutory prescription. For example, the CRA often seeks to impose the same method for tax and financial accounting purposes, although this appears unwarranted. Changes to the method of valuation must be approved by the Minister of National Revenue and will be permitted only where the taxpayer proves that the new method is more appropriate, is consistent with the taxpayer's financial accounting and will be used consistently going forward.[416]

As previously noted, LIFO has generally been rejected as an acceptable method of determining the flow of inventory, although it remains to be determined whether this method might not be acceptable where inventory disposed of could be traced to a particular source.

Under the Income Tax Act, inventory valuation is specifically required for certain materials and supplies (such as advertising or packaging material or parts) and also for work-in-progress of certain professional businesses.[417]

d. Statutory Inclusions

Complementing the rules for accounting for profit are provisions specifically including certain amounts in the computation of income. These provisions may override the general principle that "capital" receipts are not "income."

Some of these rules are addressed in this Portfolio in other contexts (e.g., recapture of capital cost allowance and goodwill proceeds, taxation of resource income, and taxation of corporate benefits). A few general provisions are considered in VIII.C.2.d., below.

(1) Interest

A taxpayer must include any income received or receivable in the year (depending upon the method regularly followed in computing the taxpayer's profit) due to interest.[418] While this seems to permit either cash or receivable accounting for interest, in fact, some version of accrual is required.[419]

In the case of certain "prescribed debt obligations," interest is deemed to accrue to the holder.[420] Generally, these rules provide a system for "accruing" a notional return on deep discount or zero-coupon bonds and similar obligations, based on a computed yield to maturity.

(2) Imputed Interest

Subject to certain exceptions, where a nonresident person owes an amount to a corporation resident in Canada, the corporation must include interest on the amount owing at a prescribed rate in computing its income if the amount owing remains outstanding for longer than one year without interest at a reasonable rate having been included in computing the corporation's income.[421] Amounts owing include not only loans, but also other types of indebtedness including trade receivables, outstanding guarantees and the unpaid purchase price of property or services.

The interest imputation rules do not apply if the amount owing has been subject to nonresident withholding tax, generally as a deemed dividend, or, if the nonresident person is not related to the Canadian resident corporation, the amount owing arose with respect to goods sold or services rendered in the ordinary course of business, and the terms and conditions are those that would have been created had the parties dealt at arm's length.[422] A special exception is also provided for loans or advances made to a controlled foreign affiliate of a Canadian resident corporation where the funds are used by the foreign corporation in an active business.[423] For these purposes, a special, extended definition of "controlled foreign affiliate" applies.

The interest imputation rules may also apply to amounts owing by nonresidents to either a partnership or a trust of which a corporation resident in Canada is a member or beneficiary.[424] If, for instance, a nonresident owes an amount to a partnership

[411] ITA, subsec. 249.1(1).
[412] ITA, subsecs. 249(4), 256(9).
[413] ITA, sec. 10; ITR, Part XVIII.
[414] ITA, subsec. 10(1.01).
[415] ITA, para. 12(1)(r).
[416] ITA, subsec. 10(2.1), Interpretation Bulletin IT-473R (12/21/98).
[417] ITA, subsecs. 10(4), (5).
[418] ITA, para. 12(1)(c).
[419] ITA, subsecs. 12(3), (4).
[420] ITA, subsec. 12(9); ITR, Part LXX.
[421] ITA, sec. 17.
[422] ITA, subsecs. 17(7), (9).
[423] ITA, subsec. 17(8).
[424] ITA, subsecs. 17(4), (5).

ISBN 978-1-63359-385-5

that remains outstanding for more than one year, the Income Tax Act requires each member of the partnership to include a portion of the imputed interest in the member's income at the end of the tax year. Similarly, the Income Tax Act also addresses situations where amounts are owing by a nonresident to a trust. Where the trust is nondiscretionary, the amount owing by the nonresident debtor is deemed owed to the beneficiaries of the trust in proportion to the value of their trust interests. The beneficiaries must include any imputed interest in their income. Where the trust is discretionary, any nonresident indebtedness is considered owed to the trust's settlors rather than the beneficiaries. In such a case, the settlors will be subject to the interest imputation rules.

The interest imputation rules also apply to certain amounts owing by nonresident persons that are indirectly funded by a Canadian resident corporation. The indirect loan rule applies where a nonresident person owes an amount to a person or partnership (other than a corporation resident in Canada) and the amount became owing or remained outstanding because it is reasonable to conclude that a corporation resident in Canada made, or was anticipated to make, a transfer or loan of property. In such cases, the nonresident debtor is deemed to owe the amount outstanding to the corporation resident in Canada so that the general interest imputation rules discussed in the paragraph above apply. In many instances, it could be factually difficult to determine whether a particular amount owing arose *because* a corporation resident in Canada transferred or lent property. The indirect loan rule does not apply where both the nonresident creditor and the debtor are controlled foreign affiliates of the Canadian resident to whom the rule would otherwise have applied.[425] Another exception applies where the creditor and debtor are not related, the terms and conditions are at arm's length, and, if interest were payable, it would not be subject to current Canadian tax as passive income under the Canadian controlled foreign corporation rules.[426] Specific loans and transfers by a Canadian resident corporation are also exempted from the rule.[427] A similar imputation rule applies where any shareholder of a corporation receives a loan from or otherwise incurs a debt to the corporation by virtue of such shareholding. The rule extends as well to most persons who do not deal at arm's length with the shareholder.[428] The imputation is based, again, on a prescribed rate (less interest actually paid) and results in a deemed dividend paid to the nonresident in the amount of the imputed interest, giving rise to a withholding tax obligation on that amount.

(3) Contingent Payments

A taxpayer must include in computing income any amount received in the year that was dependent on the use of or production from property, even if it represents an installment on the sale price of the property.[429] It is generally accepted that this rule would not extend to the purchase price of corporate shares that is based, in whole or in part, on the performance of the business.[430]

(4) Restrictive Covenant Payments

Certain amounts with respect to restrictive covenants that are received or receivable by a taxpayer (or by a non-arm's-length person) must be included in computing a taxpayer's income (unless certain exceptions are satisfied).[431] These rules are intended to ensure that non-compete payments are treated as proceeds of disposition, income or amounts subject to withholding tax, reversing the decision of the Federal Court of Appeal in *Manrell*,[432] where certain non-compete payments were held to be non-taxable. However, these rules are drafted extremely broadly and may apply in other (potentially unintended) circumstances. For example, the definition of "restrictive covenant" does not require the existence of a covenant or a restriction. These rules are subject to certain exceptions that should be carefully reviewed, especially where noncompete payments are being made.

e. Deductions

As a rule, current expenses are deductible in computing income from business or property. The principle is phrased in the negative; i.e., no deduction may be made with respect to an outlay or expense except to the extent that it was made or incurred for the purpose of gaining or producing income.[433] Few expenses incurred in the ordinary course of business will fail to meet this criterion, and, indeed, a number of cases indicate a more liberal trend toward greater current expense deductibility.[434] "Personal or living expenses," as defined, are not deductible.[435] To be deductible, an expense must also be absolute rather than contingent. In *McLarty v. R.*,[436] the Supreme Court of Canada ruled that a debt for the purchase of seismic data that provided that the lender only had recourse at maturity to the seismic data itself was an absolute liability and was not contingent.

Probably the most important hurdle in the deductibility of expenses is the rule that no amount may be deducted with respect to an outlay, loss or replacement of capital, except as permitted by the capital cost allowance system (tax depreciation) established under the Income Tax Act.[437]

The line between expenses on capital and income account is a fine one and court decisions are numerous. The general principle of the distinction is whether the expenditure is an integral part of the income-earning process or rather relates to the "profit-making apparatus" of the business as such, i.e., its capital structure. By analogy, items on the income account relate to the fruit grown on a tree, while items on the capital account relate to the tree itself. Thus:

(i) A payment made to cancel an agency agreement will generally be deductible, unless the agreement establishes

[425] ITA, para. 17(3)(a).
[426] ITA, para. 17(3)(b).
[427] ITA, subsec. 17(15), definition of "exempt loan or transfer."
[428] ITA, subsec. 80.4(2).
[429] ITA, para. 12(1)(g).
[430] Interpretation Bulletin IT-426 R (9/28/04).
[431] ITA, sec. 56.4.
[432] [2003] 3 CTC 50 (FCA).
[433] ITA, para. 18(1)(a).
[434] *See Royal Trust Co. v. MNR*, [1957] CTC 32; *MNR v. Algoma Central Ry.*, [1968] CTC 161; *Pigott Investments Ltd. v. The Queen*, [1973] CTC 693; *65302 British Columbia Ltd. v. The Queen*, [2000] 1 CTC 57.
[435] ITA, subsec. 248(1), para. 18(1)(h).
[436] 2008 SCC 26.
[437] ITA, para. 18(1)(b).

ISBN 978-1-63359-385-5

an exclusive agency and payment is made to acquire the ability to do business.[438]

(ii) The deductibility of legal expenses depends on the reason for which they were incurred. Thus, expenses in an action to defend a company's trade name have been permitted, as have expenses to amend an aging charter of a trading company.[439] Legal expenses relating to a "capital" transaction (for example, investment) are generally capital. Legal expenses incurred in connection with an income item (for example, the recovery of receivables) are deductible.[440]

(iii) Loans and guarantees, particularly in favor of related persons, have been the source of some difficulty. Special rules governing bad and doubtful debts generally apply with respect to debts that have been included in computing the income of the taxpayer (such as accounts receivable) or are owed to a taxpayer that is an insurer (or the ordinary business of which includes the lending of money), and that made or acquired the loan in the ordinary course of its business as an insurer or money lender. Apart from such special rules, amounts paid out (or not collected), guarantees or loans may be deductible as business expenses in certain circumstances. Thus, in one case, the taxpayer successfully deducted the amount of a loan that was not repaid, made by him in his capacity as landlord to a tenant in order that the latter might remain in business and continue to pay his rent.[441] In another, an investment corporation made loans to a related company and successfully deducted these amounts on the basis that they were an integral part of its investment business.[442] On the other hand, a deduction has been denied where a taxpayer has been unable to establish that it made a loan for purposes of earning income on the loan.[443] Where "loans" are not properly documented as such and appear to be capital contributions to a corporation, a deduction may not be allowed.

(iv) Engineering and feasibility studies for establishing a capital plant may be deductible where, ultimately, no capital asset is created. In such a case, the cost may be treated as having been incurred as part of the cost of doing business.[444] Some such expenses may fall within a statutory allowance with respect to investigating the suitability of a site.[445]

(v) A purchase of customer lists may be on either income or capital account. If the purchase is part of the acquisition of an entire business of a going concern, the expenditure will generally be regarded as capital.[446] A restricted write-off may then be available under statutory rules. (See the discussion at VIII.C.2.e.(4), below.)

(vi) Historically, the CRA took a restrictive interpretation to allowing the deductibility of transaction costs or takeover expenses, such as the costs of borrowing, issuing shares, investment bankers' fees, professional fees (fees of lawyers, accountants, valuators and economists, for example) and circular printing fees. Three leading decisions markedly expanded the scope of deductibility of these expenses well beyond the limits historically imposed by the CRA.[447] In each of these cases, the disputed fees were incurred by the taxpayer as a target company in response to third-party attempts to acquire control of the target on a share acquisition. In all three cases, the court determined that the fees at issue were incurred for the purposes of gaining or producing income from a business and were not capital in nature. However, the Federal Court of Appeal held in *Imperial Tobacco Canada Ltd. v. The Queen* that cash payments for the surrender of stock options in connection with a takeover were on account of capital and not deductible.[448]

In *Rio Tinto Alcan Inc. v. The Queen*, the Federal Court of Appeal held that investment banker fees and certain other expenses incurred prior to deciding whether to proceed with an acquisition, were deductible as oversight expenses, while similar expenses incurred after that decision was made were on capital account (as they were made to implement a capital transaction).[449] Other less significant decisions have also addressed the deductibility of transaction costs. For example, in one case,[450] the issue was whether fees paid to outside professionals (including lawyers, accountants and financial consultants) for services rendered with respect to the acquisition of competitors' shares, interests in joint ventures and the acquisition of other assets were on current account, or were capital in nature. The services rendered in this case included performing due diligence checks, developing an acquisition strategy, writing takeover bid circulars and preparing a request for an advance ruling certificate from the Competition Bureau. The fees

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[438] *Automatic Toll Systems Ltd. v. MNR*, [1974] CTC 30; *Dymo of Canada Ltd. v. MNR*, [1973] CTC 205.

[439] *MNR v. Kellogg Co. of Canada Ltd.*, [1943] CTC 1; *C.I.R. v. Carron Co.*, (1968) 45 T.C. 18.

[440] See, e.g., *Neonex International Ltd. v. The Queen*, [1977] CTC 472; *aff'd in part*, [1978] CTC 485.

[441] *The Queen v. Lavigueur*, [1973] CTC 773.

[442] *MNR v. Kelvingrove Investments Ltd.*, [1974] CTC 450; *The Queen v. F.H. Jones Tobacco Sales Co. Ltd.*, [1973] CTC 784. *Cf. The Queen v. Pollock Sokoloff Holdings Corp.*, [1976] CTC 349.

[443] *The Queen v. Doral Investment Corp.*, [1979] CTC 398; *H.Y. Louie Company v. The Queen*, [1986] CTC 499.

[444] *Bowater Power Co. Ltd. v. MNR*, [1971] CTC 818; *MNR v. M.P. Drilling Ltd.*, [1976] CTC 58.

[445] ITA, para. 20(1)(dd); *see The Queen & Metcalfe Carpark Ltd. v. MNR*, [1973] CTC 810.

[446] *See Cumberland Investments Ltd. v. The Queen*, [1975] CTC 439; *R v. Farquhar Bethune Insurance Ltd.*, [1986] 1 CTC 2326.

[447] *BJ Services Co. Canada and the Successor to Nowsco Well Services Ltd. v. Her Majesty the Queen*, 2004 DTC 2032; *International Colin Energy Corp.*, 2002 DTC 2185; and *Boulangerie St. Augustin Inc.*, 97 DTC 5012 (FCA), *aff'd*, 95 DTC 164 (TCC). The specific costs under dispute in *Boulangerie St. Augustin* were related to the preparation of directors' circulars in reaction to takeover bids. For the most part, in *International Colin*, the contested fees were for developing strategic financial alternatives to a takeover bid, finding, evaluating and recommending third parties interested in merging, negotiating a merger, and preparing a directors' circular (including the provision of a fairness opinion). In *BJ Services*, the disputed fees were similar to those in *International Colin* but also included certain "hello" and "break" fees that were paid in the course of responding to a hostile takeover.

[448] 2012 DTC 5003 (FCA). Leave to appeal to the Supreme Court of Canada was denied.

[449] *Rio Tinto Alcan Inc. v. The Queen*, 2018 FCA 124. Leave to appeal to the Supreme Court of Canada was denied.

[450] *Rona Inc. v. R.*, 2003 TCC 121.

ISBN 978-1-63359-385-5

relating to the construction of new stores were held to be on capital account and thus were nondeductible, primarily because the company was steadily expanding and building stores every year.

Conversely, in another case,[451] the Federal Court of Appeal allowed deductions for regular expenses paid by a company to a contractor that found locations and negotiated leases and lease renewals for the company's stores, on the basis of its finding that the business was not expanding.

Legal and accounting fees paid by a corporation for the preparation of a unanimous shareholders' agreement were deductible for the corporation and did not constitute shareholder benefits under Subsection 15(1) of the Income Tax Act in another case.[452] The court's view was that the *BJ Services* case and the other decisions cited in *BJ Services* should not be restricted in their application to situations involving hostile takeover bids or economically difficult circumstances.

Beyond these general rules are various statutory deductions designed either to provide greater certainty or to allow for the deduction of amounts that may not otherwise be deductible. Thus, interest and other financing costs, generally considered to be capital outlays, are deductible in certain cases. Similarly, a system of allowances is established with respect to the capital cost of depreciable property and for goodwill and similar intangible property. Scientific research expenses, both current and capital, are deductible. A system of reserves is established, though only in some cases, outside of which no reserves are allowed. These deductions will be considered in greater detail below. In addition, the following partial list indicates some of the other statutory deductions:

(i) Share transfer and similar fees;[453]

(ii) Pension fund contributions, in certain circumstances;[454]

(iii) Certain manufacturer's warranty reserves;[455]

(iv) An amount payable by a lessor for the cancellation of a lease;[456]

(v) Investment counsel and portfolio management fees;[457]

(vi) Expenses of representations made to governments or governmental bodies;[458] and

(vii) Utilities service connection.[459]

Recognition of an expenditure where a taxpayer or non-arm's-length person has a right to reduce or eliminate an amount in respect of the expenditure, including a contingent right where it is reasonable to conclude that the right will become exercisable, is denied or deferred until such time as the contingent amount is paid.[460]

(1) Interest and Related Charges

For decades, whether a debt obligation was on capital account or on income account seemed to be determined by the use of the proceeds of the debt obligation. If the proceeds were used to acquire capital assets, the debt obligation was considered to be on capital account; if the proceeds were used to acquire income assets, the debt obligation was considered to be on income account. It seemed to many to be the case that, if a debt obligation was considered to be on capital account, then interest, as well as other expenses, associated with the obligation would also be on capital account and the deduction of these expenses would depend on statutory authority.[461] This latter proposition was challenged in the Supreme Court of Canada decision of *Gifford*.[462] In this decision, and notwithstanding the case law discussed further below, the Court set out a new test to determine whether a debt obligation is on income or capital account. The test focused on the nature of the obligation itself, rather than on the use of proceeds.

In *Gifford*, the taxpayer was a broker who borrowed Can. $100,000 to acquire a client list. The issues were:

(i) Whether the Can. $100,000 payment for the client list was deductible; and

(ii) Whether the interest on the Can. $100,000 borrowing used to acquire the client list was deductible.

The Supreme Court found that the payment for the client list was on account of capital and therefore not deductible. The basis for this finding was that the list significantly expanded the taxpayer's client network and reduced competition from other brokers. Under traditional tests in the Canadian tax jurisprudence (as outlined later below), this finding would suggest that the interest paid on the Can. $100,000 borrowing was also on capital account. However, in *Gifford*, the Supreme Court stated that interest is not always a capital expense. To determine whether interest is on income or capital account, one must look at the nature of the liability itself rather than the use of the proceeds of the liability. The Supreme Court found the interest payment in *Gifford* was "on account of capital" because the funds borrowed to make the payment added to the financial capital of the taxpayer and as such are expressly denied deductibility under ITA, subparagraph 8(1)(f)(v). In contrast, if a borrowing arises as part of a taxpayer's business (e.g., if the borrowing arises in the context of a banking business) then interest payments will be on income account regardless of the taxpayer's actual use of the borrowed funds.

Under the Income Tax Act, an amount paid or payable with respect to the year (depending on the method regularly followed in computing income) pursuant to a legal obligation to pay interest is deductible if the interest relates to borrowed money used for the purpose of earning income from a business or property, or to a balance of sale with respect to property acquired for the purpose of gaining or producing income therefrom or from a business, and the amount of interest does not ex-

[451] *Pantorama Industries Inc.*, 2005 DTC 5230.

[452] *Truckbase Corp. et al. v. The Queen*, 2006 TCC 215. This case was an informal procedure case, which does not hold precedential value. Many judges, however, do consider these decisions in rendering their opinions and, accordingly, they may carry some weight.

[453] ITA, para. 20(1)(g).

[454] ITA, para. 20(1)(q).

[455] ITA, para. 20(1)(m.1).

[456] ITA, paras. 20(1)(z), (z.1).

[457] ITA, para. 20(1)(bb).

[458] ITA, para. 20(1)(cc).

[459] ITA, para. 20(1)(ee).

[460] ITA, sec. 143.4, effective for taxation years ending on or after March 16, 2011.

[461] *Canada Safeway Ltd. v. MNR*, [1957] CTC 335; *Inter-Provincial Pipe Line Co. v. MNR*, [1968] CTC 156.

[462] *Gifford v. The Queen*, [2004] 1 SCR 411.

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ceed a reasonable amount.[463] Generally, one would expect that an interest rate determined between two arm's length persons would be a reasonable rate of interest for purposes of para. 20(1)(c). Interest is not deductible with respect to borrowed money, or a balance of sale relating to exempt income or a life insurance policy. Intercorporate dividends, which are not taxed due to the deduction available in computing taxable income, are not considered "exempt income" for these purposes, and therefore interest on money borrowed by a corporation to buy common shares is generally deductible.

Generally speaking, there is no limitation on the amount of interest that a taxpayer can deduct in a tax year, other than:

(i) The requirement that the amount of interest deducted by a taxpayer in the year with respect to a particular debt obligation cannot be more than a "reasonable amount";

(ii) The thin capitalization limits discussed in further detail below; and

(iii) The new "excessive interest and financing limitation" (EIFEL) rules discussed in further detail below.

Capital gains are, by definition, not income from property,[464] and therefore interest on money borrowed to acquire property that is not income-producing and is not acquired for the purpose of resale at a profit is not deductible.

On the other hand, interest on money borrowed to acquire property for resale may be deductible. One major issue relating to the deductibility of interest is the extent to which borrowed money must be traced to a particular use. This "tracing" problem may arise in a variety of situations. For example, where an employer borrows money that is "used" to make low-interest loans to employees, the CRA has, on occasion, challenged the deduction of interest by the employer. Another situation in which the question of deductibility may arise is the acquisition of a corporation followed by a merger of the acquired and acquiring corporation. Generally, the CRA is prepared to rule that, provided the assets of the subsidiary continue to be used in the business, interest on money borrowed to finance the acquisition will continue to be deductible notwithstanding that the assets acquired (the shares) have disappeared.

In an important decision, the right of a corporate taxpayer to deduct interest on borrowed money used, in the first instance, to redeem preferred shares, was recognized on the ground that deductibility depends not on the first use of the money but on its use in the business; i.e., where the money enters the working capital of an ongoing business, interest is deductible.[465]

However, the Supreme Court of Canada[466] denied the deductibility of interest paid by a trust on borrowed money used "directly" by the trust to make capital distributions to its beneficiaries, although the taxpayer argued that the borrowed funds were "used" to enable it to make the distributions to its beneficiaries without having to dispose of income-producing properties. The trust argued, and the Crown conceded, that if it had sold income-producing assets to fund the capital distributions and had then borrowed the money to reacquire such income-producing assets, the interest would have been deductible. The Court seriously questioned this concession. The Court held that the "use" of the funds was to make the capital distributions and the interest was therefore not deductible. In its reasons for judgment, the Court stated that the income produced by the trust assets was minimal relative to the interest expense sought to be deducted.

In a subsequent case,[467] a lower court relied on this decision to deny the deductibility of interest expense incurred by a taxpayer in satisfying its obligations arising under guarantees of various debts of an operating corporation it owned in conjunction with a joint venturer. The taxpayer received no fees for providing such guarantees but argued that the interest expense arose as a consequence of borrowed money "used" to fund its business activities. In another case, the same Supreme Court decision was applied to deny a taxpayer an interest deduction in the following situation.[468] While waiting for funds to arrive from overseas relatives, the taxpayer borrowed money at a 10 3/4% interest rate, which he used to purchase a residence. When he subsequently received the overseas funds, he was able to invest the money in term deposits that, at the time, were earning 14% to 16% interest. The court denied the interest deduction on the basis that the indirect use of the borrowed funds did not make the deduction permissible.

In all cases, the issue depends on the current use of the borrowed money. For example, if a taxpayer borrows money to buy personal property, which he subsequently sells, the interest payments will become prospectively deductible if the proceeds of sale are used to purchase eligible income-earning property. There is, however, an important natural limitation on this principle. The borrowed funds must still be in the hands of the taxpayer, as traced through the proceeds of disposition of the preceding ineligible use, if the taxpayer is to claim the deduction based on current eligible use.[469]

In *The TDL Group Co. v. The Queen*,[470] the Federal Court of Appeal overturned a decision of the Tax Court and held that interest was deductible where borrowed money was used by a Canadian corporation to acquire shares of a U.S. subsidiary during the period in which the U.S. subsidiary made an interest-free loan to the Canadian corporation's U.S. parent company.

The CRA's administrative practice with respect to interest deductibility is set out in Income Tax Folio S3-F6-C1. In accordance with such practice, interest is deductible on borrowed money used by:

(i) A corporation to pay dividends not exceeding its accumulated profits determined immediately before the dividends are paid; or

(ii) A partnership to make distributions of profits not exceeding its accumulated profits determined immediately before the distributions are made, to the extent the accumulated profits were used by the corporation or the partnership for a qualifying purpose (i.e., to earn income, and

[463] ITA, para. 20(1)(c).
[464] ITA, subsec. 9(3).
[465] *Trans-Prairie Pipelines Ltd. v. MNR*, [1970] CTC 537.
[466] *The Queen v. Bronfman Trust*, [1987] 1 CTC 117.
[467] *Bowater Canadian Ltd. v. The Queen*, [1987] 2 CTC 47.
[468] *S.M. Attaie v. M.N.R.*, [1990] 2 CTC 157.
[469] *Bronfman Trust* at pp. 125–126.
[470] 2016 FCA 67.

ISBN 978-1-63359-385-5

not to acquire property the income from which is exempt or to acquire a life insurance policy).

In addition, any money used by:

(i) A corporation to return capital to its shareholders by way of a redemption, an acquisition, a cancellation of any shares, a reduction of capital or otherwise; or

(ii) A partnership to make a distribution of capital,

is deductible to the extent that such capital was used by the corporation or the partnership for a qualifying purpose. Interest is generally deductible under this policy where it is payable with respect to money borrowed to make loans to the employees of a company. A deduction is also allowed with respect to loans made by a shareholder to a corporation in situations where the recipient of the loan uses the proceeds to earn income and is unable by reason of its own financial position to obtain financing on comparable terms.

As stated above, interest may, if certain conditions are met, be deductible if it relates to borrowed money used for the purpose of earning income. In *Mark Resources Inc. v. The Queen*,[471] the Tax Court of Canada rendered a judgment that, while perhaps raising more questions than it answers, held that an arrangement without a money-making motive does not give rise to an interest deduction when the purpose of the loan is not to earn income. Essentially, a Canadian parent borrowed money to contribute to the capital of its U.S. subsidiary. The U.S. subsidiary had loss carryforwards that it used to shelter interest income earned on the funds so received. Although the Canadian corporation earned dividend income on the shares in the subsidiary, the court found that the true purpose for which the borrowed money was used was to implement a plan to absorb into the Canadian parent's income the losses of the foreign subsidiary. Accordingly, the funds were not borrowed for the purpose of earning income and interest deductibility was denied.

In *Ludco Enterprises Ltd. et al. v. The Queen*,[472] the Supreme Court of Canada considered:

(i) The judicial test for determining a taxpayer's purpose for which borrowed money is used in the context of the general interest deduction provision, paragraph 20(1)(c) of the Income Tax Act; and

(ii) The meaning of "income" for purposes of that provision.

In *Ludco*, the taxpayers borrowed funds to acquire shares in a number of offshore corporations. In accordance with their business plans, the offshore corporations earned income from debt securities, reinvested almost all the profits and distributed a relatively small portion of the income earned as dividends to their shareholders. During the eight years that the taxpayers owned the shares they received approximately Can. $600,000 in dividends and incurred approximately Can. $6 million in interest expenses. The disposition of their shares resulted in gains of approximately Can. $9.2 million.

The Supreme Court rejected the notion that the purpose of earning income need be the primary or dominant purpose for the use of the funds. Absent sham or "window dressing," interest may be deductible provided one of the purposes is to earn income and that purpose is present if the taxpayer has a reasonable expectation of earning income when the investment is made.

In discerning the meaning of "income," the Supreme Court in *Ludco* noted that there is no statutory definition of the word and rejected the commonly held belief that "income" is equivalent to "profit" or "net income." Instead, "income" in paragraph 20(1)(c) of the Income Tax Act refers to amounts that are included in computing income for taxation purposes. In other words, investment of the borrowed funds for the purpose of earning gross income is sufficient. The Supreme Court appeared to take support for this view from the purported objective of the interest deductibility provision, which is to encourage the accumulation of capital from which income is produced. Therefore, the Supreme Court held in favor of the taxpayers. The Court found that they had a reasonable expectation of earning dividend income on the share investments and there was no requirement in paragraph 20(1)(c) that the dividend income exceed the interest expense for the interest to be deductible.

In certain circumstances, interest will continue to be deductible on borrowed funds where such funds were initially borrowed to acquire property that has been sold at a loss or to carry on a business that has been discontinued.[473] This rule applies, for example, where the borrowed funds were used to acquire property that has declined in value and was subsequently sold at a loss.

Because interest is deductible only when paid pursuant to a legal obligation, and because it must be deducted against income for the year with respect to which it is payable if the accrual method is followed, it is not possible for a lender to make a retroactive request for interest and thereby enable the borrower to deduct the entire amount so requested in the year. This situation may arise where the lender is a nonresident that finds itself subject to an interest imputation under the tax laws of its own jurisdiction and wishes the borrower, a related Canadian taxpayer, to get the benefit of a deduction. In one such case, the Canadian borrower was not allowed a deduction, first because the retroactive request probably did not create a legal obligation to pay and second because, even if it did, the interest would be deductible only in the year with respect to which it was charged, i.e., in the year in which the borrowed money was used.[474]

A long-standing controversy has related to participating interest arrangements under which a borrower agrees to pay an amount of interest that depends on the profits of its business. The CRA has expressed a narrow view, arguing based on certain case law, that many forms of participating interest would not be deductible.

In *The Queen v. Sherway Centre Corporation Ltd.*,[475] the Federal Court of Appeal rejected the notion that it is an absolute requirement for interest to accrue per diem. Instead, the court relied on a reasonable commercial notion that interest is fundamentally compensation for the use of money. The CRA be-

471 93 DTC 1004.

472 2001 DTC 5505.

473 ITA, sec. 20.1.

474 *MNR v. Mid-West Abrasive Co. of Canada Ltd.*, [1973] CTC 548.

475 98 DTC 6121.

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lieves that the *Sherway* decision should be limited to the specific facts of the case — namely, if the participation payment is in lieu of interest it will be considered interest.[476] Where the evidence shows, as it did in *Sherway*, that the participation payments are intended to increase the interest rate of the loan to the prevailing market rate, the CRA will consider the payments to be interest under paragraph 20(1)(c) of the Income Tax Act. Outside of these circumstances, the CRA would generally not permit a deduction for participation payments as interest expenses.

Another important decision regarding the deductibility of interest expenses involved the use of a financing "product" and weak currency borrowings. In *Shell Canada Limited v. The Queen*,[477] Shell required U.S. $100 million for general business purposes. Rather than borrowing the funds directly, however, Shell acquired NZ$150 million from a foreign bank. The interest rate on the New Zealand dollar loan was much higher than the prevailing U.S. lending rates at the time. Shell then proceeded to enter into a series of forward contracts and debenture agreements whereby the New Zealand dollar loan was, in effect, economically converted into a U.S. dollar borrowing. The taxpayer deducted the higher interest cost of the New Zealand dollar loan, being the Canadian equivalent of the New Zealand dollar interest rate. At the end of the loan term, the effect of the forward contracts was to give rise to a predetermined and fixed foreign exchange gain, in economic terms offsetting the excessive interest costs. The taxpayer reported the currency gain as a capital gain taxable in the year of realization.

The Supreme Court held that Shell was entitled to deduct the full amount of interest on the New Zealand dollar loan. The Court reasoned that the requirements for deducting interest on borrowed money, as provided for in the Income Tax Act, were met: the interest was payable in the year in which it was sought to be deducted; it was paid pursuant to a legal obligation to pay interest on borrowed money; the borrowed money was used for the purpose of earning income from business or property; and the interest deduction was reasonable. In choosing to adhere to the legal form of the transaction, the Court decided that the characterization of the payment on the New Zealand dollar loan could not be changed by other legal relationships that the taxpayer may have concluded with third parties. This included any additional arrangements Shell entered into involving the borrowed funds after receiving them from the foreign lenders.

As for the characterization of the foreign exchange gain arising from the hedging contract and debenture agreement, the Supreme Court held that it was to be viewed as a capital amount because the characterization of the debt obligation to which it related was also on account of capital. This was consistent with the "linkage" principle developed in other foreign exchange gain cases.

As a result of the Supreme Court of Canada decision in *Shell*, the government added section 20.3 to the Income Tax Act, effectively to limit the deductibility of interest on such weak currency borrowing arrangements or "Kiwi loans" to the interest that would have been payable had the borrowing been in the currency that the taxpayer actually used to earn income. Section 20.3 applies where a taxpayer borrows in a currency (the "weak currency") other than the currency (the "final currency") that is used by the taxpayer to earn income and the interest rate on the weak currency debt is two percentage points higher than the interest that would have been payable on a similar debt denominated in the final currency. The interest deduction permitted is the interest that the taxpayer would have paid had the debt been denominated in the final currency. Regardless of the nature of the transaction (i.e., as a transaction on a capital account), any foreign exchange gain or loss arising on the settlement or extinguishment of the debt is deemed to be on an income account. The disallowed portion of the interest expense is deemed to be an amount paid to settle the debt that serves to reduce any exchange gain or increase any exchange loss arising on debt settlement or extinguishment. A *de minimis* rule provides that section 20.3 applies only to debt exceeding Can. $500,000.

Accordingly, the outcome of the decision in *Shell* is now of limited application to weak currency borrowing transactions, but remains of some importance, more generally, for the interpretation of the interest deduction provisions and, indeed, the relationship between economic substance and taxation in Canada.

Another Supreme Court decision followed the reasoning in *Shell* with respect to the requirements of paragraph 20(1)(c) of the Income Tax Act and also held that the legal effect of a taxpayer's transactions cannot be ignored in determining the tax consequences of the transactions. In *The Queen v. John R. Singleton*,[478] the taxpayer received Can. $300,000 out of the capital account of the law firm of which he was a partner, used this amount to assist in the purchase of a personal residence, and then used borrowed funds to contribute to his law firm's capital account. The CRA argued that the "true economic purpose" of the borrowing was to fund the acquisition of the personal residence (a non-income-earning use) and that the steps taken to achieve this objective should be viewed together as a simultaneous transaction. The Court rejected the argument that the legal nature of the transactions could be ignored for purposes of paragraph 20(1)(c) in the circumstances. In the Court's view, each transaction had to be viewed independently to give effect to the legal relationships. On this view, the direct use of the borrowing was to refinance the taxpayer's partnership capital account to earn income from the law firm. The fact that partnership capital was used to purchase residential property was irrelevant in determining the deductibility of the interest on the borrowed funds used to invest back into the partnership. The borrowings were directly used for the purpose of earning income from the partnership and there was no need to examine the matter further. See the decision in *Lipson*, referred to at XI.C.2., below, regarding the potential application of the general anti-avoidance rule (GAAR) on similar facts.

Interest on interest is deductible in the same circumstances (although, technically, only when actually paid), as is interest on money borrowed to repay borrowed money.[479] Certain other financing charges may also be deducted (generally on a straight-line basis over five years), such as expenses incurred

[476] CRA Income Tax Technical News, Issue No. 16 (3/8/99).

[477] 99 DTC 5669.

[478] 2001 DTC 5533.

[479] ITA, para. 20(1)(d), subsecs. 20(2), (3).

ISBN 978-1-63359-385-5

in the course of issuing or selling shares of the taxpayer or in the course of borrowing money used by the taxpayer for the purpose of earning income from a business or property.[480] Commissions or fees paid to underwriters in the course of issuing shares have been a source of contention, however, and warrant careful consideration.[481]

Fees paid in consideration for a reduction in interest rates or penalties or bonuses paid in consideration for the early repayment of borrowed funds are deductible, although they must be amortized over the remaining term of the loan (or the term that would have remained if the loan had not been repaid).[482] The treatment of discount obligations is also a subject of controversy, where the statutory rules do not apply.[483]

The treatment of discount obligations was considered by the Supreme Court of Canada in two cases.[484] By a four-to-three majority, the Court held that a debtor's foreign exchange loss on the repayment or repurchase of a capital debt denominated in a foreign currency was not deductible from its business income under paragraph 20(1)(f) of the Income Tax Act,[485] and that the loss was a capital loss under a residual provision of the Act.[486] The immediate result of the Court's decisions in *Imperial Oil* and *Inco* is that foreign exchange losses incurred on the repayment or repurchase of capital debts are not deductible in computing business income, but are capital losses. The facts of these cases and the broader implications for other taxpayers are discussed in greater detail at VIII.C.3.e., below.

Subsequent to the Supreme Court of Canada's decisions in *Imperial Oil* and *Inco*, the Federal Court of Appeal, in *Tembec Inc. et al. v. The Queen*, considered whether taxpayers were entitled to deduct the difference between the fair market value of common shares issued on the conversion of convertible debt obligations and the issue price of the obligations.[487] Applying *Imperial Oil*, the Court held that under paragraph 20(1)(f), the "principal amount" of an obligation is required to be determined at the time of its issuance, not at the time of its conversion into shares. Therefore, the deductions were denied.

Prior to the Supreme Court's decision in *Imperial Oil*, the CRA had administratively taken the view that the principal amount of an exchangeable debenture was the fair market value of the shares delivered, thus allowing a deduction under paragraph 20(1)(f) if the fair market value of shares delivered exceeded the issue price of the obligation. The CRA had similarly stated that a paragraph 20(1)(f) deduction would be available with respect to a commodity-based loan if the amount payable on maturity exceeded the issue price due to fluctuations in commodity prices. The CRA has since stated that its prior position was not supported by law and that it will follow *Tembec* for exchangeable debentures.[488]

Special rules are designed to prevent borrowers from claiming tax deductions for interest payments on long-term debt obligations, where purported interest payments in substance represented repayments of principal.[489] Essentially, the rules treat the amount of principal owing on debt as having been reduced by the amount of deductible interest by reference to this reduced principal amount.

Of particular interest in international operations are the "thin capitalization" and the EIFEL rules.

To prevent the expatriation of earnings by way of deductible interest rather than non-deductible dividends, the thin capitalization rules in the Income Tax Act provide that a Canadian resident corporation may deduct only that part of interest paid or payable on "outstanding debts to specified nonresidents" that corresponds to a debt-to-equity ratio of 1.5 to 1.[490] For these purposes, the "specified nonresidents" referred to in the above definition effectively include a nonresident shareholder or group of shareholders owning either 25% or more of the voting shares of the corporation, or shares having a fair market value equal to 25% or more of the fair market value of all issued and outstanding shares of the corporation, and a nonresident person who does not deal at arm's length with the nonresident shareholder or group of shareholders. For purposes of determining when the 25% thresholds have been met, rights to acquire shares and rights to require the corporation to redeem any other shares will be considered exercised.

In computing the debt portion of the debt-to-equity ratio, only interest-bearing debts owing to specified nonresidents are taken into account.[491] Debt is defined as the average of the greatest total amount of interest-bearing debt owed to specified nonresidents at any time during each calendar month that ends in the particular year. Equity is the total of three amounts.[492] The first amount is the retained earnings of the corporation at the start of the particular tax year. The second amount is the average of the contributed surplus at the start of each calendar month that ends during the particular year that was contributed by a specified nonresident shareholder of the corporation. The third amount is the average of the paid-up capital at the start of each calendar month that ends during the tax year that is attributable only to shares owned by a specified nonresident shareholder of the corporation. It is important to note that if the ratio is exceeded at any time in the year, the rule comes into effect and interest on the portion of the debt that exceeds the 1.5 to 1 ratio is not deductible. Where a specified nonresident lends money to another person on condition that the latter lend money to the Canadian corporation, the second loan is treated as if it were made by the specified nonresident, i.e., the "back-to-back" loan rule (see below for further discussion).[493]

[480] ITA, para. 20(1)(e).

[481] *See The Queen v. Royal Trust Corp. of Canada*, [1983] CTC 159.

[482] ITA, subsec. 18(9.1).

[483] The ITA deals with certain deep discount obligations (ITA, paras. 18(1)(f), 20(1)(f)), but not zero-coupon debt.

[484] *Imperial Oil Ltd. v. Canada; Inco Ltd. v. Canada*, 2006 SCC 46. Both cases were heard together.

[485] Under ITA, para. 20(1)(f) (which has traditionally been associated with original issue discounts), 50% of the excess of: (i) the principal amount repaid over (ii) the amount for which the debt was issued, is deductible by a taxpayer from business income unless the excess is a "shallow" discount (in which case, the full amount of the excess would be deductible).

[486] ITA, subsec. 39(2).

[487] 2009 DTC 5089.

[488] CRA Document No. 2009-0347251C6, *Exchangeable debentures = Débentures échangeables — 20(1)(f)* (November 24, 2009).

[489] ITA, subsecs. 18(9.4) to (9.8).

[490] ITA, subsecs. 18(4) to (8). The 1.5-to-1 ratio became effective for tax years beginning after 2012. Previously, the ratio was 2-to-1.

[491] Definition of "outstanding debts to specified nonresidents" in ITA, subsec. 18(5).

[492] ITA, subsec. 18(4).

[493] ITA, subsec. 18(6).

ISBN 978-1-63359-385-5

Interest expense of a Canadian resident corporation that cannot be deducted because it exceeds the 1.5 to 1 debt-to-equity ratio will be recharacterized as a dividend and will be subject to Canadian withholding tax at a rate of 25% (or a reduced rate under an applicable income tax treaty).

In the case of partnerships, Canadian resident corporate partners of a partnership are allocated their proportionate share of debts owed by a partnership and each property owned by the partnership for purposes of determining whether the debt-to-equity ratio of the corporation with respect to debts owing to specified nonresidents has been exceeded. If the debt-to-equity ratio of a corporation with respect to debts owing to specified nonresidents is exceeded with respect to debt allocated from a partnership, the corporation will have an income inclusion that offsets the interest expense allocated to the corporate partner by the partnership.[494]

In the case of Canadian resident trusts, the rules disallow any deductions of interest paid out to beneficiaries in relation to any debt that exceeds a debt-to-equity ratio of 1.5 to 1. Canadian resident trusts with disallowed interest deductions have the option of designating such amounts as distributions to nonresident beneficiaries, thereby attracting withholding tax to the beneficiaries rather than additional tax to the trust. Similar to the concept of "specified nonresidents" referred to above, the rules incorporate the analogous concept of "specified nonresident beneficiaries."

The rules discussed above also apply to certain nonresident corporations and trusts that carry on business through a Canadian branch. The rule is implemented through a debt-to-asset ratio that parallels the debt-to-equity ratio used for resident corporations and trusts. The maximum proposed debt-to-asset ratio for nonresidents is 3 to 5.

Certain anti-avoidance rules have been implemented that prevent taxpayers from circumventing the application of the thin capitalization rules through the use of back-to-back loans. These rules apply generally where a Canadian taxpayer is obligated to pay an amount to an intermediary and either:

(i) A nonresident person has provided an interest in property as security to the intermediary for the Canadian taxpayer's obligation; or

(ii) The intermediary has a debt or other obligation outstanding to a nonresident which is limited recourse to the Canadian taxpayer's obligation.

In such a circumstance, the Canadian taxpayer would be deemed to owe the amount to the nonresident person for purposes of the thin capitalization rules and withholding tax rules (which could result in withholding tax being payable by the Canadian taxpayer in respect of interest paid to the intermediary).

The new "excessive interest and financing limitation" (EIFEL) rules impose a general restriction on the deductibility of interest that is broadly in line with OECD BEPS Action 4. Under the EIFEL regime, the amount of "interest and financing expenses" that a taxpayer may deduct in computing income for a particular taxation year will be limited to a fixed percentage of "adjusted taxable income," which is generally defined as the taxpayer's taxable income after adding back certain deductions such as interest and other financing expenses, capital cost allowance, and certain other amounts. Since the definition of adjusted taxable income is based on "taxable income," it reflects deductions for dividends received under sections 112 (for inter-corporate dividends) and 113 (for dividends received from foreign affiliates). Thus, the new rules can limit the deductibility of interest expense incurred to invest in shares that produce such dividends.

In addition to interest payments, the EIFEL rules define "interest and financing expenses" to include many other types of expenses such as guarantee (or similar) fees, certain lease financing amounts and certain net amounts earned from agreements or arrangements entered into in relation to a loan or financing arrangement.

The rules do not apply to any entity that is an "excluded entity," which is generally:

(i) A Canadian-controlled private corporation (CCPC) that, together with any associated corporations, has taxable capital employed in Canada of less than Can. $50 million;

(ii) A corporation or trust that, together with certain Canadian-resident corporations or trusts with which it forms a group (defined as "eligible group entities"), has aggregate net interest expense of Can. $1 million or less; or

(iii) A Canadian-resident corporation or trust, and a group consisting exclusively of Canadian-resident corporations and trusts that carry on substantially all of their business in Canada, provided: no non-resident with book cost or share value of more than Can. $5 million is a foreign affiliate of any group member; no non-resident holds a significant interest in any group member; and no group member has any significant amount of interest and financing expenses payable to a non-arm's length "tax indifferent investor," currently defined in the ITA to include non-residents of Canada and tax-exempt entities.

As noted, the EIFEL rules limit the amount of interest and financing expenses that a taxpayer may deduct in computing its income to a fixed percentage of the taxpayer's adjusted taxable income. For most taxpayer's, the fixed percentage will be 30% (40% for taxation years that commence on or after October 1, 2023 and before January 1, 2024). However, members of a consolidated group may use a "group ratio" that is higher than 30% if the consolidated group's net third-party interest expense to book EBITDA ratio (as reflected on the group's consolidated financial statements) exceeds 30%. A "group ratio" election would permit the allocation of this maximum deductible amount among Canadian group members. However, since the group ratio is based on the applicable accounting rules, rather than taxable income, it will not always be available to a particular group due to various book-to-tax differences that may arise.

To the extent the deduction of interest is denied under the EIFEL rules, a taxpayer may carry forward the denied interest expense. The EIFEL rules also permit members of a consolidated group to transfer excess unused interest deduction capacity to other members of the same group.

The EIFEL rules generally apply with respect to taxation years that begin on or after October 1, 2023. The rules apply to

[494] ITA, subsec. 18(7).

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interest and other financing expenses for new and existing borrowings.

Another restriction on the deductibility of interest relates to money borrowed to acquire land. Such interest is not deductible unless the land is held for the purpose of gaining or producing income therefrom in the year, or is used in a business, other than a business of selling or developing land.[495] For these purposes, "land" does not generally include land on which a building is situated or contiguous land. Although generally denied a deduction with respect to interest expense, land traders and developers are entitled to a safe harbor calculated as a notional amount of interest payable annually on Can. $1 million of debt. Corporations with common ownership must generally share this safe harbor limit.

Finally, interest (and other expenses) incurred during the construction, alteration or renovation of a building and related costs, or costs incurred during that period relating to the ownership of subjacent or contiguous land, must be capitalized.[496] This results in a denial of "soft costs."

(2) Reserves

No amount may be deducted with respect to a reserve, contingent account or sinking fund except as expressly permitted under the Income Tax Act.[497]

A commonly claimed reserve is that for doubtful debts.[498] A reasonable amount may be deducted as a reserve for doubtful debts that have been included in computing the income of a taxpayer for the year or a previous year. In addition, in the case of a taxpayer that is a financial institution or the ordinary business of which includes the lending of money, a reserve may be claimed with respect to certain impaired loans or lending assets. In the case of a bank, the deductible reserve is based on the reserve reported by the bank in its annual report with its regulatory authority or in its financial statements for the year as provisions against impaired loans or lending assets.[499] In effect, a loan will be considered impaired for tax purposes when it is considered impaired for financial statement reporting purposes. Alternatively, with respect to any claim not otherwise reserved against, an insurer or moneylender may generally claim a reasonable amount as a reserve based on the amortized cost of the claims, but the amount may not exceed 90% of the reserve claimed in accordance with GAAP with respect to such claims.[500]

Insurers and money lenders may also claim a reasonable reserve with respect to credit risks associated with guarantees, indemnities, letters of credit or other credit facilities, bankers acceptances, swaps, future or options contracts, and other similar instruments.[501]

The amount claimed as a reserve in one year is brought into income in the next. Bad debts may be deducted in similar circumstances. Although this is not technically a "reserve," the result is similar, as bad debts recovered are also taxable as income.[502]

A reserve is also available with respect to amounts included in computing income on account of goods not yet delivered or services not yet rendered.[503] It is noteworthy, however, that this reserve is not available with respect to future reclamation obligations.

Equally important is the reserve that relates to inventory sales; i.e., for amounts not due until a subsequent year with respect to property sold in the year.[504] This reserve is available with respect to the sale of land if proceeds are not due until after the end of the year, and, in the case of other property, if proceeds are not due until after the end of the year and more than two years after the date on which the property was sold. The calculation of this reserve is subject to two restrictions. First, the amount must represent a "reasonable" reserve. Second, no reserve at all can be claimed if the sale occurred more than 36 months before the end of the year, thus effectively limiting the deferral to three years.[505] A taxpayer who is not resident in Canada and does not carry on business in Canada cannot claim this reserve.[506]

(3) Capital Cost Allowances

Since 1949, the Income Tax Act has contained a system of allowances available with respect to the capital cost of depreciable property.[507] At the heart of the system lies a classification of such assets into categories, with respect to each of which a maximum allowance is available, usually equal to a fixed percentage of the "undepreciated capital cost" of the class; i.e., the capital cost of property in the class, less capital cost allowances previously claimed and the proceeds of disposition of property of the class previously disposed of (up to the original capital cost). Capital cost allowance is available on a diminishing balance basis only (subject to a few exceptions) and taxpayers may claim any amount up to the maximum allowed in the year. Thus, unclaimed allowances are effectively conserved, as the undepreciated capital cost is not diminished if no claim is made.

The class system operates so as to defer any "recapture" of capital cost allowance until such time as the proceeds of disposition of a depreciable property exceed the undepreciated capital cost of the class of property to which that property belongs, otherwise causing a negative balance in the account.[508] Thus, if the class is continuously replenished with new property, recapture may be postponed indefinitely. The undepreciated capital cost of property of a class is determined at the end of each tax year. The cost of any depreciable property of the class purchased in the year, therefore, affects this balance, as do the proceeds of any such property disposed of in the year.

This class system affords a high degree of flexibility. Although taxpayers may not claim an allowance greater than the amount determined by applying the fixed percentage to the un-

[495] ITA, subsecs. 18(2)–(3).
[496] ITA, subsecs. 18(3.1)–(3.7).
[497] ITA, para. 18(1)(e).
[498] ITA, paras. 20(1)(l), 12(1)(d).
[499] ITA, subpara. 20(1)(l)(ii), reg. 8000.
[500] ITA, subpara. 20(1)(l)(ii).
[501] ITA, para. 20(1)(l.1).
[502] ITA, paras. 20(1)(p), 12(1)(i).
[503] ITA, paras. 20(1)(m), 12(1)(e), 20(7)(d).
[504] ITA, paras. 20(1)(n), 12(1)(e).
[505] ITA, para. 20(8)(b).
[506] ITA, para. 20(8)(a).
[507] ITA, para. 20(1)(a); ITR, Part XI.
[508] ITA, subsec. 13(1).

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depreciated capital cost of property of the class at the end of the year, they may claim less, deferring but not losing the deduction. Effectively, this allows taxpayers to use straight-line depreciation, or depreciation on a declining balance basis at a different rate, so long as the maximum allowance is not exceeded. It may be advantageous to claim no allowance at all, for example, if the taxpayer is in a loss position. Further flexibility is added through provisions that allow taxpayers, in some cases, to group properties of several classes into a single class, generally for administrative simplicity.[509] Although the rate of depreciation is not increased, property used in a single business may potentially be included in a single class, with the effect of preventing untoward recapture of capital cost allowance that might otherwise occur if the property were spread among several classes.

On the other hand, in certain cases, separate classes are prescribed for properties that would otherwise be included in a single class. For example, separate classes are required for depreciable property used to produce income from different businesses.[510] The effect of creating separate classes is to prevent the deferral of recapture of capital cost allowance. In this regard, special rules are designed to prevent such deferral and, in certain cases, the use of depreciation losses against other income, with respect to rental real property and leasing properties. A separate class is prescribed for each rental building with a cost exceeding Can. $50,000, and for leasing properties (personalty) that would otherwise fall within a particular prescribed class.[511]

Furthermore, as a rule, it is not possible to use excess capital cost allowance claims with respect to such rental or leasing properties to reduce other income.[512] As this prohibition is designed to prevent the proliferation of tax shelter investments, it does not apply to certain taxpayers whose principal business is renting or leasing such property.

To qualify for capital cost allowance, property must be included in one of the enumerated classes. No capital cost allowance may be claimed, however, with respect to the following types of property:[513]

(i) Land;

(ii) Property, the cost of which is deductible in computing income;

(iii) Property included in inventory;

(iv) Property not acquired for the purpose of gaining or producing income;

(v) Property of a nonresident that is situated outside Canada; and

(vi) Certain artwork and antiques.

Once it has been determined into what class a property falls, the maximum capital cost allowance is determined by applying the prescribed percentage to the undepreciated capital cost of property of the class. As noted, these percentages are fixed with respect to each class and vary from 4% to 100%. Leasehold interests and certain patents and franchises receive special treatment amounting, in effect, to straight-line depreciation.

In certain circumstances, capital cost allowance beyond the usual amount may be available. For example, an additional allowance applies to some property acquired before 1999 that is certified by the Minister of Supply and Services as pollution control equipment.[514]

The deductions described above are subject to reduction or prorating in certain cases. First, a "half-year" convention applies. Normally, one-half of the otherwise available capital cost allowance is deductible in the year an asset is acquired.[515] Second, where the taxation year is less than 12 months, as may be the case where a business is formed or wound-up, the available allowance is proportionately reduced.[516] The determining factor is the length of the fiscal year of the business, not when the depreciable property was acquired.

Five possible outcomes could arise on the disposition of depreciable property. First, the property may be disposed of for proceeds that do not exceed the undepreciated capital cost of property of the class. This will most likely occur where the class contains several properties. In this case, the only income tax effect is that the proceeds (to the extent of original cost) reduce the balance of the undepreciated capital cost of the class (as discussed below, any excess would be a capital gain).

Second, the proceeds may be less than the undepreciated capital cost, but all the property has been disposed of or transferred out of the class. For example, the class may contain a single property and this property is disposed of for proceeds that are less than the undepreciated capital cost. In these circumstances (assuming additional property of the same class is not acquired before year end), a deduction equal to the undepreciated capital cost must be claimed as a terminal loss in computing income.[517] There is never a capital loss on the disposition of depreciable property.[518]

Third, the proceeds may exceed the undepreciated cost of property of the class but not the capital cost of the property disposed of. In this case, there will be a recapture of capital cost allowance previously claimed equal to this excess.[519]

Fourth, the proceeds may exceed both the undepreciated capital cost and the capital cost. In this case, there is a recapture of capital cost allowance equal to the difference between cost and undepreciated capital cost, and the excess over capital cost is treated as a capital gain, the taxation of which is discussed in VIII.C.3., below.

Finally, if the proceeds exceed cost but not undepreciated capital cost, a capital gain without recapture will result.

A number of rules may deem proceeds to have been received in certain circumstances and, at the same time, a number of other provisions allow for the rollover of depreciable property at its tax cost. Both are discussed at VIII.C.3., below, as

[509] ITR, sec. 1103.
[510] ITR, subsec. 1101(1).
[511] ITR, subsecs. 1101(1a–c), (5c).
[512] ITR, subsecs. 1100(11)–(14), (15)–(20).
[513] ITR, subsecs. 1102(1), (2).
[514] ITR, paras. 1100(1)(t), (ta), Class 27 of schedule II.
[515] ITR, para. 1100(1)(t), subsec. 1100(2).
[516] ITR, subsec. 1100(3).
[517] ITA, subsec. 20(16).
[518] ITA, subpara. 39(1)(b)(i).
[519] ITA, subsec. 13(1).

ISBN 978-1-63359-385-5

they apply to capital property generally, including depreciable property.

Taxpayers may only begin claiming capital cost allowance once a property has become "available for use." The Income Tax Act contains specific rules for determining when property is available for use. In general, property is considered available for use when the property has been acquired and either:

(i) Used by the taxpayer for the purpose of earning income; or

(ii) Owned for two years.

In the case of certain types of property, special rules may apply for determining the time the property is first available for use. In some instances, the time of acquisition is unclear. For example, where a taxpayer entered into a written agreement before its year-end to acquire depreciable property, but the property was in fact delivered and paid for in the subsequent year, the property is considered acquired in the year in which the agreement was signed. In this and other cases, the courts have usually looked to the relevant private law to determine when title passes, and this view has generally been adhered to by the CRA.[520] Where the taxpayer is a public corporation, all (or a portion) of the property (other than a building) will be available for use if the property (or the portion thereof, as the case may be) is subject to a depreciation claim in accordance with GAAP in the corporation's financial statements.[521]

A special election is available with respect to long-term construction or manufacturing projects (other than buildings that are to be used principally for the purpose of earning rent). By filing an election form with its tax returns, a taxpayer may accelerate, in accordance with a complex formula, the time at which a portion of the project will be regarded as available for use.[522]

Capital cost allowance is based on an asset's capital cost, a term that is not defined in the Income Tax Act. In general terms, the capital cost of an asset is the amount laid out by the taxpayer to acquire the asset. Acquisition costs include the actual cost of the asset as well as any legal, accounting and engineering fees that are incurred in connection with the acquisition. The courts have taken a relatively lenient view as to what incidental costs may be included in computing the capital cost of depreciable property.[523] A number of rules in the Income Tax Act can apply to deem a taxpayer to have a particular cost. For instance, where a property used for a non-income-earning purpose commences to be used for the purpose of earning income, the taxpayer is deemed to have disposed of the property and reacquired the property at a determined cost.[524] Similarly, the cost of depreciable property acquired in non-arm's-length or tax-deferred transactions is computed in accordance with specific rules.[525] The capital cost of depreciable property is reduced to the extent the taxpayer deducts certain federal investment tax credits or receives governmental assistance with respect to the property.[526]

(4) Goodwill and Other Intangibles

Prior to January 1, 2017, goodwill and other intangible property were not subject to the capital cost allowance regime. Rather, properties were treated as "eligible capital properties" and subject to a modified version of the capital cost allowance regime that was generally less favorable for taxpayers. As of January 1, 2017, the distinction between eligible capital property and "ordinary" depreciable property has been eliminated. As a result, expenses relating to goodwill and other intangible property are now included in a new class of depreciable property, Class 14.1, with taxpayer's being entitled to an annual 5% deduction (on a diminishing balance basis).

Under the current rules, Class 14.1 property includes any purchased goodwill of the taxpayer and any other property of the taxpayer other than:

(i) Property that is tangible or corporeal property;

(ii) Property that is not acquired for the purpose of gaining or producing income from business;

(iii) Property with respect to which any amount is deductible (otherwise than as a result of being included in this class) in computing the taxpayer's income from the business;

(iv) Property with respect to which any amount is not deductible in computing the taxpayer's income from the business because of any provision of the ITA (other than paragraph 18(1)(b)) or the ITA Regulations);

(v) An interest in a trust;

(vi) An interest in a partnership;

(vii) A share, bond, debenture, mortgage, hypothecary claim, note, bill or other similar property; or

(viii) Property that is an interest in, or for civil law a right in, or a right to acquire, a property described in any of (i) to (vii).

A taxpayer will only have a single goodwill property and any acquisitions or dispositions of goodwill will increase or decrease the capital cost of the goodwill associated with the taxpayer's business.[527] In addition, a taxpayer may be deemed to have acquired or disposed of goodwill if it incurs capital expenses or obtains capital receipts that do not relate to a specific property (i.e., amounts that would have been "eligible capital expenditures" or "eligible capital receipts" under the old eligible capital property regime).[528]

(5) Scientific Research

Current expenditures made in Canada by a taxpayer on scientific research and experimental development (SR&ED) related to its business, and directly undertaken by the taxpayer or on the taxpayer's behalf, are fully deductible in the year, or may be carried forward for deduction in a subsequent year. The same

[520] *MNR v. Wardean Drilling Ltd.*, [1969] CTC 265; *Construction Berou Inc. v. The Queen*, 99 DTC 5868 (FCA).

[521] ITA, subsecs. 13(27), (28).

[522] ITA, subsec. 13(29).

[523] See, e.g., *Sherritt Gordon Mines Ltd. v. MNR*, [1968] CTC 262. *See* Interpretation Bulletin IT-285R2.

[524] ITA, para. 13(7)(b).

[525] See, e.g., ITA, para. 13(7)(e), subsecs. 85(1), 85(2), and 87(2).

[526] ITA, subsec. 13(7.1).

[527] ITA, subsec. 13(34).

[528] ITA, subsecs. 13(35) and (36).

ISBN 978-1-63359-385-5

treatment extends to certain payments to universities and approved research institutions, or generally to a corporation resident in Canada for scientific research related to the taxpayer's business, provided the taxpayer is entitled to exploit the results of such SR&ED.[529] Capital expenditures cannot be deducted under the SR&ED regime. A more restricted rule permits the deduction of current expenditures on scientific research carried on outside Canada.[530] Certain types of SR&ED claims have more onerous disclosure requirements through a requirement to disclose the identity of any third parties that have assisted in the preparation of applications for SR&ED claims and penalties for SR&ED program claims that have not been correctly filed.

"Scientific research and experimental development" is defined to include basic research and applied research and development (R&D), so long as there is a systematic investigation or search carried out in a field of science or technology by means of experiment or analysis.[531] Certain prescribed activities are excluded from the definition, such as market research, sales promotion, quality control, routine testing, and routine data collection.

Additional tax incentives are available with respect to SR&ED, such as the investment tax credit (ITC) — see VIII.E.4.a. and b., below).

f. Business Cessation

A number of rules apply where a taxpayer ceases to carry on a business or ceases to use property in a business.

Where a taxpayer sells all or substantially all of the property used in carrying on its business, including accounts receivable, the taxpayer may jointly elect with the purchaser that a series of statutory rules applies to those receivables.[532] The purpose is to obviate the difficulties that can otherwise arise regarding any discount computed based on collection costs or doubtful debts. Such a discount is not otherwise deductible as a business expense or reserve. The effect of the joint election, which states an amount as having been paid for the receivables, is that any discount may be deducted by the seller and is taxed in the hands of the purchaser. The latter, however, may claim a deduction with respect to receivables that prove to be uncollectible.

Another rule is designed to override the case law, which has established that the profit realized on the sale of a business is a capital gain rather than income. Where a taxpayer has sold all or any part of its inventory on disposing of or ceasing to carry on business, this property will be deemed to have been sold by the taxpayer in the course of carrying on the business, giving rise to ordinary income rather than a capital gain.[533]

Specific rules apply where a nonresident taxpayer ceases to use property in connection with a business carried on by the nonresident in Canada. Where a nonresident carrying on business in Canada ceases to use property that is inventory in connection with that business, the nonresident is deemed to have disposed of the property at fair market value and to have reacquired the property at the same value.[534] These rules would apply, for instance, where the nonresident removes the property from its Canadian business and subsequently uses the property in a business carried on outside Canada. The deemed disposition ensures that any change in value of the property is subject to Canadian tax. Similar rules apply where a nonresident acquired capital property for the purpose of gaining or producing income from a source in Canada and commences to use the property for some other purpose.[535] For capital gains tax and capital cost allowance purposes, the nonresident will be deemed to have disposed of and reacquired the property immediately after the change in use at the property's fair market value.[536]

3. Capital Gains

The taxation of capital gains was introduced in 1972, with one-half (50%) of a gain being included in a taxpayer's income and taxed at the applicable income tax rate (less allowable capital losses). Over the years, the inclusion rate was first increased to 75% of the gain but has since been reduced back to 50%. Special transitional rules may apply to tax years during which the inclusion rates were changed. The federal government has abandoned a Budget 2024 proposal to increase the inclusion rate to two-thirds of the capital gain (proposed to be effective after June 24, 2024 but never enacted).

a. What Is a Capital Gain?

The Income Tax Act does not define either "income" or "capital gain." Some assistance is rendered by the broad definition of "business" as including a profession, calling, trade, manufacture or undertaking of any kind whatever, and an adventure or concern in the nature of trade. Many tax cases have dealt with whether a particular transaction amounted to a business, thus giving rise to taxable income, or was a realization of an investment, giving rise to a capital gain.

The case law has established certain indicia or tests of the distinction. While each case is decided entirely on its own facts, these judicial tests may serve as useful guides. For example, a gain would probably be classified as income if the answer to any of the following questions is in the affirmative:

(i) Did the taxpayer enter into the transaction for the purpose and with the intention of realizing a profit?

(ii) Has the taxpayer repeatedly and systematically entered into transactions similar to that under consideration?

(iii) Is the transaction closely related to an activity that, before the transaction, has been an admitted income earning activity of the taxpayer?

(iv) Did the taxpayer purchase the asset with the intention of turning it to account by whatever means appeared feasible, though perhaps not primarily intending to dispose of it for a profit?

Other factors, such as the length of time an asset is owned and the circumstances surrounding its sale, are relevant to the determination of whether a capital gain has been realized. Ultimately, the taxpayer should be able to establish that the asset in

[529] ITA, subsec. 37(1).
[530] ITA, subsec. 37(2).
[531] ITA, subsec. 248(1).
[532] ITA, sec. 22.
[533] ITA, sec. 23.
[534] ITA, subsecs. 10(12) and 14(14).
[535] ITA, subsecs. 45(1), 13(9); para. 13(7)(a).
[536] ITA, subsecs. 45(1), 13(9); para. 13(7)(a).

ISBN 978-1-63359-385-5

question was an investment and its sale merely a realization or change of investment, so that the "whole course of the venture" is such as to indicate investment gains rather than income.

The uncertainty necessarily surrounding this determination may present a number of difficulties in business planning. Sometimes it will be hard to predict whether a proposed transaction will give rise to a gain or loss that is to be accounted for as income or as capital. The CRA advance ruling procedure generally does not apply to such questions of fact. In some cases, the doubt as to the proper tax treatment of such a gain or loss, even after it has occurred, may affect the taxpayer's confidence in the computation of special corporate surpluses.

To some extent, there has been a limited response to this uncertainty, at both the administrative and statutory levels. Thus, the CRA has announced its policy of allowing commodity trading gains and losses of individuals to be reported as either income or capital, on a consistent basis, and a similar policy generally applies to the options market.[537] The Income Tax Act itself includes a system of "guaranteed capital gains" (and losses) whereby certain Canadian resident taxpayers may permanently opt for capital treatment of all gains and losses on prescribed Canadian securities.[538]

The Income Tax Act also contains special rules that deem a capital gain (or a capital loss) to arise in certain situations, such as where a corporation purchases its own bonds in the open market or makes a gain or sustains a loss by virtue of any fluctuation in the value of a foreign currency relative to the Canadian dollar.[539]

b. Taxation of Capital Gains

In general, the excess of the taxpayer's "taxable capital gains" for the year over its "allowable capital losses" for the year is taxable at full tax rates. A "taxable capital gain" is a specified portion of the actual gain from the disposition of property and an "allowable capital loss" is the specified portion of the capital loss from the disposition of property.[540] The current specified portion or "inclusion rate" is one-half of the capital gain or loss.

The capital gain or loss from the disposition of property is the difference between the "proceeds of disposition" and the property's "adjusted cost base." "Proceeds of disposition" is broadly defined and includes the following:[541]

(i) The sale price of property sold;

(ii) Compensation for property unlawfully taken, destroyed, expropriated, or injuriously affected or damaged;

(iii) The reduction of mortgage liability as a result of the forced sale of mortgaged property, plus any proceeds received; and

(iv) The value of a debt extinguished by foreclosure of a mortgage or repossession of property sold under a conditional sale.

The "adjusted cost base" of depreciable property is its capital cost and, of any other property, the cost of such property as increased or decreased by virtue of specific provisions of the Income Tax Act.[542] The cost base will be increased (thus reducing any subsequent capital gain and increasing any subsequent capital loss) where the taxpayer has made an outlay with respect to such property effectively increasing its "cost" to the taxpayer. Similarly, various amounts must be deducted from the cost of property in computing its adjusted cost base.[543]

Individuals resident in Canada are also allowed an exemption from tax with respect to gain arising from the disposition of a "principal residence," as defined in the Income Tax Act (although mortgage interest on a principal residence is not deductible).

Gains derived from the disposition of a "qualified small business corporation share" or a "qualified farm or fishing property" are eligible for a special cumulative lifetime capital gains exemption (LCGE).[544] The amount of the exemption is equal to Can. $1,016,836 for 2024 (indexed to the rate of inflation for subsequent years). The exemption also applies to capital gains reserves that are brought into income in the tax year.

Legislative Note: Budget 2024 proposed to increase the exemption to $1.25 million for dispositions starting on June 25, 2024, with indexation of the amount to resume in 2026. The federal government has not confirmed whether this proposal will also be abandoned in line with the abandonment of the proposed increase to the capital gains inclusion rate, and, if it is abandoned, what the 2025 amount of the exemption will be based on the inflationary index.

For purposes of these exemptions, a taxpayer who ceases to be or becomes resident in a tax year will be treated as being resident throughout the year if the taxpayer was resident throughout the immediately preceding or following year. Gains or losses realized by an individual while not resident in Canada do not affect the computation of the individual's entitlement to the capital gains exemption.

Net capital losses that can be deducted in the year of death and in the immediately preceding year from sources of income other than capital gains will be reduced to the extent of all capital gains exemptions claimed by the deceased individual.

Legislative Note: Budget 2024 proposed to introduce a new Canadian entrepreneurs' incentive that would reduce the capital gains inclusion rate to half the ordinary rate (i.e., generally, one-quarter) for up to $2 million of certain capital gains. The reduction would be available for dispositions at fair market value of qualifying shares by eligible persons that occur on or after January 1, 2025. Draft legislation was released on August 12, 2024. The federal government has not confirmed whether this proposal will also be abandoned in line with the abandonment of the proposed increase to the capital gains inclusion rate.

Qualifying shares are, generally, shares of a small business corporation that was a CCPC for 24 months prior to the disposition and that principally used over 50% of its assets in an active business carried on primarily in Canada; certain corporations

[537] See Interpretation Bulletin IT-346R (11/20/78).
[538] ITA, subsecs. 39(4)–(6).
[539] ITA, subsecs. 39(2), (3).
[540] ITA, sec. 38.
[541] ITA, sec. 54.
[542] ITA, sec. 54.
[543] These adjustments are found in ITA, sec. 53.
[544] ITA, subsec. 110.6(1).

ISBN 978-1-63359-385-5

are excluded, including professional corporations, corporations the reputation or skill of one or more of whose employees is their principal asset, and corporations carrying on certain types of businesses.

An eligible person is, generally, someone who: (i) held the shares for a total period of at least three years prior to the disposition and who was "actively engaged on a regular, continuous, and substantial basis in the activities of the business" during those three years; and (ii) for the 24 months prior to the disposition, directly owned more than 5% of all issued and outstanding shares by votes and value.

The $2 million lifetime limit would be phased in between 2025 and 2029 in $400,000 increments and would be available in addition to other capital gains exemptions.

c. Deemed Dispositions

In various circumstances, a taxpayer will be deemed to have disposed of capital property and to have realized a gain or loss on such disposition.

The Income Tax Act provides that, immediately before his or her death, a taxpayer is deemed to have disposed of each capital property owned by him or her at fair market value. The taxpayer's beneficiaries are deemed to have acquired the property at these values (subject to special rules for spousal bequests discussed below).[545] A gift of property is also treated as a disposition at fair market value.[546]

A deemed disposition also occurs when a taxpayer ceases to have or establishes Canadian residence.[547] The rules apply to individuals, trusts and corporations that cease to be or that become resident in Canada. Generally, a taxpayer that ceases to be resident in Canada is treated as having disposed at fair market value of all of its property (other than, in the case of an individual, in general terms, property with respect to which Canada would expect to collect tax on a subsequent disposition by the nonresident taxpayer) immediately before ceasing to be resident in Canada. A taxpayer that becomes resident in Canada is treated as having acquired all of its property (other than, generally, property with respect to the disposition of which the nonresident would already have been subject to Canadian tax) at a cost equal to the fair market value of that property at the time that the taxpayer becomes resident.

A taxpayer may take advantage of an election to furnish security for payment of this "departure tax" in lieu of immediate payment. Further, there is no deemed disposition of property brought to Canada or received while resident in Canada by way of inheritance or gift by an individual if the taxpayer was resident in Canada for periods aggregating less than five of the 10 years preceding his or her departure.

The income tax immigration rules determine the capital, for tax purposes, of shares of corporations that become resident in Canada. In general terms, such capital will not exceed the excess of the cost of the corporation's assets (as determined for Canadian tax purposes, as described above) over its liabilities.

The "departure tax" described above entails a realization of accrued gains with respect to property held by a Canadian resident who becomes a nonresident. The tax applies to individuals, trusts and corporations. As a corollary, individuals, trusts and corporations that become resident in Canada generally enter the system with a tax cost of property equal to fair market value at the time of taking up residence.

Related rules determine the tax consequences of an amalgamation, merger or similar combination of corporations that are resident in more than one jurisdiction. Where the combined corporation is resident in Canada, any nonresident predecessor corporations are deemed to have become resident in Canada immediately before the merger. Where the combined corporation is nonresident, any Canadian resident predecessor corporations are deemed to have ceased to be resident immediately before the merger. The rules generally applicable to taxpayers becoming and ceasing to be resident in Canada, described above, will apply accordingly.

A corporation that has been granted articles of continuance (or similar constitutional documents) in a jurisdiction is treated, for purposes of applying the Income Tax Act after that time, as having been incorporated in that jurisdiction.[548] Before the introduction of this rule, the Canadian tax authorities had taken the opposite approach, with unfortunate results for continued corporations in many cases. For example, a corporation continued into Canada could generally never achieve the status of a "taxable Canadian corporation." (The application of most of the reorganization tax deferral rules and the intercorporate dividend deduction, among other things, depends upon that status.) Similarly, although a corporation continuing out of Canada was subject to the "departure tax" described above, the corporation generally was considered to retain its status as a resident of Canada for Canadian tax purposes on the basis that it had been incorporated in Canada.

A third type of deemed disposition applies only to trusts. Generally, a trust is deemed to dispose of its property and immediately reacquire it every 21 years.[549] Where the trust has been created in such a manner as to allow a rollover of property to the taxpayer's surviving spouse (see VIII.C.3.e., below), a deemed disposition occurs when that surviving spouse dies.

Lastly, a deemed disposition rule is applicable in respect of so-called synthetic disposition schemes, which eliminate all or substantially all of the risk of loss or opportunity for profit regarding a specific property. Hedging arrangements intended to reduce the risk of owning specific property may be subject to these rules. Similarly, "equity monetization" transactions will likely be subject to these rules. When the synthetic disposition scheme is intended to have effect for longer than one year, the rules deem the property in question to have been sold and reacquired at fair market value after 30 days of entering into the arrangement.

d. Rollovers

As a rule, taxpayers not dealing at arm's length must, in effect, transfer property between them for proceeds equal to fair market value. Unless otherwise provided by a specific provision of the Income Tax Act, the purchaser's cost will be deemed equal to fair market value if the actual proceeds ex-

[545] ITA, subsec. 70(5).
[546] ITA, para. 69(1)(c).
[547] ITA, sec. 128.1.
[548] ITA, subsec. 250(5.1).
[549] ITA, subsec. 104(4).

ISBN 978-1-63359-385-5

ceed this amount, while the seller's proceeds will be deemed equal to fair market value if the actual proceeds are less than this amount.[550] Note that the CRA's position is that, where the seller's proceeds are deemed to be the fair market value of the property because the actual proceeds are less than this amount, there is no corresponding increase to the purchaser's cost of the property based on the wording of subsection 69(1). Thus, there is the possibility of economic double taxation on a subsequent sale of the property by the purchaser. Hence, it is important to use various "rollovers" to facilitate certain transfers without the realization of accrued capital gains or losses.

Where rollover treatment is afforded, the transferor is generally deemed to have disposed of the property for proceeds of disposition equal to his or her adjusted cost base, thereby eliminating gain or loss. The recipient is deemed to have acquired the property at the adjusted cost base of the transferor. Thus, tax is not saved, but is merely deferred. The transferee will ultimately pay the tax that the transferor has been spared, unless the transferee too benefits from a rollover on a subsequent disposition of the property.

The more important situations in which a rollover occurs include the following:

(i) On the transfer of most types of property by any person to a Canadian corporation where the consideration includes shares (although, in this case, the rollover is elective and not necessarily at cost);[551]

(ii) On the winding-up of a 90% or more owned Canadian subsidiary of another Canadian corporation;[552]

(iii) In certain instances of domestic corporate reorganizations, amalgamations, debt-for-debt exchanges or share-for-share exchanges, and analogous reorganizations involving foreign affiliates;[553]

(iv) In certain divisive reorganizations where the property of a corporation is divided among "non-arm's-length" corporations, or where the property of a corporation is divided among arm's-length corporations and each such recipient receives the proportion of assets of each type owned by the transferor corporation equal to the proportion of the shares in the transferor owned by the recipient immediately before the transfer, or on certain public company split-ups;[554]

(v) On the transfer of property *inter vivos* or on death to a spouse or to a trust for a spouse fulfilling certain conditions;[555]

(vi) On the purchase of replacement property with insurance proceeds or compensation received by virtue of expropriation, or, in limited cases, purchase of a replacement for real property used in a business;[556]

(vii) On the winding-up of a partnership in certain circumstances;[557] and

(viii) On certain distributions of trust property to capital beneficiaries.[558]

e. Property Receiving Special Treatment

Property owned by a person is considered "personal-use property" if it is primarily for the personal use or enjoyment of the owner or of any individual related to the owner,[559] such as personal effects, automobiles, furniture and residences (other than principal residence). Two special rules distinguish the treatment of personal-use property from other property with regard to capital gains. First, when any such property is disposed of, the gain is measured against a deemed minimum cost of Can. $1,000. Second, losses on dispositions of personal-use property are not deductible from income, even income resulting from the disposition of other personal-use property. An exception to this latter rule is made in relation to "listed personal property," that is, various forms of valuable property such as jewelry, rare folios, works of art, etc.[560] Losses on dispositions of listed personal property may be deducted from gains on dispositions of other listed personal property. A net loss may not be taken against other income; however, any unabsorbed losses may be carried forward seven years and back three years to offset gains on such property.

One type of property with respect to which the classification of gains or losses may be difficult is money. Canadian taxpayers engaged in international commerce, and foreign taxpayers trading with Canada, may realize gains or losses with respect to currencies other than Canadian dollars. The characterization of any such gains or losses will normally depend on the use to which the money is put and the context for the transaction. Further, gains and losses may be recognized without a "disposition" where the taxpayer has "made" a gain or "sustained" a loss by reason of currency fluctuations, for example, on the repayment of foreign currency-denominated debt.[561]

The tax treatment of foreign exchange losses was dealt with in the two Supreme Court of Canada cases of *Imperial Oil* and *Inco*.[562] In both cases, the taxpayers issued U.S. dollar-denominated debentures at a discount. By the time some of these debentures were redeemed years later, the Canadian dollar had depreciated relative to the U.S. dollar. Apart from the original issue discount, the redemption payment (expressed in Canadian dollars at the time of redemption) exceeded the face amount of the redeemed debentures (expressed in Canadian dollars at the time of issue). Relying on paragraph 20(1)(f) of the Income Tax Act (which at the time allowed a deduction for 50% of the excess of the amount paid in satisfaction of the principal amount of a debt over the amount for which the debt was issued), the taxpayers sought to deduct 50% of the excess from their business income.

[550] ITA, sec. 69.
[551] ITA, sec. 85.
[552] ITA, subsec. 88(1).
[553] ITA, secs. 86, 51, 51.1, 85.1, subsec. 95(2). The rollover in subsec. 85.1(3) and para. 95(2)(c) will generally not apply on the transfer of foreign affiliate shares that are "excluded property" where a loss would otherwise arise.
[554] ITA, paras. 55(3)(a) and (b).
[555] ITA, subsecs. 73(1), 70(6).
[556] ITA, subsec. 13(4), sec. 44.
[557] ITA, subsecs. 98(3), (5), (6).
[558] ITA, subsec. 107(2).
[559] ITA, secs. 54, 46.
[560] ITA, sec. 41.
[561] ITA, subsec. 39(2).
[562] 2006 SCC 46. Both cases were heard together.

ISBN 978-1-63359-385-5

Under paragraph 20(1)(f) (which has traditionally been associated with original issue discounts), 50% of the excess of: (i) the principal amount repaid over (ii) the amount for which the debt was issued, is deductible by a taxpayer from business income unless the excess is a "shallow" discount (in which case, the full amount of the excess is deductible). The dispute with the tax authorities was whether this provision also applied to foreign exchange losses (i.e., the excess, not attributable to the discount, that arises because the foreign currency in which the debt is denominated appreciates relative to the Canadian dollar). In turn, it was argued, this depends upon whether the principal amount of the debt is to be expressed in Canadian dollars using the foreign exchange rate at the time of issue (as was argued by the Crown) rather than at the time the debt was repaid (as was argued by the taxpayers).

The majority held that paragraph 20(1)(f) of the Act only applies to the costs that arise as a result of the debt being issued at a discount because, based upon the words of the provision, that best reflects the statutory scheme and the intent of Parliament. It was never intended that paragraph 20(1)(f) apply to foreign exchange losses. Such losses are costs with respect to financing in foreign currency that are of a wider class than discounts and are not referred to in the provision. Consequently, the majority held, the provision did not apply, and the foreign exchange losses were capital losses under subsection 39(2), a residual provision that applies to foreign exchange losses.

The immediate result of the Supreme Court's decisions in *Imperial Oil* and *Inco* is that foreign exchange losses incurred on the repayment or repurchase of capital debts are not deductible in computing business income, but instead are capital losses. However, the Court's reasoning in reaching that conclusion may have broader implications that should find favor with taxpayers:

(i) Although the majority and the minority did not agree that the foreign exchange losses were direct or intrinsic costs of the borrowing, they did agree that, to encourage businesses to raise debt capital, the Income Tax Act provides a deduction for virtually all other financing costs that arise directly out of the borrower-lender relationship.

(ii) Both the majority and the minority acknowledged that they were dealing with indebtedness that was on capital account. However, the majority also acknowledged that the character of a foreign exchange gain or loss cannot be separated from that of the underlying transaction. This means that, where an underlying business transaction is on income account, the foreign exchange gain or loss with respect to that transaction is also on income account and is not transformed into one on capital account (for example, because the underlying business transaction is not completed).

More troubling for taxpayers, however, is that both the majority and the minority acknowledged that the Minister's treatment of commodity-based loans and exchangeable debentures was inconsistent with the Minister's treatment of foreign currency indebtedness. Although the minority agreed with the administrative position and found no principled basis on which to justify the Minister's differing position in *Imperial Oil* and *Inco,* the majority did not deny the Minister's ability to take such inconsistent positions, nor did it allow that inconsistency to interfere with its interpretation and application of the Act.

Comment: Taxpayers who are considering transactions that rely on an administrative position of the Minister should carefully consider whether that position properly reflects the law, failing which, taxpayers would be well advised to obtain advance income tax rulings with respect to their proposed transactions.

The CRA has generally taken the view that a foreign currency hedge may be on capital account where it reduces the taxpayer's risk with respect to a capital transaction. However, the CRA has generally considered that a similar result would not arise where the taxpayer hedges risk with respect to a capital property (such as shares of a subsidiary) rather than a transaction. However, in *George Weston Limited v. The Queen,*[563] the court held that certain currency hedges were on capital account where they hedged the taxpayer's indirect foreign exchange exposure to shares of a subsidiary — which was relevant to the taxpayer's accounting and financial reporting. The Supreme Court of Canada subsequently held in *MacDonald v. The Queen*[564] that the tax characterization of a derivative contract is dependent on the contract's purpose as determined using objective indicia, such as the contract's linkage to an underlying asset, liability or transaction. The greater the linkage between the derivative contract and the underlying asset, liability or transaction, the stronger the presumption that the purpose of the derivative contract is to hedge the underlying asset, liability or transaction.

Options also receive special treatment.[565] The general rule is that granting an option to acquire property is itself a disposition that triggers a capital gain equal to the amount received for the option. When the option is exercised, the purchaser includes its cost in the cost of the property and, in lieu of realizing a gain on the grant of the option, the seller may include the original amount received in the proceeds of disposition of the property. An option respecting shares of a corporation is different. There is no gain to the issuer on a grant of an option by a corporation to acquire shares of itself unless the option goes unexercised and certain other conditions are satisfied.

There are special treatment rules concerning certain "character conversion transactions" — i.e., financial agreements intended to purchase or sell capital property where the value of consideration is not determined by reference to the actual value of the property, the value of the associated capital gains or the income derived from the property. Investment funds have traditionally entered into such agreements in pursuit of higher-than-expected returns. The rules deem any gains or losses derived from character conversion transactions to be on account of income, rather than on account of capital gains.

There is an exception to these rules if the price payable under the contract is determined by reference to the value of the capital property to be acquired thereunder, or revenue, income or cash flow in respect of such property.

The availability of this exception is limited in certain circumstances where the capital gain from the disposition of the

[563] 2015 TCC 42.
[564] 2020 SCC 6.
[565] ITA, sec. 49.

ISBN 978-1-63359-385-5

derivative can reasonably be considered to be attributable to interest, dividends or income of a trust that was paid or payable on the underlying security. This limitation is generally effective as of March 19, 2019.

f. Capital Losses

Normally, allowable capital losses may be set off only against taxable capital gains. Allowable capital losses not used in a particular tax year may be carried back three years or forward indefinitely to offset taxable capital gains realized in those other years. The loss carryover provisions are discussed at VIII.D.6., below.

An exception to the rule that allowable capital losses may only reduce taxable capital gains is provided where the capital loss constitutes an allowable "business investment loss."[566] This is generally a loss from the disposition, to an arm's-length purchaser, of shares or debts of a "small business corporation." In general, a small business corporation is defined as a Canadian controlled private corporation all or substantially all of the assets of which are used in an active business carried on primarily in Canada by the particular corporation or by a corporation related to it. In the case of debts, where the taxpayer is a corporation, the debtor must be dealing at arm's length. One-half of a business investment loss (an "allowable business investment loss") may be used to offset income from any source.[567] Any unused portion of an allowable business investment loss in a particular tax year becomes a noncapital loss, which may be carried back three years and forward 20 years to offset income from any source.[568] An allowable business investment loss not used within the 20-year carryforward period becomes a net capital loss, which may be carried forward indefinitely, but applied only against taxable capital gains in future years.[569]

D. Computation of Taxable Income

In general terms, a taxpayer's "taxable income" is the taxpayer's income adjusted for certain additions and deductions in Division C of the Income Tax Act. The taxpayer's income tax is determined by applying the applicable tax rates to the amount of taxable income. The income tax is then subject to further adjustments to determine the taxpayer's final tax payable.

1. Personal and Similar Deductions

Individuals are allowed various personal, charitable, medical and other credits in computing income tax payable. These items are dealt with at VIII.E.4., below.

2. Employee Stock Options

The tax treatment of employee stock options is discussed at VIII.C.1.a.(5), above. Part of that system involves certain deductions available to individuals in computing taxable income. In particular, individuals may deduct one-half of the amount of the benefit deemed to have been received on the exercise or disposition of a qualifying stock option, subject to the limitation on stock option deductions. This includes rights to acquire shares that are prescribed shares (essentially common equity shares), where the amount payable by the taxpayer to acquire the shares under the agreement is not less than the fair market value of the shares at the time the agreement was made.[570]

Where the employee surrenders the option for cash in lieu of exercising it, the paragraph 110(1)(d) deduction may be available in certain circumstances. However, an employee will generally be prevented from claiming a deduction under paragraph 110(1)(d) unless the employer elects in the prescribed form to forgo a corporate deduction for the cash payment.

However, based on the 2011 decision of the Federal Court of Appeal in *Imperial Tobacco Canada Ltd. v. The Queen*,[571] cash payments made on the surrender of options in the context of a corporate takeover may not be deductible.

In addition, as part of the special system applicable to rights to acquire shares from CCPCs, a taxpayer may deduct one-half of the benefit deemed to have been received on the disposition of a share subject to those rules, provided he or she has not disposed of the share (otherwise than as a consequence of death) or exchanged the share within two years after the day it was acquired. This deduction does not apply if the other deduction in computing taxable income with respect to qualifying stock options referred to immediately above has been claimed.[572]

3. Charitable Gifts

Charitable gifts made by an individual entitle the donor to a tax credit against tax otherwise payable. However, corporations are entitled to a deduction for charitable donations in computing taxable income. Gifts to charitable and other organizations, as well as gifts to the Crown, are deductible by a corporation up to an annual maximum of a total of 75% of the corporation's income for the year, plus 25% of any taxable capital gain resulting from the gift and 25% of any recaptured depreciation included in income as a consequence of a charitable donation. Gifts not deductible in the year may be carried forward five years. To qualify, a donation must be proven by filing receipts that contain prescribed information and must have been made to:

(i) A registered charity;

(ii) A registered Canadian amateur athletic association;

(iii) A tax-exempt Canadian housing corporation;

(iv) A Canadian municipality;

(v) The United Nations or an agency thereof;

(vi) A prescribed foreign university;

(vii) A foreign charitable organization to which the Canadian government has made a gift during the year or the preceding 12 months; or

(viii) His Majesty in right of Canada or a province.

[566] ITA, para. 39(1)(c).
[567] ITA, para. 38(1)(c) and sec. 3.
[568] ITA, para. 111(1)(a) and subsec. 111(8) definition of "noncapital loss." Note that noncapital losses that arose in taxation years ending before March 23, 2004, are carried forward seven years, and those in taxation years ending from March 23, 2004 through December 31, 2005, are carried forward 10 years.
[569] ITA, subsec. 111(8) definition of "net capital loss."
[570] ITA, para. 110(1)(d).
[571] 2012 DTC 5003 (FCA), leave to appeal to the Supreme Court of Canada denied.
[572] ITA, para. 110(1)(d.1).

ISBN 978-1-63359-385-5

Ordinarily, a gift of property entails a deemed disposition of the property given at fair market value. Where, however, a corporation makes a gift of capital property to a qualified donee or, in the case of a corporation not resident in Canada, a gift of Canadian real property to a prescribed donee who provides a satisfactory undertaking that the property will be held for use in the public interest, then the corporation may choose an amount, not greater than the fair market value and not less than the adjusted cost base of the property, as constituting both the amount of the gift and the proceeds of disposition.[573]

Where a donor derives some advantage or benefit from a gift to an eligible charitable donee, the donor's qualifying charitable donation is limited to the excess of the fair market value of property donated over the value of the advantage or benefit, if any, to which the donor is entitled as a result, such excess being defined as an "eligible amount." Furthermore, the minimum designated amount for a gift of capital property and certain real property of the type discussed above is limited to the greater of the amount of the advantage, if any, related to the gift and the cost of the property.[574]

Individuals and corporations making donations of certain types of ecological or cultural property, securities listed on designated stock exchanges, mutual fund units and segregated funds of life insurance companies to charities (other than private foundations) do not have to include any portion of any resultant capital gain in their income.[575]

A parallel provision applicable to the exercise of employee stock options and the donation of such shares (or mutual fund units) reduces the inclusion of any amount of an employee benefit in income to zero.[576] To qualify for this treatment, the security must meet the criteria for donations of publicly listed securities,[577] the taxpayer must qualify for the employee stock option deduction,[578] and the taxpayer must donate the security during the year and within 30 days of exercising the option.[579]

Notwithstanding the above, the donation of an option to acquire a property of the taxpayer will not entitle the taxpayer to a tax credit until the option is exercised. Recognition of the donation is also generally deferred for nonqualifying securities (generally speaking, securities of the donor and those of persons not dealing at arm's length with the donor that are not listed on a designated stock exchange) until such time within five years of the donation as they are disposed of by the donee for a consideration that is not other nonqualifying securities of any person.

4. *Preferred Share Dividends*

A fuller discussion of the complex rules relating to the taxation of preferred share dividends is at IX.C.1.a.(5) and (6), below. As part of that system, a dividend-paying Canadian corporation, in certain circumstances, may be required to pay a special tax under Part VI.1 of the Income Tax Act that is equal to a defined percentage of dividends paid at a rate of 25% (for dividends paid on taxable preferred shares) or 40% (for dividends paid on short-term preferred shares). That tax is recoverable against ordinary Part I income tax through a deduction in computing taxable income. In particular, an amount equal to 3.5 times the tax payable by the taxpayer for the year is deductible in computing taxable income.[580] This tax regime is analogous to the old U.K. Advance Corporation Tax (ACT) system. The tax is intended to ensure that a shareholder is not afforded a credit greater than the amount of tax actually paid by the corporation.

There are several exemptions from Part VI.1 tax, the most significant of which is an exemption for dividends paid to a shareholder that has a "substantial interest" in the dividend payor.[581] A shareholder has a substantial interest in a dividend payor where, among other things, the shareholder is related to the dividend payor. Thus, dividends on preferred shares between related parties that are part of the same corporate group are generally not subject to Part VI.1 tax.

5. *Capital Gains Exemption*

The special lifetime exemption for certain capital gains realized by Canadian resident individuals is discussed at VIII.C.3.b., above. The exemption is effected by way of a deduction in computing taxable income.[582]

6. *Losses*

Losses incurred in other tax years may, subject to various restrictions, be deducted in computing taxable income.[583] For this purpose, losses are divided into five categories:

(i) Noncapital losses;

(ii) Net capital losses;

(iii) Restricted farm losses;

(iv) Farm losses; and

(v) Limited partnership losses.

In each case, no amount may be deducted in any year until losses deductible in previous years have been claimed. Losses need not be claimed in any particular year, subject to the carryover limitations noted in VIII.D.6., below.[584]

The Income Tax Act generally does not contain a provision permitting consolidated returns or group relief.[585] The utilization of losses within a corporate group, however, is possible in limited circumstances, as discussed in VIII.D.6.f., below.

a. *Noncapital Losses*

A taxpayer's noncapital loss for the year is the amount by which:[586] the taxpayer's losses for the year from an office, employment, business or property, and allowable business in-

[573] ITA, subsec. 110.1(3).
[574] ITA, subsecs. 248(30) to (32).
[575] ITA, subsec. 38(a.1).
[576] ITA, para. 110(1)(d.01).
[577] ITA, subpara. 110(1)(d.01)(i).
[578] ITA, subpara. 110(1)(d.01)(iv).
[579] ITA, subpara. 110(1)(d.01)(iii).

[580] ITA, para. 110(1)(k).
[581] ITA, subsecs. 191(1) and (2).
[582] ITA, subsec. 110.6(1). This provision was amended in 2007 to extend the lifetime capital gains exemption, as well as various intergenerational rollovers, to fishers by way of a capital gains exemption for qualified fishing property.
[583] ITA, subsec. 111(1).
[584] ITA, subsec. 111(3).
[585] Part VI.I tax may be transferred to a related corporation through a joint election in ITA, sec. 191.3.
[586] ITA, subsec. 111(8).

ISBN 978-1-63359-385-5

vestment loss (see VIII.C.3.f., above) plus amounts deductible with respect to intercorporate dividends (see VIII.D.7., below), the capital gains exemption, and certain other items, exceed the taxpayer's net income from these sources, plus taxable capital gains.

Noncapital losses may be carried forward for 20 years and back for three years.[587] That is to say, in computing taxable income for a particular year, the taxpayer may deduct against income or gains noncapital losses of the 20 immediately preceding years and the three years immediately following.

b. Net Capital Losses

As a rule, capital losses are not deductible against sources of income other than capital gains. Allowable capital losses, other than allowable business investment losses (see VIII.C.3.f., above), may only be claimed against taxable gains in the year.

To temper the harshness of this rule, a "net capital loss" for a year may be carried forward indefinitely. In essence, net capital losses are the portion of a taxpayer's allowable capital losses that have not been used to offset any taxable capital gains in a particular year. In particular, the taxpayer may deduct in computing taxable income his or her net capital losses of all taxation years preceding, and the three taxation years immediately following, the year up to the amount of the taxpayer's net taxable capital gains for that year. Net capital losses are adjusted to reflect the inclusion rate of the year in which the losses are incurred and the year to which they are carried over so that a capital loss incurred in one year will fully offset a capital gain of the same amount incurred in another year, even if different inclusion rates would otherwise mean that the quantum of net capital loss and taxable capital gain are not equal.

c. Farm Losses

Where a taxpayer's chief source of income is neither farming nor a combination of farming and some other source ("hobby farmers"), the taxpayer's loss from any farming business carried on by him or her is restricted in such a manner that the maximum possible loss that may be claimed in a tax year is Can. $17,500.[588] More precisely, if the loss does not exceed Can. $2,500, it is fully deductible; if the loss exceeds that amount, the deduction is Can. $2,500 plus one-half the amount of the excess, up to the Can. $17,500 maximum. Such part of the loss as may not be deducted due to the application of this formula is referred to as a "restricted farm loss." Such a loss may be carried forward for 20 years and back for three years subject, however, to the further limitation that it be used only to reduce the taxpayer's income from farming businesses carried on by the taxpayer.[589]

Other losses from a farming (or fishing) business are treated essentially as noncapital losses, which may be carried forward 20 years and back three years.[590]

d. Limited Partnership Losses

Rules to restrict the deductibility of losses by limited partners are discussed in greater detail in connection with partnerships at IX.A.1., below. Generally, a loss of a partner disallowed under these rules becomes a "limited partnership loss," which may then be deducted in computing taxable income against, in effect, limited partnership profits. In particular, the limited partnership loss with respect to a partnership for all preceding tax years is deductible to the extent of the partner's "at-risk amount," less other losses and deductions. Since the "at-risk amount" increases when the partnership earns income, the system enables the partner to claim the disallowed loss against such a partnership profit.[591]

e. Acquisition of Control

Special rules restrict the ability of a corporation to carry forward accumulated losses after an acquisition of control of the corporation. These rules are intended to discourage taxpayers from trading losses through the purchase and sale of corporations in significant loss positions where the business of the loss company is not continued after the acquisition of control. The losses restricted include noncapital and net capital loss carryforwards, as well as accrued but unrealized losses inherent in the value of the corporation's non-depreciable capital property. The traditional test for determining whether there has been an acquisition of control is a test of legal or *de jure* control — i.e., ownership of a sufficient number of shares with voting rights to enable the holder to elect a majority of the board of directors.

These rules also may apply to deem an acquisition of control of an acquiring corporation where shares of the acquiring corporation are issued in exchange for the acquired corporation, and where shares of a corporation are issued in exchange for interests in a specified investment flow-through (SIFT) trust, a SIFT partnership or a real estate investment trust.

A bright-line test deems *de jure* control to have been acquired in certain instances to curtail corporate loss trading. When a person or a group of persons holds shares of a company the value of which, in aggregate, exceeds 75% of the fair value of all shares of the corporation, regardless of voting rights, and it is reasonable to conclude that the ownership structure has been created to avoid the application of loss-restriction rules, the rules deem such persons to have control of the corporation.

Where there has been an acquisition of control of a corporation, the corporation's tax year is deemed to have ended immediately before control was acquired.[592] This gives rise to all of the consequences of a taxation year-end, such as the obligation to file a corporate tax return, and also supports the rules that restrict certain loss carryovers. A separate determination of the income or loss of the corporation for the period ending on the date of acquisition of control must therefore be made, permitting the loss carryforward limitations to be applied.

In the case of net capital losses, a carryforward is not permitted if control of the corporation that incurred the loss is acquired by persons that did not control it at the end of the loss year. There is no carryback if control is acquired before the be-

[587] ITA, para. 111(1)(a). Note, however, that non-capital losses that arose in tax years ending before March 23, 2004, are carried forward only seven years, and those that arose in taxation years ending between March 23, 2004, and December 31, 2005, are carried forward only 10 years.

[588] ITA, sec. 31.

[589] ITA, para. 111(1)(c).

[590] ITA, para. 111(1)(a), subsec. 111(8).

[591] ITA, para. 111(1)(e).

[592] ITA, subsec. 249(4).

ISBN 978-1-63359-385-5

ginning of the loss year by persons that did not control the corporation at the beginning of the preceding year into which the loss is being carried.[593] Gains or losses on foreign-denominated debt arising from currency fluctuations will be treated in the same manner as other capital gains and losses.[594]

The adjusted cost base of non-depreciable capital property owned by the corporation immediately before the change of control is reduced to its fair market value, with the amount by which the adjusted cost base is so reduced constituting a capital loss of the corporation for the year ended immediately before the change of control. The corporation may elect to be treated as having disposed of, and reacquired, other of its capital property immediately before the year-end deemed to occur on an acquisition of control, thus enabling the corporation to realize accrued gains to offset these losses.[595]

In the case of noncapital losses or farm losses, the rule is more complex. Where control has been acquired before any particular tax year, the carryforward of prior losses depends on both a qualitative and a quantitative test. First, no deduction is available unless the business that incurred the loss is carried on throughout the year for profit or with a reasonable expectation of profit. Second, in such a case, the deduction is limited to the corporation's income from that business or a substantially similar one.[596] The carryback of such losses is subject to an analogous restraint. The loss business must be carried on for profit or with a reasonable expectation of profit, throughout the carryback year and in the loss year. The deduction is limited to income from the business or a substantially similar business.[597]

The deduction for noncapital or farm losses is also limited to such losses as may reasonably be regarded as losses from carrying on a business. Losses from property or allowable business investment losses may not be carried either forward or backward over an acquisition of control.

The carryforward of R&D expenses on an acquisition of control is restricted in a similar manner. Such expenses are deductible for a year after an acquisition of control only if the business to which the expenses relate is carried on throughout that year for profit or with a reasonable expectation thereof, and only to the extent of the income earned from that or a similar business.[598]

Where a corporation acquires depreciable property within the 12-month period before an acquisition of control and the property was not used (or acquired for use) in a business carried on by the corporation before that 12-month period, the property is deemed to have been acquired immediately after the acquisition of control for purposes of computing undepreciated capital cost of the property. The same deeming rule applies for purposes of calculating certain investment tax credits.[599] A similar rule applies with respect to foreign or Canadian resource property acquired by a corporation that was not a principal business corporation (essentially, a natural resource company) for purposes of calculating foreign exploration and development expenses, cumulative Canadian development expenses, and cumulative Canadian oil and gas property expenses. These rules prevent the transfer of property with respect to which certain tax deductions or credits are available, in contemplation of an acquisition of control to reduce taxable income, where the persons acquiring control would not be in a position to use the deductions or credits themselves.

Various other rules support these loss restricting provisions. For example, on an acquisition of control there is a deemed realization of accrued losses in depreciable property, rendering such losses effectively subject to the strictures described above.[600] Various natural resource deduction accounts also are affected by an acquisition of corporate control.[601]

f. Corporate Reorganizations

The rules described above prevent the use of losses in certain cases where control of the loss company is acquired. However, special rules provide that "control" for these purposes will not generally be regarded as having been acquired where the loss company was controlled by a person related to the acquiring taxpayer.[602] This prevents the loss restriction rules from applying on certain corporate reorganizations.

Because the Canadian income tax system does not permit consolidated tax returns, rules permitting the carryforward of losses on certain mergers are of particular importance. Noncapital and net capital losses of a predecessor taxable Canadian corporation may be used by the corporation resulting from an amalgamation as if they had been incurred by it.[603] Similarly, losses of this type flow to the Canadian parent of a wholly owned Canadian subsidiary on liquidation of the subsidiary.[604] The Income Tax Act also contains rules designed to prevent the use of these relief provisions to acquire losses from outside a corporate group.

g. Nonresident Taxpayers

A nonresident subject to Canadian tax may accumulate losses, which may be deducted in computing taxable income earned in Canada only to the extent they may reasonably be considered to relate to Canadian-source employment income, business income or capital gains.[605] However, the computation of a taxpayer's loss for a year during which the taxpayer was a nonresident takes into account neither losses from businesses the income of which would be treaty-exempt nor losses from properties with respect to which any gain realized upon their disposition would be treaty-exempt.[606]

7. Intercorporate Dividends

The taxation of dividend income will be discussed at greater length in the context of corporate distributions at IX.C.1., below. Deductions for certain dividends received are discussed briefly here because they are elements of the computation of taxable income.

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[593] ITA, subsec. 111(4).
[594] ITA, subsec. 111(12).
[595] ITA, para. 111(4)(c)–(e).
[596] ITA, para. 111(5)(a).
[597] ITA, para. 111(5)(b).
[598] ITA, para. 37(1)(h), subsec. 37(6.1).
[599] ITA, subsec. 13(24).

[600] ITA, subsec. 111(5.1).
[601] ITA, subsec. 66.7(10).
[602] ITA, subsec. 256(7).
[603] ITA, subsec. 87(2.1).
[604] ITA, subsecs. 88(1.1)–(1.3).
[605] ITA, para. 115(1)(d).
[606] ITA, subsec. 111(9).

ISBN 978-1-63359-385-5

Dividends received by a corporation are included in income but are deductible in computing taxable income if the dividends are taxable dividends paid by a taxable Canadian corporation or Canadian resident corporation controlled by the recipient corporation.[607] A "taxable Canadian corporation" is a corporation that is not exempt from tax, is resident in Canada, and was either incorporated in Canada or has continuously been resident in Canada since June 18, 1971.[608]

Dividends from nonresident corporations are also included in income.[609] Under a complex set of rules, such dividends received by a Canadian resident corporation may be partially or completely deductible in computing taxable income.[610] These rules are discussed at XI.E.2.c.(2), below.

E. Computation of Tax

Income tax payable is determined by applying a percentage rate to a taxpayer's taxable income. Individuals, trusts, and corporations use different tax rates and rules in computing their tax payable.

1. Individuals

The taxable income of an individual is subject to progressive taxation. The threshold levels at which each rate increase applies are subject to indexing for inflation.[611] For the 2025 taxation year, Canadian federal taxes imposed on individuals are as follows:

15% (proposed to be reduced to 14.5% for 2025 and 14% for 2026 onward in Bill C-4)	$0 – $57,375
20.5%	$57,376 – $114,750
26%	$114,751 – $177,882
29%	$177,883 – $253,414
33%	$253,415 and above

To these federal taxes must be added (nondeductible) provincial income taxes levied, except in the case of Quebec (which collects its own tax on separate tax returns). In addition, a surtax is imposed on higher-income individuals in certain provinces. Married taxpayers in Canada do not file "joint returns;" each spouse files and pays tax individually.

Individuals and certain trusts are also subject to an "alternative minimum tax" (AMT). An individual's minimum tax is calculated as a percentage, currently 15%, of an adjusted income amount. The individual must then pay the greater of his or her tax otherwise determined or the AMT. In determining the individual's adjusted income amount, only certain basic deductions may be claimed, and certain additional amounts must be included (e.g., the total amount of capital gains and losses). From this adjusted amount is deducted an exemption equal to Can. $40,000, before calculating the individual's AMT. Additional taxes paid pursuant to the AMT rules may be carried forward for deduction for seven years.[612]

Legislative Note: Numerous amendments to the AMT were proposed as part of Budget 2023, effective for tax years commencing on or after January 1, 2024. The changes include broadening the adjusted income amount representing the AMT tax base, limiting the application of non-refundable tax credits to 50% (currently 100%) and increasing the AMT rate from 15% to 20.5%. The government also proposed to raise the exemption to the start of the fourth federal tax bracket, which is indexed annually to inflation ($177,882 for 2025). The Department of Finance released draft legislation for this proposal on August 4, 2023 and proposed further changes to the draft legislation in Budget 2024 (including increasing the amount of charitable donations that can be claimed to 80%, allowing certain other deductions and credits, allowing certain disallowed credits to be carried forward, and fully exempting certain trusts relating to Indigenous groups, communities and peoples that hold rights recognized and affirmed by section 35 of the *Constitution Act, 1982*). Some of the amendments to the AMT were enacted on June 20, 2024, while other proposed amendments remain outstanding.

2. Trusts

As a general rule, trusts are taxed under the Income Tax Act in a manner similar to individuals, except that all *inter vivos* trusts (other than mutual fund trusts) and most testamentary trusts are subject to tax at the top marginal federal rate of 33% (rather than the graduated rates that apply to individuals). Certain limited types of testamentary trusts are subject to tax based on the graduated rates that apply to individual taxpayers.

Trusts other than mutual fund trusts are subject to the surtaxes applicable to individuals, as described in above. Trusts are also subject to the alternative minimum tax as described above in connection with individuals. Anti-avoidance rules ensure that the Can. $40,000 alternative minimum tax exemption cannot be increased by using a multiple trust structure.

Certain public income trusts and partnerships that are specified investment flow-through (SIFT) trusts or partnerships are taxed in the same manner as corporations by disallowing previously deductible income distributions and by imposing a tax on certain trusts or partnerships at the combined federal/provincial corporate rate. These rules are quite complicated and are intended to apply to a SIFT trust or partnership, although they may apply in various unintended circumstances. (See further details in IX.B.5., below.)

Trusts are also subject to rules restricting loss-trading. Specifically, the rules, discussed in relation to corporations in VIII.D.6.e., above, apply equally to trusts that have been subjected to a "loss restriction event" — i.e., an event whereby a person or a group of persons acquire a beneficiary interest in the trust that is greater than 50% of the fair market value of all of the interests in the trust. Much like with corporations, anti-avoidance rules exist that restrict the ability to structure trusts in a way that avoids the application of the loss restriction rules of the ITA.

[607] ITA, sec. 82 and subsec. 112(1).
[608] ITA, subsec. 89(1).
[609] ITA, sec. 90.
[610] ITA, sec. 113.
[611] TA, secs. 117, 117.1.
[612] ITA, secs. 127.5 to 127.55.

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3. Corporations

a. Basic Tax Rate

The basic federal corporate income tax rate is 38%, which is applied to a corporation's taxable income or, where the corporation is a nonresident, its taxable income earned in Canada.[613] The basic rate is generally reduced to 25% (as described in VIII.E.3.d., below) for full rate taxable income pursuant to the general rate reduction. The tax rate may also be further reduced in certain circumstances depending on the type of corporation, as well as the character of the income earned.

In addition to the deductions from tax payable discussed under separate headings at VIII.E.3.b. to d., below, a corporation's tax otherwise payable is reduced by an amount equal to 10% of the corporation's taxable income earned in a province, for a net federal tax rate of 15%.[614] This is commonly referred to as the "provincial tax abatement" and is intended to leave room for the provinces to levy their respective taxes on a corporation's income that is considered earned in those provinces. Reference should be made to the discussion of provincial tax at VIII.A., above, and the rate chart contained in the Worksheets. Income that is not considered earned in a Canadian province, such as income earned from a foreign operation, is not eligible for the provincial tax abatement.

b. Small Business Deduction

The "small business deduction" is intended to provide tax relief to small businesses. In simplified terms, the small business deduction provides a deduction from tax payable equal to 19% of the first Can. $500,000 of active business income earned by a "Canadian-controlled private corporation." This effectively reduces the basic tax rate on this income from 38% to 19%, which is reduced further to a net 9% rate by the 10% abatement for income earned in a province.

For purposes of the small business deduction, an active business is any business other than a "specified investment business" or a "personal services business." A "specified investment business" is defined as a business (other than a business of leasing personal property) the principal purpose of which is to derive income from property (including interest, dividends, rents or royalties), except the business of a corporation that employs in the business throughout the year more than five full-time employees. Thus, real property rentals, which could arguably qualify as an "active business" in the abstract, will not so qualify if the corporation engaging in the rentals does not have more than five full-time employees. The definition of personal services business is generally meant to capture "incorporated" employees and management companies that essentially provide services that would otherwise have been provided by employees. An exception exists where the corporation employs more than five full-time employees. In addition to the restriction on the types of business that are considered "active businesses," income from an active business is defined to exclude income from property.

As noted earlier, the small business deduction is available only to a "Canadian-controlled private corporation," (commonly referred to as a "CCPC"), which is defined as a "private corporation" that is a "Canadian corporation" that is not controlled directly or indirectly in any manner whatever by nonresidents or public corporations.[615] A "private corporation" is a corporation resident in Canada that is not a public corporation (as defined for income tax purposes) or controlled by one or more public corporations. A "Canadian corporation" is a company either incorporated in Canada or continuously resident in Canada since June 18, 1971. Under an aggregation rule, a corporation will not be a CCPC if all of the shares of the corporation owned by nonresident persons or by most public corporations had been owned by a single person and that person would have controlled the corporation. However, in *Perfect Fry Co. Ltd. v. The Queen*,[616] the court held that a corporation was a CCPC even though its shares were held by a public corporation because it in turn was controlled by Canadian resident individuals.

To further tighten the definition of a "Canadian-controlled private corporation," the meaning ascribed to "control" has been expanded to include circumstances in which another corporation, person or group of persons has any direct or indirect influence that, if exercised, would result in control in fact of the corporation.[617] A person may have de facto control of a company, and thus control for purposes of CCPC status, even though the person cannot elect a majority of the corporation's board of directors. The March 2017 Federal Budget indicated that, in determining whether de facto control exists in any given situation:

(i) All factors relevant in the circumstances must be considered; and

(ii) Such factors will not be limited to whether the taxpayer has a legally enforceable right to effect a change to the board of directors or its powers, or to exercise influence over the shareholder or shareholders who have that right or ability.

A number of rules prevent members of the same economic unit from benefiting from the small business deduction on more than Can. $500,000 (the "business limit") of active business income. Certain rules effectively require an aggregation of income earned through corporate partnerships so that the total amount of income eligible for tax relief does not exceed the business limit. In addition, the business limit must be shared among "associated corporations." In very general terms, two corporations are associated if one controls the other, both are controlled by the same person or group of persons, or some other test of common control applies.[618] However, the association rules are highly complex and include various provisions dealing with options, de facto control and other special circumstances. The small business deduction is progressively reduced for corporations with taxable capital employed in Canada (as calculated for the large corporations tax (LCT) that only applies to certain financial institutions in Part I.3 of the Income

[613] ITA, sec. 123.

[614] ITA, subsec. 124(1).

[615] ITA, subsec. 125(7).

[616] 2007 TCC 133, aff'd 2008 FCA 218.

[617] ITA, subsec. 256(5.1).

[618] ITA, sec. 256.

ISBN 978-1-63359-385-5

Tax Act) exceeding Can. $10 million or corporations that earn passive investment income in excess of Can $50,000 for the year.[619] The small business deduction is completely eliminated once a corporation's taxable capital that is employed in Canada exceeds Can. $50 million (as of taxation years beginning on or after April 7, 2022; previously, $15 million) or its passive investment income exceeds Can. $150,000 for the year.

c. Manufacturing and Processing Deduction

Another deduction in computing tax payable derives from the special rate applicable to Canadian manufacturing and processing profits.[620] Historically, this deduction provided a more favorable rate of tax in respect of manufacturing and processing profits. However, due to reductions in the general corporate tax rate through the general rate reduction deduction (discussed below), the tax rate in respect of manufacturing and processing profits is now equal to the general corporate tax rate. Despite this, several provinces still maintain a favorable tax regime for manufacturing and processing profits such that the computation of such profits may still be relevant.

Unlike the small business deduction, the manufacturing and processing incentive is potentially available to all corporations. It applies only to certain types of profits, however. In the case of corporations with income not exceeding Can. $200,000, without any foreign business income and not carrying on certain prescribed activities, provision is made for deeming all the business profits to qualify if the corporation's activities are primarily manufacturing or processing in Canada goods for sale or lease. In other cases, however, a formula must be applied to total business profits to determine what portion qualifies for the lower rate. This formula involves a prorating of profits based on capital and labor costs involved in the manufacturing and processing sector.[621]

In determining whether a corporation's profits qualify as Canadian manufacturing and processing profits, certain activities are expressly excluded. These include farming, fishing, logging, construction, resource operations, producing industrial minerals, producing electrical energy for sale, and processing gas as part of the business of selling or distributing gas. No corporation may qualify unless at least 10% of its gross revenue from active business in Canada derives from either the manufacturing or processing of goods for sale or lease in Canada, or from the sale or lease of such goods manufactured or processed by it. In other cases, the determination is a question of fact. In one such case, the Supreme Court of Canada determined that the taxpayer was entitled to the manufacturing and processing deduction on the full amount of its profits, although a substantial portion of the profits constituted income from the investment of surplus funds on a short-term basis. The funds made up approximately 50% of the taxpayer's assets and had been acquired on the forced sale of the taxpayer's broadcasting division as a result of the nonrenewal of the taxpayer's license.[622]

An accelerated rate of depreciation (Capital Cost Allowance) applies for certain types of manufacturing and processing equipment. This temporary measure allows for amortization at a 50% straight-line rate under Class 29, whereas these assets would otherwise be included in Class 43 at a 30% declining-balance rate.

d. General Corporate Rate Reduction

The basic federal statutory rate of corporate income tax is 38%.[623] However, all corporations are entitled to a deduction based on a "general rate reduction percentage" that effectively reduces the rate of tax on a corporation's "full rate taxable income."[624] As of 2025, the general rate reduction percentage is 13% such that the effective federal corporate income tax rate on full rate taxable income is 25% (before taking into account any provincial tax abatement).

As stated above, the general rate reduction percentage is applied to a corporation's full-rate taxable income. In general terms, a corporation's full-rate taxable income is income that does not benefit from the small business deduction, or the manufacturing and processing profits deduction. As explained above, these deductions already provide a reduction in a corporation's effective tax rate. Thus, the government takes the view that corporations already benefiting from these rate reductions should not benefit further through the general rate reduction. In addition, investment corporations, mortgage investment corporations and mutual fund corporations already have special tax regimes and do not generally benefit from the general rate reduction.

e. Zero-Emission Technology Manufacturing Deduction

A temporary deduction in computing tax payable derives from a special rate applicable to zero-emission technology manufacturing has been introduced.[625] The reduction is 7.5% for income that would otherwise be taxed at the general corporate rate (15% after the federal tax abatement and the general rate reduction), and 4.5% for income that would otherwise be taxed at the small business rate (9%). The reductions are available from January 1, 2022, onward. The reductions will be phased out for taxation years beginning after 2028, until they are fully eliminated for taxation years beginning after 2031. At least 10% of a taxpayer's gross revenue from its active business in Canada must derive from eligible activities for the taxpayer to benefit from the reduction.

f. Canada Recovery Dividend

A one-time 15% charge on taxable income over Can. $1 billion applied for the 2021 tax year (referred to as the "Canada Recovery Dividend") for the country's large financial institutions, which generally includes a taxpayer that is a bank or life insurer, and any other "financial institution," as that term is defined for purposes of Part VI of the ITA, that is related to a bank or life insurer.[626]

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[619] ITA, subsec. 125(5.1).
[620] ITA, sec. 125.1.
[621] ITR, part LII.
[622] *Canadian Marconi Co. v. The Queen*, [1986] 2 CTC 465.
[623] ITA, sec. 123.
[624] ITA, sec. 123.4.
[625] ITA, sec. 125.2.
[626] ITA, sec.191.5.

ISBN 978-1-63359-385-5

g. Additional Tax on Financial Institutions

An additional tax on banking and life insurance groups increases the corporate tax rate for entities within such groups by 1.5% for all taxable income in excess of Can. $100 million.[627]

h. Share Buyback Tax

A new 2% tax applies at the corporate level on share buybacks by Canadian-resident corporations and certain other entities (such as specified investment flow-through (SIFT) trusts and SIFT partnerships) with shares or units listed on a designated stock exchange (excluding mutual fund corporations). The tax applies to the net value of such buybacks effective January 1, 2024. The tax is subject to certain exclusions, including where shares or units are issued or cancelled pursuant to certain corporate reorganizations and acquisitions and where the shares or units are non-participating debt-like preferred shares or units. There is also a *de minimis* exception where the gross equity repurchases are less than Can. $1 million. Finally, special rules govern the acquisition of equity by affiliates. The share buyback tax is generally intended to be similar to the 1% stock buyback tax introduced in the United States as part of the Inflation Reduction Act of 2022 (P.L. 117-169).[628]

4. Tax Credits

a. Individual Personal Tax Credits

In computing federal tax payable, individuals are permitted a number of diverse tax credits. Both refundable and nonrefundable tax credits reduce tax otherwise payable, but the latter are of no value where the individual does not have sufficient income to fully utilize the credits. The types of tax credits provided range from credits based on age and marital status and to those for medical expenses and tuition fees. The basic personal tax credits are as follows:

(i) Basic personal credit;

(ii) Spousal credit;

(iii) Equivalent-to-spouse credit;

(iv) Age credit;

(v) Disability credit;

(vi) Home caregiver credit; and

(vii) Pension credit.

The basic personal tax credits shown above are nonrefundable and are computed by applying the lowest personal marginal tax rate to the tax credit base. Using the lowest marginal rate ensures that the value of the credit is neutral among all income levels. The personal tax credits are fully indexed based on the annual increase in the Consumer Price Index for a 12-month period. A number of personal tax credits are reduced or eliminated where the individual's income exceeds certain thresholds on the basis that certain higher income individuals do not need the assistance provided by the particular tax credits.

Credit is also allowed for charitable gifts made by individuals. The rules regarding qualified donations are similar to those applicable to corporations, discussed at VIII.D.3., above. The credit is based on the total charitable gifts to which is applied the highest personal tax rate. However, the first Can. $200 of gifts is subject to credit at the lowest personal tax rate. The credit is effectively limited to gifts not exceeding 75% of the taxpayer's income in a given year. As discussed in connection with corporations, special rules apply to Crown gifts and cultural gifts. Gifts of certain qualifying public securities and ecological land receive special treatment whereby, upon the donation of such securities or land to a charity, the taxable capital gain is equal to zero.[629] Gifts of appreciated property are subject to an elective provision, also discussed in connection with corporations, permitting the taxpayer to claim a credit with respect to an amount between the adjusted cost base and the fair market value of the property, which amount is also treated as the amount of the gift. Legislative amendments operate to reduce the amount eligible for credit where the taxpayer has received some sort of advantage in return for the gift.[630] The charitable credit may be carried forward for five years.

In addition to the foregoing credits, there are also credits (at the lowest personal tax rate) for tuition fees and education costs, certain medical expenses, and interest paid on student loans. Credits (at the lowest personal tax rate) are also provided in recognition of Employment Insurance premiums and Canada Pension Plan contributions made by an individual taxpayer.

The refundable personal tax credits are the Goods and Services Tax Credit, the Medical Expense Tax Credit Supplement and the Canada Child Tax Benefit. Eligibility for these tax credits depends on a number of factors, including marital and family status, as well as level of income. Certain other tax measures are available to first-time home buyers, including a nonrefundable tax credit of up to Can. $1,500. Bill C-4, introduced to Parliament on June 5, 2025, proposes to provide a rebate until 2030 for GST paid by first-time home owners for a newly built house or condominium (subject to timing requirements for the construction and an upper limit for the total consideration paid of Can $1,000,000). Although the legislation has not yet passed, it is intended to have effect from May 27, 2025 as the Bill is currently drafted.

b. Investment Tax Credit

The ITC is an incentive for taxpayers to engage in economic activity in particular regions of the country or specific sectors of the economy and operates as a deduction in computing a taxpayer's tax otherwise payable, as computed for purposes of the ITC. The ITC is available to reduce the federal tax payable only after certain other tax credits have been claimed. In most cases, where the ITCs generated in a particular tax year exceed the federal tax payable net of the other credits, the unused ITCs can be carried back for three years and forward for 10 years to offset tax payable in those other years. In limited circumstances, a CCPC may be eligible for a refund of its ITCs where the corporation has insufficient tax otherwise payable to use those ITCs currently.

[627] ITA, sec.123.6.

[628] *See* U.S. I.R.C. 4501 (effective for stock repurchases after December 31, 2022).

[629] ITA, subsecs. 38(a.1) and 38(a.2), respectively.

[630] ITA, subsec. 118.1(6) and subsecs. 248(31) and (32).

ISBN 978-1-63359-385-5

The main components of the ITC are as follows:[631]

(i) The specified percentage of the taxpayer's capital cost of certified property or qualified property. The specified percentage varies depending on the geographic location and nature of the property or expenditure. In general terms, this item is intended to stimulate economic activity in Canada's eastern provinces and the far north.

(ii) 15% of the taxpayer's SR&ED qualified expenditure pool at the end of the year. From the federal fiscal perspective, this is probably the most significant ITC item. As discussed at VIII.C.2.e.(5), above, qualifying SR&ED expenses are deductible in computing income. The additional relief provided by the ITC is for a more restricted set of SR&ED expenditures and includes amounts the government believes are particularly beneficial to the growth of the Canadian economy.

(iii) Where the taxpayer is an individual, 15% of the taxpayer's flow-through mining expenditures. In general terms, these expenditures are expenses incurred in connection with the exploration of mineral resources in Canada. A mining company is able to flow these expenses out to its shareholders so that the shareholders may deduct the expenses in computing their income. This addition to the ITC regime is a further incentive to encourage Canadian mineral exploration. The current tax credit is only available for agreements to flow-through expenses signed before April 1, 2025, however the federal government has announced that it intends to extend its application through to March 31, 2027. A 30% critical mineral exploration tax credit for individuals, introduced effective April 7, 2022, generally follows the current rules in place for the 15% credit described above, except that it is only available to individuals who invest in mining flow-through shares where the project targets specified minerals (copper, nickel, lithium, cobalt, graphite, rare earth elements, scandium, titanium, gallium, vanadium, tellurium, magnesium, zinc, platinum group metals and uranium). An individual cannot benefit from both the 15% tax credit and the enhanced 30% tax credit.

(iv) Where the taxpayer is a CCPC, up to 20% of the corporation's SR&ED qualified expenditure pool.[632] This amount is in addition to the SR&ED amount already included in a corporation's ITC, (see (ii), above), and is intended to encourage small business growth in SR&ED. Generally, a CCPC can fully utilize the enhanced ITC (regardless of its income) for up to Can. $3 million in qualifying activities provided its capital remains below Can. $10 million.

Specific rules restrict the ability of passive investors in flow-through vehicles from benefiting from the ITC system. Restrictions apply regarding the amount of ITC that a partnership may allocate to a limited partner, to support general rules that restrict a limited partner's deductions to the amount of capital the partner has at risk in the partnership. Essentially, the amount of ITC that can be allocated to a limited partner is limited to the lesser of the partner's remaining "at-risk amount" under the general rules and the portion of ITC that is attributable to expenditures made based on contributions by the partner. The partnership is entitled to allocate expenditures generating a higher rate of ITC for limited partners.

In addition to the limited partnership restrictions, other rules eliminate the ability of *inter vivos* trusts to flow ITCs through to beneficiaries, subject to a narrow exception. The flow-through of ITCs is available in the case of testamentary trusts and deemed trusts under section 143 of the Income Tax Act (communal organizations).

Several provinces also offer ITCs in computing provincial taxes, similar in many respects to the federal ITCs. This is particularly true with respect to scientific research activity carried out in a province. The federal ITC takes into account certain provincial tax credits with respect to SR&ED by reducing the SR&ED expenditure eligible for the ITC by the provincial deduction or tax credit available to the taxpayer.

Furthermore, Budget 2022, Budget 2023 and Budget 2024 proposed to introduce several new refundable ITCs, some of which have since been enacted. All of the ITCs other than the clean technology manufacturing ITC are reduced by 10% if certain labor conditions are not fulfilled (generally relating to wages and apprenticeship opportunities), meaning a 30% ITC would be reduced to 20% if the conditions are not fulfilled.

The carbon capture, utilization and storage (CCUS) ITC is available for certain eligible expenses incurred between January 1, 2022 and December 31, 2040, including a phase-out period from 2031–40. Eligible expenses include the cost of purchasing and installing certain eligible equipment for an eligible project that utilizes the captured carbon dioxide for certain eligible uses. The applicable CCUS ITC rate ranges from 37.5% up to 60% of the eligible expenditure, depending on the use to which the equipment concerned is put and when the expenditure was incurred.

The clean technology ITC is available with respect to the cost of qualifying equipment, such as certain electricity generation systems, non-fossil fuel-based stationary electricity storage systems, low-carbon heat equipment and industrial zero-emission vehicles (including charging or refueling equipment). The initial rate of the ITC is 30%. It is available for expenses incurred between Budget Day 2023 and 2035, including a phase-out period from 2032 to 2035.

The clean hydrogen ITC is available with respect to investments in clean hydrogen projects. The rate varies based on the life cycle carbon intensity of hydrogen. The initial highest rate is 40% and will apply where emissions are 0.75kg of CO_2e or less per kg of hydrogen and certain labor criteria are satisfied. The credit is available at lower rates of 25% and 15% if the emissions from the production of clean hydrogen are, respectively, between 0.75kg of CO_2e and less than 2kg of CO_2e per kg of hydrogen, or less than 4.0kg of CO_2e per kg of hydrogen. It is available for expenses incurred between Budget Day 2023 and 2034, including a one-year phase-out period in 2034.

The clean technology manufacturing ITC is a refundable ITC for 30% of the capital cost of eligible property used for eligible activities, including manufacturing renewable energy equipment, zero-emission vehicles and extracting and certain processing activities for six specified minerals. It is available for expenses incurred between January 1, 2024 and 2034, in-

[631] ITA, subsec. 127(9) definition of "investment tax credit."

[632] ITA, subsecs. 127(10.1) and (10.2).

ISBN 978-1-63359-385-5

cluding a phase-out period from 2032–2034. This ITC is not subject to the 10% reduction if the required labor criteria are not satisfied.

The clean electricity ITC was announced in Budget 2023 as a 15% refundable ITC for eligible investments in clean electricity, including solar, wind, wave and tidal electricity, as well as related equipment. It is available to both taxable and non-taxable entities (including provincial and territorial Crown corporations, which are subject to additional requirements) and can apply to both new projects and the refurbishment of existing facilities. It cannot be claimed on top of the clean technology ITC. It is expected to be generally available for expenses incurred between the date of Budget 2024 and 2034 for projects that began construction on or after March 28, 2023. Draft legislation was released on August 12, 2024.

Finally, the electric vehicle supply chain ITC, announced in Budget 2024 (with certain details modified in the 2024 Fall Economic Statement), is a 10% credit (available in addition to the 30% clean technology manufacturing ITC) for the cost of buildings used for the electric vehicle assembly, electric vehicle battery production or cathode active material production supply chains segments. This ITC is only available to taxpayers that acquired at least $100 million in property that is eligible for the clean technology manufacturing ITC and is available for use with respect to all of the three supply chain segments (or in two segments plus have a qualifying minority interest — meaning at least 10% of votes and value — in an unrelated corporation that acquired at least $100 million in property that is eligible for the clean technology manufacturing ITC and available for use with respect to the remaining segment). It is expected to be generally available for buildings that are acquired and available for use from 2024 to 2034, including a phase-out period from 2033 to 2034. Draft legislation was released on February 21, 2025.

c. Political Contributions

Taxpayers may deduct from federal tax a portion of contributions made to registered federal political parties and candidates through the channels legally established for such contributions.[633] The maximum credit is Can. $650. Analogous deductions for provincial donations may be available in computing provincial tax.

d. Foreign Tax Credit

The foreign tax credit rules are discussed at XI.E.2., below.

[633] ITA, subsecs. 127(3)–(4.1).

ISBN 978-1-63359-385-5

IX. Taxation of Partnerships, Trusts, Corporations

A. Partnerships

Under Canadian income tax law, a partnership is not recognized as a separate taxpayer and, subject to the specified investment flow-through (SIFT) tax rules discussed at IX.B.5., below, neither pays tax nor files an income tax return (although there are partnership information returns). Instead, each partner is subject to tax on the partner's share of partnership income. A partnership interest is generally capital property, the disposition of which may give rise to a capital gain or loss.

The rules described below apply only to associations that are, in law, partnerships and not to other similar groupings such as syndicates or joint ventures. This distinction is a fine one, particularly where foreign entities are involved. (Canada does not have a "check-the-box" type regime for determining the character of a foreign entity. Instead, the case law has followed a process of identifying the main characteristics of the entity and comparing them to the characteristics of Canadian entities, i.e., basing treatment on a preponderance of the entity's characteristics.) The Income Tax Act does not contain a definition of partnership. To determine, therefore, whether the relationship between two or more persons is one of partnership for Canadian income tax purposes, reference is made to the legal rights and obligations between the parties according to the law of the jurisdiction governing such rights and obligations.[634] Generally, under the law of the province of Ontario, for example, a partnership is the relationship that exists between persons carrying on business in common with a view to profit.[635] Accordingly, a determination as to whether a partnership exists is essentially a question of fact. Neither a written agreement nor formal registration is conclusive evidence of the existence of a partnership. The mere co-ownership of property not associated with the carrying on of a business does not of itself create a partnership, and this is so regardless of any arrangement to share profits and losses.[636]

1. Allocation of Income or Loss

A taxpayer who is a partner in a partnership must include (or deduct) in computing income the taxpayer's share of partnership profits (or losses) for the fiscal period of the partnership ending in the particular tax year of the partner,[637] regardless of whether any distributions have been made by the partnership to the partners. For purposes of computing a partner's income or loss, a partnership is treated as if it were a separate person resident in Canada. The income, loss, taxable capital gains and allowable capital losses of the partnership are computed, taking into account the deductions allowed, including capital cost allowance. The taxpayer's share of the net profit or loss of the partnership is then attributed to the taxpayer in proportion to the taxpayer's share in the partnership (as determined under the partnership agreement). The income allocated to the partners generally retains its character and source in the hands of the partners. Income or loss of a partnership allocated to a partner with respect to the fiscal period in which the partner's partnership interest is sold is included or deducted, as the case may be, in computing the partner's income for tax purposes in the same manner as if the partner were still a member of the partnership.[638] Corporate partners with a 10% or more interest in a partnership are required to include accrued partnership income in their income for tax years ending prior to the partnership's fiscal period.[639]

Anti-avoidance rules provide that if the sharing of income or loss among partners occurs in a manner designed to achieve a reduction or postponement of tax otherwise payable, or if such sharing occurs in a manner that is not reasonable having regard to capital invested or work performed, then, notwithstanding any agreements to the contrary, the partners will be deemed for income tax purposes to share income or loss of the partnership in a manner that is reasonable in the circumstances.[640]

Under the "at-risk" rules, a limited partner's share of the losses from a business or property of a partnership of which the limited partner is a member are not deductible to the extent they exceed the partner's equity in the partnership, as adjusted. A limited partner is defined for these purposes as a member of a partnership where the partner's exposure to loss is limited by the operation of any law governing the partnership agreement (other than statutory law that limits a partner's liability for certain debts, obligations or liabilities of a limited liability partnership).[641] The rules will also apply where the form and existence of the partner is such as to provide limited liability, as is the case of a corporation formed for purposes of holding a partnership interest, other than for purposes of carrying on business in the most effective manner. The existence of an agreement for the disposition of a partnership interest, one of the main reasons for which may be considered an attempt to avoid the application of the definition of a limited partner, will also trigger the application of the rules.

The adjusted equity amount, which acts as the limit on the deduction of losses, is referred to as the partner's "at-risk amount." The at-risk amount of a partner is calculated as the adjusted cost base of the partner's interest plus the partner's share of the income of the partnership at the end of the current fiscal period. This amount is reduced by amounts owing by the partner (or non-arm's-length persons) to the partnership (or persons with whom the partnership does not deal at arm's length) and by the amount of any benefit to which the partner (or non-arm's-length persons) may be entitled by way of reimbursement, compensation or revenue guarantee as protection against loss. The latter does not include normal liability insurance or an entitlement that arises as a consequence of the death of the partner.

The statutory at-risk rules are a source of complexity in determining the tax consequences of participation in a partner-

[634] *Continental Bank Leasing Corporation v. The Queen*, 98 DTC 6505 (SCC); *Spire Freezers Ltd. v. The Queen*, 2001 DTC 5158 (SCC); and *Backman v. The Queen*, 2001 DTC 5149 (SCC).

[635] Partnerships Act, R.S.O. 1990, c. P-5.

[636] Partnerships Act, R.S.O. 1990, c. P-5. *A.E. LePage Ltd. v. Kamex Developments Ltd.* (1977), 78 D.L.R. (3d) 223 (Ont. C.A.), *aff'd* [1979] 2 SCR 155.

[637] ITA, sec. 96.

[638] ITA, sec. 98.1.

[639] ITA, sec. 34.2.

[640] ITA, sec. 103.

[641] ITA, subsec. 96(2.4).

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ship. The breadth of some of the rules can cause limitations or lost deductions in unexpected cases. At the same time, the rules are generally restricted in their application to limited partnerships, although a general partnership may be deemed limited for these purposes. A loss denied under the at-risk rules becomes a "limited partnership loss," which may be deducted in computing taxable income in subsequent years against future partnership profits.

2. *Cost of Partnership Interest*

Where a partnership interest has been disposed of, it will be important to calculate its adjusted cost base. Generally, the cost of a partnership interest is increased by the amount of income attributed to a partner from the partnership and the amount of any additional capital contributed by that partner. It is reduced by partnership losses allocated to the partner and the partner's drawings from the partnership.[642] Generally, whenever a taxpayer's adjusted cost base in property would otherwise become "negative," the taxpayer is deemed to have a capital gain equal to the "negative" amount. A partner in a partnership is specifically excluded from the negative adjusted cost base rule,[643] but only if the partner is a general partner who is actively engaged in the activities of the partnership on a regular, continuous and substantial basis. Accordingly, as long as a general partner continues to hold his or her partnership interest, and as long as the interest constitutes capital property to the partner, no capital gain will be deemed to arise if the deductions required to be made in computing the adjusted cost base exceed the original cost plus any required additions. On a subsequent disposition or deemed disposition by the partner of the partnership interest, however, the capital gain would be, in effect, the difference between the proceeds of disposition and the "negative" adjusted cost base to the partner of the partnership interest.

3. *Transfers of Property between Partner and Partnership*

Generally, transfers between a partner and the partnership of which the partner is a member are deemed to take place at fair market value.[644] However, where a Canadian partnership exists, that is, a partnership all of the members of which are, at the relevant time, resident in Canada,[645] then property may generally be transferred to the partnership on a tax-deferred rollover basis. A partner or prospective partner may generally transfer property at an elected amount that is less than the fair market value of the property to a Canadian partnership if all the partners jointly so elect.[646] An elected amount that is equal to the cost of the transferred property would generally allow any accrued gains to be deferred. However, in a number of cases, the courts have recharacterized these rollovers where the partner who transferred the property has subsequently received a share of partnership capital in the form of cash or other partnership assets that had a value in excess of the elected amount (i.e., a disguised sale). In several cases, including *Haro* and *MDS Health*, the courts addressed situations in which a partner received cash or some other consideration, other than a partnership interest, subsequent to the partner's contribution of property to the partnership on a rollover basis.[647] In *MDS Health*, the taxpayer entered into a partnership with another Canadian corporation and transferred Can. $3 million worth of technology rights to the partnership. The transfer was made under a partners' joint election to deem the taxpayer's proceeds of disposition of the rights to be a nominal amount. A few days after the transfer, the taxpayer received Can. $1.5 million from the partnership, purportedly as a distribution of capital. The court held that the amount received by the taxpayer was consideration for the disposition of the property and, accordingly, denied the rollover election to that extent.

If a Canadian partnership is liquidated in such a manner that each partner becomes an undivided owner of each partnership asset in proportion to his or her share in the partnership, it is possible to obtain rollover treatment.[648] The same result occurs when a Canadian partnership ceases to exist and one member of the partnership continues to carry on the partnership business using partnership property received as proceeds of the disposition of his or her interest.[649]

It is also possible for a partnership to transfer partnership property to a corporation for consideration including shares on a tax-deferred basis and a further rollover may be available on the subsequent dissolution of the partnership within 60 days.[650] The combination of these rollovers is one means of converting a partnership to a corporation on a tax-deferred basis.

Comment: The tax rules governing the termination of a partnership or the withdrawal of a member are relatively complicated, and consequently steps taken to effect a change of membership should be carefully considered from an income tax perspective.

Because partnerships are not normally considered resident in any particular jurisdiction, the Income Tax Act contains special rules designed to prevent the use of partnerships to avoid the payment of Canadian nonresident withholding tax. One such rule provides that whenever a person resident in Canada pays or credits an amount to a partnership, other than a "Canadian partnership," the partnership will be deemed, for nonresident withholding tax purposes, to be a nonresident person.[651] Depending on the nature of the amounts paid or credited to the partnership, the partnership may be liable to Canadian nonresident withholding tax. Another such rule provides that a partnership will be deemed to be a person resident in Canada to the extent that it pays or credits an amount to a nonresident person out of Canadian-source income, and a deduction with respect to the payment is available in computing Canadian income.[652] In these circumstances, the nonresident payee would be subject to Canadian nonresident withholding tax and the partnership would be required to withhold the tax on behalf of the nonresident payee.

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642 ITA, paras. 53(1)(e), 53(2)(c).
643 ITA, subsec. 40(3).
644 ITA, subsecs. 97(1), 98(2).
645 ITA, sec. 102.
646 ITA, subsec. 97(2).
647 *Haro Pacific Enterprises Limited v. The Queen*, 90 DTC 6583 (FCTD); *MDS Health Group Limited v. The Queen*, 97 DTC 5009 (FCA).
648 ITA, subsec. 98(3).
649 ITA, subsec. 98(5).
650 ITA, subsecs. 85(2), (3).
651 ITA, para. 212(13.1)(b).
652 ITA, para. 212(13.1)(a).

ISBN 978-1-63359-385-5

B. *Trusts*

1. *General*

The term "trust" is not defined in the Income Tax Act and the existence of a trust is determined based on common law principles. For income tax purposes, a trust is considered a taxpayer separate and distinct from its settlor, trustees and beneficiaries. As a separate taxpayer, it is deemed to be an individual for purposes of the Income Tax Act so that many of the rules generally applicable to individuals apply to the taxation of a trust.

Technically, the Income Tax Act provides that a reference to a trust includes "a reference to the trustee, executor, administrator, heir or other legal representative having ownership or control of the trust property."[653] Despite this rule, the determination of a trust's residence is unclear in many cases. The Supreme Court of Canada's decision in *Fundy Settlement v. The Queen*[654] establishes that the residence of a trust is determined based on where the trusts' central management and control is located. This case rejects the principle established in earlier case law that the residence of a trust is determined by reference to the residence of trustees and the place where the trust is managed. As with natural persons, a trust resident in Canada is taxed on its worldwide income while a trust not resident in Canada is only taxed on its Canadian-source income.

Although a trust is considered an individual for income tax purposes, rules specific to trusts and their beneficiaries effectively treat a trust as a hybrid entity with some elements of a separate entity, such as a corporation, and aspects of a flow-through vehicle, such as a partnership. In computing its income, a trust is entitled to deduct income that is paid or payable to a beneficiary. Thus, income distributed to a beneficiary is generally not taxed at the trust level (although see possible application of the SIFT tax rules discussed at IX.B.5., below). Unless a specific rule applies to maintain the source of the income in the beneficiaries' hands, the income deducted by the trust and distributed to a beneficiary is taxed in the hands of the beneficiary as income from property that is an interest in a trust and not from any other source.[655] To permit beneficiaries to access preferential treatment with respect to certain sources of income, the following items statutorily retain their source when earned by a trust and distributed to a beneficiary:

(i) Taxable dividends and eligible dividends[656] paid by a Canadian corporation;[657]

(ii) Non-taxable dividends;[658]

(iii) Net taxable capital gains;[659] and

(iv) Foreign income.[660]

Income retained by a trust is subject to taxation in a manner similar to the income of a natural person, except that no personal tax credits are available and the trust will be taxed at the highest marginal rate applicable to individuals (currently 33%) on all of its income (except for certain types of testamentary trusts, which pay tax based on the graduated rates that apply to individuals).

2. *Deemed Disposition Rule*

For capital gains tax purposes, a trust is deemed to have disposed of and reacquired all its property at fair market value every 21 years. This rule is premised on the belief that property held outside a trust is likely to have been disposed of within a certain number of years after the property's acquisition (including, for instance, a disposition arising on the death of the property owner). The rationale for setting the time frame at 21 years is unclear, although it happens to be consistent with the common law rule against perpetuities. The same rule applies, for purposes of computing ordinary income, to the extent the trust owns land inventory or certain resource property. In the case of depreciable property, the proceeds of disposition are deemed to be the fair market value and the new cost is deemed to be the greater of the fair market value and the capital cost.[661]

3. *Distributions of Trust Property*

Distributions of trust income are included in computing the income of a beneficiary. Special rules apply with respect to the transfer or distribution of property to a beneficiary in satisfaction of either an income or a capital interest in the trust. For these purposes, an income interest in a trust is a right of a taxpayer as a beneficiary under a personal trust to receive any of the income and, generally, to enforce payment of an amount by the trust that arises as a consequence of the original right.[662] An income interest can exist only in a "personal trust," namely, a trust that is either a testamentary trust or an *inter vivos* trust, and no beneficial interest in which was acquired for consideration payable to the trust or to a person who has made a contribution to the trust.[663] A "capital interest" means all rights of a taxpayer as a beneficiary under the trust (other than an income interest) including, generally, consequential enforcement rights.[664]

Comment: The distinction between personal and other trusts was enacted to prevent certain financing schemes that enabled investors in business trusts to receive distributions as reductions in their income interest.

As a rule, transfers of property from a trust to an income beneficiary in satisfaction of an income interest are deemed to occur at fair market value and the disposition of an income interest in a trust gives rise to fully taxable proceeds.[665] The trust may, in most situations, distribute property in satisfaction of a capital interest and obtain rollover treatment.[666] The beneficiary

[653] ITA, subsec. 104(1).

[654] 2012 SCC 14, *aff'g St. Michael Trust Corp. v. The Queen*, 2010 FCA 309, and *Garron v. The Queen*, 2009 DTC 1287 (TCC). *Fundy Settlement* was referred to by the names "*St. Michael Trust Corp.*" and "*Garron*" in the lower courts.

[655] ITA, subsec. 108(5).

[656] An enhanced dividend tax credit regime applies for "eligible dividends" paid after 2005 by Canadian corporations to individual shareholders resident in Canada. See the discussion at IX.C.1.a.(10), below.

[657] ITA, subsec. 104(19).

[658] ITA, subsec. 104(20).

[659] ITA, subsec. 104(21).

[660] ITA, subsec. 104(22).

[661] ITA, subsecs. 104(4), (5).

[662] ITA, subsec. 108(1).

[663] ITA, subsec. 248(1).

[664] ITA, subsec. 108(1).

[665] ITA, subsec. 106(3).

[666] ITA, subsec. 107(2).

ISBN 978-1-63359-385-5

inherits the trust's cost of the distributed property so that any appreciated value is taxed in the hands of the beneficiary if the property is subsequently sold at a gain. However, a beneficiary's loss on a subsequent disposition of property distributed to him or her by a trust will be reduced by the portion of the loss that accrued during a period when the beneficiary did not own a capital interest in the trust.[667] Generally, the cost to a beneficiary of an income interest or a capital interest in a trust is nil, except where the beneficiary acquired the interest from a person who was previously the beneficiary with respect to that interest.[668]

Specific rules prevent the use of trusts to allocate the income and capital elements of investment growth to different beneficiaries. Where it is reasonable to consider that one of the main purposes of the creation of an interest in a trust is to give a beneficiary a percentage interest in the property of the trust that is greater than his or her percentage interest in its income, a trust subject to these anti-avoidance rules will be denied a deduction in computing its income for amounts payable in the year to a beneficiary.[669]

4. Nonresident Beneficiaries

Special rules apply where a trust is established for the benefit of a nonresident beneficiary. Where designated income of a trust is paid or payable to any beneficiary who is a "designated beneficiary" (essentially, a nonresident of Canada), the trust is liable to a special tax equal to 36% of the amount deductible by the trust (subject to certain complex adjustments relating, in particular, to capital cost allowance).[670] "Designated income" includes taxable capital gains from the disposition of taxable Canadian property (discussed in connection with the taxation of nonresidents in VIII.B.3., above), income from real property in Canada, timber resource property and Canadian resource property, and income from businesses carried on in Canada.[671] The special tax is, in effect, treated as a credit against the income tax payable by a beneficiary of the trust who is not a "designated beneficiary."[672] As noted, a "designated beneficiary" includes, in particular, a nonresident person.[673] Thus, in the case of distributions of designated income to Canadian resident beneficiaries, the special tax has no net effect. However, the special tax does apply with respect to designated income distributed to nonresidents. Nonresident withholding tax is also applicable.

Comment: The discussion above is only a general summary of highly complex rules, which are beyond the scope of this Portfolio. For example, there are sophisticated definitions to deal with beneficiaries of trusts that are themselves trusts or partnerships.

5. Specified Investment Flow-Through Tax Rules

Certain public income trusts and partnerships are taxed in the same manner as corporations by disallowing previously deductible income distributions and by imposing a tax on these trusts or partnerships at a combined federal/provincial corporate tax rate.

These rules are intended to "level the playing field" between earning income through a corporation with earning income through a trust or partnership. The rules apply to a publicly traded trust or a partnership that qualifies as a "specified investment flow-through" or SIFT. Where such a SIFT is a partnership that earns taxable nonportfolio earnings or is a trust that makes taxable SIFT trust distributions to investors, it will generally be subject to tax on those taxable nonportfolio earnings or taxable SIFT trust distributions, as the case may be, at combined federal and provincial rates that are comparable to rates that apply to income earned by corporations. The rules also tax investors in such trusts or partnerships as though the taxable nonportfolio earnings or taxable SIFT trust distributions received by them, as the case may be, are taxable dividends paid by taxable Canadian corporations. Taxable income of a SIFT that is not distributed to investors will be subject to the highest individual federal and provincial tax rates at the trust level and members of a SIFT partnership will still be allocated their proportionate share of a partnership's income that is not taxable nonportfolio earnings. The SIFT rules are quite complicated and may apply in various unintended circumstances.

C. Corporations and Their Shareholders

Though the taxation of corporate income follows the same principles as the taxation of income derived by other taxpayers, various special rules apply to the distribution of corporate earnings and to corporate reorganizations, for example, by way of liquidation, restructuring of capital or amalgamation. Four important types of corporations are defined in the Income Tax Act: a "private corporation;" a "public corporation;" a "Canadian corporation;" and a "taxable Canadian corporation."

The distinction between a "private corporation" and a "public corporation" for income tax purposes does not necessarily correspond with similar distinctions made for purposes of company law or securities regulation. Under the Income Tax Act, a corporation will be a "public corporation" if it is resident in Canada and a class of its shares is listed on a designated stock exchange in Canada. A corporation that is not listed may elect to be a public corporation if it meets certain qualifications respecting dispersal of ownership.[674] A corporation, once public, remains so qualified until it elects not to be public or is designated by the authorities as not public. There are various restrictions on the ability to make such elections.

A "private corporation" is a Canadian resident corporation that is not a public corporation and is not controlled by one or more public corporations.[675] Thus, a nonresident corporation is neither a private corporation nor a public corporation for income tax purposes; nor is a Canadian resident corporation that, though not itself a public corporation, is controlled by one. A wholly owned Canadian subsidiary of a nonresident corporation is normally a private corporation.

[667] ITA, subsec. 107(6).
[668] ITA, subsecs. 106(1.1), 107(1.1).
[669] ITA, subsecs. 104(7.1) and (7.2).
[670] ITA, subsec. 210.2(1).
[671] ITA, subsec. 210(1).
[672] ITA, subsec. 210.2(3).
[673] ITA, subsec. 210(1).
[674] ITA, subsec. 89(1); ITR, Part XLVIII.
[675] ITA, subsec. 89(1).

ISBN 978-1-63359-385-5

A “Canadian corporation” is a Canadian resident corporation that was either incorporated in Canada or has been continuously resident in Canada since June 18, 1971.[676]

Lastly, a “taxable Canadian corporation” is a “Canadian corporation” that is not exempt from tax by virtue of any provision of the Income Tax Act. As discussed below, certain rules apply only to corporations that qualify as Canadian corporations or taxable Canadian corporations.

1. Dividends and Distributions

a. Taxable Dividends

Under the Income Tax Act, a taxable dividend is, in general terms, any dividend paid by a corporation other than certain non-taxable dividends.[677] The definition of the word “dividend” contained in the Income Tax Act is not particularly illuminating because it merely provides that a “dividend” includes a stock dividend (other than certain stock dividends paid by a nonresident corporation).[678] Consequently, the accepted ordinary meaning is to be given to the word.[679] The ordinary meaning of the word “dividend” could be considered to be a distribution of profits, whether at a fixed rate or otherwise, allocable to the holders of shares in a company.[680] Nonetheless, this broad, ordinary definition of a dividend has to be tempered in appropriate situations with a view to the general scheme of the Income Tax Act.[681]

Looking to that scheme, monies distributed out of surplus funds of any kind may be characterized as dividends.[682] This characterization has been found appropriate even where there has been a return of capital in the form of contributed surplus.[683] Unlike the taxation of dividends under the tax systems of some other jurisdictions, including the United States, the taxation of dividends under the Canadian tax system is not tied to the income or earnings of a corporation. A distribution made by a Canadian company may constitute dividends even when the company does not have sufficient earnings to fund the distribution. The Income Tax Act does, however, contain several deeming provisions that clarify the characterization of payments as dividends or otherwise, in certain specified situations.

(1) Corporate Recipients Generally

The amount of any taxable dividend (including “eligible dividends”) received in the year from a Canadian resident corporation is included in computing the income of the shareholder.[684] However, where the recipient is a corporation, a corresponding deduction equal to the amount of the dividend is generally available with respect to a taxable dividend paid by a taxable Canadian corporation or a non-exempt corporation resident in Canada and controlled by the recipient.[685] Therefore, in most situations, the general Canadian system of taxing domestic intercorporate dividends allows the recipient corporation to receive such income free of tax. Exceptions to this treatment are discussed below.

Comment: As a consequence, it could be advantageous for corporations paying tax at less than the full standard corporate tax rate to finance their operations through the issue of debt-like preferred shares, as opposed to borrowing funds. However, numerous complex restrictions prevent such after-tax financing techniques. Dividend deductions are denied in computing taxable income with respect to “term preferred shares,” “guaranteed shares” and “collateralized shares.” As well, a special tax applies to dividends paid on “taxable preferred shares” or “short-term preferred shares.”

This discussion does not apply to nonresident shareholders, who are generally subject to Canadian nonresident withholding tax with respect to dividends received from Canadian resident corporations. The taxation of nonresident receipts is discussed in VIII.B.3., above.

(2) Term Preferred Shares

A deduction is prohibited with respect to a dividend received by a “specified financial institution” on a share that was, at the time the dividend was paid, a “term preferred share,” unless the share was not acquired in the ordinary course of the business carried on by the shareholder.[686]

A “specified financial institution” is defined generally as:[687]

(i) A bank, a trust company, a credit union or an insurance corporation, or a corporation the principal business of which is the lending of money to arm’s-length borrowers, or the purchasing of debt obligations issued by such persons;

(ii) Any corporation that is controlled by one or more corporations of the kinds described above in (i); and

(iii) Any other corporation related to a corporation of one of the kinds described above in either (i) or (ii).

While including institutions such as banks and other entities commonly thought of as financial institutions, the concept of a specified financial institution extends much further and, for example, would include all members of a corporate group when there is, within that group, a captive insurance subsidiary.

The exception for shares acquired out of the ordinary course of business of the shareholder is frequently difficult to apply with a high degree of certainty. Although “acquired in the ordinary course of business carried on” is not defined in the Income Tax Act, “business” is defined as including an undertaking of any kind whatever and an adventure or concern in the nature of trade.[688] In this particular context, the phrase may refer to an acquisition that is prompted by the normal considerations that govern the ordinary day-to-day business activities

[676] ITA, subsec. 89(1).
[677] ITA, subsecs. 89(1) and 248(1).
[678] ITA, subsec. 248(1).
[679] *Cangro Resources Ltd. v. MNR,* [1967] Tax ABC 852.
[680] *Halsbury’s Laws of England,* 4th ed., vol. 7, p. 349.
[681] *Henry v. Great Northern Railway Co.*, (1857), 27 LJ, ch. 1, cited with approval in *German v. MNR* (1959), 22 Tax ABC 302 at 305.
[682] *Robinson Industries Ltd. v. MNR,* 12 Tax ABC 14; *No. 463 v. MNR,* 18 Tax ABC 111, and *Walter Crassweller v. MNR,* 1 Tax ABC 1.
[683] *Cangro Resources Ltd.*, see above.
[684] ITA, subsec. 82(1).
[685] ITA, subsec. 112(1).
[686] ITA, subsec. 112(2.1).
[687] Definition in ITA, subsec. 248(1).
[688] Definition of “business” in ITA, subsec. 248(1).

ISBN 978-1-63359-385-5

of the taxpayer.[689] The only Canadian judicial consideration of this exception found that a share acquisition made in violation of a corporate taxpayer's investment policy was not acquired in the ordinary course of its business.[690] The CRA has indicated that, for example, shares issued on the incorporation of a wholly owned subsidiary would not, generally, be acquired in the ordinary course of the business of the parent.[691]

The definition of "term preferred share" extends beyond preferred shares. Any share of the capital stock of a corporation may be a term preferred share. As a consequence of repeated amendments to the definition of "term preferred share" since 1977, the definition is replete with effective dates, deeming provisions, and transitional rules.[692]

In very general terms, a share is a term preferred share if:

(i) At the time the share was issued or acquired, the existence of the issuing corporation was limited;

(ii) The share may be redeemed at the option of the holder or is guaranteed; or

(iii) The share is held by a specified financial institution and that institution controls the issuer.

Shares convertible into debt or term preferred shares are also term preferred shares.

Two specific exemptions may apply. First, a share is not a term preferred share if it was acquired by the holder after June 28, 1982, if it is of a series or class that is listed on a Canadian stock exchange, and if persons with whom the holder does not deal at arm's length do not, in the aggregate, receive more than 10% of the dividends paid, at the particular time, on the series or class. Second, a share is not a term preferred share if it is issued for a term not exceeding five years by a corporation resident in Canada as part of bankruptcy proceedings, or where the issuing corporation or another corporation resident in Canada with which it does not deal at arm's length, has by reason of financial difficulty defaulted on a debt obligation and the proceeds of the issuance may reasonably be regarded as having been used by the issuing corporation (or another corporation resident in Canada with which it does not deal at arm's length) in the financing of the relevant corporation's business carried on in Canada immediately before the issuance of the share, and in substitution for the obligation.

(3) Guaranteed Shares

The "guaranteed share" rules are designed to prevent circumvention of the term preferred share rules by having a specified financial institution guarantee the payment of dividends to another person.

More specifically, a deduction is prohibited if a person (other than the issuer of the share) that is a specified financial institution is obliged to effect any undertaking including any guarantee, covenant, or agreement to purchase or repurchase the share given to ensure that any loss that the holder might otherwise sustain is limited, or that the holder will derive earnings from the ownership or disposition of the share.[693] The rule applies potentially to all share classes, including a common share.

As is the case with term preferred shares, the rules with respect to guaranteed shares contain several exceptions and transitional provisions.[694] Shares issued in situations involving financial difficulty are exempt provided they meet the requirements discussed above under "term preferred shares." With the introduction of the special tax on dividends paid on "taxable preferred shares," discussed in IX.C.1.a.(6), below, the application of the guaranteed share rules has been restricted. The denial of a deduction in computing taxable income with respect to guaranteed shares does not apply with respect to a taxable preferred share issued after December 15, 1987, if the class is listed on a designated stock exchange and all guarantee agreements with respect to the share were given by the issuer or related persons, and provided the holder and certain related and other affiliated persons received dividends representing no more than 10% of all the dividends payable on shares to which the guarantee agreement applies. A public listing 10% exemption, similar to the exemption applicable to term preferred shares, applies to guaranteed shares as well, provided the shares are taxable preferred shares subject to the special taxable preferred share taxes described below.

(4) Collateralized Shares

Collateralized shares are yet another category of shares on which dividends are not deductible in computing the taxable income of a corporation. Once again, the relevant rules were enacted to deal with a perceived abuse arising from the circumvention of the term preferred share provisions. Essentially, a collateralized share is a share with respect to which any person is obligated to effect an undertaking, including any guarantee, covenant or agreement to purchase or repurchase the share, under which an investor is entitled to receive or obtain any amount or benefit for purposes of reducing the impact of any loss that the investor may sustain by virtue of the ownership, holding or disposition of the share; provided, however, that property is used either directly or indirectly to secure the undertaking. This branch of the definition requires a guarantee agreement, but also security. Alternatively, a share will be treated as collateralized if the consideration for which it was issued includes an obligation of an investor to make income payments to the issuer, or a right to receive income payments, which right is held on condition that it may revert to an investor. In effect, the second branch of the definition contemplates circumstances in which the proceeds of issue are deposited with the investor or a related party.[695]

These rules are also subject to a number of exemptions. The most important exception is that the provisions apply only with respect to a dividend on a share where, having regard to all the circumstances, it may reasonably be considered that the share was issued as part of a transaction that enabled any corporation to earn investment income or a substitute therefor, and the tax payable by the corporation is less than the tax that would

[689] See, by analogy, the Australian cases of *Burn v. McFarlane* (1940), 64 CLR 108, 125; *Downs Distributing v. Associated Blue Star Stores* (1948), 76 CLR 463, 476–7; and *Re Bradford Roofing Industries*, [1966] 1 NSWR, 674.

[690] *Société d'Investissements Desjardins v. MNR*, 91 DTC 393.

[691] Canadian Tax Foundation, "Revenue Canada Round Table," 1984 Conference Report, p. 828, question 62, and CRA access documents 9608455 dated March 28, 1996 and 2001-0079985 dated November 13, 2001.

[692] Definition of "term preferred share" in ITA, subsec. 248(1).

[693] ITA, subsec. 112(2.2).

[694] ITA, subsecs. 112(2.21) and (2.22).

[695] ITA, subsec. 112(2.4).

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be payable by the corporation if such income were its only income.[696] However, there is considerable uncertainty regarding the proper interpretation of this exemption.

(5) Dividend Rental Arrangements

Generally speaking, a "dividend rental arrangement" is a transaction in which the taxpayer retains the ability to receive a dividend on a particular share while all or substantially all of the opportunity for gain/profit or risk of loss with respect to that share is transferred to another person. The taxpayer would continue to receive dividends on the shares that it legally owns but would be required to make a dividend equivalent payment to the counterparty.

The Canadian government was concerned that certain taxpayers were abusing the intercorporate dividend deduction regime by entering into such dividend rental arrangements with "tax-indifferent investors" (generally, a non-resident or a tax-exempt entity). The taxpayer would take the position that it was entitled to take a deduction with respect to the dividends received on the shares that it continued to legally own and another deduction for the dividend equivalent payments that it made to the tax-indifferent investor (creating a tax loss for the taxpayer that could be used to shelter other income). The tax-indifferent investor would not have any Canadian income tax inclusion with respect to the dividend equivalent payment it received from the taxpayer.

As a result, rules were implemented that deny the intercorporate dividend deduction if the dividend is received on a share where there is a "dividend rental arrangement" with respect to that share, unless the taxpayer can establish that, throughout the relevant period, no tax-indifferent investor or group of affiliated tax-indifferent investors had all or substantially all of the opportunity for gain/profit and risk of loss with respect to the share.[697]

The dividend deduction denial rules were extended to apply to certain specified hedging transactions entered into by financial institution groups, generally effective as from April 7, 2022 (with limited grandfathering available for dividends paid or payable before October 2022 in respect of specified hedging transactions entered into before April 7, 2022). As a result of the amendment, the dividend deduction denial rule applicable to dividend rental arrangements apply where a Canadian member of a consolidated group holds shares of a Canadian company and receives dividends on those shares but the consolidated group's economic risk with respect to those shares is limited because another member of the group has entered into a hedging transaction with respect to the shares.

(6) Taxable Preferred Shares

Following the 1987 tax reform, a system to deal with the perceived preferred share "problem" was introduced, adding to the term preferred share, guaranteed share and collateralized share rules, as described above. In basic terms, this system is a funding mechanism for the dividend tax credit and the intercorporate dividend deduction, modeled on an advance corporate tax system as it applies in certain other countries. However, the funding mechanism does not apply to all shares, but only applies to "taxable preferred shares" and "short-term preferred shares." A "taxable preferred share" is a share that provides for a dividend entitlement that is fixed, limited to a maximum or established to be not less than a minimum (subject to a preference in the case of a minimum). Alternatively, a share will be so qualified if the liquidation entitlement is fixed, limited to a maximum or established to be not less than a minimum. A share is also a taxable preferred share if it is convertible into or exchangeable for another share that is a taxable preferred share, or if there is a guarantee agreement with respect to the share.[698]

Where a corporation pays a dividend on a taxable preferred share, it is liable to a special tax of either 25% or 40%. Where the 25% rate is chosen, a further tax is imposed on certain corporate recipients of the dividends to fund the balance of the intercorporate dividend deduction. This recipient tax is imposed at the rate of 10%, generally on public corporations. There is no recipient tax where the 40% rate is chosen.[699] To assist smaller corporations, the special tax does not apply to the extent of the corporation's "dividend allowance." The annual dividend allowance is Can. $500,000, subject to a dollar-for-dollar clawback with respect to dividends paid on taxable preferred shares in the preceding calendar year in excess of Can. $1 million.[700] Associated corporations must share the Can. $500,000 dividend allowance.[701]

The issuing corporation may recover the special tax on dividends paid. Accordingly, the tax is analogous to an advance corporate tax. The recovery operates not by way of a tax credit but by way of a deduction in computing taxable income equal to 3.5 times the tax paid. This is intended to approximate a full credit at a notional combined federal and provincial tax rate.[702]

The special taxes are subject to exceptions and exclusions. Most important, no tax is payable with respect to dividends paid to a shareholder that has a "substantial interest" in the payer. Essentially, a shareholder has a substantial interest if it is related to the corporation, or if it owns at least 25% of the shares of the payer by votes and value, as well as at least 25% of the corporation's shares (other than taxable preferred shares).[703]

(7) Short-Term Preferred Shares

A short-term preferred share is a share subject to redemption at the option of the holder, or mandatory redemption, within five years.[704] Supporting rules deal with shares convertible into other shares. A guarantee agreement applicable within the first five years also renders a share a "short-term preferred share."

Dividends paid on short-term preferred shares are also subject to the special issuer tax, but at a rate of 40%.[705] There is no special tax on the recipient, unlike in the case of taxable preferred shares taxed at the 25% rate, as discussed above.

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[696] ITA, subsec. 112(2.5).
[697] ITA, subsec. 112(2.3) and (2.31).
[698] ITA, subsec. 248(1).
[699] ITA, Parts IV.I and VI.I.
[700] ITA, subsec. 191.1(2).
[701] ITA, subsecs. 191.1(3), (4), and (5).
[702] ITA, para. 110(1)(k).
[703] ITA, subsec. 191(2).
[704] Definition in ITA, subsec. 248(1).
[705] ITA, subpara. 191.1(1)(a)(i).

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(8) Mark-to-Market Property

The dividend deduction is generally not available to financial institutions receiving dividends after 2023 on shares that are mark-to-market property. Mark-to-market shares held by financial institutions are marked to market on a yearly basis, resulting in a recognition of any gain or loss on income account. The federal government has expressed its view that treating such gains or losses on income account resulted in a policy conflict with not taxing the dividends received on such shares. An exemption is available for, generally, dividends received or deemed to be received by an insurance corporation on certain shares or mutual fund trust units held by the corporation in connection with an insurance contract that the corporation entered into, issued or acquired in the ordinary course of its insurance business (meaning such dividends still benefit from the dividend deduction).

(9) Special Refundable Tax

As previously discussed, taxable dividends received by a corporation are generally deductible in computing the corporation's taxable income. However, individual taxpayers could defer the taxation of dividend income by having the dividends diverted to a corporation, which would claim the intercorporate dividend deduction. To prevent taxpayers enjoying the tax advantages of such arrangements, the Income Tax Act levies a special 38 1/3% refundable tax on certain taxable dividends received by private and other corporations that are both resident in Canada and controlled or deemed to be controlled by or for the benefit of an individual or related group of individuals.[706] The refundable tax rate is intended to be equivalent to the rate of tax that an individual subject to the maximum combined federal and provincial tax would pay on a taxable dividend.

The special 38 1/3% tax applies to portfolio taxable dividends, but it does not apply to dividends paid out of the active business income of a "connected corporation." A "connected corporation" is generally any corporation in which the recipient holds more than 10% of the issued voting shares having a value of more than 10% of the value attributable to all issued shares. A "connected corporation" also includes any corporation in which the recipient, or any other person with whom the recipient does not deal at arm's length, owns, in the aggregate, more than 50% of the issued voting shares.[707]

The special 38 1/3% tax is refundable to the corporation on the payment of dividends by it to its shareholders but (subject to limited exceptions) only where such dividends are "non-eligible dividends."[708] The "eligible" and "non-eligible" dividend system is described in further detail below. Effectively, for every Can. $100 of non-eligible taxable dividends paid out, Can. $38.33 of tax may be recovered.

> *Example:* If a private corporation owned by individuals receives taxable portfolio dividends, it may totally avoid this special tax by paying out the full amount of these dividends to its shareholders as non-eligible dividends, who in turn pay tax under the dividend gross-up and credit system described below, just as if they had received the portfolio dividends directly.

The same refund system applies to most forms of investment income, in addition to dividends, when received by a private corporation that is Canadian controlled.[709] A "Canadian controlled private corporation" is defined as a private corporation that is a Canadian corporation other than a corporation controlled, directly or indirectly, by one or more nonresident persons or public corporations.[710] This system is discussed in IX.C.1.d., below.

(10) Individuals Receiving Taxable Dividends

Taxable dividends received by resident individuals are subject to a gross-up and credit mechanism that is intended to provide full or partial integration of shareholder and corporate level taxation.

The amount of a taxable dividend (other than an "eligible dividend") received from a taxable Canadian corporation is included in income together with an additional amount equal to 15% (commonly referred to as a "gross-up") of the dividend.[711] Once the individual's income tax liability has been computed, a special dividend tax credit may be claimed on the grossed-up amount of the dividend. The gross-up is a notional amount that theoretically represents the income earned by the corporation that was subject to corporate level tax. Under the Income Tax Act, the dividend tax credit is equal to 9/13 of the "gross-up," the remaining 4/13 being effectively recovered as a credit against the provincial income tax that also applies to the dividend.[712] The credit represents the taxes paid by the corporation on the amount distributed as a taxable dividend. The credit depends on the gross amount of the dividend, without reference to carrying and other charges.

A different gross-up and tax credit calculation is performed in respect of "eligible dividends" received by an individual resident in Canada. "Eligible dividends" are generally taxable dividends paid by a Canadian corporation out of the corporation's income that is subject to the general rate of tax, that is, income that is not subject to a reduced tax rate or certain other benefits (such as those applicable to a Canadian-controlled private corporation with respect to the first Can. $500,000 of its active business income). A taxable dividend paid would be considered an eligible dividend if the payer corporation designates it as such in writing at the time the dividend is declared.

When an individual receives "eligible dividends," the individual must include the amount of the taxable dividend in income plus a gross-up amount equal to 38% of the eligible dividend.[713] An "enhanced" dividend tax credit equal to 6/11 of the gross-up amount can then be deducted in computing the individual's taxable income.[714]

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[706] ITA, Part IV.
[707] ITA, subsecs. 186(2), (4).
[708] ITA, sec. 129.
[709] ITA, subsec. 129(4).
[710] ITA, subsec. 125(7).
[711] ITA, subpara. 82(1)(b)(i).
[712] ITA, sec. 121.
[713] ITA, subpara. 82(1)(b)(ii).
[714] ITA, subpara. 121(b)(iv).

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To track the income earned by a Canadian corporation that is subject to the general rate of tax and separate it from the income earned by the corporation that is subject to preferred rates of tax, two tax accounts are relevant: the "general rate income pool" (or GRIP) and the "low-rate income pool" (or LRIP). Conceptually, for Canadian-controlled private corporations (CCPCs), GRIP tracks all income of the corporation that has been taxed at the general rate of tax, while LRIP tracks all preferentially taxed income for other Canadian resident corporations — including any non-eligible dividends received by the corporation. The balances in GRIP and LRIP are relevant to determining the extent to which a corporation can pay eligible dividends without being subject to a penalty tax with respect to "excessive eligible dividend designations."[715] This puts the onus on Canadian corporations to keep track of the GRIP/LRIP character of income that they earn, including certain dividends they receive from other corporations.

The following example illustrates the dividend gross-up and tax credit mechanism with respect to taxable dividends and eligible dividends that applies to an individual shareholder that resides in Ontario and is subject to a federal marginal tax rate of 33% and a provincial marginal tax rate of 20.53% (note that the actual rates vary by province):

Income	**Non-Eligible Dividends**	**Eligible Dividends**
Dividend received	Can. $80	Can. $80
Add gross-up (15% or 38% of dividend)	12	30.40
Income	Can. $92	Can. $110.40
Tax Calculation		
Federal tax (at 33%)	Can. $30.36	Can. $36.43
Less dividend tax credit (9/13 or 6/11 of gross-up amount)	(8.31)	(16.58)
Federal tax payable	22.05	19.85
Provincial tax (at 20.53%)	18.89	22.67
	40.94	42.52
Less provincial dividend tax credit (2.99% or 10% of grossed-up dividend)	(2.75)	(11.04)
Total (Combined) Tax Payable	Can. $38.19	Can. $31.48

Thus, while the combined federal and provincial tax rate of this individual on every additional dollar of income is about 50.53%, the effective rate on a taxable dividend after the dividend tax credit is approximately 47.73%, and on an eligible dividend it is 39.35%. This system partially compensates for the fact that such dividend income has as its source corporate income that has itself been taxed.

[715] ITA, secs. 185.1 and 185.2.

b. Stock Dividends

A stock dividend (i.e., the issue by a corporation of its own shares as a dividend to shareholders) is generally regarded as a taxable dividend, the amount of which is the increase in the paid-up capital of the corporation as a result of the stock dividend. Thus, the increase in capital, rather than the value of the shares, represents the amount subject to taxation, be it nonresident withholding tax or individual income tax. The rationale for looking to the paid-up capital is related to the Canadian system of taxing capital distributions, discussed in IX.C.1.d., below.

The cost to the shareholder of the shares received as a stock dividend is generally the amount of the dividend.[716] However, the cost of the shares received by a corporate shareholder will be reduced by the amount of the intercorporate dividend deduction taken by the corporation with respect to the stock dividend.[717]

c. Capital Dividends

Canadian private corporations that realize taxable capital gains may accumulate the non-taxable portion of such gains in a special surplus account called the capital dividend account. This account includes certain other amounts such as the non-taxable portion of proceeds from the sale of goodwill or other intangibles. By making an appropriate election, a private corporation may pay capital dividends to its shareholders out of its capital dividend account.[718] Because the amounts that comprise the capital dividend account would not have been taxed had they been received or earned by a shareholder directly, a capital dividend is not included in the income of the recipient shareholder.

The capital dividend account is usually of limited use to nonresident-controlled Canadian corporations. Dividends paid out of the capital dividend account are subject to nonresident withholding tax like other taxable dividends. Because the account is of value to Canadian shareholders, the Income Tax Act contains special anti-avoidance rules. Thus, where a nonresident controlled private corporation becomes a Canadian-controlled private corporation (other than by a change of residence of the shareholders), the capital dividend account is effectively erased.[719] More elaborate rules prevent the "sale" of the capital dividend account (e.g., by seeking out investors who would acquire immediately redeemable preferred shares on which the capital dividend account would be streamed).[720]

d. Integration

The purpose of the capital dividend account, the tax refund system, and the dividend gross-up and tax credit mechanism is to afford integration between shareholders and private corporations with respect to certain income earned by private corporations and distributed to their shareholders. As discussed in IX.C.1.c., above, where a private corporation realizes a capital gain, a portion of the gain may flow through to its shareholders by way of a capital dividend. The tax-free status of the non-tax-

[716] ITA, para. 52(3)(a).
[717] ITA, subsec. 112(1).
[718] ITA, subsec. 83(2).
[719] ITA, subsec. 89(1.1).
[720] ITA, subsecs. 83(2.1) to (2.4).

ISBN 978-1-63359-385-5

able portion of the gain is thereby preserved. Capital dividends do not reduce the adjusted cost base of shares. The other part of the capital gain, the taxable capital gain, is regarded as investment income subject to the refund system applicable to private corporations.

A special additional refundable tax of 10 2/3% is imposed on investment income earned by CCPCs as a method of discouraging individuals from indefinitely deferring tax through the use of corporations. The deferral of tax arises because corporate tax on investment income may be less than the tax that would have been payable had the individual earned the income directly. A deferral exists to the extent the income is retained by the corporation and not distributed to the individual as taxable dividends. The additional 10 2/3% tax is intended to remove this deferral advantage. This tax is included in the refundable tax that a CCPC is entitled to receive when dividends are paid. The partial tax refund at the rate of 10 2/3% can only be obtained by payment of dividends at the same 100-to-38.33 rate (Can. $100.00 dividend for every Can. $38.33 of refund) as outlined in IX.C.1.a.(7), above.

New rules that create a new category of "substantive CCPCs" generally apply to taxation years that end on or after April 7, 2022. The new rules treat certain corporations that are not otherwise CCPCs as if they were CCPCs in some circumstances. The rules are intended to address planning where a CCPC deliberately loses its CCPC status and as a result, investment income earned by the corporation was not otherwise subject to the additional refundable tax.

Legislative Note: Draft legislation released on August 12, 2024 proposes to reduce, in certain circumstances, the deduction available for foreign tax paid by a controlled foreign affiliate (CFA) of a CCPC for purposes of computing the foreign accrual property income (FAPI, discussed in section XI.E.1., below) inclusion by the CCPC with respect to the CFA.

The refund system for dividend and investment income is intended to make individuals largely indifferent as to whether they earn such income directly or indirectly through a corporation. The system has to balance two concerns: the integration of corporate and shareholder level taxation to minimize double taxation and the elimination of any deferral advantage that arises from earning income in a corporation rather than directly.

e. *Corporate Distributions Tax*

The enactment of the special capital gains exemption for Canadian resident individuals put greater pressure on the Canadian income tax system as regards "surplus stripping." That is, with a zero tax rate on certain capital gains, the incentive to convert what would otherwise be dividend distributions into capital gains became high. In addition to various anti-avoidance rules within the capital gains exemption system, a special corporate distributions tax was enacted in 1986.[721]

The tax is imposed on the distributing corporation. It applies generally only to public corporations. Payable at a rate of 45%, the tax applies to amounts paid by the corporation or any non-arm's-length person as proceeds of disposition, if the payment may reasonably be considered to have been paid as a substitute for dividends that would otherwise have been paid in the normal course. A number of supporting rules extend the distributions tax to certain stock dividends and other schemes. In the simplest case, this tax could apply where shares are redeemed by the corporation in circumstances such that the recipient is not regarded as having received a dividend (e.g., in certain purchases through the facilities of a stock exchange). A saving rule provides that there is no tax if none of the purposes of the series of transactions may reasonably be considered to have been to enable shareholders who are individuals or nonresident persons to receive an amount, directly or indirectly, as proceeds of the disposition of property rather than as a dividend on a publicly traded share.

f. *Shareholder Benefits and Loans*

As discussed above, there are specific rules for the taxation of dividends distributed by corporations to shareholders. However, dividends are not the only means by which investors receive income from a corporation. Thus, under the Income Tax Act, appropriations of property to shareholders and, in some cases, loans to shareholders or connected persons, may give rise to an income tax liability.

The amount or value of any benefit conferred by a corporation on a shareholder or a person in contemplation of becoming a shareholder is included in the shareholder's or person's income.[722] Unless the benefit was made or conferred by the corporation for purposes of earning income, it will be denied any deduction for the cost of the benefit. "Benefit" is not defined in the Income Tax Act and is construed very broadly to include generally a corporation's payment of a shareholder's personal expenses, the provision of services to a shareholder, a shareholder's use of company assets without payment of adequate consideration or the acquisition by a shareholder of corporate property at less than fair value. Exceptions exist to this rule, including where the benefit occurs as a result of:

(i) The reduction of capital, the redemption of shares or the winding-up, discontinuance or reorganization of the corporation's business, or on the capitalization of contributed surplus.

(ii) The payment of a dividend, including a stock dividend.

Note: There is, however, an exception to this exception which provides that the payment of a stock dividend can result in a taxable benefit to a shareholder where the payment of the stock dividend was made for the purpose of significantly altering the value of the interest of any "specified shareholder" (generally any person that holds at least 10% of the shares of a class) of the corporation.[723]

(iii) The conferring on all holders of common shares of an identical right to acquire additional shares of the corporation.

In the case of nonresident corporations, a special rule exists that limits the availability of the exceptions described above where the nonresident corporation undertakes a foreign demerger transaction and a Canadian resident shareholder acquires shares of one or more of the nonresident corporations formed as a result of the foreign demerger. If this rule applies,

[721] ITA, Part II.1.

[722] ITA, subsec. 15(1).

[723] ITA, subsec. 15(1.1).

ISBN 978-1-63359-385-5

the nonresident corporation that undertakes the foreign demerger transaction will be deemed to have either paid a dividend or conferred a benefit on the Canadian resident shareholder.[724]

A separate rule addresses loans made by corporations to their shareholders. Where a shareholder (other than a corporation resident in Canada) has received a loan or has become indebted to a corporation, the amount of the loan or indebtedness is included in the shareholder's income.[725] This rule extends to loans or indebtedness made by a corporation to any persons who do not deal at arm's length with a shareholder of the corporation.[726] Therefore, a loan made by a corporation to a shareholder's spouse (who is non-arm's-length in relation to the shareholder) is included in the spouse's income even if he or she is not a shareholder. The full amount of the loan or indebtedness is included in a shareholder's income.

The general income inclusion rule is subject to exceptions, some of which are applicable only where the shareholder is also an employee of the corporation. The general rule applies regardless of whether the loan or debt arose as a result of the position of the taxpayer as a shareholder of the corporate creditor. It is generally sufficient if, as a matter of fact, the taxpayer receives a loan while the taxpayer is a shareholder of the corporation. Some of the exceptions attempt to restrict this general rule for shareholders who are also employees of the corporation. Shareholders who are also employees are not subject to the general income inclusion rule where the loan or debt arose because of the employment and not because of any person's shareholdings, bona fide arrangements were made for the repayment of the loan or debt within a reasonable time, and any of the following circumstances exist:[727]

(i) The employee owns less than 10% of the shares of the corporation or deals at arm's length with the corporation;

(ii) The loan or debt enabled the employee to acquire or assisted the employee in acquiring a dwelling; or

(iii) The loan or debt enabled the employee to acquire or assisted the employee in acquiring a motor vehicle for employment use.

Other exceptions to the general rule are available regardless of whether the shareholder is also an employee of the corporation. These exceptions are as follows:[728]

(i) Where the indebtedness arises between nonresident persons.

(ii) Where the loan is made in the ordinary course of the corporation's ordinary business of lending money and bona fide arrangements are made to repay the loan. This exception may apply, for example, where an individual is a shareholder of a bank that provides the individual with a personal loan. As from June 22, 2023, the "ordinary business of lending money" exception was narrowed such that it will only apply if at least 90% of the aggregate outstanding amount of the loans of the business is owed by arm's length borrowers at any time during which the relevant shareholder loan is outstanding.

(iii) Where the loan or indebtedness is repaid within one year after the end of the taxa year of the lender in which the loan or indebtedness arose and is not part of a series of loans and repayments (which would effectively circumvent the one-year limit). Where the loan extends beyond the shareholder's year in which the loan was made, the general rule requires the amount of the loan to be included in income. On a subsequent repayment of the loan within the one-year limit, the shareholder can deduct an amount equal to the amount previously included in income.[729]

In an effort to prevent circumvention of the shareholder loan rules through "indirect" distributions, the Income Tax Act stipulates that deemed income will arise where the loan was made not only by a corporation to its shareholder, but also by the corporation or a related corporation to the shareholder or to a person who is non-arm's-length in relation to the shareholder. Similarly, this treatment also extends to partnerships or trusts of which corporations or shareholders are members.

To facilitate transfers of funds within Canadian corporate groups, the shareholder loan rules do not apply with respect to loans made to, or debt of, a Canadian resident corporate shareholder.

A new alternative business succession option for retiring business owners is available that allows the creation of trusts that hold shares of a corporation for the benefit of its employees and without the employees having to pay for the shares. Certain loans and debts connected with employee ownership trusts are exempt from the shareholder loan rules. The first $10 million in capital gains realized on the sale of a business to an employee ownership trust is also, generally, exempt.

Nonresident shareholders are also subject to the shareholder benefit and shareholder loan rules. However, nonresident status means that a deemed income inclusion does not generally result in any Canadian tax for a nonresident. Where the amount of a benefit, loan or debt is required to be included in the income of a nonresident shareholder or person, the amount that would otherwise be included in income is deemed to be a dividend paid to the nonresident by a Canadian resident corporation. The normal nonresident withholding tax rules then apply to tax the dividend deemed paid.[730] In the case of loans or other indebtedness, subsequent repayment of the debt entitles the nonresident shareholder to recoup the withholding tax previously paid.[731]

As discussed in VIII.C.1.a.(3), above, other provisions in the Income Tax Act impute an interest benefit to a shareholder in certain situations where the rules discussed here do not cause the principal amount of the loan to be included in income.

2. *Capital Alterations and Reorganizations*

The rules regarding the income tax treatment of corporate reorganizations are designed, on the one hand, to ensure that the ultimate, and in some cases, the immediate tax payable is

[724] ITA, subsec. 15(1.5).

[725] ITA, subsec. 15(2).

[726] The precise test is whether the person is "connected" with the shareholder as determined under ITA, subsec. 15(2.1).

[727] ITA, subsec. 15(2.4).

[728] ITA, subsecs. 15(2.2), (2.3), and (2.6).

[729] ITA, para. 20(1)(j).

[730] ITA, para. 214(3)(a).

[731] ITA, subsec. 227(6.1).

ISBN 978-1-63359-385-5

not reduced as a result of a change in the capital structure of a corporation. On the other hand, some rules are designed to facilitate businesslike reorganizations by preventing a realization of accrued gains and otherwise allowing the transformation of corporate structures without adverse income tax consequences. The following discussion is necessarily only an outline of the special regimes that apply to certain types of corporate reorganizations.

a. Return or Alteration of Capital

The share capital of a corporation may be altered in a number of transactions, such as increases and decreases in capital, the redemption or cancellation of shares, the acquisition of shares on the open market (where this is permitted by the relevant company law), and certain other reorganizations of capital.

Where a Canadian resident corporation, other than a public corporation, has redeemed, acquired or cancelled any of its shares, a deemed dividend may result if the amount paid exceeds the paid-up capital in respect of the shares so redeemed, acquired or cancelled.[732]

A deemed dividend may also result from a reduction in the capital of a Canadian resident corporation equal to the amount by which the payment on the reduction exceeds the amount of the capital reduction.[733] An increase in the capital of a Canadian resident corporation also may result in a deemed dividend.[734] This will be the case if, as a result of the transaction, the increase in paid-up capital exceeds the increase in the net asset value of the corporation.

A further rule provides that any amount paid by a public corporation on the reduction of its paid-up capital is deemed to have been paid by the public corporation and received by the person to whom it is paid as a dividend. This rule does not, however, apply where the payment on the reduction of paid-up capital is part of a specified reorganization of capital or a consequence of distributions made on the winding-up, discontinuance or reorganization of the business of the particular public corporation, or on a return of capital where the amount may reasonably be considered to be derived from the proceeds of disposition realized by the public corporation (or a lower tier entity) from a transaction that occurred outside the ordinary course of business of the disposing person and within 24 months preceding the payment.[735]

The foregoing rules all apply based on a definition of paid-up capital that generally depends on the relevant corporate law,[736] although in certain cases paid-up capital may be increased or decreased in accordance with specific provisions of the Income Tax Act. In addition, for corporations that were incorporated prior to 1977, special transitional rules apply that adjust paid-up capital to account for the fact that a different (more complicated) system for computing distributable capital applied prior to 1977.[737]

Comment: Nonresidents with interests in Canadian corporations should carefully consider these rules respecting the computation and distribution of paid-up capital. In effect, the Canadian system is designed to permit the tax-free distribution of an amount equal to the corporation's paid-up capital (through redemption, capital reduction or other appropriate corporate means) as a return of capital.[738]

In particular, a tax-free distribution to nonresident shareholders of Canadian corporations can generally be accomplished (i.e., without the imposition of Canadian nonresident withholding tax). However, amounts that have been contributed to a corporation that do not form part of paid-up capital, do not benefit from this special treatment. Thus, nonresident shareholders should generally not contribute capital to their Canadian subsidiaries. It may be preferable to provide such amounts as loans or as subscriptions to share capital to ensure their tax-free distribution. Further, the rules permit a corporation to convert contributed surplus into paid-up capital, provided the surplus arose on the issuance of shares or as a result of a contribution of property by a shareholder.[739] In the latter case, the nonresident shareholder must not have received shares of the corporation as consideration for the disposition. For these purposes, the contributed surplus of a public corporation is reduced by dividends paid in excess of retained earnings.[740]

In addition to the question of deemed dividends, alterations in the capital structure of a corporation may have capital gains tax consequences for the shareholders. For example, the redemption of shares constitutes a disposition,[741] and thus shareholders must determine their cost and proceeds of disposition; should the latter exceed the former, a capital gain results. The amount of any dividend deemed received by virtue of the redemption is excluded from the proceeds of the disposition, to prevent double taxation.

Comment: Nonresident shareholders of Canadian corporations should consider the terms of any applicable tax treaty that may prevent the imposition of tax on any such gain deemed to arise as a result of a corporate reorganization.

b. Liquidation

Winding-up a corporation also raises the possibility of a deemed dividend and a capital gain with respect to the disposition of shares. Further, the property of a corporation is deemed sold immediately before winding-up, which may create additional income tax consequences, albeit at the corporate level.

The rules relating to deemed dividends on winding-up are similar to those discussed above with respect to a share redemption. A deemed dividend results where funds or property of a Canadian resident corporation are distributed or appropriated to a shareholder on the winding-up, discontinuance or reorganization of its business if the amount distributed or appropriated to the shareholder exceeds the paid-up capital with respect to the shareholder's shares.[742]

[732] ITA, subsec. 84(3).
[733] ITA, subsec. 84(4).
[734] ITA, subsec. 84(1).
[735] ITA, subsec. 84(4.1).
[736] ITA, para. 89(1).
[737] ITA, sec. 84.2.

[738] See *Copthorne v. The Queen*, 2011 SCC 63, discussed below at XI.C.2., where the Supreme Court of Canada held that the general anti-avoidance rule (GAAR) applied to deny the duplication of paid-up capital on a reorganization.
[739] ITA, para. 84(1)(c.3).
[740] ITA, subsec. 84(10).
[741] ITA, subsec. 248(1).
[742] ITA, subsec. 84(2).

ISBN 978-1-63359-385-5

To assist in the orderly distribution of surplus on liquidation, a special rule applies where, in the course of winding-up a Canadian corporation, all of the corporation's property is distributed to the shareholders. In this case, surplus computations are made immediately before the winding-up and the various accounts are considered distributed as separate dividends, enabling the corporation to elect with respect to such dividends in the manner previously discussed.[743]

The deemed disposition of shares in the liquidated corporation may give rise to a taxable capital gain. As with a redemption, any deemed dividend is not included in the proceeds of disposition of the shares.

The property of any corporation, Canadian or otherwise, that is appropriated to a shareholder on the winding-up of the corporation is deemed to have been disposed of by the corporation immediately before the winding-up at fair market value. The shareholder is deemed to have acquired the property at a cost equal to this same value.[744]

The foregoing description of the income tax treatment of a winding-up is subject to an exceptional regime that applies to the winding-up of a subsidiary where both the subsidiary and parent are taxable Canadian corporations. Other similar rules apply with respect to winding-up distributions for foreign subsidiaries.[745] The parent must own at least 90% of the issued shares of each series or class of the subsidiary, and all of the shares of the subsidiary not owned by the parent must be owned by persons with whom the parent is dealing at arm's length.[746] In this case, no gain is realized with respect to the property of the subsidiary distributed on the winding-up. In most cases, the shares of the subsidiary are also subject to a tax-free rollover; however, a capital gain will result if the adjusted cost base of the shares is less than both the paid-up capital of the subsidiary and the net tax value of the property distributed. On the other hand, if the net tax cost of the subsidiary's assets distributed is less than the adjusted cost base of the shares, the difference may be applied, in very limited circumstances and subject to various restrictions, to increase the cost to the parent of capital property other than depreciable property received on the winding-up, up to the fair market value of such property at the time the parent acquired control of the subsidiary. The rules governing such a situation are commonly referred to as the "bump rules."[747]

Comment: The bump rules are advantageous in circumstances where a parent corporation acquires a subsidiary with the intention of divesting some of the subsidiary's non-depreciable capital property. In such circumstances, the capital gain that would otherwise be realized by the parent corporation on the intended divestiture would be reduced through an increase or "bump" in the adjusted cost base of the subsidiary's non-depreciable capital property that is acquired by the parent on the winding up or amalgamation of the subsidiary. Although the bump rules provide a valuable tax planning tool, they are quite detailed and complex, and, therefore, it cannot be assumed that they will apply without conducting a detailed review of their potential application in the context of a particular transaction or series of transactions.

Additional rules applicable to such a winding-up provide for a continuation of various surplus accounts and reserves so as to assimilate the winding-up to a statutory amalgamation (see IX.C.2.f., below). The ordinary deemed dividend rule does not apply in this case and, instead, any special tax surplus accounts of the subsidiary flow up to the parent. Loss carryforwards of the subsidiary may be available to the parent in its first tax year commencing after the winding-up. The loss carryforwards may also be flowed through on a subsequent winding-up of the parent into its parent corporation.[748]

c. Share-for-Share Exchange

Where a Canadian corporation acquires shares of any other Canadian corporation in exchange for its shares, a tax-free rollover is available.[749] The shares of the purchaser must be acquired from the purchaser itself (i.e., they must be treasury shares). A further restriction is that the purchasing corporation and the taxpayers from whom shares of the acquired corporation are purchased must deal at arm's length. In addition, the sellers (i.e., the shareholders of the acquired corporation) must not, either alone or together with persons with whom they do not deal at arm's length, control the purchasing corporation immediately after the exchange or beneficially own shares with a value of more than 50% of the value of all the shares.

The consideration received by the shareholders of the acquired corporation cannot consist of anything other than shares of the purchasing corporation, but this does not exclude the possibility that the shareholders may dispose of additional shares that are not included in the rollover for other consideration from the purchaser.

While there is no formal elective procedure for the rollover to apply, the disposing shareholder is given the choice of realizing gains or losses rather than treating the transaction as a tax-free reorganization. The acquiring corporation's cost of the acquired shares is deemed to be the lesser of their fair market value and their paid-up capital immediately before the exchange.

A share-for-share exchange is, in many respects, similar to the transfer of property to a corporation for shares (see g., below), where the property transferred consists of shares of another corporation, but this rule, which does not require a taxpayer election, may be more useful in certain public transactions.

A similar tax deferred share-for-share rollover is also provided where a taxpayer disposes of shares (the "transferred shares") of a foreign affiliate (see XI.E.1.a., below) to another foreign affiliate (the "acquiring foreign affiliate") in exchange for consideration including shares of the acquiring foreign affiliate.[750] Anti-avoidance rules require that the exchange not be part of a series of transactions that includes an arm's-length sale.[751] Like the domestic share-for-share exchange, the foreign affiliate share exchange deferral applies automatically without

[743] ITA, subsec. 88(2).
[744] ITA, subsec. 69(5).
[745] ITA, subsec. 88(3).
[746] ITA, subsec. 88(1).
[747] ITA, paras. 88(1)(c) and 88(1)(d).
[748] ITA, subsecs. 88(1.1), (1.2).
[749] ITA, sec. 85.1.
[750] ITA, subsec. 85.1(3).
[751] ITA, subsec. 85.1(4).

ISBN 978-1-63359-385-5

the need for the taxpayer to file any election. Unlike under the domestic share exchange rule, the taxpayer may receive non-share consideration for the transfer. The taxpayer's cost of the shares issued by the acquiring foreign affiliate is equal to the adjusted cost base of the transferred shares less the value of any non-share consideration received by the taxpayer for the disposition. The taxpayer's proceeds of disposition for the transferred shares are equal to the cost of the shares issued by the acquiring foreign affiliate and the non-share consideration received. The acquiring foreign affiliate acquires the transferred shares at a cost equal to the taxpayer's proceeds of disposition. Thus, any accrued capital gain on the transferred shares is retained in the hands of the acquiring foreign affiliate and in the Canadian resident's shares of the foreign affiliate.

Legislative Note: Draft amendments released on August 9, 2022, expand subsection 85.1(4), the anti-avoidance provision mentioned above. Similar amendments are proposed for subsection 87(8.3). The amendments are intended to address the potential deferral of capital gains on the sale of foreign affiliate shares where there is a subsequent disposition of any property, the fair market value of which is derived from the shares or a substituted property. The current proposed amendments are broad and may apply to transactions in unexpected ways that do not accord with the underlying policy goals of the amendments, particularly since there is no minimum threshold for the value being derived. It is understood that the Department of Finance intends to make further amendments to the proposals before they are finalized to prevent their application in unintended circumstances.

d. Foreign Share-for-Foreign Share Exchange

Foreign shares may be exchanged for other foreign shares on a tax-deferred basis similar to that applying in the case of Canadian share-for-share exchanges (see IX.C.2.c., above) even where the acquirer is not a foreign affiliate.[752] The purchaser's shares must be issued on the share exchange. In addition, the only consideration received on the exchange must be those issued shares. A further restriction is that the purchasing corporation and the taxpayers from whom shares of the acquired corporation are purchased must deal at arm's length. In addition, the sellers (i.e., the shareholders of the acquired corporation) must not, either alone or together with persons with whom they do not deal at arm's length, control the purchasing corporation immediately after the exchange or beneficially own shares with a value of more than 50% of the value of all the shares.

e. Share Conversions and Reorganizations

Relief is also provided under section 51 of the Income Tax Act where shares of a corporation have been acquired by a taxpayer in exchange for (i) another share of the corporation or (ii) a bond debenture or note of the corporation the terms of which confer on the holder the right to make the exchange, and no consideration was received for the convertible property other than the shares acquired.[753] Where this rule applies, the exchange is deemed not to be a disposition, so it is unnecessary to determine the proceeds of disposition of the convertible property. The rule does, however, deem the tax cost of the acquired shares to be equal to the tax cost of the transferred property. This rule applies automatically unless the taxpayer elects to transfer the property pursuant to section 85 (discussed under IX.C.2.g., below) or the reorganization rule in section 86 of the Income Tax Act, discussed next, applies.

Section 86 of the Income Tax Act provides an automatic rollover where a taxpayer disposes of shares of a class of a corporation during a reorganization of the corporation's share capital. Consideration for the share disposition must include shares of the corporation undergoing the reorganization and may include non-share consideration. A reorganization of capital is generally considered to include a change to the share structure such as the creation of a new class of shares. This rule applies only where the taxpayer disposes of all shares of the class that the taxpayer owns; dispositions of only some of the shares owned by the taxpayer are not subject to the rollover but may still qualify for a rollover under section 51, as described above. The shares acquired by the taxpayer are deemed to have a cost equal to the tax cost of the transferred shares less the value of the non-share consideration received by the taxpayer. The taxpayer's proceeds for the shares disposed of are equal to the cost of the shares acquired plus the value of the non-share consideration received. Therefore, a capital gain arises to the extent the value of the non-share consideration exceeds the tax cost of the transferred shares. Rules are provided to limit the paid-up capital of the shares acquired and to address situations where the share reorganization is intended to provide a benefit to a person related to the taxpayer.

f. Amalgamation

Under Canadian federal and provincial company law, two or more corporations may amalgamate and continue as a single corporation. Such an amalgamation constitutes a statutory fusion of two or more corporations. Although the participants in such an amalgamation cease to have separate existences, they do not cease to exist. Rather, the participants join together and continue as one corporation. The case law has frequently used analogies such as two streams flowing together to form a river or two strands of a rope uniting as one. The corporate concept involves neither a transfer of assets nor a discontinuance of the amalgamating corporations.

The Income Tax Act makes special provision for such statutory amalgamations. The tax treatment of a qualifying amalgamation, however, differs considerably from the corporate concept.[754] In particular, the Income Tax Act provides that the corporate entity formed as a result of the amalgamation will be deemed to be a new corporation, the first tax year of which will be deemed to have commenced at the time of the amalgamation.[755] Beginning from this premise, the amalgamation provisions set out an extensive list of rules for determining whether, and if so how, certain characteristics of the amalgamating corporations are carried over to the "new corporation."

The amalgamation provisions apply to a merger of two or more taxable Canadian corporations into a single new corpora-

[752] ITA, subsecs. 85.1(5) and (6).

[753] ITA, sec. 51; ITAR, subsec. 26(24).

[754] ITA, sec. 87.

[755] ITA, para. 87(2)(a).

ISBN 978-1-63359-385-5

tion such that all of the property, liabilities and shareholders of the predecessors become the property, liabilities and shareholders of the new corporation. Exception is made for intercorporate debts and shareholdings. The rollover does not apply where the merger occurs as a result of the acquisition of property of one corporation by another or the distribution of property on the winding-up of a corporation. These rollover provisions also apply to a "triangular amalgamation" under which a shareholder receives shares of a parent corporation of a predecessor corporation rather than shares of the new, amalgamated corporation.[756]

If the merger qualifies under these provisions, the tax years of the predecessor corporations come to an end immediately before the amalgamation and the first tax year of the new corporation commences at the time of the amalgamation. Inventory and capital property, including depreciable property, are rolled into the new corporation at their tax values to their predecessors. Various reserves and surplus accounts are also carried forward, and, generally, the new corporation stands in the shoes of the old. For example: scientific research and experimental development (SR&ED) expenditures that could be carried forward by a predecessor may be carried forward by the new corporation; employees of a predecessor are deemed to be employees of the new corporation for purposes of determining whether certain benefits are conferred during a period of employment; and outlays made under warranties are treated as if the warranties had been made by the new corporation. Loss carryforwards of the predecessors may be available to the amalgamated corporation. Special rules apply to various types of property, such as shares of foreign affiliates and partnership interests.

The shareholders of the predecessor corporations who receive no consideration for the disposition of their shares on the amalgamation other than shares of the new corporation also benefit from a rollover. They regard the cost of the old shares as the cost to them of the new shares and realize no capital gain or loss. However, where the fair market value of the shares received in the amalgamated corporation is less than the fair market value of the shares held in a predecessor corporation and it is reasonable to regard any portion of that excess as a benefit that the shareholder desired to confer on a related person, there is no longer a complete rollover. Rather, the taxpayer is, generally, deemed to have disposed of the taxpayer's old shares for proceeds equal to their adjusted cost base plus the amount of the "benefit" described above. Notwithstanding this increase in the proceeds of disposition, the taxpayer still, generally, has a cost of any new shares of the amalgamated corporation equal to the adjusted cost base of the shares formerly held.[757]

Where an amalgamation qualifying for rollover treatment is between a parent corporation and its wholly-owned subsidiary, the Income Tax Act provides that the cost to the amalgamated corporation of each capital property acquired on the amalgamation is the amount that would have been the cost to the parent had the property been distributed to the parent on a liquidation of the subsidiary to which the rollover regime described in IX.C.2.b., above, applied. As a result, upon a qualifying amalgamation between a parent corporation and its wholly-owned subsidiary, the bump rules may — subject to all of their restrictions being met — be available to increase the cost to the parent corporation of the subsidiary's non-depreciable capital property distributed to it.

Shareholders may receive the same rollover treatment with respect to a "foreign merger." Generally, a foreign merger is a merger of two or more nonresident corporations in a manner that is in substance, but not necessarily in form, similar to a Canadian amalgamation.[758] The foreign merger rollover rule also applies in certain circumstances where a predecessor corporation owns shares of a Canadian corporation that would otherwise have resulted in a disposition of "taxable Canadian property" on the merger.

Rollover treatment also applies in cases of vertical, horizontal and triangular foreign mergers. In the latter case, the shareholder of the predecessor corporation receives shares of the foreign parent that controls the new corporation rather than shares of the new corporation itself. It is not necessary for the predecessor corporations to be resident in the same country. Consequently, the tax-deferred rollover will be available whether the foreign predecessor corporations are resident in the same country or in different countries.

Where the shares of the predecessor corporation were taxable Canadian property, that is, property subject to Canadian capital gains tax when held by nonresidents, the new shares are deemed to be taxable Canadian property as well. This prevents the avoidance of tax on capital gains by nonresidents where, by virtue of an amalgamation, shares are received that would not otherwise constitute taxable Canadian property.

The same rollover treatment applies to an exchange of options to acquire shares of a predecessor corporation for options to acquire shares of the new corporation and to an exchange of bonds, debentures, mortgages, notes or other similar obligations.[759]

g. *Transfer of Property for Shares*

Where a taxpayer has disposed of a capital property, inventory, lending assets of money lenders or certain resource properties to a taxable Canadian corporation for consideration that includes shares of the corporation, the taxpayer and the acquiring corporation may jointly elect that the disposition occur at an agreed amount.[760] This rollover is governed by subsection 85(1) of the Income Tax Act and is commonly referred to as a "section 85 election." Certain exclusions, however, are made to the types of property that qualify for the election. The election does not extend to inventory consisting of real property, an interest in real property or an option with respect to real property. Where the taxpayer is a nonresident, capital property that is real property may be transferred on a rollover basis only if the transfer is part of the incorporation of a Canadian branch of the nonresident.

The amount agreed on in the election is treated as the proceeds of disposition of the property to the taxpayer and as its cost to the acquiring corporation. Subject to certain restrictions,

[756] ITA, subsec. 87(9).
[757] ITA, subsec. 87(4); ITAR, subsec. 26(21).
[758] ITA, subsec. 87(8).
[759] ITA, subsecs. 87(5), (6); ITAR subsecs. 26(22), (23).
[760] ITA, sec. 85. This provision is closely akin to U.S. Internal Revenue Code §351.

ISBN 978-1-63359-385-5

the taxpayer and the corporation are free to choose any agreed amount. Basically, these restrictions are that the agreed amount may not be less than the fair market value of any non-share consideration received by the taxpayer on the disposition nor greater than the fair market value of the property disposed of. In the case of inventory or capital property other than depreciable property, the agreed amount may not be less than the lesser of the fair market value and the tax cost of the property disposed of. Where depreciable property is transferred in connection with such an election, the transferee corporation is treated as if it had acquired the property at a cost equal to the acquisition cost to the transferor and the transferee had claimed any depreciation previously claimed with respect to the property. Thus, recapture of capital cost allowance is not avoided by virtue of such a transfer, but merely deferred.[761]

The election will not be wholly effective where an "indirect gift" is made. If the fair market value of the property disposed of exceeds both the value of the consideration received and the agreed amount, and if it is reasonable to regard any portion of such excess as a benefit that the taxpayer desired to confer on a related person, the agreed amount is automatically increased by the amount that may reasonably be so regarded as a benefit.[762]

This rule appears to meet, for example, the situation in which a taxpayer seeks effectively to transfer an accrued gain to his or her spouse by electing for a rollover at cost and taking as consideration only preferred shares with a par value equal to this cost. If the spouse owns all of the common shares, the effect of the indirect gift rule would probably be that the agreed amount would be increased so that the amount considered an indirect gift to the spouse is realized as a gain on the disposition. However, special rules provide that no benefit is considered to have been conferred where the transfer is made to a wholly-owned subsidiary of the taxpayer.

The tax cost of the consideration received on a transfer of property to a corporation under section 85 is computed according to a "waterfall" formula as set out in the Income Tax Act that depends on the type of consideration received by the shareholder. In aggregate, the tax cost of all consideration received by the taxpayer will equal the aggregate elected amount in respect of all of the property that was transferred to the corporation, with such cost being allocated in the following manner:

(i) First, to all non-share consideration up to fair market value;

(ii) Second, if any aggregate unallocated tax cost remains after the allocation in (i), to consideration that is preferred shares up to fair market value; and

(iii) Lastly, if any aggregate unallocated tax cost remains after the allocations in (i) and (ii), to consideration that is common shares up to fair market value.[763]

As discussed above, a Canadian corporation can distribute amounts up to the paid-up capital of a share to shareholders generally free from Canadian tax. Due to the advantages associated with paid-up capital, the paid-up capital of the shares issued by the corporation is limited to the amount elected (or deemed elected) on the property transfer to the corporation and is allocated between classes of shares based on the proportionate fair market value of such shares.[764]

h. Anti-Surplus Stripping

In view of the historical differential between the rate of tax applied to capital gains (nil until 1972) and dividends, the authorities have for some time expressed concern over transactions that effectively "distribute" corporate earnings but achieve the form of capital transactions.

In addition to the general anti-avoidance rule (see XI.C., below), there are two specific rules to prevent surplus stripping. The first rule applies to Canadian resident individuals transferring shares of a Canadian resident corporation to another Canadian resident corporation. The second applies where the transferor is a nonresident person. There is no equivalent rule applicable to Canadian corporate transferors, since the general tax-free receipt of intercorporate dividends prevents the surplus stripping mischief from arising.

The first rule applies where a taxpayer resident in Canada (other than a corporation) disposes of shares of a corporation resident in Canada to a purchaser corporation with which the taxpayer does not deal at arm's length[765] and, immediately after the disposition, the first corporation is "connected" with the purchaser corporation.[766] The general meaning of non-arm's-length transactions has a special extended sense in this context. "Connected" extends to situations where the transferred company is controlled by the transferee or, generally, where the transferee has a 10% interest in the transferred company. In these cases, the paid-up capital of any shares received on the transfer is reduced so that it does not exceed the greater of the paid-up capital and the adjusted cost base of the shares transferred. There may also be an immediate deemed dividend, subject to tax, to the extent that any non-share consideration (including indebtedness) exceeds the greater of the paid-up capital and the adjusted cost base of the transferred shares.

An analogous rule applies where the transferor is a nonresident person, or a partnership of which either a majority interest partner or every member of a majority interest group of partners is a nonresident person. The rule applies where such a transferor disposes of shares of a Canadian-resident corporation to another Canadian-resident corporation with which the transferor does not deal at arm's length if, immediately after the disposition, the transferee corporation is connected with the purchaser corporation. Once again, non-arm's-length dealings have an extended meaning, and the same defined sense of "connected" applies. In this case, the rule effectively prevents any increase in the paid-up capital of the shares, and thereby prevents any reduction in the potential nonresident withholding tax on future distributions. If non-share consideration (including indebtedness) is involved, there may be an immediate deemed dividend to the extent that such consideration exceeds the paid-up capital of the shares transferred.[767]

[761] ITA, subsec. 85(5).
[762] ITA, para. 85(1)(e.2).
[763] ITA, paras. 85(1)(f), (g) and (h).
[764] ITA, subsec. 85(2.1).
[765] Under ITA, para. 251(1)(a), related parties are deemed to deal not at arm's-length even if they do deal at arm's-length in fact.
[766] ITA, sec. 84.1.
[767] ITA, sec. 212.1.

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i. Foreign Spin-Offs

The Income Tax Act allows for a rollover to Canadian resident shareholders with respect to certain foreign spin-off or demerger transactions. The relevant provisions provide for a tax-deferred transaction to Canadian resident shareholders where a publicly traded foreign corporation whose shares are widely held, or a foreign corporation whose shares are not publicly traded but are widely held and registered with the U.S. Securities and Exchange Commission, undertakes a "spin-off" transaction whereby it distributes to its common shareholders common shares of another foreign corporation owned by the distributing corporation.[768] A number of requirements must be met for this rollover to apply. In the absence of this rollover, such a foreign spin-off or demerger transaction would generally be a taxable event for Canadian resident shareholders. As discussed in IX.C.1.f., above, in certain instances, a foreign demerger can result in a deemed dividend having been received by or a deemed benefit being conferred on a Canadian resident shareholder.

j. Divisive Reorganizations

The Income Tax Act allows a rollover with respect to certain divisive corporate reorganizations where the property of a Canadian resident corporation is divided among its shareholders. One such type of divisive reorganization to which the rollover would apply, subject to a number of restrictions being met, is an internal reorganization pursuant to which a corporation distributes its property among related shareholders.[769] Another divisive reorganization where a rollover may be permitted is where property of a corporation is split-up with each recipient receiving a pro rata share of each type of assets owned by the transferor corporation (although the "types of property" requirement does not apply on certain public company split-ups).[770] This type of reorganization is commonly referred to as a "butterfly." The rollover provisions applicable to these divisive reorganizations are complex and require very strict conditions and restrictions to be met.

3. Special Corporations

Particular rules apply to the taxation of certain types of corporations, as defined in the Income Tax Act.

An "investment corporation"[771] is a Canadian public corporation at least 80% of the property of which consists of shares, bonds, marketable securities or cash, from which it derives at least 95% of its income. Further, at least 85% of its gross revenue must be from sources in Canada and no more than 25% of such revenue may be derived from interest. The portfolio of an investment corporation cannot contain more than 10% of shares, bonds, or securities of any one corporation or debtor (except a government), and no one shareholder may hold more than 25% of the shares of any class of the corporation or any related corporation. In determining whether a shareholder owns more than 25% of any class of shares, shares held by related persons, and through trusts or partnerships of which the shareholder is a beneficiary or member, respectively, are considered owned by the shareholder.

A corporation qualifying as an investment corporation throughout the tax year enjoys a tax rate reduction equal to approximately 20% of its taxable income, other than net taxable capital gains. These latter amounts may flow through to the shareholders of the corporation, retaining their character, on the payment of special capital gains dividends.

A "mutual fund corporation"[772] is a Canadian corporation established solely for investment purposes. At least 95% of its issued shares, by value, must be redeemable at the demand of the holder at prices determined under the share conditions. A mutual fund corporation may or may not also qualify as an investment corporation, as discussed above. A principal advantage of a mutual fund corporation is that it has the ability to flow out capital gains to its shareholders by electing to treat a dividend as a "capital gains dividend" to the extent of the corporation's net capital gains. Corresponding rules apply to mutual funds organized as trusts. An important difference between a mutual fund corporation and a mutual fund trust relates to the treatment of investment income other than dividends and capital gains. Interest income, for example, can effectively "flow through" a mutual fund trust under the normal rules applicable to trusts. This is not the case for mutual fund corporations.

Legislative Note: Budget 2024 proposed to restrict the eligibility conditions for qualifying as a mutual fund corporation for tax purposes. The public corporation requirement is currently met if any class of shares is listed on a designated Canadian stock exchange, even if that class does not confer control of the corporation or benefit from most of the economic return. Draft legislation released with Budget 2024 would deny mutual fund corporation status to a corporation that is controlled by, or for the benefit of, one or more "specified persons" (meaning any combination of persons and partnerships that do not act at arm's length with each other) that own more than 10% of all the issued and outstanding shares of the corporation, as measured by value.

Special rules are intended to discourage nonresidents from using mutual fund corporations or mutual fund trusts as a means of avoiding Canadian tax on Canadian real property investments. Where it is reasonable to conclude that the entity in question was established or maintained primarily for the benefit of nonresidents, the entity qualifies as a mutual fund corporation or mutual fund trust only if all or substantially all of its property consists of property other than Canadian real property, options in Canadian real property or other taxable Canadian property.[773] This rule ensures that nonresidents continue to be taxed on their Canadian real property investments despite the indirect ownership of the realty.

In addition, certain distributions out of a mutual fund corporation or trust to a nonresident that would otherwise not have been subject to Canadian income or withholding tax (such as a return of capital to a nonresident unit holder or shareholder) are subject to a 15% tax.[774]

[768] ITA, sec. 86.1.
[769] ITA, para. 55(3)(a).
[770] ITA, para. 55(3)(b).
[771] ITA, sec. 130.
[772] ITA, sec. 131.
[773] ITA, subsecs. 131(8.1) and 132(7).
[774] ITA, subsec. 218.3(2).

ISBN 978-1-63359-385-5

This tax applies only to distributions on a Canadian mutual fund trust unit or mutual fund corporation share:

(i) That is listed on a designated Canadian or foreign stock exchange; and

(ii) More than 50% of the fair market value of which is attributable to one or more properties each of which is real property in Canada, a Canadian resource property or a timber resource property.

Although these provisions technically deem the distribution to which the tax applies to be a disposition of taxable Canadian property, the nonresident is not required to file a Canadian income tax return or apply for a clearance certificate under section 116 of the Income Tax Act in connection with the deemed disposition. Finally, in accordance with these rules, a nonresident unit holder is entitled to carry back or forward losses from a disposition of Canadian property mutual fund investments to a year in which the new tax is payable. The application of losses carried back or forward for this purpose should be reported in a prescribed return and may give rise to a refund or reduction of tax payable in a particular year.

A "mortgage investment corporation"[775] is a Canadian corporation the only undertaking of which is the investing of funds of the corporation and provided that certain other conditions are satisfied. To qualify, a corporation must neither manage or develop real property, nor own either debts secured on real property situated outside Canada or owned by nonresident persons (unless secured on Canadian real property), or shares of a nonresident corporation, or foreign real property. The corporation must have at least 20 shareholders, not one of which owns more than 25% of the shares of any class of the corporation. The 25% share ownership threshold is the same as the threshold for an investment corporation, as discussed above, so indirect share ownership is counted in determining whether the threshold has been exceeded. Certain additional requirements are made regarding the mortgage portfolio of the company. A mortgage investment corporation can flow out interest income to its shareholders and this is not treated as a dividend, as would ordinarily be the case.

D. Tax-Exempt Persons

1. In General

Certain persons are exempt from Canadian income tax under the terms of the Income Tax Act, including the following:[776]

(i) Employees of foreign governments and their families residing in Canada;

(ii) Municipal authorities and corporations, commissions or associations at least 90% of the capital of which is owned by a federal or provincial government or by a Canadian municipality and no more than 10% of the income of which is earned outside the municipality or a wholly-owned corporation that is a subsidiary of such a corporation, commission or association;

(iii) Certain special purpose organizations, such as certain agricultural or labor organizations, housing corporations, and nonprofit clubs or societies;

(iv) Trusts for pension funds and other schemes of remuneration specifically dealt with in the Income Tax Act; and

(v) "Registered charities."

2. Charities

The "registered charity" is probably the most important category of tax-exempt persons in practice and comprises several distinct types of organizations, all of which, however, must be resident in and created or established in Canada (or be branches of such organizations).[777] Essentially, registered charities comprise "charitable organizations," which directly carry on charitable activities, and private or public "charitable foundations."[778] Charities can use their resources to provides funds to other "qualified donees" (i.e., other registered charities and certain specified entities), or, as a result of amendments made effective June 23, 2022, to non-qualified donees under specified circumstances (generally, the charity ensures the recipient uses the resources to carry out the charitable purpose of the charity). The common elements of these categories of registered charities are the purpose of the organization, which must be "charitable" as defined in the case law[779] (i.e., essentially for the advancement of education or religion, the relief of poverty or the benefit of the community), and the unavailability of any part of the organization's income for the personal benefit of shareholders or members.[780] The differentiating features relate to the degree of control exerted by way of disbursement rules and similar annual qualification tests.

The regime respecting charities is relevant from two perspectives. First, purportedly charitable organizations must meet the appropriate tests for their income to be tax exempt. Second, they must obtain registration to issue receipts to donors entitling those taxpayers to an appropriate charitable deduction (in the case of corporate donors) or credit (in the case of individuals).

The rules respecting qualification as a charitable foundation or charitable organization are complex and involve compliance with various provisions respecting the governance of the organization, the disbursement of revenues and the carrying on of related businesses. In addition, a charitable foundation or organization is required to maintain a publicly available list of its qualified donees. The Minister of National Revenue has the discretion to revoke or refuse the registration of a charitable organization and to suspend its authority to issue donation receipts.

Charitable organizations and foundations may have special status under certain bilateral tax treaties. For example, under the Canada-United States tax treaty, a charitable organization resident in one of the contracting states and exempt from tax in that state is similarly exempt in the other state.[781] So long as the charity receives substantially all of its support from

[775] ITA, sec. 130.1.

[776] ITA, sec. 149.

[777] ITA, para. 149(1)(f), definition in subsec. 248(1).

[778] ITA, sec. 149.1, for the procedure required to deregister a charity; see generally *Renaissance International v. MNR*, [1982] CTC 393.

[779] See *Pemsel v. Special Commissioners of Income Tax*, 3 T.C. 53.

[780] See, e.g., *Burns v. MNR*, [1983] CTC 2629.

[781] Canada-U.S. tax treaty, Art. XXI(1).

ISBN 978-1-63359-385-5

persons other than U.S. citizens or residents, it is also exempt from the U.S. excise tax imposed with respect to private foundations.[782] Special provision is made also for the deduction of charitable contributions to entities of the other contracting state, but only to the extent of the domestically applicable deduction limitations applied to income from sources in that other state.[783]

3. *Pension Plans*

A trust governed by a registered pension fund or plan is exempt from tax, as is a corporation incorporated and operated solely for the administration of a registered fund or plan and accepted by the Minister of National Revenue as a funding medium. Certain other corporations and trusts operated to hold pension investments are also exempt.[784] Rules relating to conditions for registration refer to such matters as eligible employment, pension levels, past service funding, benefits provided, etc.

To a significant extent, the income tax rules overlap the provincial and federal regulation of pension plans. Indeed, the rules are to some extent contradictory. Pension regulation generally aims to ensure that benefits reach minimum standards; income tax rules are intended to prevent pension benefits from being richer (and therefore involving greater indirect government support) than intended.

One matter of importance in international operations is that the Canadian system is applicable only to plans registered under the Income Tax Act. Hence, foreign pension plans that are not registered in Canada are generally regarded as retirement compensation plans. For this reason, many international employers find themselves in the position of establishing parallel or tandem pension arrangements for the various countries in which their employees are situated.

[782] Canada-U.S. tax treaty, Art. XXI(4).
[783] Canada-U.S. tax treaty, Arts. XXI(5) and (6).
[784] ITA, paras. 149(1)(o), (o.1), (o.2) and (o.4).

4. *Qualified Investments*

In the case of certain tax-exempt entities, restrictions may be placed on the types of investments that are permitted if they are to retain eligible status. Budget 2024 solicited feedback from stakeholders regarding how these rules might be improved and modernized, including the appropriateness of allowing crypto-backed assets to be qualified investments. There are no such rules respecting charities, although provincial regulation of such entities may create restrictions. The same applies to pension plans. Although highly regulated in terms of the requirements for registration under both the Income Tax Act and provincial pension legislation, pensions are not subjected to prescribed investment rules under the Income Tax Act.

Certain other pension-like entities are subject, however, to qualified investment restrictions. These rules apply to registered retirement savings plans (effectively private pension plans) and similar arrangements. The sanction may be a penalty tax or deregulation or both.

5. *Special Taxes*

While tax-exempt entities are, as their name indicates, generally exempt from tax, they were traditionally subject to certain special taxes, many of which have been repealed. However, they are still subject to the penalties alluded to in IX.D.4., above.

An anti-avoidance rule applies a special tax on tax-exempt entities engaging in certain dividend rental activities (i.e., agreements to purchase shares at a price that is different from their value to allow other persons to receive dividends on a tax-favored basis).[785]

[785] ITA, sec. 207.1(5).

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X. Taxation of Natural Resource Income

The exploitation of natural resources is a major element of Canadian economic life. Due to both the importance of these industries and their particular financial requirements, a number of special rules apply to the taxation of resource income.

The discussion below focuses on the rules applicable to the oil and gas industry and the mining industry.

A. *Capital Cost Allowance*

As with other industries, the various types of depreciable property used in the exploitation of natural resources fall within prescribed classes enabling the taxpayer to claim capital cost allowances in lieu of depreciation. For example, gas or oil well equipment, as defined, is depreciable at a 30% rate for Class 10 and 25% for Class 41 on a declining balance basis.[786] At various times, the Canadian government has offered preferential, or accelerated, rates of deduction for certain capital expenses to incentivize the activities of particular sectors, which has had a significant impact on the natural resource sectors.

At present, favorable capital cost allowance rules for certain manufacturing and processing equipment and clean energy equipment have also been implemented. In respect of certain manufacturing and processing equipment, 150% of the cost of such properties can be added to the capital cost allowance class.[787] In respect of clean energy equipment, an immediate 100% deduction of the cost of such property is available.[788] These rules are applicable for eligible property acquired that becomes available for use before 2028, and there is a gradual phase-out for property that becomes available for use after 2023. Despite a general carve-out for non-renewable resource activities from the definition of "manufacturing or processing," the CRA has confirmed that certain capital costs incurred by participants in the mining and energy sectors, such as downstream and midstream oil and gas processing equipment costs, may still qualify for the enhanced capital cost allowance available for manufacturing and processing equipment.[789] An accelerated capital cost allowance deduction is also available for equipment and buildings that are used in connection with the liquefaction of natural gas and was acquired before 2025.[790]

B. *Exploration and Development Expenses*

Due to the capital-intensive nature of the energy and mining industries, the Canadian government has traditionally offered incentives to explore for and develop new sources of petroleum products or minerals or to develop new renewable energy products. The Canadian system of allowances with respect to exploration and development expenses has changed many times, and many of the provisions still in force reflect historical regimes that have limited relevance to current taxpayers. The following discussion will therefore omit specific reference to the treatment of expenses incurred before 1974.

[786] ITR, schedule II, classes 10, 41.
[787] ITR, subsec. 1100(2).
[788] ITR, subsec. 1104(4).
[789] 2019 CPTS Annual Conference CRA Roundtable, Question 2 (June 6, 2019).
[790] ITR, subsec. 1100(1)(yb), 1101(4i).

The current system of tax incentives is generally based on three accounts or "pools" of expenditures incurred by industry participants, classified as "Canadian exploration expense" (CEE), "Canadian development expense" (CDE) and "Canadian oil and gas property expense" (COGPE). The CEE account generally includes expenses incurred in connection with exploration in the oil and gas and mining industries, as well as certain start-up costs for renewable energy projects. The CDE account generally correlates to costs of developing oil and gas or mining projects and includes the cost of mineral resource properties. The COGPE account applies solely to the oil and gas sector, and captures, in essence, the acquisition of oil and gas properties.

The deductions for these expense pools are not applicable to a taxpayer (other than a principal-business corporation) the business of which includes trading or dealing in rights, licenses or privileges to explore for, drill for, or take minerals, petroleum, natural gas or other related hydrocarbons.[791]

As a general rule, where an outlay or expense may fall into one or more of the categories described above, the taxpayer may choose the provision under which the deduction is claimed but cannot claim a deduction under more than one provision.[792] Another rule of general application relating to the deductions for the various resource expense pools concerns short tax years. Where the tax year is less than 51 weeks (perhaps because the corporation is newly incorporated or results from a statutory amalgamation), the amount otherwise deductible is prorated based on the number of days in the tax year.[793]

1. Canadian Exploration Expenses

The deduction of CEE depends upon the status of the taxpayer. A principal-business corporation (generally, a corporation the principal business of which is in the resource sector)[794] may deduct qualifying expenses only to the extent the corporation otherwise has income before certain specified deductions.[795] An individual or a corporation, other than a principal-business corporation, may claim up to a 100% write-off.[796]

The definition of CEE generally includes:[797]

(i) Expenses incurred (other than expenses incurred in drilling or completing an oil and gas well or site preparation) for purposes of determining the existence, location, extent or quality of an accumulation of petroleum or natural gas (other than a mineral resource) in Canada and includes expenses incurred on March 1, 2015 or later for environmental studies and community consultations;

(ii) Expenses (other than expenses incurred in drilling or completing an oil or gas well or site preparation) incurred after March 1985 for purposes of bringing a natural accumulation of petroleum or natural gas (other than a mineral resource) in Canada into production and incurred before the commencement of production (other than production

[791] ITA, subsec. 66(5).
[792] ITA, subsec. 66(13).
[793] ITA, subsec. 66(13.1).
[794] ITA, subsec. 66(15).
[795] ITA, subsec. 66.1(2).
[796] ITA, subsec. 66.1(3).
[797] ITA, subsec. 66.1(6).

ISBN 978-1-63359-385-5

from an oil or gas well) in reasonable commercial quantities from such accumulation;

(iii) Expenses incurred before April 1987 in drilling or completing an oil or gas well in Canada, or generally preparing a site with respect to a well, if drilling is completed within six months from the end of the year and either: the well is the first capable of production in commercial quantities from a previously unknown accumulation of petroleum or natural gas (other than a mineral resource); or it is reasonable not to expect the well to come into production in commercial quantities within 12 months of its completion;

(iv) Expenses incurred after March 1987 in drilling or completing an oil or gas well in Canada, or generally preparing a site with respect to a well, if one of the following four tests is passed:

- The drilling or completing of the well resulted in the discovery that a natural underground reservoir contained petroleum or natural gas where, before the time of discovery, no person or partnership had discovered that the reservoir contained either petroleum or natural gas, and the discovery occurred at any time before six months after the end of the year;[798]

  Note: Since 2019, expenses incurred for drilling "discovery wells" are treated as CDE.[799]

- The well is abandoned in the year or within six months after the end of the year without ever having produced otherwise than for specified purposes;

- The well has not produced otherwise than for specified purposes during the 24-month period after drilling is completed and that period ends in the year the expense was incurred; or

- Within six months after the end of the tax year in which the drilling was commenced, the taxpayer files with the Ministry of National Revenue a certificate (issued by the Ministry of Natural Resources) indicating that the costs of the well will exceed Can. $5 million and the well will not produce, otherwise than for a specified purpose, within 24 months of the completion of the drilling of the well;

(v) Survey expenses analogous to those described above in (i), above, but related to exploring for a mineral resource in Canada; and

(vi) Any Canadian renewable and conservation expense incurred by the taxpayer.

Except with respect to the last category of expenditures listed above, CEE does not include the capital cost of depreciable property.

2. Canadian Development Expenses

With respect to the deduction for CDE, no distinction is made among taxpayers based on whether their business is principally in the natural resources sector or not; the allowance may be claimed by *any* taxpayer at a rate of 30% of the year-end balance in the cumulative CDE account.[800] Legislative amendments introduced in 2019 provided additional deductions for "accelerated CDE," which generally includes CDE incurred after November 20, 2018 and before 2028. The additional deduction is 15% for expenses incurred from November 21, 2018 through to 2023 and 7.5% for expenses incurred from 2024 to 2027.

A taxpayer's CDE generally includes:

(i) Most drilling expenses in connection with an oil or gas well that are not included in CEE;

(ii) Most expenses in connection with bringing a new mine into production in reasonable commercial quantities;

(iii) The cost of a Canadian resource property to the extent such cost is not included in COGPE (which generally includes the costs of mineral resource properties); and

(iv) Expenses incurred after 1987 in sinking or excavating a mine shaft, main haulage way or similar underground work designed for continuing use, for a mine in a mineral resource in Canada built or excavated after the mine came into production, or in extending any such shaft, haulage way or work.

CDE does not include the capital cost of any depreciable property.

In certain circumstances, CDE may be reclassified as CEE. This may occur where, in effect, a development well is proven after the fact to have been an exploration well, for example, if the well is abandoned.[801] In addition, the cost of oil sands leases and other oil sands resource properties are generally treated as COGPE rather than CDE.

3. Canadian Oil and Gas Property Expenses

With respect to the deduction for COGPE, no distinction is made among taxpayers based on whether their business is principally in the natural resource sector or not. A taxpayer may generally deduct up to 10% of the year-end balance in their cumulative COGPE account.[802] Furthermore, additional deductions are available for "accelerated COGPE," which generally includes COGPE incurred after November 20, 2018 and before 2028. The additional deduction is 5% for expenses incurred from November 21, 2018 through to 2023 and 2.5% for expenses incurred from 2024 to 2027.[803]

A taxpayer's COGPE generally includes:[804]

(i) The cost of any right, license or privilege to explore for, drill for or take petroleum, natural gas or related hydrocarbons in Canada;

[798] ITA, subsec. 66.1(6), definition of "Canadian exploration expense," subpara. (d)(i).

[799] ITA, subsec. 66.1(6), definition of "Canadian exploration expense," clause (d)(i)(C). Discovery well expenses incurred before 2021 in connection with an obligation committed to in writing prior to March 22, 2017 continue to be eligible for CEE treatment.

[800] ITA, sec. 66.2.

[801] ITA, subsec. 66.1(9).

[802] ITA, subsec. 66.4(2).

[803] ITA, para. 66.2(2)(d).

[804] ITA, subsec. 66.4(5).

ISBN 978-1-63359-385-5

(ii) The cost of any oil or gas well in Canada or any real property in Canada the principal value of which depends on its petroleum or natural gas content (but not including any depreciable property); and

(iii) The cost of any rental or royalty computed by reference to the amount or value of production from an oil or gas well in Canada, or from a natural accumulation of petroleum or natural gas in Canada.[805]

4. Recovery of Expenses

The provisions regarding both CEE and CDE provide for the imposition of tax on a recovery of these expenses. This may arise, for example, where government assistance is provided with respect to exploration expenses. In each case, an amount is included in computing income where the total of amounts previously deducted or deductible (as the case may be) and of any proceeds with respect to property, the cost of which was deductible under these rules, exceeds the balance of the respective cumulative account.[806] A negative balance in the COGPE pool reduces the CDE pool, which may then give rise to an income inclusion if there is insufficient CDE at the end of the year.[807]

The cumulative expense pools are reduced by the amount of assistance the taxpayer receives or is entitled to receive with respect to any expense within the particular expense pool.[808]

5. Foreign Resource Expenses

The tax relief provided for foreign resource expenses (FRE) is similar to the system applicable to Canadian exploration and development expenses.[809] Essentially, FRE are exploration and development expenses with respect to petroleum, natural gas or mineral resources in a foreign country or acquisition costs relating to a foreign resource property.[810] They do not include expenditure incurred after the commencement of production. Like Canadian resource expenses, FRE are accumulated in a pool from which a taxpayer resident in Canada throughout a year may deduct an amount on a declining balance basis. The expenses are added to the taxpayer's cumulative foreign resource expense account on a country-by-country basis. The minimum amount deductible is 10% of the FRE pool at the end of the year. The maximum amount deductible is generally equal to the lesser of:

(i) 30% of the FRE pool; or

(ii) The taxpayer's net foreign resource income.

An additional amount may be deductible, which would allow the taxpayer to deduct up to 30% of the taxpayer's total cumulative FRE in respect of all countries to the extent that the taxpayer has sufficient global foreign resource income.[811] The amount deductible is computed with respect to each country in which the taxpayer incurs FRE, so foreign resource income in the above computation is with respect to the particular country in which the FRE is incurred. The taxpayer includes any negative FRE pool in income. The FRE rules apply for tax years beginning after 2000.

For earlier years, foreign resource expenditures are governed by the "foreign exploration and development expense" (FEDE) rules. The definition of FEDE is very similar to the definition of FRE and a taxpayer resident in Canada throughout a tax year may deduct 10% of the FEDE pool at the end of the year plus an additional amount based on the amount of the taxpayer's foreign resource income.[812] The additional amount is equal to 10% of the amount by which the taxpayer's foreign resource income exceeds 10% of the FEDE pool. Although the FEDE rules are no longer applicable to expenditures governed by the FRE rules[813] (generally, foreign resource expenditures incurred in tax years beginning after 2000), taxpayers' FEDE pools generated prior to the elimination of such expenditures continue to exist and the taxpayers may still claim FEDE deductions from those pools.

C. Disposition of Resource Properties

The cost of a Canadian or foreign resource property is effectively deductible within the rubric of CEE or FRE, or as part of the taxpayer's CDE or COGPE as described in X.B., above, and therefore, the proceeds of disposition of such properties may be subject to tax as income. The rules regarding capital gains and losses do not apply to Canadian or foreign resource properties.[814]

The proceeds of disposition of Canadian resource properties go to reduce the cumulative CDE or the cumulative COGPE, depending on whether the property disposed of is a mineral resource property or an oil and gas property.[815] In view of the rules regarding recovery of such expenses, discussed in X.B.4., above, it can be seen that if there are no positive amounts in the cumulative account, the full proceeds will be included in income. It is possible, however, to defer the taxation of such proceeds if sufficient expenses have been incurred with respect to development.

Disposition of a foreign resource property may also give rise to ordinary income.[816]

D. Flow-Through Shares

An important aspect of the Canadian system respecting the deduction of exploration and development expenses has been the ability of mining and oil and gas corporations to "sell" these deductions to investors. The relevant vehicle is called a "flow-through share."[817] The flow-through share system has been a significant aspect of the financing of junior mining and oil and gas companies in Canada. This regime was repealed for flow-through share agreements for oil, gas or coal entered into af-

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[805] ITA, subsec. 66.4(5).
[806] ITA, subsecs. 59(3.2), 66.1(1), 66.2(1), 66(12.1), (12.2).
[807] ITA, subsec. 66.4(1).
[808] Definitions of "cumulative Canadian exploration expense," "cumulative Canadian development expense," and "cumulative Canadian oil and gas property expense" in ITA, subsecs. 66.1(6), 66.2(5) and 66.4(5), respectively.
[809] ITA, sec. 66.21.
[810] ITA, subsec. 248(1) definition of "foreign resource property."
[811] ITA, para. 66.21(4)(b).
[812] ITA, subsec. 66(4).
[813] ITA, subsec. 66(15) definition of "foreign exploration and development expenses" paras. (k) and (l).
[814] ITA, subparas. 39(1)(a)(ii) and (ii.1).
[815] ITA, subsecs. 66.2(5), 66.4(5).
[816] ITA, subsecs. 59(1), 66(4).
[817] The rules governing flow-through shares are generally found under ITA, subsecs. 66(12.6) to (12.75) and ITR, sec. 6202. The definition for "flow-through shares" is set out under ITA, subsec. 66(15).

ISBN 978-1-63359-385-5

ter March 2023, but it remains applicable for pre-existing oil, gas or coal arrangements, Canadian renewable and conservation expenses and eligible expenses for certain critical minerals.

In effect, under a flow-through share arrangement, a “principal-business corporation”[818] that incurs CEE or CDE may transfer the benefit of these expenses to an investor who acquires flow-through shares of the corporation. The mechanism for transferring the expenses is referred to as a renunciation by the corporation. Flow-through shares are, essentially, common shares of a principal-business corporation that are issued to an investor in conjunction with an agreement made between the corporation and the investor that the corporation will incur certain resource expenses within a certain time frame, renounce the expenses to the investor, and make the necessary tax filings to make the renunciations effective. Among other restrictions and requirements, the expenses must be incurred within 24 months after the month in which the agreement is made and the amount renounced by the corporation cannot exceed the consideration paid for the flow-through share.

The effect of the renunciation is that the related expenses are considered to have been incurred by the investor on the day the corporation renounces them and not to have been incurred by the corporation. Subject to various technical requirements, the ITA allows certain Canadian exploration expense (CEE), including certain Canadian development expense (CDE) that has been recharacterized as CEE, to be renounced to an arm’s-length investor effective as of the last day of the calendar year in which the agreement is entered into by the parties. The corporation, however, must incur all applicable expenses by the end of the following calendar year.[819] The investor can then deduct the expenses in computing their own income.

A “look-back” rule further permits certain eligible expenses incurred in the calendar year following the issuance of the flow-through shares to be renounced to investors effective as of the year of issuance.[820]

It is possible in certain circumstances for a non-resident parent corporation to issue flow-through shares to Canadian investors, which can include shares listed on an exchange.[821] In this scenario, a Canadian subsidiary renounces the eligible expenditures to the foreign parent, which then renounces the expenditures to the investors holding the parent flow-through shares. Under this structure, the “look-back” rule is not applicable.[822]

Flow-through shares are deemed to have a cost of nil.[823] The ordinary rules apply in determining whether such shares are capital property or inventory to their holder. If they are capital property, a subsequent disposition gives rise to a capital gain.[824] If they are inventory, upon subsequent disposition, the full proceeds are included in computing income, although such an inclusion may be sheltered by any available CDE or COGPE,[825] in a manner similar to dispositions of Canadian resource properties.

To address perceived abuse in situations where taxpayers were taking advantage of the capital gains exemption and charitable donation tax credit regimes, the capital gains exemption is available with respect to a donation of flow-through shares only to the extent the value of the donated shares exceeds the acquisition cost of those shares.

As stated above, the flow-through share regime for oil, gas and coal activities was eliminated effective for flow-through share agreements entered into after March 2023.[826] Flow-through share agreements entered into on or before March 31, 2023, are grandfathered under the current rules.

E. Prospectors

Special rules enable a prospector to dispose of mining claims to a corporation for shares of the corporation without any immediate tax liability.[827] For these purposes, a “prospector” is an individual who prospects or explores for minerals or develops a property for minerals on behalf of himself, or himself and others, or as an employee. The rules apply where shares of a corporation are received by a prospector as consideration for the disposition to the corporation of a mining property or interest therein acquired by the individual as a result of his or her efforts. The rules also apply to any person who receives shares of a corporation as consideration for the disposition to the corporation of a mining property or interest therein, where the person acquired the mining property as a result of advancing money to cover the expenses of prospecting or exploring for minerals, or of developing a property for minerals:

(i) Under an arrangement made with the prospector before the prospecting, exploration or development work; or

(ii) If the prospector is the person’s employee, then as an employer of the prospector.

The prospector or other person receives the shares without any amount being included in computing his or her income. The corporation is deemed to have paid nothing for the property, and may not, therefore, claim any deduction for CDE with regard to the mining property in question.

On a subsequent disposition of the share by the prospector, one-half of the proceeds of disposition are regarded as income.[828] This is, in effect, the same result as if the disposition gave rise to a capital gain, but without any possible benefit of the capital gains exemption.

F. Government Royalties

Crown royalties are charges imposed by provincial governments on oil and gas production from Crown lands as payment for the right to develop the resource owned by the Crown. As of 2008, any such Crown royalties or taxes paid with respect to resource income are deductible in computing income.

[818] ITA, subsec. 66(15).
[819] ITA, subsec. 66(12.66), generally referred to as the “look-back rule.”
[820] ITA, subsec. 66(12.66).
[821] ITA, para. 66(12.67)(a) and subsec. 66(12.6).
[822] ITA, para. 66(12.66)(d).
[823] ITA, subsec. 66.3(1).
[824] ITA, subsec. 39(1).
[825] ITA, para. 66.2(2)(b) and subsec. 66.4(2).
[826] ITA, para. 66(12.62)(b.2).
[827] ITA, sec. 35.
[828] ITA, paras. 35(1)(d) and 110(1)(d.2).

ISBN 978-1-63359-385-5

G. Reorganizations

The general rules applicable to corporate reorganizations (see IX.C.2., above) apply also to corporations in the resource sector. In addition, the continuity of the various deduction accounts on which the special system of resource taxation is based is assured in a number of situations.

Generally, the cumulative CEE, the cumulative CDE and the cumulative COGPE may be preserved where one corporation has acquired, by purchase or otherwise (including an acquisition as the result of a statutory amalgamation) from another corporation, all or substantially all of the Canadian resource properties of the latter. For purposes of these rules, the purchaser is referred to as the "successor corporation" and the seller as the "predecessor corporation." These rules are generally elective.

The amount claimable depends on the same rules that apply to these various allowances. However, a critical aspect of the successor corporation rules is that the deductibility of such "inherited" tax pools is "streamed." Briefly, this means that the successor corporation may deduct tax pools of the predecessor corporation only to the extent of income attributable to production from the properties acquired. Thus, CDE, CEE and COGPE transferred under a successor election may not be used by the successor corporation to shelter income from other sources or from other properties.

Changes in the control or tax status of a corporation can limit the continuation of the corporation's resource pool accounts. Where control of a corporation has been acquired by a person or group of persons, or a corporation ceases to be exempt from tax, the corporation is deemed to be a successor corporation. The effect is to trigger the streaming of resource expenses incurred before the change in control or tax status to resource income from assets held immediately before the triggering event.[829]

[829] ITA, subsec. 66.7(10).

ISBN 978-1-63359-385-5

XI. Tax Avoidance, Tax Evasion and Income Imputation

A. *Tax Avoidance and Evasion*

The Canada Revenue Agency (CRA) criminal investigations program is responsible for the investigation of suspected cases of tax evasion, the collection of evidence of criminal offenses and the preparation of cases for prosecution in the courts. Under the Income Tax Act, it is a criminal offense to make deceptive statements, destroy records to avoid payment of tax, falsify records, and generally to willfully evade or attempt to evade compliance with the Income Tax Act or the payment of taxes imposed by it.[830] Conspiracy to evade tax is also an offense. The penalty for such tax evasion ranges from a fine of not less than 50% of the tax the taxpayer sought to evade up to a fine of double the amount of tax and imprisonment for up to five years. It is also an offense, though a less serious one, to fail to file a required return or to fail to withhold or remit tax in certain circumstances, and the punishment for such failure is generally a fine of not less than Can. $1,000 and not more than Can. $25,000, or both the fine and imprisonment for a term not exceeding 12 months.[831] Where a person has been convicted of such an offense, the court may make an order that it deems proper to enforce compliance.[832]

It is an offense to make false statements, alter documents, etc. for purposes of evading or reducing the tax payable by a person under the Income Tax Act. It is also an offense where such behavior is undertaken to obtain or increase a tax refund or credit, even if no tax is payable by the person.[833] The penalty varies from a fine of not less than 50% and not more than 200% of the amount by which the refund or credit obtained or claimed exceeds the refund or credit to which the person is entitled, to both the fine and imprisonment for a term not exceeding two years. In addition to the various penalties described above, nondeductible interest is charged on all taxes and other amounts that are not timely paid. However, the CRA has the ability to waive certain interest or penalties.[834]

The CRA also investigates cases to determine whether a tax avoidance scheme has been undertaken, with a view to recommending reassessment and/or amendment to the law. The tax authorities have recognized the distinction between cases where the taxpayer has apparently circumvented the law, without giving rise to a criminal offense, by the use of a scheme, arrangement or device, often of a complex nature, the main or sole purpose of which is to defer, reduce or completely avoid the tax payable under the law, and other cases where the taxpayer has merely sought a beneficial tax result.

Thus, the CRA attempts to differentiate among criminal tax evasion, “tax avoidance schemes” and the mere arrangement of one’s affairs so as to obtain a beneficial income tax result. The distinction is not clear-cut, and schemes that might be considered “avoidance” may be regarded as criminal tax evasion where the taxpayer has sought to conceal the true state of affairs. Thus, in one case, a scheme whereby royalties were allegedly diverted to a foreign corporation led to successful prosecution.[835] On the other hand, setting up an offshore subsidiary for purposes of reducing Canadian tax does not alone constitute tax evasion where there is no element of income that is not fully and properly recorded, and no documents destroyed or records missing or false entries made.[836] Similarly, the blatant failure to file returns may not be subject to prosecution where the taxpayer has done nothing actively to conceal himself/herself or his/her income.[837]

Aside from criminal responsibility, tax evasion or avoidance may attract the imposition of statutory penalties (see VII.H., above). The CRA has stated that, in general, its policy is to assess applicable civil penalties before instigating prosecution proceedings.[838]

B. *Substance, Form, Business Purpose and Statutory Interpretation*

The Canadian courts have dealt with tax avoidance transactions in numerous cases. The courts may approach the matter by requiring of the taxpayer a scrupulous adherence to legal formalities, by resorting to “legal substance” over “mere form” or “machinery,” or, in extreme cases, invoking a notion of “sham,” essentially a deceitful representation differing from the true state of affairs. With the advent of the statutory general anti-avoidance rule (commonly referred to as GAAR), discussed in XI.C., below, attention may stray somewhat from the pre-GAAR case law. However, cases relating to the pre-GAAR period highlight the importance of judicial attitudes toward tax avoidance and the difficulty of discerning the pattern of those attitudes.

Before turning to the anti-avoidance doctrines used by the Canadian courts, it is important to remember that taxpayers do not have any obligation to arrange their affairs to attract tax. On the contrary, the Canadian courts have consistently adhered to the principle developed in the famous English House of Lords decision, *Duke of Westminster,* that:

> Every man is entitled if he can to order his affairs so as that the tax attaching under the appropriate Acts is less than it otherwise would be. If he succeeds in ordering them so as to secure this result, then, however unappreciative the Commissioners of Inland Revenue or his fellow taxpayers may be of his ingenuity, he cannot be compelled to pay an increased tax.[839]

There is, of course, some tension between this general principle and the ability of courts to apply anti-avoidance doctrines to increase a taxpayer’s tax liability in what they consider appropriate circumstances. The following discussion of cases is intended to provide some of the flavor of the various judicial anti-avoidance doctrines and their application.

830 ITA, sec. 239.
831 ITA, subsec. 238(1).
832 ITA, subsec. 238(2).
833 ITA, subsec. 239(1.1).
834 ITA, subsec. 220(3.1).

835 *The Queen v. Myers*, 77 DTC 5278.
836 *R. v. Redpath Industries Ltd. et al.*, 83 DTC 5117, *appeal dismissed,* 84 DTC 6349; *see also Spur Oil Ltd. v. The Queen*, 81 DTC 5168.
837 *The Queen v. Paveley*, 76 DTC 6415; *The Queen v. Pongratz*, 82 DTC 6200; *but see Thistle v. The Queen,* 74 DTC 6632 and *Sturgess v. The Queen,* 84 DTC 6525.
838 Information Circular 73-10R3, para. 40 (2/13/87).
839 *Inland Revenue Commissioners v. Westminster (Duke)* [1936] AC 1 at 19–20.

ISBN 978-1-63359-385-5

In one case,[840] the taxpayer was unsuccessful in defending against an assessment in which the income of a tax haven subsidiary was treated as a part of its own income. The reasons do not carefully thread their way through concepts of "sham," "agency" or pricing, but rather seem to be based on the offshore subsidiary not "earning" the profit (i.e., that was earned by the Canadian taxpayer). In another case, the CRA attacked a pricing arrangement involving the purchase of crude oil by a Canadian corporation from a related Bermuda company. Both were subsidiaries of the same corporation. The Court found that the Bermuda company was, in fact, managed by persons in the United States and Canada, and that the crude oil continued to be sold to the plaintiff under the same procedure as was in place before the Bermuda company had been inserted into the marketing scheme. The taxpayer won, however. The new price was not excessive, and any reduction in income could therefore not be regarded as fictitious or simulated. Nor was there any sham.[841]

Stubart is a seminal Supreme Court of Canada decision on both tax avoidance and statutory interpretation. The case involved the utilization of losses among members of the same corporate group.[842] One subsidiary ("Stubart") operated a profitable business of manufacturing and selling food flavorings, while the other subsidiary had incurred losses in its manufacturing business. Written agreements were executed whereby the profitable subsidiary sold its flavoring business to the unprofitable subsidiary with the understanding that the profitable subsidiary would continue to carry on the business but as nominee for the unprofitable subsidiary. It appeared that the profitable business would be transferred back to the profitable subsidiary after the losses of its sister had been absorbed for tax purposes. In a lower court, the CRA had successfully argued that the income remained with the profitable corporation.

Contrary to the finding of the lower court, the Supreme Court of Canada determined that the transfer of the business was a valid, completed transaction. The Supreme Court also held that the determination as to whether any particular transaction was complete is a separate question from that of sham, because a sham transaction is one conducted with an element of deceit so as to create an illusion calculated to lead the tax collector away from the taxpayer or the true nature of the transaction, or simple deception whereby the taxpayer creates a facade of reality quite different from the disguised reality.

The Supreme Court also concluded that Canadian law did not, at least in the abstract, contain an independent business purpose test or abuse of rights principle. Although the GAAR does not create a business purpose test, per se, we may now have a form of abuse of rights doctrine. However, it appears that the *Stubart* case would be similarly decided under the GAAR, because it did not involve an abuse or misuse of the Income Tax Act. This conclusion follows from a determination that the various stop loss or loss streaming rules contained in the Income Tax Act are triggered by an "acquisition of control," and the various specific loss transfer prevention rules have exceptions for transactions within corporate groups, indicating that the "object and spirit" of the Income Tax Act allows "transfers" of losses within corporate groups.

In establishing guidelines on evaluating tax avoidance arrangements, the Supreme Court stated that, without invoking a general anti-avoidance rule, the formal validity of a transaction may be insufficient where:

> (i) There is a clear legislative intent to restrict the benefits sought to rights accrued prior to the establishment of the particular arrangement adopted by a taxpayer purely for tax purposes;
>
> (ii) The particular provisions in the Income Tax Act under which relief is sought necessarily relate to an identified business function; or
>
> (iii) It would not be within the "object and spirit" of the particular provision under consideration to allow the relief sought by the taxpayer.

Phrased differently, the *Stubart* decision has laid to rest the old rule, approved in *The King v. Crabbs*,[843] that taxing statutes are to be construed strictly. Rather, the provisions of the Act are to be interpreted by applying the plain meaning rule, but in a substantive sense so that if a taxpayer is within the spirit of the charge, he or she may be held liable. The desired objective is a simple rule that will provide uniformity of application of the Act across the community, and at the same time, reduce the attraction of elaborate and intricate tax avoidance plans, and reduce the rewards to those best able to afford the services of the tax technicians.

The courts' approach to statutory interpretation has evolved somewhat since *Stubart.* For example, *Neuman* involved an income-splitting arrangement among family members through a corporation.[844] The Federal Court of Appeal held that subsection 56(2) of the Income Tax Act applied to invalidate the plan because the transactions lacked commercial reality. Subsection 56(2) applies where a taxpayer directs a payment or transfer of property to some other person for either the benefit of the taxpayer or the other person. The benefit is included in the taxpayer's income to the extent it would have been had the payment or transfer been made to the taxpayer. The Supreme Court of Canada reversed the lower court based on a restrictive interpretation of the subsection and invoking the *Duke of Westminster* principle that a taxpayer may arrange his (or her) affairs to attract the least amount of tax provided the arrangement fits the technical requirements of the Income Tax Act.

Duha Printers is another Supreme Court of Canada decision that took a very narrow, legalistic approach to the consideration of a tax-motivated loss-trading scheme.[845] Duha was a corporation that wanted to acquire the losses of an unrelated corporation. Had Duha acquired the shares of the loss corporation, the acquisition rules would have applied, preventing Duha from using the losses. Instead, arrangements were made for the controlling shareholder of the loss corporation to acquire preferred shares of a special class that provided the shareholder with technical control of Duha so that there was no acquisition of control of the loss corporation. The Supreme Court held

[840] *Dominion Bridge Co. Ltd. v. The Queen*, 77 DTC 5367.
[841] *Spur Oil Ltd. v. The Queen*, 81 DTC 5168.
[842] *Stubart Investments Ltd. v. The Queen*, 84 DTC 6305.
[843] (1934) 1 DTC 272 (SCC).
[844] *Neuman v. The Queen*, 98 DTC 6297 (SCC).
[845] *Duha Printers (Western) Ltd. v. The Queen*, 98 DTC 6334 (SCC).

ISBN 978-1-63359-385-5

that it was entirely open to the parties to use the "technicalities of the revenue law" to achieve their desired end. Furthermore, "nothing in the 'object and spirit' of any of the provisions can serve to displace this result." Despite the lack of commerciality in the transactions, the Supreme Court had little difficulty in concluding that the parties' planning was effective for tax purposes.

Shell[846] is a Supreme Court of Canada decision dealing with a number of issues, including the principles for interpreting legislation and the role of the court in reviewing tax avoidance (and other) cases. As discussed in VIII.C.2.e., above, the issues in *Shell* were the deductibility of interest on a weak currency borrowing arrangement, and the characterization of the gain arising on the unwinding of the borrowing and related transactions as either income or capital. Once again, the Court took a formalistic, legal approach to the characterization of the transactions. Any adherence to the economic realities of the situation was rejected in favor of the legal relationships created by the parties. With respect to tax avoidance, the Court stated that "it is not the courts' role to prevent taxpayers from relying on the sophisticated structure of their transactions, arranged in such a way that the particular provisions of the Act are met."

In *Canada Trustco*,[847] the first Supreme Court of Canada decision concerning the GAAR, the Court advocated a unified "textual, contextual and purposive" approach to the interpretation of the Income Tax Act. Although the Court commented that the detailed nature of the Income Tax Act generally supports a greater emphasis on the text of its provisions, the Court observed that "statutory context and purpose may reveal or resolve latent ambiguities" in an otherwise unambiguous text. According to the Court: "the words of an Act are to be read in their entire context and in their grammatical and ordinary sense harmoniously with the scheme of the Act, the object of the Act and the intention of Parliament." However, the Court also cautioned that the provisions of the Income Tax Act must be interpreted to achieve "consistency, predictability and fairness." More significantly, in *Canada Trustco*, the Court confirmed the general principle that taxpayers are entitled to arrange their affairs so as to attract the least amount of tax.

Comment: Notwithstanding the considerable guidance provided by the Supreme Court of Canada in *Canada Trustco*, the historical ebb and flow of judicial reasoning in this area suggests that judicial attitudes toward tax avoidance will continue to evolve.

C. The General Anti-Avoidance Rule

1. Section 245

The application of the general anti-avoidance rule in section 245 of the Income Tax Act involves the following three steps:

(i) Determining whether there is a "tax benefit" arising from a "transaction". "Benefit" is defined in subsection 245(1) as a reduction, avoidance, or deferral of tax or other amount payable under the ITA or an increase in a refund of tax or other amount under the ITA, including a reduction, avoidance, or deferral of tax or other amount that would be payable under the ITA but for a tax treaty, or an increase in a refund of tax or other amount under the ITA as a result of a tax treaty; "transaction" is defined in subsection 245(1) to include an arrangement or event);

(ii) Determining whether the transaction, either by itself or as part of a "series of transactions," is an "avoidance transaction" as defined in subsection 245(3), or whether it has been "undertaken or arranged primarily for bona fide purposes other than to obtain the tax benefit". "Series of transactions" is defined in subsection 248(10) to include a related transaction that is completed in contemplation of the relevant series; and

(iii) Determining whether the avoidance transaction is abusive under subsection 245(4) in that it results in a "misuse" of the provisions of the Income Tax Act, the Income Tax Regulations, the Income Tax Application Rules, a tax treaty or any other tax legislation relevant in computing tax under the Income Tax Act, or in an "abuse" having regard to those provisions read as a whole.

Where the GAAR is found to apply, the Minister of National Revenue may redetermine the tax consequences (which include the amount of tax payable under the Income Tax Act or any amount that is relevant for the purposes of computing such tax)[848] to a person as is reasonable in the circumstances to deny a tax benefit that would otherwise result, directly or indirectly, from the relevant transaction or series of transactions.

As stated above, there are two important carve-outs from the application of the GAAR. First, a transaction arranged primarily for bona fide purposes other than to obtain a tax benefit is excluded from the definition of an avoidance transaction. This bona fide purpose test is meant to be a scaled-down version of the "business purpose test" originally contained in a draft version of the GAAR. The reformulated non-tax primary purpose test is intended to permit transactions motivated by family or other legitimate, non-business considerations that might otherwise not satisfy the business purpose test. Second, the GAAR will not apply to a transaction that does not result in a "misuse" of a provision of the Income Tax Act or an "abuse" of the Income Tax Act read as a whole.[849] Consequently, a transaction that does not meet the bona fide purpose test nevertheless escapes the purview of the GAAR if it does not result in such misuse or abuse.

In 2005, the GAAR was extended to avoidance transactions the tax benefits of which are realized by virtue of the misuse or abuse of the provisions of a tax treaty, the regulations under the Income Tax Act, the Income Tax Application Rules or any other enactment that is relevant in computing tax or any other amount payable by or refundable to a person under the Income Tax Act. The amendments were enacted with application to transactions entered into after September 12, 1988 (raising interesting legal issues regarding their retroactivity). In particular, the definition of "tax benefit" was amended to include a reduction, avoidance, or deferral of tax or other amount that would be payable under the Income Tax Act but for a tax treaty

[846] *Shell Canada Ltd. v. The Queen*, 99 DTC 5669.
[847] *The Queen v. Canada Trustco Mortgage Co.*, 2005 DTC 5523.
[848] See the definition of "tax consequences" in ITA, subsec. 245(1).
[849] ITA, subsec. 245(4).

ISBN 978-1-63359-385-5

or an increase in a refund of tax or other amount under the Income Tax Act as a result of a tax treaty. The "misuse and abuse" caveat referred to above was also amended, turning its original double negative language into a positive test, which stipulates that the GAAR will apply only where it may reasonably be considered that an avoidance transaction would result in a misuse or abuse of the provisions of any one or more of the enumerated enactments.

The GAAR was further extended, effective for transactions entered into on or after April 7, 2022, to broaden the scope of the definition of "tax benefits" to include the reduction, increase or preservation of amounts that could subsequently reduce tax owing by the taxpayer or increase any refund owing to the taxpayer. This amendment was made in response to a decision of the Federal Court of Appeal that the GAAR did not apply where tax attributes had not yet been used to impact actual tax owing.[850]

The most recent amendments to the GAAR were enacted on June 20, 2024, generally effective for transactions that occur on or after January 1, 2024. The amendments were initially proposed following a public consultation that ran from August 9, 2022 to September 30, 2022. The consultation paper that accompanied the launch of the public consultation set out a wide range of potential amendments, including the introduction of some form of economic substance test (in response to directions from the Prime Minister to the Minister of Finance to modernize the GAAR so as to focus on economic substance). The amendments included many but not all of the possibilities raised in the consultation. In particular, the amendments include:

(i) A new preamble to the section (a novel provision in the Canadian context) that sets out certain principles as to how to interpret and apply the GAAR.

(ii) A change in the avoidance transaction definition to the effect that only "one of the main purposes" of a transaction must be to obtain the tax benefit (compared to the current "primary" purpose).

(iii) The introduction of an economic substance rule, which provides that if the relevant series of transactions is "significantly lacking" in economic substance, that is "an important consideration that tends to indicate" that the transactions result in misuse or abuse, and further sets out three factors that "tend … to establish" this "significantly lacking" in economic substance criterion.

(iv) A new GAAR penalty and a three-year extension to the reassessment period, unless the transactions have been disclosed under the mandatory reporting rules in section 237.3 or 237.4 (which permit voluntary reporting if a transaction does not otherwise fall within their scope). The penalty applies only to transactions that occur on or after June 20, 2024.

2. *GAAR Case Law*

In 2005, the Supreme Court of Canada released its first GAAR decisions: *Canada Trustco v. Canada*[851] and *Mathew v. Canada*.[852] The Supreme Court also had the opportunity to consider the GAAR in *Lipson v. The Queen*,[853] *Copthorne Holdings Ltd. v. The Queen*,[854] *Canada v. Alta Energy Luxembourg S.A.R.L.*,[855] and *Deans Knight Income Corp. v. Canada*.[856] Prior to the Supreme Court's decisions in *Canada Trustco* and *Mathew*, the leading GAAR case was the Federal Court of Appeal's decision in *OSFC Holdings Ltd. v. The Queen*.[857]

OSFC was a GAAR case involving the use of partnerships to shift accrued losses between unrelated parties. In *OSFC*, the liquidators of an insolvent trust implemented a plan to sell properties of the trust to investors in a way that would allow the investors to make use of the losses sustained in the trust. In devising this plan, the liquidators caused a certain portfolio of nonperforming mortgages to be transferred to a partnership at an adjusted cost base that was higher than their fair market value. The trust's interest in the property was ultimately transferred to the taxpayer, with which the trust dealt at arm's length. The Minister of National Revenue opposed the transfers, asserting that the GAAR applied.

The Federal Court of Appeal dismissed the taxpayer's appeal on the basis that the transactions resulted in an abuse of the policy of the Income Tax Act that prohibits the transfer of losses between unrelated parties. However, before coming to this conclusion the Federal Court had to consider the other elements of the GAAR. A thoughtful approach to the determination of the meaning of "series of transactions" was taken, as the taxpayer argued that its acquisition of the partnership interest was not part of the pre-ordained series of transactions that provided the taxpayer with the losses.

The Federal Court referred to the extended meaning of "series" in the Income Tax Act, which provides that a series of transactions or events includes any related transactions or events completed in contemplation of the series. Under that extended definition, the acquisition by the taxpayer fell within the series of transactions that created the accrued loss, which the taxpayer subsequently realized to reduce its income. Moreover, under the meaning of avoidance transaction, the taxpayer obtaining the tax benefit does not have to be the person that undertakes or arranges the transaction that gave rise to that benefit.

The Federal Court also provided considerable guidance on the process for applying the misuse or abuse test. First, the relevant policy of the provisions of the Income Tax Act in question or the Act as a whole must be determined. The Federal Court of Appeal indicated that the onus was on the Crown to prove a "clear and unambiguous policy" underlying the relevant provision(s). Second, the facts of the case must be assessed in light of the identified policy. The particular provision(s) allegedly being misused would be analyzed in this manner before the inquiry turned to the relevant policy underlying the Income Tax Act, read as a whole.

[850] *1245989 Alberta Ltd. v. Canada (Attorney General)*, 2018 FCA 114 (*sub nom Wild v. Canada (Attorney General)*).

[851] 2005 SCC 54.

[852] 2005 SCC 55.

[853] 2009 SCC 1.

[854] 2011 SCC 63.

[855] 2021 SCC 49, aff'g 2020 FCA 43, aff'g 2018 TCC 152.

[856] 2023 SCC 16, aff'g 2021 FCA 160, rev'g 2019 TCC 76.

[857] 99 DTC 1044 (TCC), *aff'd*, 2001 DTC 5471 (FCA).

ISBN 978-1-63359-385-5

The Federal Court found that there was no misuse of a provision of the Income Tax Act in the particular circumstances, but that a review of the loss carryover legislation and commentary related to loss utilization demonstrated a policy against the transfer of losses between unrelated parties. The Federal Court of Appeal did not elaborate regarding precisely what extrinsic evidence is acceptable (or the veracity of such evidence) for purposes of discerning the intention of a provision of legislation or the Income Tax Act as a whole.

The Federal Court of Appeal's decision in *OSFC* set out what, prior to the Supreme Court of Canada decisions in *Mathew* and *Canada Trustco,* became the prevailing analytical framework for determining whether the GAAR should apply to a particular transaction or series thereof. The Supreme Court of Canada, although reaching the same decision as the Federal Court of Appeal in both *Mathew* and *Canada Trustco,* rejected the Federal Court of Appeal's analytical framework (in particular, the Federal Court of Appeal's bifurcated approach to the "misuse and abuse" analysis), introducing a three-part approach of its own and articulating key guiding interpretive and procedural principles.

In *Canada Trustco,* the corporate taxpayer was a financial institution deriving substantial revenues from leased assets. Using its own funds and borrowed funds, it purchased trailers from "TLI" and leased them back circuitously to TLI. Prepayment of the lease payments through an intermediary, coupled with the posting of a bond by that intermediary, substantially minimized any financial risk for the taxpayer. The purpose of the transaction was to generate, with minimal financial risk, capital cost allowance (CCA) deductions to be applied against other lease income subject to tax. The Minister of National Revenue assessed the taxpayer under the GAAR, disallowing the taxpayer's CCA deductions. The taxpayer was successful in its appeal to the Tax Court of Canada. The Crown's appeal of the Tax Court of Canada decision was dismissed at the Federal Court of Appeal, and it was ultimately unsuccessful in its appeal to the Supreme Court of Canada.

The facts in *Mathew* were essentially the same as those in *OSFC* (the appellants in the former case owned interests in the same partnership as that out of which OSFC was allocated losses). The Minister disallowed the taxpayers' allocated partnership losses on the basis of the GAAR. The taxpayers' appeals were dismissed at each of the Tax Court of Canada and the Federal Court of Appeal.

As in *Canada Trustco,* the only issue before the Supreme Court of Canada in *Mathew* was whether the transactions constituted abusive tax avoidance. The Court concluded that the operative provisions (one adding what would have been the transferor trust's tax loss to the cost of the transferred property, thus preserving those losses for the benefit of the transferee, and the other allowing for the allocation of the partnership's losses to its partners) were not meant to permit arm's-length parties to purchase tax losses and then to claim them as their own. The taxpayers' appeal was thereby dismissed.

In both cases, the Supreme Court concluded, consistently with the legislative text of the GAAR itself, that it is first necessary for a tax benefit to have resulted from the particular transaction or a series of transactions of which the transaction is a part. A transaction giving rise to a tax benefit will be an avoidance transaction unless the transaction may reasonably be considered to have been undertaken or arranged primarily for bona fide purposes other than to obtain the tax benefit. It was in its interpretation of the "misuse" and "abuse" caveat embedded in the GAAR provision that the Supreme Court of Canada purported to articulate a novel approach.

The Supreme Court of Canada introduced a two-step test to determine whether a particular transaction or series of transactions constitutes what it referred to as "abusive tax avoidance." The first step involves a determination of the object, spirit or purpose of the provision(s) in question. The second step involves an examination of the factual context of the particular case to determine whether the avoidance transaction defeated or frustrated the object, spirit or purpose of the provision(s).

Notably, the Supreme Court of Canada rejected the notion of any determinative inquiry into the "economic substance" of a particular transaction, stating that "GAAR was not intended to outlaw all tax benefits; Parliament intended for many to endure" and that courts must be careful not to find abusive tax avoidance simply because a nontax purpose (including an economic, commercial or family purpose) is not evident — rather, the lack of such nontax purpose may form part of the factual context to be considered.

As a procedural matter, the Supreme Court stated that the burden is on the taxpayer to refute the Minister's contention that a particular transaction or series thereof gave rise to a tax benefit and constituted an avoidance transaction. In contrast, the burden is on the Minister to establish that a particular transaction (or series) amounts to "abusive tax avoidance." Moreover, if the existence of abusive tax avoidance is unclear, the Court stated that the benefit of the doubt must go to the taxpayer.

Finally, the Supreme Court articulated the appropriate standard of appellate review for GAAR cases — namely, where a Tax Court judge has proceeded on a proper construction of the provisions of the Income Tax Act and on findings supported by the evidence, appellate tribunals should not interfere, absent a palpable and overriding error.

Both the Tax Court of Canada and the Federal Court of Appeal have had ample opportunity to consider the GAAR post-*Canada Trustco* on several occasions. The decisions demonstrate that the application of the GAAR is difficult: cases with similar facts may have different outcomes. For example, the Tax Court decisions in *Evans v. The Queen*[858] and *Desmarais v. The Queen,*[859] which both involved a rather elaborate series of transactions resulting in the extraction of corporate surplus on an effectively tax-free basis, were decided for and against the taxpayer, respectively.

The following GAAR decisions are noteworthy. *MIL Investments* is the first case to consider the application of the GAAR to a "treaty shopping" transaction in which the corporate taxpayer continued from a nontreaty country to a treaty country in order to benefit from a treaty exemption. The taxpayer in *MIL Investments,* a nonresident of Canada, was originally a Cayman Islands corporation that was continued into Luxembourg. The taxpayer owned shares in a Canadian public

[858] 2005 DTC 1762 (TCC).

[859] 2006 DTC 2376 (TCC).

ISBN 978-1-63359-385-5

company. Although evidence suggested that a sale was not intended at the time of the continuation, following a change in circumstances, the company was the target of a takeover bid approximately one year after continuation. Consequently, the taxpayer disposed of its shares in the company and realized a capital gain with respect to the disposition. The taxpayer claimed an exemption from Canadian tax on this gain under the provisions of the Canada-Luxembourg tax treaty;[860] there was also no tax payable to Luxembourg. The Minister disallowed the exemption, relying on the GAAR. Although the existence of a tax benefit was admitted, the Tax Court of Canada found that there was no avoidance transaction and no "abusive tax avoidance." The Tax Court also found that there was no anti-abuse doctrine inherent in the applicable tax treaty. Accordingly, it was held that the GAAR did not apply in these circumstances. *MIL Investments* was upheld by the Federal Court of Appeal, which concluded that there was no evidence of a "palpable and overriding error" by the Tax Court. The Federal Court gave its reasons from the bench immediately after hearing the legal arguments, indicating that there was no support for the argument that the benefit obtained by the taxpayer was a misuse or abuse of either the Income Tax Act or the Canada-Luxembourg tax treaty.

In its first GAAR case concerning a tax treaty, *Canada v. Alta Energy Luxembourg S.A.R.L.*,[861] the Supreme Court of Canada agreed that there was no abusive tax avoidance under the GAAR where a Luxembourg-resident company relied on the Canada-Luxembourg tax treaty to exempt a capital gain from Canadian income tax. The court determined that the treaty should apply to all residents of the contracting states and refused to read in additional requirements that would preclude certain residents — such as those with weak commercial or economic ties to the residence country — from obtaining treaty benefits.

The most recent GAAR decision of the Supreme Court of Canada is *Deans Knight Income Corp. v. Canada*,[862] which dealt with Canada's loss carryover rules where there is an acquisition of control of a corporation with losses (LossCo). The seven-judge majority reasons held that, where a taxpayer was able to avoid an acquisition of *de jure* control through a series of transactions that effectively allowed a LossCo to monetize its losses and other tax attributes, this constituted misuse or abuse and the GAAR applied. In reaching this conclusion, the Court considered certain factors that, outside of the GAAR context, would only be relevant for establishing *de facto* control and not *de jure* control. The Court emphasized the need to focus on the rationale of the provisions at issue in determining whether there was misuse or abuse and not the means by which Parliament chose to effect the rationale. Here, that meant focusing on the rationale of the rule denying loss carryovers where there is an acquisition of control rather than Parliament's choice of the *de jure* control test for purposes of the rule. As the LossCo underwent a "fundamental transformation" whereby its business changed and the losses ultimately benefited different parties, and moreover entered into an agreement that gave a third party the "functional equivalent" of control, the transactions were contrary to the rationale of the provision at issue and the GAAR applied.

In *The Queen v. Spruce Credit Union*,[863] the Federal Court of Appeal upheld the Tax Court of Canada's decision that the GAAR did not apply to deny an inter-corporate dividend deduction on a dividend received from a deposit insurance corporation on the basis that there was no avoidance transaction. The court stated that, consistent with the *Duke of Westminster* principle, a transaction will not be considered an avoidance transaction merely because a taxpayer could have undertaken an alternative transaction that would have resulted in greater tax consequences. Also, the fact that tax implications may play a role in the choice of transaction does not mean that the transaction will be an avoidance transaction if the transaction was entered into primarily for business reasons.

MacKay v. The Queen[864] addressed whether an avoidance transaction had occurred in the context of a series of transactions. In *MacKay*, the Crown alleged that the tax benefit was very similar (or "virtually identical") to the tax benefit received by the taxpayers in *OSFC* and *Mathew*;[865] however, in *MacKay*, the Tax Court of Canada found that the tax benefits resulting from the individual transactions forming part of the series were secondary to the overall commercial purpose of the series and, therefore, none of the transactions constituted an avoidance transaction under subsection 245(3).

The Federal Court of Appeal disagreed with the approach taken by the Tax Court of Canada. In the Court's view, the conclusion that a series of transactions was undertaken primarily for bona fide nontax purposes did not operate to preclude a finding that the primary purpose of one or more steps within the series was to obtain a tax benefit. Having concluded that the series was an avoidance transaction, the Federal Court of Appeal proceeded to conclude that the avoidance was abusive within the meaning of subsection 245(4), based on the reasoning of the Supreme Court of Canada in *Mathew*.

The Supreme Court considered the application of the GAAR in *Lipson v. The Queen. Lipson* involved a series of transactions designed to convert non-deductible home mortgage interest payments into deductible interest payments. The taxpayer's spouse borrowed money from a bank and used the borrowed funds to purchase shares from the taxpayer. The following day, the taxpayer and his spouse purchased a house, using the proceeds from the share purchase. The taxpayer and his spouse then took out a mortgage, secured by the house, which was used to repay the spouse's initial bank loan.

The taxpayer relied on the following rules:

(i) The interest on the bank borrowing to acquire the shares is deductible because the borrowing was for an income-earning purpose;

(ii) The mortgage replaced the bank borrowing and thus was deemed to have been used for the purpose of the bank borrowing;

[860] Convention Between the Government of Canada and the Government of the Grand Duchy of Luxembourg for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and on Capital, signed on Sept. 10, 1999 (the "Canada-Luxembourg tax treaty").

[861] 2021 SCC 49, aff'g 2020 FCA 43, aff'g 2018 TCC 152.

[862] 2023 SCC 16, aff'g 2021 FCA 160, rev'g 2019 TCC 76.

[863] 2014 DTC 5079 (FCA), aff'g 2014 DTC 1063 (TCC).

[864] 2008 FCA 105, *rev'g* 4 2007 TCC 94, leave to appeal to the Supreme Court denied.

[865] 2005 SCC 55.

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(iii) Transfers of property to a spouse generally are not taxable; and

(iv) Income and losses of the spouse are attributed back to the taxpayer.

The effect was that the taxpayer deducted interest on the mortgage, applying it against dividends received on the shares.

In a 4-3 decision, the Supreme Court held that the GAAR applied to the transaction. The majority found that the overall result of the transactions was a misuse or abuse of the attribution rules (but not the interest deductibility rules). The minority would not have applied the GAAR. One dissenting set of reasons stated that the government had failed to identify a specific policy that was frustrated by the transactions, and the other dissenting set of reasons stated that the GAAR should not apply because there was a specific anti-avoidance rule in the attribution rules and the GAAR should be a provision of last resort.

Even though the Court was split in a 4-3 decision, the Court was unanimous in finding that there was no misuse or abuse of the interest deductibility provisions and, in the absence of the misuse of the attribution rules, the taxpayer's spouse would otherwise be entitled to deduct interest on the mortgage that had been taken out to refinance funds borrowed to acquire shares.

It is interesting to note that the taxpayer was successful in *Overs*[866] on facts that were very similar to those in *Lipson*. However, as noted by the Tax Court, in both *Evans* and *Overs*, there was a factual underpinning of commerciality or estate planning whereas the scheme in *Lipson* had "no such redeeming features."

Copthorne Holdings Ltd. v. The Queen[867] is a further pronouncement by the Supreme Court of Canada on the GAAR. In *Copthorne*, as part of the amalgamation of certain related companies, the shareholders inserted a step that had as its sole purpose the preservation of cross-border paid-up capital (PUC). The taxpayer later took steps to access the preserved PUC to distribute funds to a nonresident shareholder free of withholding tax on a redemption of shares. In a unanimous decision, the Supreme Court of Canada reaffirmed the principles in *Canada Trustco*. The Court found that the relevant transactions formed one series of transactions under the Income Tax Act's extended meaning of that term for purposes of determining whether there was an avoidance transaction resulting in a tax benefit and concluded that both an avoidance transaction and tax benefit were present. The Court held that the transactions were an abuse of the relevant provisions of the Income Tax Act because the taxpayer had circumvented those provisions and thus defeated their underlying rationale by effectively duplicating its PUC in the amalgamated corporation.

The Federal Court of Appeal held that examining alternative transactions that a taxpayer could have entered into can be relevant to determining whether there has been a misuse or abuse of the Act for purposes of applying the GAAR. In *Univar Holdco Canada ULC v. The Queen*,[868] the taxpayer was a Canadian subsidiary of a Dutch multinational public company. A non-Canadian arm's length party effected a public takeover of the taxpayer's Dutch parent. At the time of the takeover, the taxpayer had significant surplus. Typically, such surplus can be extracted by a purchaser by establishing a Canadian acquisition company that could acquire the shares of the Canadian target company directly (the "Alternative Transaction"). However, such a transaction structure was not commercially feasible in this particular instance. As a result, a series of transactions were entered into pursuant to which the nonresident purchaser was able to extract the surplus from the Canadian subsidiary while avoiding the application of certain Canadian anti-avoidance rules. The Minister reassessed the taxpayer and applied the GAAR, arguing that the tax-free extraction of the surplus of the Canadian subsidiary was a misuse and abuse of the particular anti-avoidance rule in question. The Tax Court determined that the GAAR did apply. On appeal, the Federal Court of Appeal overturned the decision. In determining that the GAAR did not apply, the Federal Court of Appeal noted that one significant factor that indicated that the anti-avoidance rule in question had not been misused or abused was that the same tax result (i.e., the tax-free extraction of surplus by a nonresident) could have been achieved through the Alternative Transaction, which was only precluded due to commercial reasons.

The Federal Court of Appeal also held in *Univar* that subsequent amendments to legislation that prevent other taxpayers from carrying out the transactions carried out by the taxpayer in question do not necessarily suggest that the taxpayer's transactions abused or misused the Act. However, subsequently in *Canada v. Oxford Properties Group Inc.*,[869] the Federal Court of Appeal indicated that amendments to the legislation do not establish that the object, spirit, and purpose of the legislation has changed and can instead be a "clarification" of the law.

Comment: As is evident from the cases canvassed above, GAAR decisions are somewhat difficult to reconcile. More than three decades following its enactment, and despite guidance from Canada's highest court, the applicability of the GAAR to a particular transaction or series thereof is often by no means clear.

3. Information Circular 88-2

In October 1988, the CRA issued Information Circular 88-2, which sets out its general administrative approach to the application of the GAAR. In preparing the Circular, the CRA focused on identifying transactions to which the "bona fide purpose" and the "misuse or abuse" exceptions to the application of the GAAR would be pertinent.

The Circular provides that the primary purpose of a transaction is determined from the taxpayer's statement of intent and all the circumstances surrounding the transaction. If it can be inferred from the circumstances that the primary purpose in undertaking a single transaction or each step transaction within a series is to obtain a "tax benefit," it will be an "avoidance transaction" notwithstanding the taxpayer's statement of intent to the contrary.

The Circular also provides that the CRA will apply the "misuse or abuse" exception to override specific tax consequences of other provisions within the Income Tax Act where a tax benefit inconsistent with the general scheme of the Income

[866] *Overs v. The Queen*, 2006 DTC 2192 (TCC).
[867] 2011 SCC 63.
[868] 2017 FCA 207.
[869] 2018 FCA 30.

ISBN 978-1-63359-385-5

Tax Act results, but not to negate the tax consequences of a transaction that is consistent with the object and spirit of the Income Tax Act.

To ensure these principles are applied in a consistent manner, the circular provides that proposed assessments will be reviewed by the CRA, Head Office "GAAR Committee."

4. The GAAR Committee

Since the enactment of the GAAR in 1988, hundreds of files have been referred to the central "GAAR Committee" of the CRA for review. The consultation paper on the GAAR released in August 2022 noted that "the application of the GAAR was considered at the audit stage in approximately 1,600 cases… In 80 percent of those cases (over 1,300 times), the GAAR was ultimately applied by the CRA as a primary or alternative reassessing position. Of this number, the GAAR has been the primary assessing position in approximately 50 percent of the cases and an alternate or secondary position in the remainder." The consultation paper — which proposed significant changes to the GAAR on the basis that it needed to be strengthened — noted that only 24 post-*Canada Trustco* cases held that the GAAR did not apply.

The CRA established the GAAR Committee to provide advice on the application of section 245 to ensure that the GAAR was applied in an equitable manner and to ensure national consistency. The mandate of the GAAR Committee is to review the application, or nonapplication, of the GAAR in rulings being considered and reassessments being proposed and to provide recommendations to the functions concerned.

The GAAR Committee comprises senior officials from the CRA as well as representatives of the Departments of Justice and Finance. It considers referrals from the rulings division as well as from the various CRA tax services offices in connection with income tax audits.

5. The Quebec GAAR

The Quebec GAAR is very similar to its federal counterpart under the Income Tax Act and essentially parallels its three conditions of application. The Quebec GAAR will apply where the following three criteria are met:

(i) A "tax benefit" has resulted, directly or indirectly, from a transaction or series of transactions;

(ii) The transaction in question is an "avoidance transaction," or the series of transactions in question includes an "avoidance transaction;" and

(iii) It may reasonably be considered that the transaction in question would result directly or indirectly in a misuse of the provisions of the Taxation Act (Quebec) (QTA) or other related tax legislation as specified, or an abuse having regard to the provisions of the QTA read as a whole.

As under the federal GAAR, where the Quebec GAAR is found to apply, the "tax consequences" to a person may be redetermined as is reasonable in the circumstances to deny a tax benefit that would result, directly or indirectly, from the relevant transaction or series of transactions.[870]

In addition, Quebec has implemented additional measures that target aggressive tax planning schemes. Briefly, these measures consist of:

(i) A mandatory early disclosure regime for certain specified aggressive tax planning arrangements;

(ii) A clarification to the notion of bona fide purpose for purposes of the GAAR;

(iii) A three-year extension of the limitation period for assessing transactions under the Quebec GAAR; and

(iv) A new regime of penalties applicable to taxpayers and promoters where the GAAR is found to apply.

Taxpayers having a connection with Quebec, including nonresidents operating in Quebec through an establishment located therein, must therefore consider the potential application of these measures to their own circumstances

D. Other Statutory Anti-Avoidance Provisions

1. In General

Some provisions of the Income Tax Act that could be said to be anti-avoidance provisions have, over time, reached a level of acceptance where this appellation no longer seems appropriate. For example, the rule providing for a deemed dividend on liquidation was initially enacted to reverse the common law rule that all such distributions were necessarily capital. A number of provisions are discussed below, that are generally designed to prevent either purposeful or incidental avoidance or reduction of tax.

2. The Fair Market Value Rule

Generally, a taxpayer is free to dispose of property at any price. In the case of taxpayers not dealing at arm's length, however, the transaction must occur at fair market value. More precisely, where a taxpayer acquires anything from a non-arm's-length person at an amount in excess of fair market value, the taxpayer is deemed to have acquired it at fair market value. Conversely, where a taxpayer disposes of anything by gift or to a person with whom the taxpayer was not dealing at arm's length for proceeds less than fair market value, the taxpayer is deemed to have received fair market value as its proceeds of disposition but the acquirer's cost is limited to the amount actually paid (in the non-gift situation).[871] Due to the asymmetry of these provisions, it is particularly important that most non-arm's-length transfers do occur at fair market value. In the case of acquisitions by gift, bequest or inheritance, the recipient is usually allowed a cost equal to fair market value.

Similarly, where an amount can reasonably be regarded as being, in part, consideration for the disposition of a particular property, for the provision of particular services or for a restrictive covenant, the consideration for the disposition of the property, the particular services or the restrictive covenant, is that part of the total that can reasonably be regarded as being the consideration for the particular property, the particular services or the restrictive covenant.[872] This is so irrespective of the form

[870] Taxation Act (Quebec), R.S.Q., c. I-3 (QTA), secs. 1079.10 and 1079.12.

[871] ITA, sec. 69.

[872] ITA, sec. 68.

ISBN 978-1-63359-385-5

or legal effect of the contract or agreement. The amount treated as consideration for the disposition of the property, the provision of the services or the restrictive covenant, is also the cost of the property to the person who has acquired it, or the amount paid for the services or the restrictive covenant.

A number of exceptions to these rules exist in cases in which a permissive or mandatory rollover occurs. This may be to the advantage of the taxpayer, as in the case of a number of corporate reorganizations, or to the taxpayer's disadvantage, as where he had hoped to trigger a gain or loss on disposition.

Where a taxpayer transfers property to an unrelated corporation or partnership at less than the fair market value of that property (i.e., on a tax-free rollover basis) as a part of a series of transactions intended to use deductions or losses of the transferee to shelter accrued gains in the transferred property on its subsequent disposition, the transferor will be deemed to have disposed of the property at fair market value. Special rules apply in the case of an amalgamation or merger.[873]

3. *Capital Gains and Losses*

The fair market value rule is probably the most significant anti-avoidance provision encountered in practice with respect to capital gains. However, other important rules also deal with capital gains tax avoidance.

a. *Deemed Proceeds or Capital Gain*

The Income Tax Act contains a specific anti-avoidance provision enacted to prevent arrangements that convert capital gains that would otherwise have been realized on a disposition of shares at fair market value to tax-free intercorporate dividends.[874] The provision applies in the circumstances in which a corporation resident in Canada receives a taxable dividend with respect to which the recipient is entitled to a deduction in computing taxable income. For the rule to apply, one of the following conditions must be satisfied in respect of the dividend:

(i) One of the purposes (or, in the case of a deemed dividend, one of the results) of the dividend was to effect a significant reduction in the portion of the capital gain that, but for the dividend, would have been realized on a disposition of any share of the corporation at fair market value; or

(ii) The dividend (other than certain deemed dividends arising on a redemption, acquisition or cancellation of a share) is received on a share and one of the purposes of the dividend is to effect either (a) a significant reduction in the fair market value of any share or (b) a significant increase in the cost of property, such that aggregate cost of all properties of the dividend recipient before the dividend is significantly greater than the aggregate cost of all properties of the dividend recipient after the dividend.

There have been several court decisions attempting to define the phrases "series of transactions,"[875] "one of the purposes of which"[876] and "to effect a significant reduction"[877] in the context of the provision; however, the scope of the rule remains somewhat uncertain. In addition, the current form of the rule was introduced in 2015 and greatly broadened its scope. Thus, some of the court decisions determined in the context of the pre-2015 rule may be of limited assistance.

Comment: Given the significant uncertainty and the broad scope of the rule as currently written, practitioners are typically concerned that the rule could be applied to most intercorporate dividends that are paid by a corporation.

Where the provision applies, the dividend is deemed to be a capital gain from the disposition of capital property (or proceeds of disposition in respect of a share redemption/repurchase) and not a dividend (or deemed dividend) received by the corporation. Thus, the tax-free intercorporate dividend is converted back into a potentially taxable gain. The provision is not intended to apply to income that was earned or realized by any corporation after 1971 (otherwise known as "safe income"), but before a cut-off point for determining safe income. (Generally, that point is the earlier of the time of disposition or the time at which the dividend was paid.) Safe income is presumably protected from recharacterization because this income has been previously subject to corporate income tax and, therefore, should be permitted as a tax-free dividend to other Canadian corporations. Some guidance exists from the courts — notably by the Federal Court of Appeal in *Kruco* — for the calculation of the safe income of a share, which is the share's pro rata portion of the safe income of the corporation during the relevant holding period of the share.[878] However, the CRA recently stated that it disagreed with *Kruco* and that certain amendments introduced in 2016 meant that its guidance no longer applied. Instead, the CRA is of the view that, generally, safe income only includes amounts that continue to exist as tangible assets that support the fair market value of the shares.

Similarly, the provision does not apply to any portion of a dividend that is subject to the special refundable 33 1/3% tax (discussed in IX.C.1.a.(7), above), provided the tax is not refunded as a result of the payment of another dividend to a corporation as part of the same series of transactions or events that brought the provision into effect.[879]

There are two principal exceptions to the application of the provision. The first exempts dividends received in certain related-party transactions where, in the course of a series of transactions or events there is no resulting disposition of property to a person or partnership that was an unrelated person or significant increase in the interest in any corporation of one or more unrelated persons. More specifically, this provision exempts situations involving internal reorganizations, where the ownership of the corporation does not change.[880] In determining whether there has been a change of ownership for this purpose, a number of rather complex rules must be examined. These rules are intended to prevent access to the exception where

[873] ITA, subsecs. 69(11), (12), (13), (14).

[874] ITA, sec. 55.

[875] *454538 Ontario Ltd. et al. v. MNR*, 93 DTC 427; *C.P.L. Holdings Ltd. v. The Queen*, 95 DTC 5253; *Industries SLM Inc. v. MNR*, 2000 DTC 6648 (FCTD).

[876] *The Queen v. Placer Dome Inc.*, 96 DTC 6562.

[877] *Trico Industries Ltd. v. MNR*, 94 DTC 1740; *Industries SLM Inc. v. MNR*, 2000 DTC 6648 (FCTD).

[878] *Kruco Inc. v. R.*, 2003 DTC 5506; *Lamont Management Ltd. v. The Queen*, 2000 DTC 6256; *The Queen v. Brelco Drilling Ltd.*, 99 DTC 5253; *454538 Ontario Ltd. et al. v. MNR*, 93 DTC 427; *Trico Industries*, 94 DTC 1740; *The Queen v. Nassau Walnut Investments Inc.*, 97 DTC 5051.

[879] ITA, subsec. 55(2).

[880] ITA, para. 55(3)(a).

ISBN 978-1-63359-385-5

there has been a substantive change in the ownership of property.

The second exception applies to a divisive reorganization, more commonly known as a "butterfly" transaction, which is essentially used to separate the interests of shareholders and "demerge" a corporation.[881] In general terms, the exception applies to a dividend received as part of a reorganization such that each participant in the butterfly transaction that owned shares of the corporation immediately before the reorganization, receives its pro rata share, directly or indirectly, of each type of property of the distributing corporation owned immediately before the distribution. Although no legislative guidance exists in determining what constitutes a type of property, three general categories have emerged in administrative practice: cash and near cash, business assets, and passive investment assets. In certain spin-off transactions effected by public corporations, the pro rata distribution of property rule does not apply. In these cases, different types of property may be distributed unevenly to the new transferee corporation.[882]

The butterfly exception permits a "split-up" reorganization, which is designed to divide a corporation's assets among shareholders who intend to part ways. To accomplish this reorganization, the departing shareholder(s) transfer all of their shares of the distributing corporation to a transferee corporation that receives the pro rata share of the property held by the distributing corporation as outlined above. On completion of the reorganization, the departing shareholders have no ownership interest in the distributing corporation and become the owners of the transferee corporation. Another permitted butterfly exception is the "spin-off" reorganization, in which the shareholders retain ownership of the distributing corporation, but the ownership structure is changed. To effect such a reorganization, some of the distributing corporation's assets are spun off to a new transferee corporation and the shareholders retain their holdings in the distributing corporation and become shareholders of the transferee corporation.

In certain circumstances, the butterfly exception outlined above does not apply, even if there is a pro rata distribution of property, such as if the distributing corporation, a corporation controlled by it or a predecessor of any such corporation has acquired property in contemplation of the distribution.[883]

Finally, a specific provision may apply to deem persons not to be related to each other or the corporation not to control the other corporation, if it can reasonably be considered that one of the main purposes of the transactions or events was to cause a person to be related or a corporation to be controlled to avoid the application of the anti-avoidance provision.[884]

b. Superficial Losses

In a number of particular situations, a capital loss from the disposition of property may be deemed to be nil or its realization deferred. For example, to prevent taxpayers from too easily realizing accrued capital losses, a "superficial loss" rule exists whereby the capital loss is deemed to be nil if the taxpayer, his or her spouse or a controlled corporation acquires the same or identical property within 30 days before or after the disposition in question. In certain cases of deemed disposition (e.g., on death and on ceasing to be a Canadian resident), the rule does not apply. Where a superficial loss is disallowed, the amount of the loss is generally added as an adjustment to the cost base of the property, with the result that the loss is deferred rather than eradicated altogether.[885]

c. Stop Loss

Similarly, a capital loss realized on a disposition by a corporation, trust or partnership to a person "affiliated" to the transferor is deferred until the property is disposed of and an unaffiliated person owns the property (or identical property) 30 days after the disposition.[886] For this purpose, affiliated persons include a corporation and a person who controls the corporation, two corporations that are controlled by the same person, a corporation and a partnership if the corporation is controlled by majority interest members of the partnership (generally, members who are entitled to more than one-half of the partnership's income), a partnership and its majority interest partner, and two partnerships if they have the same majority interest partner.[887] The realization of the capital loss is deferred until a person unaffiliated with the transfer owns the property. The capital loss deferred is then realized in the hands of the transferor. These stop-loss rules also apply to various transactions involving shares of foreign subsidiaries of a Canadian taxpayer that might otherwise occur on a tax-deferred rollover basis.

No capital loss arises on the disposition of a debt, unless it was acquired for the purpose of gaining or producing income from a business or property, or as consideration for the disposition of capital property to an arm's-length person.[888] This rule has caused serious difficulties with regard to guarantees given by a taxpayer. When the payer is called on the guarantee, it may often be the case that, unless he or she can claim a full deduction for the amount as a business expense,[889] he or she will have no relief by way of a capital loss. In the past, the CRA has recognized a capital loss in such cases if the guarantor is a shareholder of the debtor or if the guarantee was entered into for adequate consideration.[890]

The Income Tax Act also contains stop-loss rules that may apply to reduce the amount of loss of a corporation on the disposition of a share by the amount of any tax-free dividends received or deemed to be received on the share. Generally, there is an exception to this rule where the dividend recipient and non-arm's length persons collectively held 5% or less of any class of share of the issuer corporation for at least 365 days immediately prior to receiving the dividend. However, this excep-

[881] ITA, para. 55(3)(b).
[882] ITA, subsec. 55(3.02).
[883] ITA, subsec. 55(3.1).
[884] ITA, subsec. 55(4).

[885] ITA, subpara. 40(2)(g)(i), sec. 54, para. 53(1)(f). The adjustment to the cost base of the property may, however, be reduced to the extent the dividend stop-loss rules in ITA, subsecs. 112(3) to (3.2) apply.
[886] ITA, subsecs. 40(3.3), (3.4).
[887] ITA, sec. 251.1.
[888] ITA, subpara. 40(2)(g)(ii).
[889] See Income Tax Folio S3-F6-C1: Interest Deductibility, which states, at para. 1.77, that where a guarantee is part of a taxpayer's business, the interest expense on borrowed money to honor the guarantee would generally be deductible under ITA, para. 20(1)(c).
[890] Interpretation Bulletin [Cancelled] IT-239R2 (2/9/81) and CRA Access letter nos. 9830927 and 9529806 dated May 18, 1999, and Jan. 25, 1996, respectively.

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tion does not apply in respect of a deemed dividend arising on a redemption, acquisition or cancellation of a share of the issuer corporation.

d. Attribution

To prevent the effective transfer of capital gains from a taxpayer to his or her spouse (as such transfers can be effected on a rollover basis), it is provided that, where a person has loaned or transferred property, by means of a trust or otherwise, to a spouse (or to a person who has since become the taxpayer's spouse), subsequent capital gains (or losses) realized on the disposition of the same or substituted property while the transferor is resident in Canada and the transferee is the taxpayer's spouse, are deemed to be gains of the transferor rather than the transferee.[891] This rule also applies to transfers between common-law partners. Nothing seems to prevent the rule applying where the transfer occurred while the spouses were nonresidents of Canada.[892]

4. Expenses

As a rule, no deduction may be made in computing income with respect to an outlay or expense, except to the extent that it is reasonable in the circumstances.[893] In most cases where section 67 of the Income Tax Act has been invoked, it has reduced deductions that are largely personal in nature or are amounts paid to non-arm's-length parties.

Two other anti-avoidance type provisions may apply where an amount with respect to a deductible outlay or expense is not paid within a specified period of time. One provision applies where the outlay or expense remains unpaid for two years by a taxpayer to a person with whom the taxpayer is not dealing at arm's length. An amount equal to the amount so unpaid is either included in the debtor's income for the third tax year following the year in which the expense was incurred, or the debtor and creditor may elect to deem the amount to be received by the creditor at such time.

The second rule applies where an amount with respect to a deductible outlay or expense owed by a taxpayer to a person as salary, wages or other remuneration remains unpaid 180 days following the tax year in which it was incurred. In this case, the amount is not deductible in the year incurred and is deemed to be incurred as an expense in the year of actual payment.[894]

5. Benefits and Income Imputation

Under the wide rubric of anti-avoidance measures, the Income Tax Act contains a number of rules intended to prevent taxpayers from shifting otherwise taxable income to other persons who may not be taxed on the income or may be subject to lower rates of tax. Some of the rules apply only to transactions between shareholders and corporations, or between spouses or other family members, and others have a wider general application.

Where a shareholder appropriates corporate property or a corporation confers a benefit on a shareholder, the value thereof may be included in computing the shareholder's income. This rule and the related provisions regarding outstanding loans from corporations to their shareholders are discussed at IX.C.1.f., above. These provisions are often important tools for dealing with tax avoidance schemes involving taxpayers and related corporations. As discussed earlier, absent these rules, individuals might escape shareholder level taxation while effectively receiving an economic return on their investment in a corporation.

There are several important rules of more general application that prevent the shifting of income from one person to another. Section 246 of the Income Tax Act provides that, where a person confers a benefit by any means on a taxpayer, the amount of the benefit is included in the taxpayer's income to the extent that it would be included in the taxpayer's income if paid directly by the person to the taxpayer. This section does not apply where the amount is otherwise included in the taxpayer's income under another provision of the Income Tax Act. Thus, other, more specific anti-avoidance or imputation rules would generally apply before resort is had to section 246. Where the taxpayer is a nonresident and the benefit is not included in the nonresident's taxable income earned in Canada, the amount of the benefit may be subject to nonresident withholding tax. The particular nonresident withholding tax that could apply depends on the nature of the benefit. Whether the taxpayer is a resident or nonresident, a benefit is generally not considered to have been conferred in a bona fide transaction between arm's-length parties.[895] This saving provision is intended to permit transactions that are not considered tax motivated to be carried out even if a tax advantage arises. Despite its potential breadth (or perhaps, due to that potential), section 246 has rarely stood as the sole basis for a judicial decision against a taxpayer. Quite commonly, this provision is invoked in conjunction with other, more specific rules, relating to shareholder benefits or other similar provisions.

Subsection 56(2) of the Income Tax Act is another attribution-type provision with potentially broad application. That provision applies where a taxpayer directs a payment or transfer of property to some other person for either the taxpayer's or the other person's benefit. The benefit is included in the taxpayer's income to the extent it would have been had the payment or transfer been made to the taxpayer. For this provision to apply, the courts have developed the following four requirements:[896]

(i) There must be a payment or transfer of property to a person other than the taxpayer;

(ii) The payment or transfer must be pursuant to the direction of or with the concurrence of the taxpayer;

(iii) The payment or transfer must be for the taxpayer's own benefit or for the benefit of some other person on whom the taxpayer wished to have the benefit conferred; and

[891] ITA, sec. 74.2.

[892] *Wertman v. MNR*, 64 DTC 5158.

[893] ITA, sec. 67.

[894] ITA, subsecs. 78(1), (4).

[895] ITA, subsec. 246(1), (2).

[896] *Neuman v. The Queen*, 98 DTC 6297; *Fraser Companies, Ltd. v. The Queen*, 81 DTC 5051; *Murphy v. The Queen*, 80 DTC 6314.

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(iv) The payment or transfer would have been included in computing the taxpayer's income had it been received by the taxpayer instead of the other person.

The CRA has been unsuccessful in applying subsection 56(2) of the Income Tax Act in various cases due to the requirement in (iv), above. The courts have suggested that this fourth precondition to the application of subsection 56(2) requires the taxpayer to have had an entitlement to the payment or transfer of property that would have been included in the taxpayer's income.[897] The inability to meet that requirement allowed a family of shareholders to have dividends disproportionately distributed among the shareholders so that the lower-income-earning shareholders could earn the dividend income subject to lower marginal tax rates.[898] Partly to address concerns with these family income splitting arrangements, the government introduced specific anti-avoidance legislation designed to prevent high-income individuals from paying certain types of dividends and business income, directly or indirectly, to their minor children who can effectively shelter this income through their personal tax credits and lower marginal tax rates (known colloquially as the "kiddie tax").[899] The rules also extend to certain capital gains realized on the disposition of shares of a corporation to a person who does not deal at arm's length with the minor, if taxable dividends would have been subject to the anti-avoidance rule. These rules do not, however, operate by attributing income to the transferring or directing taxpayer; rather, they increase the tax payable by the minor children and remove the incentive to arbitrage between tax rates.

In addition, another income splitting anti-avoidance rule exists that applies a special "tax on split income" (TOSI) to certain income earned by adults (specifically, dividends or interest paid by a private corporation directly or indirectly to an individual from a related business, certain split income from partnerships and trusts, and capital gains or profit from the disposition of certain properties). Certain exclusions may apply (such as where the individual has significantly contributed time or capital to the success of the business), and special rules apply to spouses who are 65 and older or individuals who are between 18 and 24.

A similar rule in subsection 56(4) of the Income Tax Act applies to the transfer or assignment of a right to income. Where a taxpayer transfers a right to income to a person with whom the taxpayer was not dealing at arm's length, the taxpayer is taxed on the income if the income would have otherwise been included in the taxpayer's income absent the transfer.[900] Attribution does not generally apply to property income arising from a transfer of the property that produces the income.

The Income Tax Act also contains a myriad of rules aimed at preventing the shifting of income between spouses and other related individuals. Generally, income arising on property transferred or loaned by a taxpayer to the taxpayer's spouse is included in the transferor's income, not the income of the spouse who acquired or borrowed the property.[901] A similar imputation rule applies in the case of transfers or loans to persons under 18 years of age. The wording of the rule is quite similar to that just described with respect to inter-spousal transfers and loans, and in this case, imputation continues until the transferee (or borrower) has attained the age of 18 years.[902] Other attribution rules may apply to a non-arm's-length transfer of property where the transfer was tax-motivated. These rules curb the tax advantages otherwise arising from moving income from individuals taxed at higher marginal tax rates to individuals who can earn the income in a lower tax bracket.

6. Transfer Pricing

Canada's current transfer pricing rules are contained in section 247 of the Income Tax Act and were implemented with effect for tax years commencing after 1997. Prior to 1997, subsections 69(2) and (3) of the Income Tax Act dealt with transactions between Canadian residents and non-arm's length nonresidents. Although the rules in subsections 69(2) and (3) no longer apply today, their interpretation by the courts has been applied by subsequent courts in interpreting the current rules in section 247.

For further discussion of Canada's transfer pricing regime, see Chapter 30 of 6945 T.M., *Transfer Pricing: Rules and Practice in Selected Countries (C–D).*

a. Prior Rules

Former subsection 69(2) applicable prior to 1998, provided, in effect, that where an amount was payable by a Canadian resident to a nonresident person for goods or services that was greater than the amount that would have been reasonable in the circumstances had the parties been dealing at arm's length (the "reasonable amount"), the deduction allowed in computing the Canadian taxpayer's income was restricted to the reasonable amount. A companion provision in subsection 69(3) provided that an amount equal to or greater than a reasonable amount must be included in a Canadian taxpayer's income when it charged a related nonresident person for goods or services.

The Income Tax Act, in this context, used the phrase "reasonable in the circumstances" rather than the phrase "fair market value." The CRA's position was that the former phrase likely meant fair market value or, possibly, a different amount in circumstances such as start-up operations, loss-leader products or market penetration strategies.

The Supreme Court of Canada considered the determination of arm's length pricing under subsection 69(2) in *Canada v. GlaxoSmithKline*,[903] where the Court noted that the transfer pricing guidelines published by the Organisation for Economic Cooperation and Development ("OECD Guidelines") are not determinative and the test must ultimately be determined in accordance with the language of the Income Tax Act. That being said, the Court did take into account the OECD Guidelines and the various methods set out therein to determine the arm's length pricing. Although the Court referred the matter for reassessment and did not draw a specific conclusion regarding the appropriate arm's length pricing in this instance, they did

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[897] *Quterbridge Est. v. Canada*, 90 DTC 6681 (*sub nom. Winter v. Canada*).

[898] *Neuman v. The Queen*, 98 DTC 6297. See also *McClurg v. The Queen*, 91 DTC 5001, and *Ferrel v. The Queen*, 97 DTC 1565 (TCC), *aff'd*, 99 DTC 5111 (FCA).

[899] ITA, sec. 120.4.

[900] ITA, subsec. 56(4).

[901] ITA, sec. 74.1.

[902] ITA, subsec. 74.1(2).

[903] *Canada v. GlaxoSmithKline*, 2012 SCC 52 at paras. 20, 38, 44, and 61.

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note that the requirements of the subsection would be satisfied if the transfer price was within a reasonable range (the reference to a reasonable amount was part of the language of subsection 69(2) but is not expressly part of subsection 247(2)). One of the more important aspects of this decision was that, in determining an arm's length price, the Court held that it is appropriate and necessary to consider the economically relevant characteristics of a transaction, which may include other transactions linked to the purchase transactions, such as agreements that confer rights and benefits.

b. Current Rules

The transfer pricing rules in section 247 of the Income Tax Act seek to apply arm's-length terms and conditions to transactions between a taxpayer or a partnership and related nonresidents via two rules.[904] The first rule, a "pricing rule," provides that where a taxpayer and a non-arm's length nonresident are participants in a transaction or series of transactions that does not have arm's length terms and conditions, the terms and conditions of that transaction or series of transactions can be adjusted to the terms and conditions to which arm's length persons would have agreed.[905]

Although the Income Tax Act does not specify the meaning of arm's-length terms and conditions, the CRA generally follows the OECD Guidelines, which use a hierarchy of traditional transaction methods over profit-based methods (see discussion related to Administrative Guidance below). The CRA's general approach has been to use the most recent version of the OECD's transfer pricing guidelines (rather than the version that was in effect at the time of the transaction) in determining whether multinational enterprises are pricing their intercompany transactions in accordance with the arm's length principle. The legislation also provides a concept of "cost contribution arrangement" that covers a broad range of shared services, including management and administrative services, and activities related to the development of intangibles.

In a 2010 decision, the Federal Court of Appeal affirmed that the arm's-length standard for purposes of paragraph 247(2)(a) and (c) of the Income Tax Act required a determination of the "economically relevant characteristics" that may influence the negotiations between parties that have no de facto or de jure control over one another.[906] The Court remarked that its decision was consistent with its earlier decision in *Canada v GlaxoSmithKline*[907] issued in the same year that interpreted subsection 69(2).

The second rule, colloquially referred to as the "recharacterization rule," applies where a taxpayer and a non-arm's length nonresident are participants in a transaction or series of transactions that would not have been entered into between arm's-length persons and that cannot reasonably be considered to have been entered into primarily for bona fide purposes other than to obtain a tax benefit.[908] A tax benefit is defined broadly as a reduction, avoidance or deferral of tax or other amount under the Income Tax Act, or an increase in a refund of tax or other amount under the Act.[909] Where this rule applies, the tax consequences are determined based on the hypothetical transaction or series of transactions that would have been entered into had the parties been dealing at arm's length.[910] Despite the potential breadth of this rule, the CRA suggested in Information Circular IC 87-2R that transactions will only be recharacterized in limited circumstances.

Although Information Circular 87-2R has since been cancelled (as noted under Administrative Guidance below), it had referred to two recharacterization circumstances, which were taken from the OECD Guidelines. The first situation is where the substance of a transaction differs from its form. An example involved an investment in a related enterprise in the form of interest-bearing debt where arm's-length parties would have structured their investment as a subscription of capital.[911] In the second situation, the transaction differed from that which independent enterprises behaving in a commercially rational manner would have entered into and the structure of the transaction makes it nearly impossible to determine an appropriate transfer price.[912] In the example provided, a taxpayer performing research sells an unlimited entitlement to the intellectual property it is developing for a lump sum payment from a related party. The CRA stated that since arm's-length parties would not have structured such a transaction, the CRA may seek to recharacterize the transaction as a form of a continuing research agreement.

To date, the recharacterization rule has only been interpreted in one case. In *Cameco Corp. v. The Queen*[913] the taxpayer (Cameco Canada) was a uranium producer that:

(i) Negotiated certain uranium purchase contracts with third parties but then permitted a subsidiary (Cameco Europe) to enter into those contracts (the Third Party Contracts); and

(ii) Agreed to sell all of its uncommitted uranium production to Cameco Europe on a long-term basis at a fixed price (the Bulk Purchase Contracts).

At the Tax Court of Canada, the court held that the test for the recharacterization rule in paragraph 247(2)(b) is an objective one that requires a determination as to whether the transaction or transactions in question are "commercially rational" transactions.

The court ultimately held that the recharacterization rule in paragraph 247(2)(b) did not apply because:

(i) The Third Party Contracts had no value at the time they were entered into and thus it was not commercially irrational for Cameco Canada to pass on the opportunity to enter into those agreements and instead allow a subsidiary to do so; and

(ii) It is commercially rational for a commodity producer to agree to sell its production for a fixed price (and thus

[904] ITA, subsec. 247(2).

[905] ITA, para. 247(2)(a) and (c).

[906] *The Queen v. General Electric Capital Canada Inc.*, 2011 DTC 5011 (FCA).

[907] 2010 FCA 201. The Federal Court of Appeal's decision was upheld by the Supreme Court of Canada.

[908] ITA, para. 247(2)(b) and (d).

[909] ITA, subsec. 247(1).

[910] ITA, para. 247(2)(d).

[911] Information Circular IC 87-2R, para. 19.

[912] Information Circular IC 87-2R, para. 20.

[913] 2018 TCC 195, *aff'd* 2020 FCA 112.

ISBN 978-1-63359-385-5

eliminate its exposure to price risk) to secure a guaranteed revenue stream for its products, even if the producer expected prices to rise in the future.

On appeal, the Crown argued that the test in paragraph 247(2)(b) requires an examination of what the taxpayer (i.e., Cameco Canada) would have done in the circumstances if it was dealing with an arm's length person. The Crown argued that the evidence established that Cameco Canada would never have agreed to allow an arm's length person to enter into the Third Party Contracts and would never have entered into the Bulk Purchase Contracts with an arm's length person. The Federal Court of Appeal rejected this interpretation of the rule, holding that the test in paragraph 247(2)(b) requires an examination of whether any two hypothetical persons dealing at arm's length would have objectively entered into these types of contracts. The Federal Court of Appeal affirmed the Tax Court's decision on the basis that the evidence established that arm's length persons would have entered into the transactions in issue. The Supreme Court of Canada declined to hear the Crown's appeal of the Federal Court of Appeal's decision.

Legislative Note: As part of Budget 2021, the federal government stated that in light of the Federal Court of Appeal's decision in *Cameco*, "shortcomings" in the current transfer pricing rules may result in the "inappropriate shifting of corporate income out of Canada" and that this may pose "a risk to the integrity of Canada's corporate income tax system." As a result, Budget 2021 indicates that the federal government intends to consult on Canada's transfer pricing rules to protect the integrity of the Canadian tax system while preserving Canada's attractiveness as a destination for new investment and business activity. The consultation paper was released more than two years later on June 6, 2023, launching a public consultation process that closed on July 28, 2023. The consultation paper proposed a wide range of potential changes and includes draft legislation. The Department of Finance explained that generally, the amendments are intended to add more detail to Canada's transfer pricing rules and emphasize the "factual substance" of transactions. The amendments include: consideration being given to the "conditions" of the actual transactions (based on their "economically relevant characteristics") as well as any conditions that would have been included by arm's length parties; a new recharacterization rule; and a new rule requiring consistency with the OECD Transfer Pricing Guidelines where the context allows (currently the 2022 version, with the possibility of the government updating the reference to subsequent versions going forward). Finally, the consultation paper proposes certain changes with respect to which no draft legislation was released, including contemporaneous documentation requirements, a higher threshold for the penalty and a different approach to pricing certain types of transaction that is intended to be easier for taxpayers to apply. The federal government has provided no further update since the consultation paper was released and the consultation period ended.

(1) Penalty Provisions

In the event that a taxpayer fails to apply an arm's-length standard in transactions involving related nonresident parties, the taxpayer will be subject to certain penalty provisions. The legislation incorporates a penalty of 10% of any transfer pricing adjustment that exceeds the lesser of 10% of gross revenue or Can. $5 million. Assuming a hypothetical federal 25% effective tax rate, the penalty equates to 40% of the federal tax adjustment. Combined with nondeductible interest, total penalties may be greater than those that would have applied in other countries, including the United States. However, if the taxpayer has made a reasonable effort to determine arm's-length pricing, the foregoing penalties do not apply. In demonstrating that it has made a reasonable effort, the taxpayer must, as a minimum, maintain contemporaneous documentation as set out in subsection 247(4). Such documentation must be made available within six months after the taxpayer's year-end and be provided to the CRA within three months of its being requested.[914]

(2) Documentation Requirements

For purposes of subsection 247(4), contemporaneous documentation must be accurate and complete in all material respects and must include the following items of information:

(i) The property or services to which the transaction relates;

(ii) The terms and conditions of the transaction and their relationship, if any, to the terms and conditions of each other transaction entered into between the participants in the transaction;

(iii) The identity of the participants in the transaction and their relationship to each other at the time the transaction was entered into;

(iv) The functions performed, the property used or contributed and the risks assumed, in respect of the transaction, by the participants in the transaction;

(v) The data and methods considered and the analysis performed to determine the transfer prices or the allocations of profits or losses or contributions to costs, as the case may be, in respect of the transaction; and

(vi) The assumptions, strategies and policies, if any, that influenced the determination of the transfer prices or the allocations of profit or losses or contribution to costs, as the case may be, in respect of the transaction.

In addition, a taxpayer is required to update its contemporaneous documentation in respect of a particular transaction each year if there has been a material change in respect of the transaction in such year.

These documentation requirements are similar to the type of documentation suggested by the OECD and consistent with the information required by some other countries.

(3) Administrative Guidance

The CRA has released two main publications that outline its administrative approach to Canada's transfer pricing rules and provides guidance with respect to the application of those rules.[915] The first was Information Circular IC 87-2R, which

[914] ITA, subsec. 247(4).

[915] In addition, the CRA has released a number of other Transfer Pricing Memoranda that outline its administrative positions regarding various aspects of transfer pricing, including TPM-15 (on intra-group services), TPM-16 (on the use of multi-year data in transfer pricing analyses) and TPM-17 (on the impact of government assistance on transfer pricing).

ISBN 978-1-63359-385-5

was released in 1999 and generally adopted the transfer pricing methods set out in the 1979 OECD Report (and adopted in the 1995 Transfer Pricing Guidelines). The second, Transfer Pricing Memorandum 14 (TPM-14), was released in 2010 and provides an update to the CRA's administrative position with respect to transfer pricing methods by adopting the revised guidance in the 2010 OECD Transfer Pricing Guidelines.

Information Circular IC 87-2R was cancelled and archived in February 2020 (while the Federal Court of Appeal considered the *Cameco* decision referred to above) on the basis that "it is inconsistent with the interpretation and application of Canadian transfer pricing legislation and does not reflect updates to the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (the "Guidelines"). It is the CRA's practice to generally apply the Guidelines in administering Canada's transfer pricing rules." Nevertheless, IC 87-2R and TPM-14 continue to provide certain useful guidance, such as with respect to the "traditional transactional methods" of pricing being generally preferred. These methods include:

(i) Comparable Uncontrolled Price (CUP) method;

(ii) Cost Plus method; and

(iii) Resale Price methods.

Information Circular IC 87-2R suggested that there is a "natural hierarchy" (consistent with the 1979 OECD Report and 1995 OECD Transfer Pricing Guidelines) in respect of these traditional transactional methods, with the CUP method providing the most reliable results. However, in TPM-14, the CRA notes that the 2010 OECD Transfer Pricing Guidelines state that there is no strict hierarchy and that the focus should be on using the methodology that provides the most direct view of arm's length behavior. However, the CRA's position is that these three traditional transactional methods are generally preferred over the transactional profit methods described in the 2010 OECD Transfer Pricing Guidelines, such as the transactional net margin method or profit split method.

In performing a comparability analysis, TPM-14 provides that taxpayers should generally follow the "typical process" as described in the 2010 OECD Transfer Pricing Guidelines. This process generally is as follows:

Step 1: Determination of years to be covered.

Step 2: Broad-based analysis of the taxpayer's circumstances.

Step 3: Understanding the controlled transaction(s) under examination, based in particular on a functional analysis, in order to choose the tested party (where needed), the most appropriate transfer pricing method to the circumstances of the case, the financial indicator that will be tested (in the case of a transactional profit method), and to identify the significant comparability factors that should be taken into account.

Step 4: Review of existing internal comparables, if any.

Step 5: Determination of available sources of information on external comparables where such external comparables are needed taking into account their relative reliability.

Step 6: Selection of the most appropriate transfer pricing method and, depending on the method, determination of the relevant financial indicator (e.g., determination of the relevant net profit indicator in case of a transactional net margin method).

Step 7: Identification of potential comparables: determining the key characteristics to be met by any uncontrolled transaction in order to be regarded as potentially comparable, based on the relevant factors identified in Step 3 and in accordance with the comparability factors set forth at paragraphs 1.38 through 1.63 of the 2010 OECD Transfer Pricing Guidelines.

Step 8: Determination of and making comparability adjustments where appropriate.

Step 9: Interpretation and use of data collected, determination of the arm's length remuneration.

The CRA has indicated that it intends to apply the OECD's Base Erosion and Profit Shifting (BEPS) project and the OECD's 2017 Transfer Pricing Guidelines on the basis that, in its view, they are consistent with Canadian law (although that has not yet been considered by the courts).[916] The CRA similarly indicated that the OECD's 2022 Transfer Pricing Guidelines are generally consistent with Canadian transfer pricing legislation and administrative guidelines.[917] However, no new Transfer Pricing Memorandum has been released by the CRA providing guidance on how the revisions in the 2017 or 2022 Transfer Pricing Guidelines should be applied by taxpayers.

(4) Advanced Pricing Arrangements

The CRA has an Advance Pricing Arrangement (APA) program to assist taxpayers in determining appropriate transfer pricing methodologies for transactions or arrangements with non-arm's-length nonresident persons. The Competent Authority Services Division (CASD) of the International and Large Business Directorate at headquarters in Ottawa administers the APA program.

The APA program was officially implemented in July 1993 and the CRA formalized its APA procedures with the publication of Information Circular 94-4 in late 1994. The CRA's APA procedures were subsequently revised in March 2001 with the publication of Information Circular 94-4R, and in February 2024 with the publication of Information Circular 94-4R2, the current source for administrative guidance on the APA process.[918]

There is no legal requirement under Canadian law to enter into an APA. The CRA provides APAs as an administrative service. An APA may be unilateral (between the taxpayer and the CRA only), or it may involve one or more foreign governments (bilateral and multilateral APAs). Regardless of the

[916] 2018 Canadian Tax Foundation Annual Conference, CRA Roundtable, Q. 4.

[917] CRA, "Transfer pricing" (May 24, 2022), https://www.canada.ca/en/revenue-agency/services/tax/international-non-residents/information-been-moved/transfer-pricing.html.

[918] CRA, "International Transfer Pricing: Advance Pricing Arrangements (APAs)" (February 22, 2024), online: https://www.canada.ca/en/revenue-agency/services/forms-publications/publications/ic94-4/international-transfer-pricing-advance-pricing.html. See also IC 06-1, paras. 108–110.

ISBN 978-1-63359-385-5

type of APA, the CASD is responsible for the administration of the program. Any taxpayer may apply for an APA consideration, regardless of the size of the organization, the type or scope of its operations, or the nature of the transactions and the proposed transfer pricing methodologies. However, under current CASD policy, branches may not obtain APAs and interest rates are not covered by APAs. The timing for obtaining an APA can vary depending on the complexity of the issues involved and whether the APA is bilateral/multilateral or unilateral. In 2022, the average duration for obtaining a completed APA was approximately 37 months for a bilateral/multilateral APA and approximately 72 months for a unilateral APA.[919] Historically, the CRA required taxpayers that sought APAs to reimburse the CRA for costs incurred in completing the APA (such as travel costs for CRA employees). On February 4, 2021, the CRA stated that it was cancelling this cost recovery charge for all future APAs.

However, IC 94-4R2 (released in 2024) at paragraph 23 notes that "In rare circumstances, the taxpayer might be asked to bear certain costs for items that are not ordinarily part of the APA process, but which are considered critical to the resolution of the particular APA. For example, the CRA or the foreign tax authority may need access to specific data and analysis that is only available at a considerable cost."

An APA request or submission does not, in itself, constitute "reasonable efforts" to determine arm's-length transfer prices for the tax years proposed to be covered under the APA; however, compliance with the terms and conditions of an APA will protect the taxpayer from a transfer-pricing penalty under subsection 247(3) of the Income Tax Act with respect to the transactions covered by the APA.[920]

For a discussion of the Canadian competent authority functions and procedures, see Chapter 30 of 6885 T.M., *Income Tax Treaties: Competent Authority Functions and Procedures of Selected Countries (A–C)* (U.S. International Series).

7. *Avoidance of Tax Debts*

Absent any specific provision to the contrary, the general principle is that taxes are assessed on an entity-by-entity basis. As a result, members of a corporate group are generally not liable for the taxes of other members of the same corporate group and there is no consolidated tax regime in Canada. In some cases, taxpayers may exploit this scheme by "stranding" tax debts in legal entities with nominal assets, which hinders the ability of the CRA to collect such taxes.

To address this concern, the ITA contains a special rule in section 160 that imposes joint and several liability for the tax debts of a tax debtor in certain situations where the tax debtor transfers any property to a person with whom the tax debtor does not deal at arm's length for consideration that is less than the fair market value of the property transferred.[921] Generally, for these rules to apply, the following four conditions must be fulfilled with respect to a transfer of property by a tax debtor (the transferor) to another person (the transferee):

(i) The transferor must be liable to pay tax under the Act at the time of transfer;

(ii) There must be a transfer of property, either directly or indirectly, by means of a trust or by any other means whatever;

(iii) The transferee must either be:

- The transferor's spouse or common-law partner at the time of transfer or a person who has since become the person's spouse or common-law partner;
- A person who was under 18 years of age at the time of transfer; or
- A person with whom the transferor was not dealing at arm's length; and

(iv) The fair market value of the property transferred must exceed the fair market value of the consideration given by the transferee.[922]

If these conditions are satisfied, the transferee of the property is jointly and severally liable for the lesser of (i) any tax liability of the transferor owing for the taxation year in which the transfer occurs (including if the tax liability arises after the date of the transfer) or any preceding tax year and (ii) the excess of the fair market value of the property received from the transferor over the consideration given for such property.

In recent years, certain tax planners and promoters have advanced tax schemes that have circumvented the application of section 160. Certain decisions of the Tax Court of Canada and Federal Court of Appeal upheld these tax plans and have interpreted section 160 in a strict manner.[923] Consequently, the federal government broadened the application of section 160 by amendments effective as of April 19, 2021:

(i) A tax debt would be deemed to arise before the end of the tax year in which a transfer of property occurs if it is reasonable to conclude that there would be a tax amount owing by the transferor and where one of the purposes of the transfer of property was to avoid the payment of the future tax debt. This amendment may require vendors of corporate shares to make "reasonable inquiries" and perform some due diligence to determine: whether the purchaser of the shares intends to shelter the tax liability of the corporation; and whether the deductions to be claimed post-sale are valid.

(ii) A transferor and transferee would be deemed not to deal with each other at arm's length if at any time within a series of transactions that includes the transfer, they do not deal at arm's length and one of the purposes was to cause the transferor and transferee to deal at arm's length at the time of transfer. This amendment appears to be intended to make the pro-

[919] CRA, "Advance Pricing Arrangement — Program report — 2022," online: https://www.canada.ca/en/revenue-agency/services/tax/international-non-residents/competent-authority-services/advance-pricing-arrangements/2022-apa-program-report.html.

[920] IC 94-4R2, para. 89.

[921] ITA, s. 160.

[922] *Canada v Livingston*, 2008 FCA 89.

[923] But see the more recent case of *Canada v. Microbjo Properties Inc.*, 2023 FCA 157, where the Federal Court of Appeal upheld the application of section 160.

ISBN 978-1-63359-385-5

vision applicable where the transferor of the property (the tax debtor) and the transferee of the property (the share vendor) were related at the outset of the series of transactions but not when the transfer of property occurred.

(iii) The provision would consider the overall result of the transactions in determining the values of the property transferred and the consideration given for the property, rather than simply using those values at the time of the transfer.

In addition, significant new penalty measures now apply to planners and promoters of tax plans that are subject to section 160.

Legislative Note: Further amendments to section 160 were proposed in Budget 2024. The first provides that the transferee will be jointly and severally liable where property is transferred by a tax debtor to another person, and as part of the same transaction or series of transactions, any person transfers property to someone who does not act at arm's length to the tax debtor. The second provides that the transferee's liability will be for the full amount of the avoided tax debt even where a portion of that avoided tax debt is effectively retained by a third party as a fee for facilitating the planning.

8. Anti-Hybrid Measures

Canada enacted new rules in 2024 to address hybrid mismatch arrangements in accordance with part of OECD BEPS Action Item 2. The new hybrid mismatch rules deny the Canadian tax benefits associated with these types of arrangements. The enacted rules are the first of two packages of legislation with respect to hybrid mismatches. The enacted rules provide for three main operative rules:

(i) The "primary rule" denies deductibility of certain payments made by a Canadian taxpayer to the extent of any "hybrid mismatch amount" (discussed below). This rule applies where the otherwise deductible payment is not included in computing the foreign income of a non-resident recipient.

(ii) A "secondary rule" requires a Canadian taxpayer to include any hybrid mismatch amount in computing income. This rule applies where the payment is deductible in computing the foreign income of a non-resident payer but would otherwise not result in taxable income in the hands of the Canadian recipient. The secondary rule is intended not to apply where the payor is subject to a comparable primary rule that would deny deductibility of the payment in the foreign jurisdiction.

(iii) A third rule limits the ability of a Canadian taxpayer to claim a deduction with respect to a dividend received from a foreign affiliate to the extent the foreign affiliate benefits from a foreign income tax deduction with respect to the dividend. Neither the secondary rule above nor this denial of a dividend deduction is intended to apply to the same payment.

A "hybrid mismatch amount" can arise in one of three situations: a hybrid financial instrument arrangement; a hybrid transfer arrangement; or a substitute payment arrangement.

(i) A "hybrid financial instrument arrangement" generally refers to an arrangement under which a payment relating to a financial instrument, or related transactions, gives rise to a deduction in one jurisdiction and no income inclusion in another jurisdiction (a deduction/non-inclusion mismatch) where it can reasonably be considered that the deduction/non-inclusion mismatch either: arises as a result of a difference in how the financial instrument (or related transactions) is treated for tax purposes under the laws of more than one country that is attributable to the instrument's terms and conditions; or would arise as a result of such a difference if any other reason for the deduction/non-inclusion mismatch was disregarded.

(ii) A "hybrid transfer arrangement" generally refers to a payment relating to the transfer of all or part of a financial instrument (or related transactions) that gives rise to a deduction/non-inclusion mismatch where it can reasonably be considered that the deduction/non-inclusion mismatch arises as a result of: a difference in how two countries treat the payment if it is made as compensation for a particular payment under the transferred financial instrument; one country treating the transactions as equivalent to borrowing/other indebtedness while the other country does not; or a difference in which entity two countries view as having made the payment due to a difference in how the countries treat one or more transactions included in the transfer arrangement.

(iii) A "substitute payment arrangement" generally refers to an arrangement where a payment relating to an arrangement under which all or a portion of a financial instrument is transferred by one entity to another entity where the payment relates to either another payment (for example, an underlying return) arising under the financial instrument or revenue, profit, cash flow, commodity price or any similar criterion.

For the rules to apply, a hybrid financial instrument arrangement, hybrid transfer arrangement or substitute payment arrangement must involve participants that do not deal at arm's length or must be a "structured arrangement." A structured arrangement generally refers to an arrangement under which the economic benefit of the deduction/non-inclusion mismatch is priced into the arrangement or where the transactions are otherwise designed to give rise to the deduction/non-inclusion mismatch. Limited exceptions are available where a Canadian taxpayer enters into a structured arrangement and it is not reasonable to expect that the taxpayer was aware of the deduction/non-inclusion mismatch at the time and did not share in any economic benefit arising from the mismatch.

The anti-hybrid rules may also apply in the context of controlled foreign corporations (to effectively include certain dividends received from a foreign affiliate and inter-affiliate dividends in computing foreign accrual property income to the extent the dividends are deductible in the foreign jurisdiction).

Legislative Note: Draft legislation released on August 12, 2024, proposes to exclude inter-affiliate dividends for purposes of computing foreign accrual property income if both affiliates are in the same foreign jurisdiction. Inter-affiliate dividends between affiliates in two different foreign jurisdictions are included in computing foreign accrual property income to the extent

ISBN 978-1-63359-385-5

of a relevant deduction/non-inclusion mismatch. The amendments are proposed to be effective as of July 1, 2024.

Administratively, the legislation specifically provides that the anti-hybrid rules must be interpreted in a manner that is consistent with the OECD Action 2 Report, as amended from time to time (unless the context specifically requires otherwise). This is the first instance of Canadian tax legislation specifically including references to OECD materials as interpretive aids for specific taxing provisions. The legislation includes an anti-avoidance rule that would eliminate a deduction/non-inclusion mismatch or other outcome that is "substantially similar" to a deduction/non-inclusion mismatch in certain circumstances. Most of the measures apply to payments arising on or after July 1, 2022 (certain specified measures came into effect on later dates).

The federal government has not provided an update on when draft legislation for the second package of anti-hybrid mismatch measures will be released.

E. Imputation of Foreign Income and Foreign Tax Credits

A person resident in Canada (including a nonresident trust deemed to be resident in Canada) is subject to income tax on the person's worldwide income from all sources, subject to possible foreign tax credit relief. To limit the avoidance or deferral of Canadian tax through the diversion of foreign income into related or controlled entities, a complex series of rules causes an imputation to the Canadian taxpayer of, essentially, passive foreign income (or income that is deemed to be passive foreign income) of certain nonresident affiliates of the Canadian taxpayer. At the same time, a system of deductions and foreign tax credits under the Income Tax Act, as augmented by Canada's tax treaties, affords a measure of relief through a full or partial credit against Canadian tax or Canadian income with respect to tax imposed by other governments.

1. Foreign Accrual Property Income

a. Nonresident Corporations

Canada's "foreign accrual property income" (FAPI) rules are intended to prevent the avoidance or deferral of Canadian tax by earning certain types of income through a "controlled foreign affiliate" of a Canadian resident shareholder. These rules are generally analogous to the U.S. Subpart F and foreign personal holding company rules. A Canadian resident shareholder is required to include its participating percentage of a controlled foreign affiliate's FAPI in computing income as earned, even if it was not distributed.[924] A "foreign affiliate" of a Canadian resident is a corporation not resident in Canada in which the resident has a direct or indirect equity interest of not less than 1%, where the direct or indirect equity interest of the resident and related persons, including nonresidents, is not less than 10%.[925] The equity interests are measured based on the number of shares owned of any class of shares of the nonresident corporation, and are not based on votes or value.[926] A controlled foreign affiliate generally has a deemed year end if the taxpayer's equity interest in the controlled foreign affiliate decreases — preventing FAPI from being avoided by disposing of a controlled foreign affiliate prior to the end of its tax year.

While FAPI is also relevant in computing the surplus accounts of a foreign affiliate (as discussed below), FAPI is only imputed on an accrual basis with respect to income earned by a "controlled foreign affiliate" (CFA) of a taxpayer resident in Canada. A CFA is a foreign affiliate of a taxpayer if it is controlled by the taxpayer or would be controlled by the taxpayer if the taxpayer owned:

(i) All the shares of the foreign affiliate;

(ii) All the shares of the foreign affiliate that are owned by persons not dealing at arm's-length with the taxpayer;

(iii) All the shares of the foreign affiliate owned by up to four other Canadian residents; or

(iv) All the shares of the foreign affiliate that are owned by persons not dealing at arm's length with any of the persons described in (iii).

In this context, control generally means the judicial test of de jure control where the controlling person has ownership of a sufficient number of voting shares of the corporation to elect a majority of the board of directors and, hence, "control" the corporation's management. The determination of de jure control takes into account any restrictions and limitations on shareholders' voting rights that are contained in the corporation's constating documents, including the articles of incorporation and the provisions of any unanimous shareholders' agreement.[927] CFA status can also be deemed to exist where a taxpayer invests in a foreign affiliate through certain tracking arrangements (e.g., where the taxpayer's return on the investment is based on the return on a specific pool of assets held by the affiliate).

The FAPI of a CFA is imputed to a Canadian resident in proportion to the latter's "participating percentage" in the nonresident corporation. A de minimis rule provides that the resident's participating percentage is nil where the FAPI of the CFA is Can. $5,000 or less. In any other case, the taxpayer's participating percentage is, generally, the taxpayer's percentage of shares held directly or indirectly at the end of the particular tax year of the CFA. Where there is more than one series or class of shares, special rules are provided for computing the participating percentage. In general terms, those rules compute the portion of the CFA's income that would have been received by the shareholders had all such income been distributed. The portion that would have been received by the Canadian resident is converted into a percentage of all the income and becomes the taxpayer's participating percentage in the corporation.

The FAPI rules are designed to ensure that income derived from sources and activities that are relatively mobile across national boundaries, the most obvious of which would be income earned from property, is included in computing a Canadian resident shareholder's income. As defined, FAPI includes income from property, income from businesses other than active businesses and net taxable capital gains from dispositions

[924] ITA, subsec. 91(1).
[925] ITA, subsec. 95(1).
[926] ITA, subsec. 95(4).
[927] *Duha Printers (Western) Ltd. v. The Queen*, 98 DTC 6334 (SCC).

ISBN 978-1-63359-385-5

of property other than property used principally for the purpose of earning active business income. There are statutory definitions of "active business," "income from an active business" and "income from property," as well as rules that deem various sources of income to be income from property or from businesses other than active businesses. Under these definitions and deeming rules, income that is not strictly passive property income can nevertheless be treated as FAPI.

The meaning of active business is central to the foreign affiliate/FAPI system. Prior to 1995, there was no statutory definition of "active business" that applied for purposes of the system, so a determination whether an active business was being carried on in a particular instance depended on the specific facts and circumstances. The Canadian courts generally found that a relatively low level of activity was sufficient for a taxpayer to be considered to have an active business.[928] In response to the breadth of the judicial active business concept and the uncertainty remaining in the legislation, the government introduced numerous definitions and rules that specified that certain activities were active businesses, and others were considered to give rise to property income or income from nonactive businesses.

"Income from property" includes: income that is traditionally considered to be property income; income from certain trading or dealing in debt; income that is from an "investment business," as defined; and income from an adventure or concern in the nature of trade, but does not include income that is statutorily considered to be income from a business other than an active business.[929] An "investment business" is defined as a business the principal purpose of which is to earn interest, dividends, rents, royalties, or similar returns or substitutes therefor, income from the insurance or reinsurance of risks, income from the factoring of trade accounts receivable, or profits from the disposition of investment property.[930] Certain specific businesses are explicitly excluded from being investment businesses. In particular, a business will not be an investment business if the affiliate employs more than five employees full-time (or the equivalent thereof) in the active conduct of the business, the business is carried on principally with arm's-length persons and the business is a specifically enumerated type of business (e.g., one that is engaged in a regulated financial business, real property development, the lending of money, leasing or licensing property, or insurance or reinsurance). However, if the affiliate's business is a regulated financial business, then the exception to the investment business definition will only be applicable if the Canadian parent of the foreign affiliate is a regulated financial institution or part of a wholly-owned regulated financial institution group, that satisfies certain minimum capital requirements. Similar capital requirements are also required to prevent certain trading or dealing in debt from being treated as income from property. With respect to "tracking arrangements," the rules require that the "more than five" full-time employee test be separately satisfied for each tracking interest in a foreign affiliate (i.e., effectively preventing FAPI from being avoided where investors would otherwise meet the employee test by pooling their investments in a single corporation).

Income from a business other than an active business is specifically identified in the legislation and is characterized as FAPI. There are five types of income that are considered to arise from a business other than an active business:

(i) Income from the sale of property (or the performance of services as an agent in relation to the purchase or sale of property) by the foreign affiliate where the cost of the property is relevant in computing the income from a business carried on by the Canadian resident taxpayer or by a related person resident in Canada.[931] In general terms, this rule was intended to prevent Canadians from transferring offshore the profit arising on the purchase of inventory. Various exceptions to this rule may apply. For example, exceptions are provided if the relevant property is manufactured or produced in the country where the foreign affiliate principally carries on business, or if at least 90% of the foreign affiliate's gross revenue is from the sale of property to arm's-length persons.

(ii) Income of the foreign affiliate from the insurance or reinsurance of Canadian risks, unless more than 90% of the gross premium revenue is with respect to the insurance or reinsurance of non-Canadian risks of arm's-length persons.[932] An anti-avoidance rule treats insurance or reinsurance income of a foreign affiliate as FAPI if the affiliate enters into an arrangement referred to as an "insurance swap," which generally involves transferring Canadian risks to a third party for foreign risks where the overall risk profile and economic returns of the affiliate remain essentially unchanged. In addition, an anti-avoidance rule exists that deems the insurance of certain risks to be the insurance of Canadian risks to ensure that profits of a Canadian taxpayer derived from insurance of Canadian risks remain taxable in Canada.

(iii) Income derived from the indebtedness and lease obligations of persons resident in Canada or with respect to businesses carried on in Canada, unless more than 90% of the foreign affiliate's gross revenue is derived from the indebtedness and lease obligations of arm's-length nonresidents of Canada.[933]

(iv) Income from the indebtedness or lease obligations of a partnership with respect to a business carried on by the partnership outside of Canada, where any portion of the partnership's income or loss is included in the income or loss of the taxpayer or a non-arm's-length person resident in Canada.[934] This rule does not apply if more than 90% of the foreign affiliate's gross revenue is derived from the indebtedness and lease obligations of arm's-length nonresidents of Canada.

(v) Income from services provided by a foreign affiliate of a Canadian resident taxpayer to the extent the services are performed by the Canadian taxpayer or a related per-

[928] *The Queen v. Canada Trustco Mortgage Co.*, 99 DTC 5094 (FCTD) and the cases cited therein.

[929] ITA, subsec. 95(1).

[930] ITA, subsec. 95(1).

[931] ITA, para. 95(2)(a.1).

[932] ITA, para. 95(2)(a.2).

[933] ITA, para. 95(2)(a.3).

[934] ITA, para. 95(2)(a.4).

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son resident in Canada, or an amount for the services is deductible in computing income from a business carried on in Canada by the Canadian resident taxpayer or a related person or is deductible in computing FAPI of a related person. Despite the potential breadth of this rule, for this purpose "services" is deemed to not include the transportation of persons or goods, or services performed in connection with the purchase and sale of goods.[935] For those types of services there is no deeming rule and it is, thus, a question of fact whether an active business is being carried on.[936] Exclusions apply for the transmission of electronic signals or electricity outside Canada, and for certain toll manufacturing services.

A number of rules exist, however, that may facilitate the movement of funds between foreign affiliates without causing an immediate imputation of income to the Canadian taxpayer. For example, dividends paid by one foreign affiliate to another foreign affiliate are not considered to be FAPI (although they are property income) and, therefore, the active business income of one affiliate may be passed to another as a dividend without causing an imputation of the dividend income (which would otherwise be considered property income) to a Canadian shareholder.[937]

Several other sources of property income are specifically deemed to be active business income (i.e., excluded from FAPI treatment) and, generally, facilitate multinational operations. These rules require that the Canadian resident shareholder directly or indirectly own shares representing at least 10% of the voting power and equity value of the foreign affiliate that earns the income. Also, these rules generally require the Canadian resident shareholder to own a similar 10% interest in the payer corporation. The deemed active business income rules include the following:

(i) Income derived by a foreign affiliate from activities reasonably considered to be directly related to the active business activities carried on by another foreign affiliate with respect to which the taxpayer has a qualifying interest provided the income would be included in computing the nonresident corporation's earnings or losses from an active business if it were a foreign affiliate of the taxpayer; this provision contemplates that the business activities of a single foreign active business may be conducted in more than one corporation.

"Qualifying interest" generally means an interest held, directly or indirectly, in a foreign affiliate representing not less than 10% of the foreign affiliate's voting shares and not less than 10% of the fair market value of all of the foreign affiliate's shares.[938]

(ii) Amounts paid or payable by one foreign affiliate to another foreign affiliate that are "excluded property" — which generally requires at least 90% of the affiliate's assets to be used in carrying on an active business. Under these rules, a Canadian taxpayer may interpose between the active business of one foreign affiliate a second foreign affiliate to function as a holding company. Not only may active business income be passed to the holding company as dividends without attracting imputation, but it would also be possible for the holding company to charge interest or royalties to the active company with respect to, for example, indebtedness or patents held by it.[939] Amendments to the relevant provision have eliminated the deeming rule that applied to amounts paid by a nonresident corporation to a foreign affiliate (where the nonresident corporation was related to the taxpayer and the foreign affiliate).[940] The provision also includes a deeming rule that may apply where a foreign affiliate receives payments from a second foreign affiliate as interest on borrowed money (or unpaid purchase price) related to the acquisition of shares of a third foreign affiliate; this rule was amended so that the taxpayer must have a qualifying interest in both the second and third foreign affiliates.[941]

(iii) Income derived from the factoring of trade accounts receivable acquired by the foreign affiliate from another foreign affiliate in which the taxpayer had a qualifying interest, to the extent the receivables arose in the course of an active business carried on outside Canada.[942]

(iv) Income derived from loans or lending assets acquired from another foreign affiliate in which the taxpayer had a qualifying interest to the extent the loans or lending assets arose in the course of an active business carried on outside Canada by the nonresident corporation.[943]

(v) Income from the disposition of property used to earn income from an active business (i.e., "excluded property") and certain income from currency hedge agreements that reduce the foreign affiliate's risk with respect to other amounts that are deemed to be included in computing active business income.[944]

A specific anti-avoidance rule is designed to prevent avoidance of the FAPI rules through an abusive manipulation of share ownership. This rule may apply where options are issued, or where shares are acquired or sold, for the principal purpose of avoiding, reducing or deferring the amount of tax that would otherwise be payable under the Income Tax Act.[945] These rules potentially apply where options are issued, or where shares are acquired or sold, principally to obtain foreign affiliate or "related" status, or artificially to avoid controlled foreign affiliate status or otherwise reduce the amount of FAPI attributable to a Canadian resident shareholder. The CRA has attempted to apply this rule as a broad anti-avoidance rule. In *Univar v. R.*,[946] the Tax Court of Canada held that ITA, subsection 95(6) did not apply in respect of shares of a financing affiliate that made loans to a related foreign corporation. In contrast, in

935 ITA, subsec. 95(3).
936 ITA, para. 95(2)(b).
937 ITA, s. 95(1) definition of "foreign accrual property income."
938 ITA, para. 95(2)(m).
939 ITA, subpara. 95(2)(a)(ii).
940 ITA, clause 95(2)(a)(ii)(A).
941 ITA, clause 95(2)(a)(ii)(D).
942 ITA, subpara. 95(2)(a)(iii).
943 ITA, subpara. 95(2)(a)(iv).
944 ITA, subpara. 95(2)(a)(v) and (vi).
945 ITA, subsec. 95(6).
946 2005 DTC 1478 (TCC).

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Canada v. Lehigh Cement Ltd.,[947] the Federal Court of Appeal held that subsection 95(6) is intended to apply to transactions where the principal purpose for the acquisition or disposition of the shares (as opposed to the purpose of the series of transactions as a whole) is to manipulate an entity's status as a foreign affiliate, controlled foreign affiliate or related corporation, for the purpose of avoiding or reducing tax.

Under "upstream loan" rules, a foreign affiliate may be deemed to have paid a dividend in respect of certain loans (or other indebtedness) that are made to a Canadian shareholder or to certain other persons that are not dealing with the Canadian shareholder at arm's length (including nonresidents of Canada that are not controlled by the Canadian shareholder or by certain other related Canadian residents).[948] A proportionate amount of such a loan or indebtedness is included in the Canadian shareholder's income, although a deduction is permitted when the loan is repaid (other than as part of a series of loans and repayments). Certain exceptions also apply (such as certain loans made in the ordinary course of the lender's money lending business (or indebtedness that arose in the ordinary course of the creditor's business), or if the loan or indebtedness is repaid within two years (other than as part of a series of loans and repayments). Relief is generally also available on a year-by-year basis for amounts which would have been fully exempt from Canadian tax if the loaned amount had been distributed as a dividend to the Canadian taxpayer.

b. Nonresident Trusts

The rules relating to nonresident trusts generally do not rely on the FAPI rules to impute offshore trust income to a Canadian taxpayer. Instead, subject to certain exceptions, including for commercial trusts, the nonresident trust rules deem a nonresident trust to be resident in Canada for most purposes of the Income Tax Act (and therefore subject to tax on its worldwide income) if there is a direct, indirect or deemed contribution to the trust by a Canadian resident. The rules divide such a trust's property into a "resident portion" and a "nonresident portion." The trust is taxed only on the income accumulated in the resident portion (if kept separate and apart from the nonresident portion) that has not been distributed to beneficiaries or attributed to resident contributors. The deemed resident trust remains obligated to pay its Canadian taxes. If the trust fails to do so, each Canadian resident contributor and beneficiary is jointly and severally liable with the trust for the tax. However, liability does not extend to a Canadian resident contributor if it has elected to be attributed its share of the trust's income (i.e., an "electing contributor"). Canadian resident beneficiaries generally remain jointly liable for the tax obligations of the trust to the extent they have received distributions, enjoyed benefits or received loans from the trust. The nonresident trust rules are drafted broadly and could apply in many unexpected circumstances, although relief is provided for certain tax-exempt entities and commercial trusts.

The treatment of certain non-discretionary nonresident commercial trusts under the new rules is generally similar to their treatment under the former law, with such trusts being treated as foreign corporations that could be subject to the FAPI rules. Such nonresident commercial trusts may be deemed to be controlled by a beneficiary for purposes of applying the FAPI rules where the beneficiary owns at least 10% of any class of fixed interests in the trust.

The Income Tax Conventions Interpretation Act contains rules to ensure that the nonresident trust rules are not overridden by Canada's tax treaties, such that a trust deemed resident in Canada under the nonresident trust rules would be a resident of Canada and not a resident of the other contracting state for purposes of applying the treaty concerned (an amendment that would have the effect of reversing recent court decisions).[949]

Additional rules further refine the rules attributing income to nonresident trusts. Under these rules, the nonresident trust will be treated for tax purposes as a resident of Canada when the assets that were transferred to the trust remain under the effective ownership of a taxpayer resident in Canada, regardless of the consideration given for the transferred property. These rules will apply specifically to nonresident trusts and will be separate from the broader trust attribution rule, discussed above, that applies to all trusts that are resident in Canada.

c. Offshore Investment Funds, Foreign Investment Entities

The offshore investment fund property (OIFP) rules are specific anti-avoidance rules designed to backstop the FAPI rules for investments in nonresident entities that are not CFAs.[950] These rules are designed to remove the tax disparity between earning certain income offshore and earning income in Canada.

In general, the OIFP rules apply where a taxpayer holds an interest in, or a right to acquire an interest in, a nonresident entity that may reasonably be considered to derive its value primarily from certain listed "portfolio investments." For the rules to apply, it must be reasonably considered that one of the main reasons for the taxpayer holding such an interest was to derive a benefit from the portfolio investments in such a manner that the taxes would be significantly less than they would have been if the income on the portfolio investments had been earned directly by the taxpayer. If applicable, the OIFP rules deem the Canadian resident taxpayer to have imputed income based on a prescribed (under Regulations to the Income Tax Act) rate of interest applied to the taxpayer's "designated cost" of the OIFP, less income for the year (other than a capital gain) emanating from the OIFP. For purposes of these rules, a "nonresident entity" is a nonresident corporation (other than a CFA), partnership, organization, or fund or a trust with respect to which the FAPI rules also apply. The types of portfolio investments subject to the rule are shares of corporations, indebtedness or annuities, and interests in corporations, trusts, partnerships, organizations, funds or entities; commodities; real property; resource property; foreign currency; or any interests in such investments. In essence, the "designated cost" of an OIFP is its cost plus any gifts, loans or transfers of property at less than fair market value designed to increase the value of the OIFP.

[947] 2014 FCA 103.

[948] ITA, subsec. 90(6) to 90(15).

[949] R.S.C. 1985 c. I-4, s. 4.3.

[950] ITA, sec. 94.1.

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The reassessment period in respect of OIFP interests is extended by three years beyond the normal reassessment period.

2. Foreign Tax Credit

The Income Tax Act contains a detailed set of rules that permit a credit or deduction against the Canadian tax otherwise payable with respect to certain foreign taxes paid by the taxpayer or a foreign affiliate of the taxpayer.[951] Different rules apply depending on whether the taxpayer earns foreign business income, foreign non-business income or income from a foreign affiliate.

a. Business Income

Canadian taxpayers carrying on business in a foreign jurisdiction may be subjected to tax under the laws of that jurisdiction, subject to the potential application of a tax treaty. The Income Tax Act generally provides relief from double taxation in Canada with respect to such taxes by permitting a taxpayer resident in Canada who carries on business in a foreign country to deduct from its Canadian federal income tax otherwise payable a specified proportion of any "income or profits tax" paid by the taxpayer to the government of the foreign country, or of a political subdivision of any such country, that may reasonably be regarded as tax with respect to income from carrying on business in that country.[952] The proportion of tax creditable bears the same ratio to such tax as the taxpayer's income from business carried on by it in the particular foreign country bears to the taxpayer's total income (minus deductible non-capital losses and intercorporate dividends). In no case may the credit exceed the Canadian tax otherwise payable less the non-business income tax credit discussed below.

The foreign tax credit is calculated on a country-by-country basis. The foreign tax credit with respect to business income tax paid may be carried forward for 10 years and back for three years.[953] Like the credit itself, the carryover is available only on a country-by-country basis.

Canada's tax treaties with other countries often provide for credits with respect to such taxes; for example, under the Canada-United States tax treaty, Canada agrees to allow a credit as far as may be in accordance with the Income Tax Act with respect to eligible U.S. taxes on income derived from sources within the United States.[954] Such treaty provisions usually contain a deemed "source" rule that assists the Canadian taxpayer in obtaining a credit even if the income would otherwise be viewed as Canadian-source under the Income Tax Act. However, a taxpayer may only credit foreign taxes against Canadian tax payable on foreign-source income to the extent the foreign-source income is not exempt from tax in the foreign country under a tax treaty.[955]

A general rule in the Income Tax Act denies any foreign tax credit for foreign taxes paid with respect to a property other than capital property if it is reasonable to expect that the taxpayer will not realize an "economic profit" (essentially, a profit net of foreign taxes) with respect to the property.[956] A foreign tax credit may also be limited with respect to certain short-term securities or debt obligations held for a short period of time. Where dividends on shares or interest on debt obligations are subject to foreign taxes that are similar to the nonresident withholding tax levied on nonresidents of Canada under the Income Tax Act, and such shares or debt obligations are disposed of within one year of their acquisition, the foreign tax credit will be limited to 40% (in the case of business income tax) or 30% (in the case of non-business income tax) of the taxpayer's gross profit from the shares or debt. The taxpayer's gross profit for purposes of this provision is essentially the total of the proceeds of disposition and interest or dividends received during the ownership period, less the taxpayer's cost of acquiring the property and expenses of disposition.[957]

Direct or indirect credits for foreign taxes may also be denied in certain circumstances on income earned via a partnership or a foreign affiliate.[958] These rules apply, for example, to any taxpayer that is a member of a partnership where tax in respect of partnership income is paid to a foreign country if the taxpayer's share of partnership income under the tax law of the foreign country is less than the taxpayer's share of partnership income under the Income Tax Act. Although the rules are intended to address schemes that artificially increase foreign tax credits, the rules may have much broader potential application.

The problems of timing regarding the credit are demonstrated in a court case in which a Canadian corporation carrying on business in the United States suffered a loss in the United States that was carried back two years for U.S. tax purposes but only one year for Canadian tax purposes. The ensuing refund of U.S. income tax was retroactively taken into account and the foreign tax credit originally claimed in Canada was reduced accordingly. This was the case even though the tax credit was, at the time, correctly computed.[959]

In another court case, the plaintiff bank earned business income in the United Kingdom. It paid its U.K. tax for its fiscal period ending October 31, 1972, on January 1, 1974. The bank contended that the Canadian dollar equivalent of the tax paid for foreign tax credit purposes should be calculated on the weighted average of the currency exchange for the fiscal period with respect to which the tax was paid. The Minister allowed a foreign tax credit calculated in Canadian dollars based on the rate of exchange on the date of payment. The Federal Court, Trial Division, allowed the appeal, holding that the practice of the bank conformed with generally accepted accounting principles and was permissible for income tax purposes. The judgment was upheld on appeal.[960]

b. Non-Business Income

A non-business income foreign tax credit is available to any Canadian resident taxpayer with respect to tax imposed by the government of a foreign country or a political subdivision of a foreign country that is not included in the foreign business income tax described in XI.E.2.a., above. This would include,

[951] See generally ITA, sec. 126.
[952] ITA, subsecs. 126(2), (2.1), subsec. 126(7).
[953] ITA, para. 126(2)(a).
[954] Canada-United States tax treaty, Art. XXIV.
[955] ITA, para. 126(6)(c).
[956] ITA, subsec. 126(4.1).
[957] ITA, subsec. 126(4.2).
[958] The relevant rules regarding foreign affiliates are discussed in XI.E.2.c.
[959] *Icanda Ltd. v. MNR*, [1972] CTC 163.
[960] *Bank of Nova Scotia v. The Queen*, [1980] CTC 57 (FCTD), [1981] CTC 162 (FCA).

ISBN 978-1-63359-385-5

for example, foreign withholding tax with respect to property income earned by Canadian residents and foreign tax paid to the extent that it is with respect to a business (or a part of a business) that is carried on in Canada.[961] Such taxes are often subject to treaty provisions that either reduce the applicable rates or eliminate the tax entirely.

The foreign tax credit for non-business income tax is also available only on a country-by-country basis. The proportion of tax creditable is equal to the proportion that the taxpayer's income from sources in the particular foreign country, computed on the assumption that no businesses were carried on in that country, bears to the taxpayer's total income (minus deductible noncapital losses and intercorporate dividends). The tax credit with respect to non-business income is available only in the year in which the tax is paid; there is neither a carryforward nor a carryback of unusable credits. However, as an alternative to applying the foreign tax credit rules, the taxpayer may deduct in computing income from a business or property the non-business income tax paid by the taxpayer for the year in a foreign jurisdiction.[962] The rules that deny foreign tax credits in certain circumstances discussed in XI.E.2.a., above, also apply to non-business income tax. In *FLSmidth Ltd. v. The Queen*,[963] the Tax Court of Canada held that no deduction was available under subsection 20(12) of the Income Tax Act with respect to U.S. taxes paid by a Canadian corporation in respect of its investment in a "Tower" financing structure that included a hybrid U.S. partnership. The Tax Court of Canada in *Emergis Inc. v. Canada*[964] has also held that no deduction was available under subsection 20(12) with respect to U.S. withholding taxes paid by a Canadian resident on interest payments received from a hybrid U.S. partnership that was received as part of a "Tower" financing structure. The taxpayer in *Emergis* has appealed the Tax Court's decision to the Federal Court of Appeal.

U.S. social security tax payable by an employee or a self-employed U.S. citizen residing in Canada is available for tax credit purposes assuming that, under the formula, the taxpayer has sufficient U.S.-source income. For these purposes, the salary or wages of an employee performing his or her services wholly in Canada, however, are not sourced in the United States.[965]

The allocation of expenses to a source of gross income in a particular foreign country for financial statement purposes is generally accepted as a basis for computing a foreign tax credit for that country. Various methods of allocating interest expense to sources of income may be acceptable in particular situations. The allocation of expenses to income sources under Canadian rules can be carried out using a tracing approach.[966] This approach may not always work to the taxpayer's advantage. For example, in one court case, a Canadian corporation lent its U.S. subsidiary funds to finance construction of the U.S. portion of an international pipeline. The United States imposed a 15% withholding tax on the gross interest payments. It was held, however, under the Canadian rules that for purposes of the foreign tax credit formula, the taxpayer's U.S.-source income was only the net interest, that is, gross interest from the subsidiary less the cost of related Canadian borrowings.[967]

A limitation is effectively placed on the rate of foreign tax subject to credit with respect to the non-business income of an individual. This rule provides a deduction in computing income, rather than a foreign tax credit, for any income or profits tax paid to the government of a foreign country with respect to property income in excess of 15% of such income.[968] An exception is made with respect to foreign tax on income from real property sourced outside Canada (i.e., in general, income from real property situated outside Canada). Thus, foreign rental income will continue to give rise to the usual foreign tax credit under the proportion formula.

To the extent a taxpayer is not prohibited by the above-mentioned rule from claiming a foreign tax credit, the taxpayer may elect either to claim a foreign tax credit (subject to the various limitations discussed above) or to deduct the non-business income tax paid by the taxpayer in computing income. Tax paid by a corporation with respect to income from a share of a foreign affiliate, however, is specifically denied the elective treatment.

Special credits apply with respect to "non-business income" imputed to Canadian taxpayers from CFAs and to dividends from foreign affiliates, and is dealt with separately under XI.E.2.c., below.[969]

c. *Credits Against Foreign Affiliate Income*

(1) *Foreign Accrual Property Income*

The rules governing the imputation of passive income of a CFA or, in certain circumstances, of a nonresident trust to a Canadian resident are discussed in XI.E.1., above. Where such income has been imputed, an equivalent to a foreign tax credit is available in the form of a deduction in computing income.[970] The deduction is, essentially, the income or profits tax paid by the foreign affiliate multiplied by a factor of 2.2 in the case of an individual Canadian resident and, in the case of a corporation, a fraction equal to one over the prevailing Canadian corporate tax rate less the corporation's general rate reduction percentage.[971] Also included are certain taxes paid by another foreign affiliate with respect to a dividend from the particular foreign affiliate.[972] The effect of the tax deduction and multiplier is to remove any Canadian tax liability with respect to imputed income if the foreign tax borne by that income approximates the Canadian rate. The Canadian resident taxpayer may claim the "credit" in the year in which the income is included by the taxpayer or any of the following five years. Recognition is also given to foreign monetary or exchange restrictions in the form of a reserve against imputed FAPI.[973]

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[961] See Income Tax Folio S5-F2-C1 at para. 1.27.

[962] ITA, subsec. 20(12).

[963] 2012 TCC 3, *aff'd* 2013 FCA 160.

[964] 2021 TCC 23.

[965] *Greenaway v. MNR*, (1966), 42 Tax ABC 368.

[966] *See* Income Tax Folio S5-F2-C1 at para. 1.87.

[967] *Interprovincial Pipe Line Co. v. MNR*, [1967] CTC 180, [1968] CTC 156.

[968] ITA, subsec. 20(11).

[969] ITA, subsecs. 20(12), 126(1), subsec. 126(7).

[970] ITA, subsec. 91(4), subsec. 95(1).

[971] ITA, subsec. 95(1) "relevant tax factor."

[972] ITA, subsec. 95(1) "foreign accrual tax."

[973] ITA, subsecs. 91(2), (3).

ISBN 978-1-63359-385-5

The rules that deny foreign tax credits in certain circumstances, discussed in XI.E.2.a., above, also apply where a taxpayer holds (directly or through another affiliate) shares in a foreign affiliate, denying recognition of foreign tax where the taxpayer, certain non-arm's-length persons or a foreign affiliate of any such person is considered under the tax law of a foreign country in which a foreign affiliate is subject to taxation to own less than all of the shares that the person is considered to hold for purposes of the Income Tax Act. These rules are very broad and may deny foreign tax credits in certain circumstances where the foreign taxes at issue are not paid by, or related to, the foreign affiliate whose ownership is considered to be different under foreign law and the Income Tax Act.

(2) Dividends

Generally, all pro rata distributions on shares of a foreign affiliate are deemed to be a dividend, unless the distribution arose as a consequence of a liquidation or dissolution of the affiliate, or the redemption, acquisition or cancellation of a share. However, an election may be made to treat certain distributions of capital to result in basis recovery rather than a dividend (a "qualifying return of capital"). Any other distribution from a foreign affiliate is deemed not to be a dividend and may result in a taxable shareholder benefit.[974]

A combined exemption and credit system applies to dividends received from a foreign affiliate, including a CFA. Under these rules, dividends paid to a Canadian resident corporation out of a foreign affiliate's "exempt surplus" are generally exempt from Canadian tax by virtue of a 100% dividends-received deduction. "Exempt surplus" generally includes income derived by the foreign affiliate from carrying on an active business in a "designated treaty country."[975] A "designated treaty country" is a country with which Canada has entered into a tax treaty that is in force in the year in question.[976] Exempt surplus can also be earned in a country or jurisdiction that, although it does not have a tax treaty with Canada, has nevertheless entered into a comprehensive tax information exchange agreement (TIEA) with Canada. As a further incentive for countries to enter into a TIEA with Canada, the Income Tax Act contains a rule that excludes income from a "non-qualifying business" from a foreign affiliate's active business income with the result that such income will be FAPI (i.e., unless the business is carried on through a permanent establishment (PE) in a country or other jurisdiction to which the Convention on Mutual Administrative Assistance in Tax Matters (concluded at Strasbourg on January 25, 1998, as amended from time to time by a protocol, or other international instrument, as ratified by Canada) is in force and effect). These jurisdictions are: Antigua and Barbuda (where TIEA is signed but not yet in force), Belize, Gibraltar, Liberia, Montserrat and Vanuatu. Generally, a non-qualifying business is a business carried on through a PE in a non-treaty country that has not concluded a comprehensive TIEA with Canada, where Canada has, more than 60 months before that time, either begun, or invited the country to begin, negotiations for a comprehensive TIEA with Canada.

As there is no regular foreign tax credit with respect to dividends received by corporations from a foreign affiliate, foreign withholding taxes imposed on exempt surplus dividends are not creditable to a Canadian corporation. Relief is, however, provided as outlined below.

"Taxable surplus" comprises various sources of income not included in computing exempt surplus. Also, all dividends received by a Canadian resident individual from a foreign affiliate are deemed to be paid out of taxable surplus. While dividends received out of the taxable surplus of a foreign affiliate are not tax-free, they may carry with them a deduction in computing the taxable income of the recipient with respect to underlying foreign taxes, and withholding taxes imposed on the dividend that can reduce or eliminate the income created by the dividend.[977]

The rules that deny foreign tax credits in certain circumstances discussed in XI.E.2.a. and XI.E.2.c.(1) may apply to deny the deduction with respect to underlying foreign taxes where the taxpayer, certain non-arm's-length persons or a foreign affiliate of any such person is considered under the tax law of a foreign country in which a foreign affiliate is subject to taxation to own less than all of the shares that the person is considered to hold for purposes of the Income Tax Act. Finally, where the dividend derives from previously imputed FAPI, there may be additional deductions in recognition of the prior tax.[978]

"Hybrid surplus" tracks capital gains realized by a foreign affiliate from the disposition of shares of another foreign affiliate where such gains are not included in FAPI. Previously, 50% of such capital gains were added to exempt earnings and 50% of such gains were added to taxable earnings. The hybrid surplus regime now requires the exempt and taxable portion of such gains to be distributed together as hybrid surplus. Dividends received out of hybrid surplus of a foreign affiliate carry a deduction in computing the taxable income of the recipient with respect to 50% of the distributed hybrid surplus and an additional deduction with respect to underlying foreign taxes.

Anti-avoidance rules may operate to recharacterize exempt earnings as taxable earnings in certain circumstances where such earnings arise on an "avoidance transaction" (which is generally a transaction that does not have a bona fide business purpose).

Dividends not considered paid out of exempt surplus, hybrid surplus or taxable surplus are regarded as payable out of "pre-acquisition surplus." This account is a residual definition necessary to deal with items such as retained earnings accumulated before the foreign corporation acquired foreign affiliate status, or before 1976. Dividends out of pre-acquisition surplus are treated as a return of capital to the Canadian corporate recipient in that they are deducted in computing taxable income but reduce the adjusted cost base of the shares.[979] An election can be made to treat a dividend as coming out of pre-acquisition surplus prior to any other surplus account (which is effectively treated as a return of capital). A gain could arise to the extent the adjusted cost base would otherwise become negative.

[974] ITA, subsecs. 90(2), 90(3), 90(5) and para. 15(1)(a.1).
[975] ITA, para. 113(1)(a); ITR, subsecs. 5900(1), 5901(1), and 5907(1).
[976] ITR, subsec. 5907(11).
[977] ITA, paras. 113(1)(b), (c); ITR, subsecs. 5900(1), 5901(1), 5907(1).
[978] ITA, subsec. 91(5).
[979] ITA, para. 113(1)(d), subsec. 92(2); ITR, subsec. 5900(1).

ISBN 978-1-63359-385-5

A loan made by a foreign affiliate to certain non-arm's-length persons generally is required to be included in a Canadian shareholder's income if the loan is outstanding for at least two years. There are a number of exceptions, such as for certain loans made in the ordinary course of business.

Detailed rules apply for purposes of computing the potential income, gain or loss, and surplus account consequences of various reorganizations involving foreign affiliates (including mergers and liquidations). Legislative amendments address the following:

(i) A liquidation and dissolution of a foreign affiliate into a Canadian-resident shareholder;

(ii) A liquidation and dissolution of a foreign affiliate into another foreign affiliate; and

(iii) A merger involving a foreign affiliate.

Rollover treatment may be available if these rules are applicable.

Comment: The taxation of foreign affiliate distributions is a complex subject and one that requires considerable planning in view of its impact on corporate structures. Further, rules that allow gains on the disposition of shares of foreign affiliates to be treated as distributions (and in some cases the reverse) render it all the more important that a careful consideration of this system be undertaken prior to establishing or reorganizing an international corporate group.

(3) Foreign Affiliate Dumping

The Income Tax Act contains detailed foreign affiliate "dumping" rules that are designed to discourage foreign multinationals from eroding the Canadian tax base by "dumping" foreign operations under their Canadian subsidiaries.[980] Under these rules, when a corporation resident in Canada ("CRIC") that is controlled by either (i) one nonresident person (which can be a corporation, individual or a trust) or (ii) a group of nonresident persons (which can be any combination of corporations, individuals or trusts) who do not deal with each other at arm's length (a "group of parents") makes an investment in a foreign affiliate, the CRIC may be deemed to pay a dividend to its nonresident parent or group of parents (which deemed dividend would be subject to withholding tax) or the paid-up capital in the CRIC may be reduced (which limits the ability of the CRIC to pay a non-taxable return of capital to its nonresident parent). An investment in a foreign affiliate includes an acquisition of foreign affiliate shares, a contribution of capital to the foreign affiliate and, subject to the exception discussed below, a transaction where an amount becomes owing by the foreign affiliate to a CRIC. An investment in a foreign affiliate may also include the acquisition of shares of a CRIC where the total fair market value of foreign affiliate shares owned by that CRIC exceeds 75% of the total fair market value of all the properties owned by that CRIC.

There are three general exceptions to the foreign affiliate dumping rules:

(i) If a CRIC has made a loan to a foreign affiliate and the CRIC has elected to be subject to an interest imputation regime requiring the CRIC to include interest income on the loan at a prescribed rate (a "pertinent loan or indebtedness" election), the foreign affiliate dumping rules will not apply with respect to the loan;

(ii) The rules will not apply to various types of corporate reorganizations where there is no new investment in a foreign affiliate; and

(iii) The rules will not apply if the strategic business expansion exception is satisfied, which applies when it can be demonstrated that foreign affiliate investments would be made by a CRIC even if the CRIC were not foreign-controlled.

An anti-avoidance rule exists that prevents combining a "pertinent loan or indebtedness" election with a reorganization exception.

Comment: These rules have a significant impact on foreign multinationals with Canadian subsidiaries and nonresident corporations acquiring Canadian corporations that derive profits from foreign operations. Careful consideration should be given to these rules by foreign-based multinationals investing in Canada.

(4) Interest Related to Investments in Foreign Affiliates

Generally, taxpayers are entitled to deduct interest on borrowed money used to invest in the shares of a foreign affiliate, even if the dividends payable by the foreign affiliate are received by its Canadian corporate shareholder free of Canadian tax because they are paid out of the foreign affiliate's exempt surplus.

F. Nonresident Withholding Tax

1. In General

An individual or corporation neither resident nor carrying on business in Canada is subject to a special Canadian income tax on certain types of income from property and certain other sources. This tax is often referred to as a "withholding tax" because, although the liability is the liability of the nonresident, it is the person in Canada who pays or credits a taxable amount to the nonresident who is obliged to deduct or withhold the tax and to remit it to the Receiver General on behalf of the nonresident.[981]

Failure to deduct or withhold, or to remit amounts deducted or withheld, renders the Canadian payer liable for the full amount of the tax owing plus a penalty of 10% (20% with respect to second and subsequent failures to withhold or remit in the same calendar year), and interest at a prescribed rate.[982] Once a payment has been withheld by a Canadian payor, the amount of such withholding must be remitted to the CRA, even if it is determined afterwards that no amount should have been withheld by the Canadian payor. In such instances, the nonresident would be required to file a tax return in Canada and claim a refund on the overpayment of withholding taxes.

Withholding tax is not applicable to amounts that would otherwise be taxed because the nonresident carries on business

[980] *See* ITA, subsec. 212(3).

[981] ITA, subsec. 215(1).

[982] ITA, subsecs. 215(6), 227(8), (9), (8.3), (9.2); ITR, part XLIII.

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in Canada and the amounts are reasonably attributable to the business carried on by the nonresident through a PE in Canada.[983] The scope of "reasonably attributable" was considered in a court case where a Canadian company owned railway property in Canada and had credited amounts by way of dividends to its nonresident controlling shareholder. The Canadian company had indirectly leased its railway properties to the nonresident shareholder for use in its railway operations in Canada. Accordingly, a portion of the dividends credited by the Canadian company resulted from the lease payments made by the nonresident shareholder. The taxpayer argued that the dividends credited were reasonably attributable to the business that the nonresident shareholder carried on in Canada. The Federal Court of Appeal, however, held that the source of the dividends was the shares and not the railway business being carried on by the nonresident shareholder in Canada.[984]

2. Withholding Rates

The general rate of nonresident withholding tax is 25% of the gross amount paid or credited to a nonresident,[985] subject to reduction under an applicable income tax treaty. Under many of Canada's income tax treaties, the statutory withholding tax rate is reduced to 15%, although in some more recent treaties particularly, the 25% rate is applicable to some forms of income, such as real property rentals and certain pensions, and a 10% rate often applies to royalties. As the treaty rate often differs from the statutory rate, the Canadian taxation authorities have indicated that the Canadian payer is responsible for determining which rate is appropriate. This may entail obtaining appropriate evidence of residence and other information from the recipient.

The Canadian tax authorities have taken the view that the application of a lower treaty withholding rate depends on the beneficial ownership of the property. This could place an undue burden on the Canadian payer. The CRA has published guidelines under which the payer's responsibility is limited in certain respects, requiring the payer to inquire beyond the registered address of the payee only where there is reasonable cause to suspect that the payee is not the beneficial owner, such as: where the payee is known to act, even occasionally, as an agent or nominee; if the agent is referred to in a manner that suggests this role; or where the mailing address for payment is different from the registered address of the owner.[986] Even with these exemptions, however, it may be difficult for payers to know at what rate to withhold. The policy of looking to beneficial ownership has been challenged successfully by a taxpayer.[987] The issue had to do with interest paid on debentures to holders in the United States. The Tax Review Board held that the payer was concerned solely with the address of the payee and was not required to inquire after the beneficial ownership. The U.S. treaty rate was held to apply even though the form of registration, at least in one case, would not have met the requirement for exemption under the CRA guidelines.

The CRA has released forms to be completed in determining the applicable withholding amounts containing more detailed information on entitlement to treaty benefits. While these forms are not mandatory, they may be relevant in determining whether penalties apply for failing to adequately withhold on various payments.[988]

3. Application

Nonresident withholding tax is exigible where a Canadian resident "pays or credits" (or is deemed by a provision of the Income Tax Act to pay or credit) an amount to a nonresident falling within certain specified categories.

The Canadian tax authorities have interpreted "crediting" to mean that an amount has been set aside and made unconditionally available to the nonresident, for example, where interest is credited on a savings account.[989]

The tax is imposed on the gross amount of the payment, without any deductions for applicable expenses.[990] In one court case, the taxpayer argued that rental payments for the use of railway cars, determined as a fixed gross rental less mileage credits allowed by the railways, should be assessed withholding tax only on the amount determined after giving effect to such credit. The Tax Review Board held that the gross amount was subject to nonresident tax.[991]

4. Types of Payments

a. Management or Administrative Fees

Two important exceptions are made to this category of chargeable payments:[992]

(i) Payments for services in an ordinary arm's-length transaction (however, fees, commissions, or other amounts paid to a non-resident for services rendered in Canada are subject to a separate 15% withholding tax pursuant to Regulation 105, and a potential additional 9% Quebec withholding tax if the services are rendered in Quebec); and

(ii) Payments made in a non-arm's-length transaction in reimbursement of specific expenses incurred by the nonresident for such services (advertising, market research, etc.).

Directors fees are generally not regarded by the CRA as management or administrative fees. A nonresident who performs duties as a director in Canada is subject to tax at normal Income Tax Act, Part I rates on director's fees received,[993] unless he or she is entitled to relief under a tax treaty. The normal rules with respect to withholding from payments of salary to employees also apply with respect to the payment of director's fees.[994]

[983] ITR, sec. 805.

[984] *The Queen v. The Canada Southern Railway Co.*, [1986] 1 CTC 284.

[985] ITA, subsec. 212(1). The law provides that the treaty-specified rate will be deemed to be the rate imposed under the ITA, see ITAR, subsec. 10(6).

[986] CRA, "Beneficial Ownership and Tax Treaty Benefits," online: https://bit.ly/2SmOOma.

[987] *MacMillan Bloedel Ltd. v. MNR*, [1979] CTC 2342; but see *Husky Energy Inc. v. The King*, 2023 TCC 167.

[988] CRA Forms NR 301, NR 302 and NR 303.

[989] Information Circular 77-16R4, para. 5 (5/12/92).

[990] ITA, subsec. 214(1).

[991] *PPG Industries Canada Ltd. v. MNR*, [1978] CTC 2055.

[992] ITA, para. 212(1)(a), subsec. 212(4).

[993] ITA, subpara. 115(1)(a)(i).

[994] ITA, subsec. 153(1).

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Legislative Note: Budget 2024 proposed to widen the CRA's ability to waive the 15% withholding tax applicable to amounts paid to a non-resident for services rendered in Canada. Currently, non-residents can apply for a waiver of the withholding tax for a specific payment if it is unlikely to be subject to tax (for example, if it is exempt under a tax treaty). In practice, such waivers are rarely sought (due to the CRA's burdensome administrative regime), and Budget 2024 noted that the economic burden of the withholding tax often falls on the Canadian payor. Budget 2024, accordingly, proposes to allow the CRA to waive the withholding tax for all payments made during a specified period of time to a specified non-resident if a treaty exemption applies or the income is exempt because it relates to international shipping or operating an aircraft in international traffic.

b. Interest

There is no withholding tax on amounts on account of interest unless such amounts are paid or credited to a non-arm's length person or such amounts constitute "participating debt interest." Participating debt interest includes interest paid on an obligation (other than a prescribed obligation) where all or any portion of the interest is contingent or dependent on the use of or production from Canadian property, or is computed by reference to revenue, profit, cash flow, commodity price or other similar criterion, or by reference to dividends paid or payable. Generally, participating debt interest is interest that is dependent on the success of the payer's business or investments. Note that the conversion premium on certain convertible debt may be deemed to be treated as interest, and therefore may result in participating debt interest for this purpose (which could be subject to withholding tax).

As noted, withholding tax is applicable to payments to nonresidents who do not deal at arm's-length with the Canadian payer, except to the extent that the interest qualifies as "fully exempt interest." Fully exempt interest includes interest paid on government or quasi-government debt, on mortgages secured by foreign property (except to the extent the interest is deductible against the payer's Canadian income), to a prescribed international organization or agency, or on certain securities lending arrangements (SLAs).

Under a tax treaty, further amounts may be exempt. The Canada-U.S. tax treaty may also apply to exempt interest payments made to qualifying U.S. residents from Canadian withholding taxes (see XII.G., below). In addition, interest paid to an arm's length U.S.-resident vendor of equipment merchandise or services in connection with a sale on credit to a Canadian resident purchaser is exempt from withholding tax.[995] Also, under the Canada-U.K. tax treaty, interest payments made to arm's length persons may be exempted from Canadian withholding taxes.

The sale of deep discount obligations (as defined) is equated to a payment of interest; similarly, a complex series of rules aims at taxing accrued or hidden interest on various sales of debt instruments.[996] Special rules apply to determine the rate of withholding tax applicable to certain coupon-stripping arrangements (i.e., arrangements where the entitlement to a periodic interest payment on a bond has been removed from the principal amount of the bond and offered for sale as a separate security).[997] These rules generally apply to interest that accrues on or after April 7, 2022 (with limited grandfathering available for the first year for interest accruing on debts entered into before April 7, 2022, with certain interest coupon holders).

Payments with respect to standby charges and guarantee fees are deemed to be interest for withholding tax purposes.[998]

c. Estate or Trust Income

Withholding tax is imposed on amounts paid or credited, or deemed to be paid or credited, by Canadian residents to nonresidents as income from an estate or a trust. Such payments are deemed to be income payments, unless it can be shown that they are made by way of a distribution of capital.[999]

In addition, to ensure that withholding tax on capital dividends is not avoided by flowing the dividends through a trust, withholding tax is payable on a capital distribution made by a trust to a nonresident where the distribution may reasonably be considered to relate to a capital dividend received by the trust.[1000]

There are several important exceptions to the withholding tax on estate or trust income:

(i) Amounts that may reasonably be regarded as having been derived with respect to copyright royalties are exempted if no tax would have been payable had the amounts been paid directly to the nonresident;[1001]

(ii) Where all beneficiaries are resident in, and all sources of income of a trust in the tax year are derived from, a single country other than Canada, and the trust was created prior to 1949, no withholding tax is payable;[1002] and

(iii) The Canada-United States tax treaty and certain other of Canada's tax treaties exempt from withholding tax amounts paid or credited to a U.S. (or other relevant treaty country) resident beneficiary that are derived from sources outside Canada.[1003]

d. Rents, Royalties, and Similar Payments

Amounts paid or credited by a Canadian resident to a nonresident on account of rent, royalty or a similar payment are subject to withholding tax. The following items are included in this category:[1004]

(i) Payments for the use of or for the right to use in Canada any property, invention, trade name, patent, trademark, design or model, plan, secret formula, process, or any other thing whatever;

[995] Canada-United States tax treaty, Art. XI(3)(d).
[996] ITA, subsecs. 214(6)–(12).
[997] ITA, subsecs. 212(21)–(23).
[998] ITA, subsec. 214(15) and the Income Tax Conventions Interpretation Act, R.S.C. 1985, c. I-4, secs. 3 and 6, which provide that, to the extent a term is not defined or not fully defined in a treaty, that term has the meaning it has for purposes of the ITA, as amended from time to time.
[999] ITA, para. 212(1)(c), subsec. 212(11).
[1000] ITA, para. 212(1)(c).
[1001] ITA, subsec. 212(9).
[1002] ITA, subsec. 212(10).
[1003] Canada-United States tax treaty, Art. XXII(2).
[1004] ITA, para. 212(1)(d).

ISBN 978-1-63359-385-5

(ii) Payments for information concerning industrial, commercial or scientific experience, if the amount payable for such information is dependent at least in part on the use to be made of, or the benefit to be derived from, the information, or on the production or sale of goods or services, or on profits;

(iii) Payments for services of an industrial, commercial or scientific character performed by a nonresident (such as most "technical services") where the payments are at least partly dependent on the use to be made of or the benefit to be derived from the services, or on the production or sale of goods or services, or on profits (however, this category does not include payments made for services performed in connection with the sale of property or the negotiation of a contract);

(iv) Payments made pursuant to an agreement with the nonresident under which the nonresident agrees not to use, or not to permit another to use, anything referred to above in (i) or any information referred to above in (ii); and

(v) Payments dependent on the use of or production from property in Canada, whether or not the payments were installments on the sale price of the property (however, payments that are installments on the sale price of agricultural land are specifically exempted).

In addition to certain exemptions already noted, no withholding tax is imposed on the following items:

(i) A royalty or similar payment on or with respect to a copyright of literary or dramatic works;

(ii) A payment made under a *bona fide* cost-sharing arrangement under which the Canadian payer shares, on a reasonable basis with one or more nonresidents, research and development (R&D) expenses in exchange for an interest in any or all property or other things of value that may result therefrom;

(iii) A rental payment for the use of or the right to use outside Canada any corporeal property; and

(iv) Any payment made to an arm's-length recipient that is deductible in computing the Canadian payer's foreign business income.

The charge on royalties and similar payments has been very broadly applied. A most difficult area is that of payments for information and services combined, and payments for "know-how."[1005]

In one case, a Canadian taxpayer acquired from a U.S. company the exclusive right to purchase machines used in the replacement of automotive exhaust systems, and also the technique of merchandising replacement muffler systems, together with the use of a trade name and logos.[1006] For this "package," the Canadian company made two lump sum payments. The Canadian tax authorities sought to impose withholding tax on the basis that the lump sum payments were rents, royalties or similar payments. The Federal Court held that they were not. Contrary to the position taken in CRA Interpretation Bulletin IT-303, the court reasoned that the withholding tax ought not generally apply to a payment on capital account but only to a payment on income account. On the facts, it found that the only portion of the payments that might be regarded as having been made on income account related to the use of the trade name and logos, and there was no basis on which to allocate any portion of the payments to these particular items. This judgment was, however, substantially changed on appeal. The Court of Appeal dismissed the appeal of the Crown on the basis that one could not allocate as between chargeable and non-chargeable payments. The Court of Appeal expressly disagreed with the proposition that only payments on income account were in fact covered by the charge to tax. In another decided case, however, payments were made for computerized information and the court held that the lump sum payment could not be regarded as a royalty and therefore was not subject to tax.[1007]

A category of royalty-type payments separately charged nonresident withholding tax is any amount paid or credited for a right in or the use of a motion picture film, or a film or videotape for use in connection with television that has been or is to be used or reproduced in Canada.[1008]

As noted earlier, nonresident withholding tax is generally applied to the gross amount paid or credited. An important exception to withholding on a gross basis applies to rent on real property in Canada and timber royalties.[1009] The nonresident may opt to pay the usual net-income-based Canadian income tax in lieu of gross basis withholding tax. In this case, tax is computed as if:

(i) The taxpayer was resident in Canada;

(ii) The taxpayer's only source of income was such real property or timber royalties; and

(iii) The taxpayer was not entitled to any deductions from income for the purpose of computing taxable income or to certain deductions in computing tax payable (for example, personal and charitable credits, or loss carryforwards).

The result is Canadian tax on the net rental or timber royalty income (less all expenses, including depreciation) instead of withholding tax on the gross. To take advantage of this regime, a special Canadian income tax return must be filed by the nonresident. In addition, the nonresident or the nonresident's Canadian withholding agent must file an undertaking that the nonresident will file a Canadian income tax return within a specified time.

Nonresidents should note that filing a subsection 216 return that results in no Part 1 tax does not relieve the resident payer of its withholding obligation. In a 2009 case, the nonresident was found liable for interest on unremitted withholding tax for the period starting when the withholding tax became due and ending when she filed her section 216 return.[1010]

[1005] *See* Interpretation Bulletin IT-303 (4/8/76).

[1006] *Farmparts Distributing Ltd. v. The Queen*, [1979] CTC 263, [1980] CTC 205.

[1007] *The Queen v. Saint John Shipbuilding and Dry Dock Co. Ltd.*, [1979] CTC 380, *aff'd*, [1980] CTC 352; for a discussion of the *Farmparts* and *Saint John Shipbuilding* cases, see 12 *Tax Mgmt. Int'l J.* 29 (1979); regarding the nature of lump sum payments, see *Canadian Industries Ltd. v. The Queen*, [1980] CTC 222.

[1008] ITA, subsec. 212(5).

[1009] ITA, sec. 216.

[1010] *Carole Pechet v. R.*, 2009 FCA 341.

ISBN 978-1-63359-385-5

e. Dividends

Taxable dividends and capital dividends are subject to withholding tax if paid or credited by a Canadian resident corporation to a nonresident shareholder.[1011] Deemed dividends are similarly taxed and, where a benefit would be taxed in the hands of a resident shareholder, the deemed income is treated as a deemed dividend for purposes of the nonresident withholding tax.[1012] Stock dividends are also subject to nonresident withholding tax, the amount of the dividend being the amount of the increase in the corporation's paid-up capital as a consequence of the dividend payment.[1013]

f. Other Payments

The statute provides that various other forms of payment are subject to withholding tax, including:[1014]

(i) Patronage dividends;

(ii) Certain pensions, and other employment and benefit payments; and

(iii) Annuities (other than the capital element).

In one case, the trustee of a pension plan of a Canadian company transferred funds out of the plan to the trustees of the U.S. pension plan of a subsidiary company, following the transfer of employees from the Canadian parent to the U.S. subsidiary.[1015] The trustee was assessed for failure to withhold with respect to the transferred funds, on the basis that the transfer constituted the payment or crediting of amounts in satisfaction of pension benefits to nonresidents. Although the trustee was successful at trial in disputing this result, the Federal Court of Appeal held that the transfer gave rise to income subject to nonresident withholding tax.

Withholding is also required on payments made with respect to certain types of restrictive covenants, for example, under a noncompetition agreement.[1016]

5. Deemed Residence

In general, withholding tax is imposed only where a Canadian resident is the payer. In certain cases, however, the tax may apply even though both the payer and the recipient are nonresidents of Canada. In these cases, the nonresident payer is deemed to be resident in Canada.

[1011] ITA, subsec. 212(2).
[1012] ITA, subsec. 214(3).
[1013] See definition of "amount" in ITA, subsec. 248(1).
[1014] ITA, paras. 212(1)(g), *et seq.*
[1015] *The Queen v. Sun Life Assurance Co. of Canada*, [1979] CTC 68, [1980] CTC 418.
[1016] ITA, para. 212(1)(i).

Thus, mortgage interest with respect to Canadian real property is subject to withholding tax where the payer is a nonresident who has benefited from a deduction.[1017] This would also be the case if the interest income was paid in the course of carrying on business in Canada or if a nonresident investor purchased real property in Canada, financed by a foreign lender, and elected to be taxed on a net basis rather than suffer withholding tax on the gross rentals.

Amounts paid by any partnership to a nonresident that are deductible in computing the partnership's Canadian-source income are treated as passing from a Canadian resident to a nonresident for withholding tax purposes. Conversely, where a Canadian resident makes a payment to a partnership any one of the members of which is a nonresident, the payment is treated as having been made to a nonresident person.[1018]

Legislative Note: Effective for amounts paid or credited after 2022, amendments to subsections 212(13.2) and (13.3) extend the circumstances in which a nonresident must withhold tax on payments made to another nonresident to the extent the payment is deductible in computing Canadian-source income, including payments made to partnerships that are not "Canadian partnerships" (i.e., partnerships no members of which are, directly or indirectly, nonresidents). Proposed amendments to subsection 212(13.1) and proposed new subsection 212(13.11), which were released on August 9, 2022 and have not yet been enacted, would extend the circumstances in which a partnership must withhold tax on payments made to a nonresident or to a non-Canadian partnership to include situations in which the payment is deductible by a member of the partnership in computing its Canadian income (regardless of whether the partnership itself has earned any Canadian-source income).

Similarly, any nonresident person is deemed to be a Canadian resident for withholding tax purposes if the nonresident's business is principally carried on in Canada (or if the nonresident manufactures or processes goods in Canada, or operates a resource business in Canada), to the extent the amount paid to another nonresident was deductible in computing the first nonresident's taxable income earned in Canada.[1019] A nonresident is deemed to be a Canadian resident with respect to any payment made to another nonresident that is deductible in computing the first nonresident's taxable income earned in Canada from any source other than a business or property exempt from taxation under Part I by virtue of a tax treaty.[1020]

[1017] ITA, para. 212(13)(f).
[1018] ITA, subsec. 212(13.1).
[1019] ITA, subsec. 212(13.2).
[1020] ITA, subsec. 212(13.2).

ISBN 978-1-63359-385-5

XII. Avoidance of Double Taxation

A. Tax Treaties

Canada has entered into many international tax treaties and tax information exchange agreements (TIEAs) with a multitude of additional countries. For the most part, Canada's tax treaties follow the Organisation for Economic Co-operation and Development (OECD) model double taxation convention on income and capital. Some tax treaties with developing countries also reflect Canada's willingness to adopt several modifications to the OECD Model suggested in the United Nations (UN) model double taxation convention between developed and developing countries, as well as Canada's willingness to implement tax sparing arrangements where these are considered appropriate.

In addition, Canada may enter into other intergovernmental agreements focused on international taxation. For instance, Canada has entered into an intergovernmental agreement (IGA) with the United States in respect of the U.S. Foreign Account Tax Compliance Act (FATCA), which is aimed at curbing international tax avoidance by U.S.-resident taxpayers.[1021]

For the texts and status of Canada's tax treaties and other tax-related agreements, see International Tax Treaties.

B. Treaty Adoption and Ratification

As a matter of international law, the government of Canada has the authority to enter into binding agreements with other states, and no Parliamentary action is required. To the extent the provisions of any such international agreements conflict with Canadian domestic law, however, they cannot have any force or effect in Canada until sanctioned by Parliament. Needless to say, most of the provisions of Canada's tax treaties fall within this latter category.

As a practical matter, the implementation of Canada's tax treaties normally involves the following three steps. First, the government of Canada negotiates and concludes a tax treaty that, by its terms, comes into force only upon the exchange of instruments of ratification. Second, legislation is passed by Parliament that provides that, in the event of any inconsistency between the provisions of the particular treaty and the operation of any other law, the provisions of the particular treaty prevail to the extent of such inconsistency. Third, instruments of ratification are exchanged by the respective governments.

C. Provincial Taxation

Under the Canadian Constitution, the federal government does not have the capacity to enter into international agreements with respect to matters within provincial authority and, accordingly, provinces can levy taxes in accordance with the power to tax that they possess under the Constitution Act, regardless of tax treaties. As a consequence, none of Canada's tax treaties affects or restricts the taxing powers of the provinces. In determining the fiscal implications of foreign investment in Canada, it is always important to consider the income tax acts of the various provinces, as well as the federal legislation.

[1021] Canada and the United States signed a Model 1 IGA that went into force on June 27, 2014 and became effective on June 30, 2014.

In an unusual act of provincial independence from the federal government, the province of Quebec has entered into a tax treaty with France. No other Canadian province has a tax treaty with any other country.

D. Treaty Interpretation

For many reasons, treaties are not drafted with the precision or detail found in domestic legislation. In recognizing this, the Canadian courts have held that treaties should be interpreted in a fair and liberal manner, and that the terms used therein should be given their ordinary meaning.

The liberal and purposive approach to the interpretation of tax treaties was reinforced by the leading decision of the Supreme Court of Canada in *Crown Forest Industries Ltd.*[1022] At issue was whether a Bahamas corporation operating in the United States was resident in the United States for purposes of the Canada-United States tax treaty, with the result that the rate of the nonresident withholding tax payable with respect to the rental payments made by the taxpayer to the Bahamas corporation would be reduced from 25% to 10%. The head office and place of management of the Bahamas corporation was located in the United States, and it was subject to tax in the United States on income effectively connected with the trade or business it carried on there. It, in fact, paid no U.S. tax, because its income was exempt from tax under a specific Code provision with respect to international shipping income. The Supreme Court held that the Bahamian corporation was not a resident of the United States for purposes of the Canada-United States tax treaty because it was not liable to tax in that country by reason of its domicile, residence, place of management, place of incorporation or any other criterion of a similar nature. Rather, the corporation was only potentially liable to tax with respect to its trade or business conducted in the United States. That limited source liability for tax was insufficient to create residency for the purposes of Article IV of the treaty.

In setting out some principles for the interpretation of tax treaties, the Supreme Court stated that a liberal interpretation should be taken with a view to implementing the true intention of the signatories. In determining that intention as well as the meaning of the words used in a tax treaty, the Court referred to extrinsic materials such as the OECD Model Tax Convention,[1023] the Vienna Convention and their official commentaries, as well as the U.S. Technical Explanation of the Canada-United States tax treaty. It was not considered necessary to find ambiguity in the wording of a tax treaty before resorting to extrinsic material.

Another source of interpretive rules is the Income Tax Conventions Interpretation Act.[1024] That Act provides the general rule that undefined and partially defined terms in a tax treaty, and those terms that are to be defined by reference to the laws of Canada, have the meaning that they hold for purposes of the Income Tax Act, as that Act is amended from time to time. The courts had previously held that amendments to domestic income tax legislation could not have the effect of

[1022] *The Queen v. Crown Forest Industries Ltd.*, 95 DTC 5389.

[1023] Organisation for Economic Co-operation and Development, Model Tax Convention on Income and on Capital (Paris: OECD).

[1024] R.S.C. 1985, c. I-4.

ISBN 978-1-63359-385-5

amending existing treaties;[1025] the Income Tax Conventions Interpretation Act puts an end to this static interpretation of tax treaties. The Act also specifically provides that profits attributable to a Canadian permanent establishment (PE) are to be calculated in accordance with the rules under the Income Tax Act, and that "immovable property" and "real property" in Canada include property in the nature of mineral rights and timber limits.

The reduced withholding tax rates on interest, dividends and royalties in most of Canada's tax treaties apply only if a treaty resident is the "beneficial owner" of such income. In February 2009, the Federal Court of Appeal interpreted "beneficial owner" to mean the person who receives the dividends for his or her own use and enjoyment and assumes the risk and control of the dividend received. In that case, *Prévost Car Inc. v. The Queen*,[1026] the court held that a Dutch holding company was the beneficial owner of dividends received from a Canadian subsidiary, despite having paid substantially all of the dividends received to its Swedish and U.K. shareholders. The court also indicated that tax treaties should be interpreted with the benefit of the OECD Commentaries, including revisions to the Commentaries made after a particular tax treaty is signed (especially where the revised Commentaries represent a fair interpretation of the words of the Model Convention and do not conflict with Commentaries in existence at the time the treaty was entered into, and where neither treaty partner has registered an objection to the revised Commentaries).

A 2012 Tax Court of Canada case, *Velcro Canada Inc. v. The Queen*,[1027] interpreted the meaning of "beneficial owner" in the context of royalty payments made by a Canadian resident to a corporation resident in the Netherlands. The Dutch corporation was required to pay approximately 90% of the royalties received to its parent (the owner of the IP licensed to the Canadian taxpayer), a corporation resident in a jurisdiction that did not have an income tax treaty with Canada. The Tax Court relied on the principles set out in *Prévost Car* in concluding that the Dutch corporation (and not its parent) was the beneficial owner of the royalty payments, and that the Canada-Netherlands tax treaty[1028] should apply to reduce or exempt withholding tax on the royalty payments. The Tax Court distilled four elements that should be considered in determining where beneficial ownership lies:

(i) Possession;

(ii) Use;

(iii) Risk; and

(iv) Control.

The court looked to the Commentary to the OECD Model Tax Convention on Income and on Capital and concluded that the Dutch corporation was not an agent, nominee or conduit in respect of the royalties received. The court suggested that the Dutch corporation would not be a conduit unless it had absolutely no discretion with respect to the funds, as set out by *Prévost Car*. The limited discretion which the Dutch corporation exercised in respect of the funds prevented the court from piercing the corporate veil. The court also noted that neither Canadian domestic law, the international community nor the Canadian government through the process of objection to OECD materials had adopted a pejorative view of holding companies established in countries with favorable tax treaties. Rather, the OECD Conduit Report warned of the dangers of readily looking through corporations, which is "incompatible with the principle of the legal status of corporate bodies, as recognized in the legal systems of all OECD Member countries."[1029]

In 2023, the Tax Court of Canada rendered its judgment in *Husky Energy Inc. v. The King*, which involved a Canadian corporation with Barbados shareholders. The Barbados shareholders transferred their shares to non-arm's length Luxembourg companies under securities lending agreements. The Canadian corporation paid dividends to the Luxembourg companies, which subsequently made matching dividend compensation payments to the Barbados corporations. The Canadian corporation withheld tax on the basis that the 5% rate under the Canada-Luxembourg tax treaty applied. The Tax Court concluded that the Barbados corporations were the beneficial owners of the dividends and therefore the Canada-Luxembourg tax treaty did not apply. The Tax Court further held that the Canada-Barbados tax treaty did not apply either because the dividends were not actually paid to the Barbados corporations, and the Canadian corporation should have withheld tax at the full 25% rate.[1030]

E. Business Income

The preliminary question in deciding whether a foreign entity is subject to Canadian tax with respect to business income is whether the entity is carrying on business in Canada. Under the Income Tax Act, a corporation may carry on business in Canada in accordance with the standard jurisprudential tests relating to the locus of its business activities or may be deemed to so carry on business in Canada if, for example, the entity offers anything for sale in Canada. Entities that carry on business in Canada, whether in fact or as a result of the statutory deeming rules in section 253, are required to file annual income tax returns and may need to register for corporate purposes.

However, where the entity carrying on business in Canada may take advantage of a tax treaty, however, it will normally only be subject to Canadian income tax on business income if it has a PE in Canada, as defined in the applicable treaty, and then only to the extent that such income is attributable to that PE. "Permanent establishment" is defined in each treaty. Each treaty must be carefully examined to determine its applicability (for example, the definition of residence) and effect.

At a high level, a foreign entity should determine:

(i) Whether it is carrying on business in Canada (the common law test);

[1025] *The Queen v. Melford Developments Inc.*, [1982] CTC 330.

[1026] 2009 FCA 57.

[1027] 2012 TCC 57.

[1028] Convention Between the Government of Canada and the Government of the Kingdom of The Netherlands for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, signed on May 27, 1986 (the "Canada-Netherlands tax treaty").

[1029] OECD, Double Taxation Conventions and the Use of Conduit Companies (OECD, Paris, 1987), at para. 24(i).

[1030] 2023 TCC 167.

ISBN 978-1-63359-385-5

(ii) Whether it is deemed to be carrying on business in Canada (the statutory test); and

(iii) If the answer to either of the above is yes, whether a treaty exemption applies.

Generally, entities concerned that their activities in Canada may give rise to income tax obligations should: (i) confirm whether they are entitled to tax treaty benefits (including whether any limitation on benefits may arise under the relevant treaty or the Multilateral Instrument — which may apply to deny treaty benefits under certain treaties through a "principal purpose" test); and (ii) consider whether any risk factors are present that might suggest they have a PE in Canada (as set out in the applicable treaty, which commonly includes: a fixed place of business; the presence of a dependent agent in Canada that habitually concludes contracts on the entity's behalf; and the possibility of having a services PE).

Foreign entities with personnel who work remotely in Canada are at risk not only of unintentionally carrying on business in Canada or creating a PE in Canada, but also potentially being subject to withholding obligations under Regulations 102 and 105 (with respect to remuneration for services provided in Canada).

Canada does not have any rules on digital PEs. It enacted legislation for a digital services tax but subsequently announced that it intends to rescind it before the first payment was due, as discussed above.

As discussed in VIII.B.3.a., above, a corporation other than a "Canadian corporation" that carries on business in Canada is liable to a 25% tax on, effectively, after-tax profits. This "branch tax" is also dealt with in many of Canada's tax treaties. Often the rate of the tax is equated to the rate of withholding on dividends (between 5% and 15% in most treaties, 5% in the Canada-United States tax treaty) and some treaties contain de minimis exemptions and rules respecting calculations of branch profits.

The Income Tax Act requires a corporation to file a return of income, if in the year the corporation is resident in Canada, it carries on business in Canada, it has a taxable capital gain or it disposes of a taxable Canadian property. The requirement to file a tax return applies even if the corporation claims a treaty exemption with respect to the income that would otherwise be subject to tax under the Income Tax Act.[1031]

F. Investment Income

As discussed under XI.F., above, a nonresident of Canada is subject to a special Canadian tax on certain types of income from property that arise in Canada. This tax is often referred to as a "withholding tax" because, although the liability is upon the nonresident, it is the person in Canada who pays or credits a taxable amount to the nonresident who is obliged to deduct or withhold the tax and remit it to the Receiver General of Canada on behalf of the nonresident.

The general rate of withholding tax is 25%. Under most of Canada's tax treaties, however, the withholding tax rate applicable to most types of investment income (e.g., dividends, interest and royalties) is limited to 15%. Often the rate applicable to royalties is limited to 10%. In some cases, certain types of income, such as real property rentals and certain pensions, are subject to withholding tax at the full 25% rate. As the treaty rate often differs from the statutory rate, the Canadian authorities have indicated that the Canadian payer is responsible for determining which rate is appropriate. This may entail obtaining evidence that the recipient is resident in the appropriate tax treaty jurisdiction.

G. Canada-United States Tax Treaty

1. In General

On August 16, 1984, Canada and the United States exchanged instruments of ratification implementing the tax treaty that was signed between the two countries on September 26, 1980, and subsequently amended by Protocols signed on June 14, 1983, March 28, 1984, March 17, 1995, July 29, 1997, and September 21, 2007. As stated above, the Fifth Protocol, which was signed on September 21, 2007, and released with two sets of diplomatic notes (Annexes A and B), entered into force on December 15, 2008.

2. Withholding Taxes

Dividends are dealt with under Article X of the Canada-U.S. tax treaty and are generally subject to withholding tax at a rate of 15%, unless the beneficial owner is a company that owns at least 10% of the voting stock of the company paying the dividends, in which case the rate is reduced to 5%. Article X of the Canada-U.S. tax treaty provides that the 10% beneficial owner requirement will be met where a fiscally transparent entity is the owner of the shares of the company paying the dividend. This means that the 5% reduced withholding rate can apply to, for instance, dividends paid to a limited liability company (LLC) that has U.S. corporate members.[1032] "Dividends" means income from shares or other rights, not being debt-claims, participating in profits, as well as any other items of income that are treated as dividends under the taxation laws of the state of which the payer is a resident. Canada's right to levy the "branch tax" was preserved under the amendments of the Fifth Protocol (see the discussion at VIII.B.3.a., above), as was the right of the United States to levy accumulated earnings tax and personal holding company tax, provided certain ownership tests are met. The United States also has the right to levy withholding tax on dividends paid by any company where, during a prescribed period, at least 50% of the gross income of the company is attributable to a PE in the United States.

Interest payments are defined as income from debt claims of every kind, whether or not secured by mortgage, and whether or not carrying a right to participate in the debtor's profits, as well as income assimilated to income from money lent by the taxation laws of the country in which the income arises.

Generally, the Canada-U.S. tax treaty reduces the rate of withholding tax on interest paid between unrelated residents of Canada and the United States to 0%. However, certain types of interest payments are not exempt from withholding tax un-

[1031] ITA, para. 150(1)(a).

[1032] *See TD Securities (USA) LLC v. The Queen*, 2010 TCC 186, discussed at XII.G.8., below.

ISBN 978-1-63359-385-5

der the treaty. For instance, certain types of participating interest arising in Canada and paid to a beneficial owner resident in the United States are subject to withholding tax at a rate not exceeding the rate generally applicable to dividend payments (i.e., 15%). Participating interest includes amounts determined with reference to receipts, sales, income, profits or cash flow of the debtor, to any change in the value of any property of the debtor or a related person, or to any dividend, partnership distribution or similar payment made by the debtor to a related person. Similarly, the 15% withholding tax rate generally applicable to dividends also applies to interest arising in the United States that is "contingent interest" of a type that does not qualify as portfolio interest under U.S. law where the beneficial owner of the interest is a resident of Canada. In addition, the reduced withholding rate in Article XI does not apply to interest that exceeds, by reason of a special relationship between the payer and the beneficial owner, the amount that would have been agreed to in the absence of such a relationship. Generally, interest is deemed to arise in the country where the payer resides or where a PE, in connection with which the indebtedness arose, is situated.

Royalties arising in one country and paid to a resident of the other country are generally subject to withholding tax at a rate of 10%, but an exemption applies with respect to the following four categories:

(i) Copyright royalties and other like payments with respect to the production or reproduction of any literary, dramatic, musical or artistic work (but not including royalties with respect to motion pictures, and works on film, videotape or other means of reproduction for use in connection with television);

(ii) Payments for the use of, or the right to use, computer software;

(iii) Payments for the use of, or the right to use, any patent or any information concerning industrial, commercial or scientific experience (but not including any such information provided in connection with a rental or franchise agreement); and

(iv) Such payments with respect to broadcasting as may be agreed for these purposes in an exchange of notes between Canada and the United States.

Royalties are defined as payments of any kind received as consideration for the use of, or the right to use, any copyright of literary, artistic or scientific work (including motion pictures and works on film, videotape or other means of reproduction for use in connection with television), any patent, trademark, design or model, plan, secret formula or process, or for the use of, or the right to use, tangible personal property, or for information concerning industrial, commercial or scientific experiments, and include gains from the alienation of such property or rights to the extent such gains are contingent on the productivity, use or subsequent disposition of such property or rights.

Income from real property may be subject to withholding tax at the rate determined under domestic law. For this purpose, real property generally has the meaning ascribed to it under the taxation laws of the country in which the property in question is situated. Any option or similar right with respect to such property is also included.

3. *Business Profits*

Business profits of a resident of a contracting state (including profits in respect of independent personal services provided by the resident of a contracting state) are not taxable by the other state unless the resident carries on business in that other state through a PE situated therein, in which case the resident may be taxed in the other state to the extent the profits are attributable to that PE. Annex B to the Fifth Protocol indicates that Canada and the United States have agreed that the business profits attributable to a PE would include only the profits derived from the assets used, risks assumed, and activities performed by the PE. Moreover, Canada and the United States have agreed that the OECD Transfer Pricing Guidelines are applicable, by analogy, to determine the profits attributable to a PE. Accordingly, Parts 1, 2, 3 and 4 of the OECD study with respect to attributing income to a PE are applicable.

Generally, a PE means a fixed place of business through which the business of a resident of a contracting state is wholly or partly carried on. A building site, or construction or installation project constitutes a PE if it lasts for more than 12 months. Similarly, the use of an installation or drilling rig or ship in a contracting state to explore for or exploit natural resources constitutes a PE, if such use is for more than three months in any 12-month period. Certain fixed places of business that are used solely with respect to activities that have a preparatory or auxiliary character or that are used for purposes of the storage, display, or delivery of goods or merchandise do not constitute a PE.

Profits derived by a resident of a contracting state from the operation of ships or aircraft in international traffic, and gains derived by such a person from the alienation of ships, aircraft or containers used principally in international traffic, are exempt from tax in the other contracting state. For this purpose, international traffic means any voyage of a ship or aircraft to transport passengers, or property except where the principal purpose of the voyage is to transport passengers or property between places within one contracting state. The same exemption generally applies with respect to the profits of a resident of a contracting state engaged in the operation of motor vehicles or a railway as a common carrier or a contract carrier. Profits derived by a resident of a contracting state from the use, maintenance or rental of railway rolling stock, motor vehicles, trailers or containers used in the other contracting state for a period not expected to exceed in the aggregate 183 days in any 12-month period are exempt from tax in the other contracting state, unless they are attributable to a PE situated therein.

4. *Personal Services*

Income derived by a resident of a contracting state with respect to employment may be taxed by the other contracting state if the employment is exercised in that other state. An exemption applies if:

(i) The income does not exceed Can. $10,000 (in the currency of the other state); or

(ii) The recipient is present in the other contracting state for less than 183 days in any 12-month period commencing or ending in the fiscal year concerned and the remuneration is not paid by, or on behalf of, a person that is a

ISBN 978-1-63359-385-5

resident of that other contacting state and is not borne by a PE in that other contracting state.

Comment: The CRA's guidance on this provision is somewhat unclear, particularly with respect to its potential application to fees for services.[1033]

In *Dudney*,[1034] the Tax Court of Canada examined the provision of personal services in the context of former Article XIV of the Canada-U.S. tax treaty. The taxpayer in this case was a U.S. resident who, pursuant to a personal services contract, was present in Canada for more than 183 days training the employees of a Canadian company. In carrying out his duties, the taxpayer was provided with workspace at the premises of the Canadian company that hired him. It was the CRA's position that this amounted to maintaining a "fixed base" in Canada in accordance with the terms of the Canada-U.S. tax treaty. The Tax Court of Canada, however, disagreed. In the Court's view, the taxpayer was under the control and direction of the Canadian company while performing his services in Canada. Moreover, he was not in a position to use the locale for business activities outside the scope of the personal service contract. As a result, the taxpayer did not maintain a PE or "fixed base" in Canada. The Federal Court of Appeal agreed with the Tax Court's conclusion and dismissed the Crown's appeal. In doing so, the Federal Court of Appeal stated that a literal or legalistic interpretation of the treaty should be avoided to prevent defeating the intention of the treaty's drafters.[1035]

As a reaction to the *Dudney* case, the Fifth Protocol repealed former Article XIV (Independent Personal Services) and introduced a new rule in Article V (Permanent Establishment) that deems a nonresident enterprise to have a PE if services are provided in the other state for an extensive period if and only if it provides services in the other state that meet one of the following two thresholds:

(i) The services are performed in the other state by an individual who is present in the other state for more than 183 days in any 12-month period and, during those 183 days, more than 50% of the gross active business revenues of the enterprise consists of income derived from such services; or

(ii) The services are provided in the other state for an aggregate of 183 days or more in any 12-month period with respect to the same or a connected project for customers who are either residents of the other state or who maintain a PE in the other state, and the services are provided with respect to that PE. Annex B to the Treaty clarifies that projects are considered to be connected if they constitute a coherent whole, commercially and geographically.

Under this rule, an individual who is a resident of one contracting state providing services that are not with respect to an employment in the other state and that satisfy one of the thresholds could be subject to tax in the other state under the Business Profits article.

Notwithstanding the foregoing, there are provisions in the Canada-U.S. tax treaty dealing with personal services income earned by an entertainer, musician or athlete (or such a person's personal holding company). In each of these cases, income earned from personal activities exercised in a contracting state may be taxed by that state, except where the gross receipts do not exceed Can. $15,000 (in the currency of the state concerned) for the calendar year concerned. An exemption applies with respect to the income of an athlete derived from his or her activities as an employee of a team that participates in a league with regularly scheduled games in both contracting states.

5. Gains

Under Article XIII of the Canada-U.S. tax treaty, gains derived by a resident of a contracting state from the alienation of real property situated in the other contracting state may be taxed in that other state. In the case of property situated in the United States, this rule extends to a U.S. real property interest and real property as defined under U.S. domestic tax laws. In the case of Canada, it includes: real property as defined under Canadian domestic tax law; a share of the capital stock of a company, the value of the shares of which is derived principally from real property situated in Canada; and an interest in a partnership, trust or estate the value of which is derived principally from real property situated in Canada.

Gains from the alienation of personal property forming part of the business property of a PE, including gains from the alienation of a PE, may be taxed in the state in which the PE is or was situated.

In addition, both countries retain the right to tax a former resident with respect to gains from the alienation of property that was owned by such former resident at the time the former resident moved to the other country. This extension of taxing jurisdiction arises where the alienator was a resident of the first country at any time during the 10 years immediately preceding the alienation of the property and was so resident for at least 10 of the previous 20 years.

In general, the amount of the gain from the alienation of a capital asset by a resident of one state that may be taxed by the other state is limited to the portion of the gain that is attributable to the period commencing January 1, 1985.

The Canada-U.S. tax treaty also contains provisions to accommodate cross-border reorganizations. The Income Tax Act provides a mechanism that facilitates the operation of this treaty provision. With approval of the Minister of National Revenue, tax is deferred and the tax base maintained in Canada where the disposition of property by a U.S. resident has tax-deferred status in the United States but does not have this status in Canada.[1036]

6. Administrative Matters

The Canada-U.S. tax treaty contains articles dealing with the elimination of double taxation, nondiscrimination mutual agreement procedure (MAP), assistance in tax collection, and

[1033] See CRA Document No. 2011-0418281E5, *Employment income — treaty exemption* (January 23, 2012).

[1034] *The Queen v. William A. Dudney*, 99 DTC 147 (TCC), *aff'd* 2000 DTC 6169 (FCA).

[1035] See the CRA Transfer Pricing Memorandum issued in response to *Dudney*: "The Dudney Decision: Effects on Fixed Base or Permanent Establishment Audits and Regulation 105 Treaty-Based Waiver Guidelines" (5 December 2005), https://www.canada.ca/en/revenue-agency/services/tax/international-non-residents/information-been-moved/transfer-pricing/08.html.

[1036] ITA, sec. 115.1.

ISBN 978-1-63359-385-5

the exchange of information.[1037] In the last case, provision is made for extensive sharing of information between the Internal Revenue Service (IRS) and the CRA.

In addition, the Canada-U.S. tax treaty authorizes reassessments within six years from the end of the tax year to avoid double taxation and prevent tax avoidance, where related persons are engaged in cross-border transactions.

The Canada-U.S. tax treaty provides for mandatory "baseball-style" arbitration of certain cases that the competent authorities have been unable to resolve pursuant to the MAP. Under this procedure, an arbitration board with three members must accept a proposed resolution submitted by one of the contracting states.

Mandatory arbitration should result in the resolution of competent authority cases within three years or less; furthermore, the prospect of arbitration of unresolved cases may induce the competent authorities to reach a negotiated settlement at an earlier stage in the process.

Arbitration is available only for cases in which a tax return has been filed with at least one of the contracting states for the taxable year at issue and that involve the following Articles:

(i) Article IV (Residence of an individual);

(ii) Article V (Permanent Establishment);

(iii) Article VII (Business Profits attributable to a permanent establishment);

(iv) Article IX (Related Persons);

(v) Article XII (Royalties, but only with respect to transactions involving related persons to whom Article IX might apply, or an allocation of amounts between royalties that are taxable and royalties that are exempt under Art. XII (2) and (3)); or

(vi) Any other issue that both competent authorities agree on an *ad hoc* basis to arbitrate. Both competent authorities may agree that a particular case is not suitable for arbitration, but they must do this before the arbitration proceeding for that case begins.

An arbitration proceeding will begin on the later of:

(i) The date that is two years after the "commencement date" of any case that has not been resolved by mutual agreement unless both competent authorities have agreed to a different date; and

(ii) The date each "concerned person" (a taxpayer whose tax liability is affected by the case) and his or her authorized representatives deliver to both competent authorities a written agreement not to disclose to any other person any information received during the course of the arbitration proceeding from either contracting state or the arbitration board, other than the determination of the board.

The competent authorities may reach a mutual agreement to resolve a case and terminate arbitration proceedings at any time before a determination by the board has been made. It appears that a concerned person may terminate arbitration, but only by withdrawing its request for competent authority relief.

[1037] Canada-U.S. tax treaty, Arts. XXIV, XXV, XXVI, XXVI A, and XXVII.

The arbitration board's decision will constitute a resolution by mutual agreement and will be binding on both contracting states, unless the decision is not accepted by the person concerned.

7. *Treaty Planning*

Article XXIX A of the Canada-U.S. tax treaty contains a comprehensive limitation on benefits (LOB) or treaty shopping provision that applies to both Canada and the United States. To be entitled to benefits under the new LOB provision, a resident must be a "qualifying person," which includes the following:

(i) Natural persons;

(ii) Governments and their agencies;

(iii) Companies or trusts whose principal class of shares or units (and certain "tracking" shares or units) is "primarily and regularly" traded on a recognized stock exchange (including major Canadian and U.S. exchanges);

(iv) Certain companies or trusts that are controlled by other qualifying persons, subject to a potential limitation on expenses paid to nonqualifying persons; and

(v) Estates and certain pension trusts, nonprofits, and tax exempts.

Benefits under the Canada-U.S. tax treaty are also extended to residents who are not qualifying persons but who are engaged in the active conduct of a trade or business in the jurisdiction where they are resident, but only for income derived in connection with or incidental to the trade or business, and only if the trade or business is substantial in relation to activities in the other country. Certain investment activities do not constitute a trade or business for this purpose.

A "derivative benefits" clause extends benefits under the Canada-U.S. tax treaty relating to Articles X (Dividends), XI (Interest), and XII (Royalties) to companies controlled (requiring, generally, at least 90% ownership) by residents of neither Canada nor the United States if those persons:

(i) Are resident in a country that has a comprehensive income tax treaty with the United States or Canada, as the case may be;

(ii) Would be qualified persons or otherwise eligible for Canada-U.S. tax treaty benefits if they were residents of the United States or Canada; or

(iii) Would be entitled to a rate of tax in that treaty country on the relevant income that is at least as low as the tax rate in the Canada-United States tax treaty; and

(iv) The amount of expenses deductible from gross income payable directly or indirectly to persons that are not qualifying persons for the preceding fiscal period is less than 50% of gross income.

Finally, a person who does not qualify for Canada-U.S. tax treaty benefits under any of the above provisions may apply for competent authority relief where the person was not created to obtain benefits under the Canada-United States tax treaty or where it would not be appropriate to deny such benefits.

Where a Canadian investment is held through an intermediary company, care must be taken to establish that the intermediary corporation is the beneficial owner of the shares, and

ISBN 978-1-63359-385-5

not merely an agent, nominee or mere administrator for the true beneficiary. The Canadian tax authorities have expressed the opinion that the Canadian general anti-avoidance rule (GAAR) may apply to certain "treaty shopping" transactions using intermediary type entities and the GAAR was amended to apply specifically to tax treaties[1038] (see also the discussion on *MIL Investments* at XI.C.2., above). In that case, the Canadian tax authorities argued that tax treaties contain an implicit anti-abuse rule, but that was rejected by the Federal Court of Appeal in *MIL Investments.* Also, the Canadian tax authorities have argued the term "beneficial owner" in most dividend, interest and royalty articles of Canada's tax treaties could prevent treaty shopping through intermediary companies that act as conduits. However, the Federal Court of Appeal concluded to the contrary in *Prévost Car Inc. v. The Queen,*[1039] a case that involved U.K. and Swedish resident companies holding shares of a Canadian company through a Dutch holding company, as did the Tax Court of Canada in *Velcro Canada v. The Queen,*[1040] a case that involved a back-to-back royalty arrangement.

8. Treatment of Fiscally Transparent Entities

The coming into force of the Fifth Protocol ensures that U.S.-resident members of LLCs and other fiscally transparent entities are entitled to claim benefits under the Canada-U.S. tax treaty. Previously, in the CRA's view, an LLC was not a resident of the United States for purposes of the Canada-U.S. tax treaty (if it was treated as fiscally transparent for U.S. federal income tax purposes).

Pursuant to the amendments of the Fifth Protocol, the Canada-U.S. tax treaty provides that an amount of income, profit or gain is considered to be derived by a person who is a resident of one contracting state if:

> (i) The person is considered under the tax law of the state of residence to have derived the amount through an entity that is not a resident of the other contracting state; and
>
> (ii) By reason of such entity being treated as fiscally transparent under the tax law of the person's resident state, the tax treatment of the amount is the same as if it had been derived directly by that person.

This change makes it clear that an amount paid by a Canadian resident to an LLC (that is treated as a partnership or branch for U.S. income tax purposes) would be considered to be derived by a resident of the United States to the extent the members of the LLC are resident in the United States.

The Fifth Protocol has provided welcome clarification for U.S. residents investing in Canada through LLCs, especially with respect to the application of the Canada-U.S. tax treaty to gains realized by certain LLCs on the disposition of shares of a Canadian corporation. The Fifth Protocol has also made it clear that dividends received by an LLC with U.S.-resident members that are corporations are eligible for the reduced dividend withholding tax rate under the treaty (i.e., 5% instead of 15%), provided the requisite 10% ownership threshold is met. Furthermore, where a Canadian branch of an LLC (with U.S.-resident members that are corporations) repatriates its earnings, the reduced "branch tax" rate of 5% applies.

The decision in *TD Securities (USA) LLC v. The Queen,*[1041] suggests that certain LLCs may be entitled to treaty benefits even in the absence of the Fifth Protocol. In that case, the Tax Court of Canada held that a Delaware LLC was liable to tax in, and therefore a resident of, the United States for purposes of the Canada-United States tax treaty.

This case overturned the CRA's long-established position that LLCs that are fiscally transparent for U.S. tax purposes cannot be U.S. residents for purposes of the treaty prior to the Fifth Protocol (which did not apply to the tax years at issue), although the court was careful to limit its decision to the facts at issue.

The issue in *TD Securities (USA) LLC* was whether the taxpayer was entitled to enjoy the benefits of the Canada-U.S. tax treaty in respect of its Canadian-source income even though it was treated as a disregarded entity for U.S. federal income tax purposes. As a disregarded entity, its Canadian-source income was subject to tax in the United States in the hands of its only member, a U.S.-resident company. Despite its disregarded entity status, the Tax Court found that the taxpayer was a resident of the United States for purposes of the treaty because the United States retained, and exercised, the jurisdiction to tax its worldwide income, including its Canadian branch income, on a comprehensive basis. Accordingly, the taxpayer was entitled to claim the benefits of the treaty. The CRA did not appeal the decision in, although it has indicated that it disagrees with the result. Accordingly, the issue will likely be before the courts in the future for other taxpayers for the years in which the Fifth Protocol applies.

9. Hybrid Entities — Treaty Benefit Denial Rules

Certain amendments to Article IV (Residence) of the Canada-U.S. tax treaty provided in the Fifth Protocol have denied treaty benefits with respect to the use of two categories of hybrid entities that are disregarded in one country and not the other.

The first rule applies to payments to, or amounts derived by, a resident of one contracting state through a hybrid entity that is recognized by that state but that is disregarded by the other state. This rule appears to apply to certain "reverse hybrid" arrangements that are typically used by U.S. residents in Canada. This rule applies where a U.S. resident establishes a partnership in Canada and elects to have the partnership treated as a corporation for U.S. federal income tax purposes. Under the new rule, assuming the partnership is viewed as an "entity," the U.S.-resident partners are not eligible for benefits under the Canada-United States tax treaty (under the former version of the treaty, Canada disregarded the Canadian partnership and afforded its U.S.-resident members benefits under the treaty).

The second rule applies to payments to, or amounts derived by, a resident of one contracting state from a hybrid entity that is disregarded by that state but that is recognized by the other state. This rule will likely apply where, for example, a U.S. parent company provides a loan to its Canadian operating companies through, for instance, an unlimited liability compa-

[1038] ITA, subsec. 245(4).
[1039] 2009 FCA 57.
[1040] 2012 TCC 57.
[1041] 2010 TCC 186.

ISBN 978-1-63359-385-5

ny (ULC) which is fiscally transparent for U.S. tax purposes. Under this rule, Canada is permitted to deny benefits under the Canada-U.S. tax treaty on amounts paid by the ULC to its U.S. parent.

These hybrid entity rules became effective as of January 1, 2010.

H. Base Erosion and Profit Shifting

Canada is part of the inclusive framework of over 100 countries and jurisdictions that are collaborating on the implementation of the OECD/G20 Base Erosion and Profit Shifting (BEPS) package. The BEPS Action Plan was released on July 19, 2013, and was subsequently followed by a series of reports suggesting various potential changes to domestic laws and tax treaties. Canada has implemented — or is in the process of implementing — the OECD's "minimum standards" under the BEPS project, including:

- Implementing legislation requiring large multinational enterprises to file country-by-country (CbC) reports in accordance with BEPS Action Item 13 (see the discussion at XI.D.6.b.(2), above);[1042]
- Entering into and ratifying the OECD's Multilateral Instrument to Implement Tax Treaty Related Measures to Prevent BEPS; and
- Implementing enhanced information sharing procedures with other tax administrators pursuant to the OECD's Common Reporting Standard.[1043]

1. OECD Multilateral Instrument

The Multilateral Instrument (the "MLI") operates to modify those bilateral treaties that Canada has entered into with other signatories of the MLI that Canada has designated as "Covered Tax Agreements." Canada has designated 84 of its 93 bilateral tax treaties as Covered Tax Agreements. These include most of Canada's significant tax treaties although its treaties, with Germany and Switzerland were not covered — (Canada has since announced that it is renegotiating those treaties). The MLI was ratified by Canada on August 29, 2019, and came into force with respect to Canada's Covered Tax Agreements on December 1, 2019. Pursuant to the provisions of the MLI, the provisions of the MLI are now in effect for Canada's Covered Tax Agreements with respect to withholding taxes and became effective for all other taxes for tax years that commenced after June 1, 2020 (which for calendar year taxpayers was January 1, 2021).

The most significant treaty modifications implemented through the MLI are the addition of a broad anti-avoidance rule into Covered Tax Agreements, referred to as the principal purpose test or PPT. Under the PPT, a treaty benefit may be denied where it is reasonable to conclude that one of the principal purposes of an arrangement or transaction was to gain such benefit, unless it is established that granting the benefit would be in accordance with the object and purposes of the relevant provisions of the treaty.

Other minimum standards implemented through the MLI include:

(i) An amended preamble, suggesting that Covered Tax Agreements are intended to eliminate double taxation without creating opportunities for non-taxation or reduced taxation through tax evasion or avoidance, and

(ii) Modified dispute resolution procedures, including the potential adoption of mandatory arbitration procedures.

Canada also removed its initial reservations on some of the optional MLI provisions, including the addition of:

(i) A one-year holding period test to access treaty-based withholding tax reductions on dividends received by corporations;

(ii) A one-year lookback test to determine whether capital gains on a sale of equity interests derive their value principally from immovable property for purposes of a Covered Tax Agreement; and

(iii) Certain factors to be considered by competent authorities when resolving cases of dual residency for entities.

2. Common Reporting Standard

Canada has implemented the OECD's Common Reporting Standard (CRS). Under the CRS, Canadian financial institutions are required to obtain certain information regarding the financial accounts of nonresidents and certain entities that are controlled by nonresidents and report this information to the CRA. The CRA would then provide each foreign jurisdiction with which it has a CRA partnership all the information collected relating to residents of that jurisdiction, while obtaining the same information from such jurisdiction relating to the financial accounts of Canadian residents.

Budget 2024 proposed to amend the CRS rules effective 2026, including broadening which types of financial assets are subject to the CRS and increasing the information on financial accounts and account holders that has to be reported.

Budget 2024 also proposed to introduce a new information reporting regime that will apply effective 2026 to "crypto-asset services providers," which will be required to provide the CRA with information about certain crypto-asset transactions of both residents and non-residents. The new regime is proposed in response to the OECD's model rules in the Crypto-Asset Reporting Framework released in 2022. The regime will not exempt certain entities that are exempted from the CRS, including registered plans, pension plans and registered charities.

[1042] *See* ITA, subsec. 233.8.
[1043] *See generally* ITA, Part XIX.

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