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Canadian Tax Laws: A Review of 2016 and a Look Ahead to 2017

Each year at this time, we offer a look back at some of the more significant income tax developments in Canada affecting domestic and international business over the past year and a look ahead to possible Canadian tax developments in the coming year.

I. CANADIAN INCOME TAX REVIEW AND OUTLOOK

A. Developments in 2016

1. *Legislative Developments*

The Liberal government's first full calendar year in office saw legislative changes advancing the new government's tax policy objectives and others furthering commitments made by the Harper government relating to international tax proposals by the Organisation for Economic Co-operation and Development (OECD).

The principal measures were announced as part of the 2016 federal budget, delivered on March 22, 2016. Our comments on these changes, including changes affecting switch fund shares, linked notes and debt parking, are available in our article 2016 Federal Budget: Tax Highlights. These proposals (with certain revisions) were included in draft legislation released on October 21, 2016, and received royal assent on December 15, 2016.

Eligible Capital Property Regime Ends

The year 2016 marked the end of the eligible capital property (ECP) regime, a long-standing feature of the *Income Tax Act* (Canada) (ITA) governing the treatment of goodwill and other intangible property with no fixed life. The ECP regime has been integrated into the existing capital cost allowance (CCA) regime in the ITA, effective January 1, 2017. Although the new rules provide deductions in computing income that are similar to those under the old ECP regime and offer a degree of simplification in this area, the change will have a significant impact on the sales of businesses by Canadian business. This is particularly true for those operating through Canadian-controlled private corporations (CCPCs) – essentially private Canadian corporations that are not controlled by non-residents and/or public companies. The gain on the sale of ECP will now be taxed as a capital gain and subject to the refundable tax anti-deferral mechanism applicable to investment income when realized by a CCPC. For a greater discussion of these changes, see Repeal of the Eligible Capital Property Regime.

Emissions Trading Regime

A new federal emissions trading regime begins for taxation years commencing after 2016. This regime establishes tax rules governing the use and sale of emission allowances by taxpayers that are regulated emitters. Under these rules, emission allowances received by such taxpayers are treated as inventory and are valued at their cost, rather than the "lower of cost or market" approach that generally applies to other types of inventory.

A regulated emitter does not include the receipt of an allowance in its income. When an emission allowance is used to settle an emission obligation, a taxpayer may deduct the cost of the allowance, and no gain or loss will be realized on the disposition of that allowance. Conversely, the sale of an emission allowance to a third party will result in a taxable income to the extent that the proceeds of the sale exceed the cost of the emission allowance. Identical allowances – that is, allowances that have essentially identical terms and can be used to settle the same emission obligation – are subject to a cost averaging rule. Other rules address the treatment of expenses deducted in respect of emission obligations that exist over a period of many years (resulting in a deduction-inclusion cycle in respect of the obligation), and the valuation of an emission allowance in the event of a change of control.

Expansion of 55(2) Anti-Avoidance Rule Enacted

Dividends paid by one Canadian corporation to another are generally received tax-free under the intercorporate dividends-received deduction (DRD). The availability of the DRD is subject to the anti-avoidance rule in subsection 55(2) of the ITA, which has historically prevented the payment of tax-free dividends for the purpose of reducing or avoiding capital gains on the disposition of the shares of the dividend payer. In the 2015 federal budget, the Canadian government proposed to substantially broaden this anti-avoidance rule, applying it to circumstances beyond capital gains stripping transactions. Notwithstanding the numerous submissions received by the Department of Finance expressing concerns with the proposals, they were enacted on June 6, 2016. Clearly, Finance is concerned about abuses of the DRD, evidenced in recent court cases in which challenges to highly structured transactions have been unsuccessful.

The scope of subsection 55(2) has been broadened to apply where a tax-free intercorporate dividend is paid (i) for the purpose of reducing or avoiding capital gains on the disposition of shares; or (ii) where one of the purposes of the dividend is (a) to effect a significant reduction in the fair market value of any share; or (b) to increase the cost of property of the dividend recipient. In addition, the long-standing exception from subsection 55(2) for dividends paid within a related group now applies only to a deemed dividend arising on a redemption or repurchase of a share. The new rules may materially impede the ability of taxpayers to undertake certain creditor-proofing transactions or even to implement ordinary movements of cash within their corporate groups. It has been hoped that through the development of administrative policies, the Canada Revenue Agency (CRA) would provide guidance to corporate groups that routinely move cash by way of dividends, but its comments to date have provided little comfort.

Alternative Basis for Assessment

There is a long-standing principle under Canadian tax law that the CRA may not advance an argument in respect of a disputed tax assessment after the end of the normal reassessment period if that would increase the amount of tax payable under the assessment. Recently, the Federal Court of Appeal in *Last v. The Queen* confirmed that in addition to the above principle, in positing alternative arguments, the CRA must treat each source of income separately and may not advance an alternative argument that would change the amount of tax payable in respect of any particular source of income (in *Last*, the Minister was prohibited from recharacterizing a capital gain as business income after the reassessment period). In response to that decision, subsection 152(9) of the ITA has been amended to permit the Minister to advance alternative arguments – after the end of the normal reassessment period – that may adjust the amount of taxes payable in respect of particular sources of income provided that the total amount of the assessment (from all sources) is not increased.

This change raises concerns for taxpayers required to comply with the large corporation rules, which, among other things, require a taxpayer to specifically identify each issue in a notice of objection and prohibit the raising of new issues at a later date. Unfairness may result if, during the objection process, an alternative basis for reassessment gives rise to a new issue to which the taxpayer did not originally object. This added flexibility afforded to the CRA may also interfere with the tax audit process by undercutting the usefulness of a limited waiver (a commonly used tool that extends the limitation period for a specified issue or issues to facilitate ongoing audit activity) if the CRA now has the ability to recharacterize an amount of income subject to the waiver as being from a different source than the issue to which the waiver relates.

Extension of the Back-to-Back Rules

In 2014, the Canadian government introduced detailed rules (often referred to as the “back-to-back” rules) to prevent the use of intermediaries to reduce withholding taxes on payments of interest to non-residents or to avoid the application of the thin capitalization rules by, for example, having a related non-resident deposit amounts with a financial institution that makes a loan to a Canadian group member. Effective January 2017, the back-to-back rules have been extended to apply to broader categories of inbound transactions and to certain outbound back-to-back transactions.

First, the aspect of the back-to-back rules intended to prevent the use of intermediaries to reduce withholding taxes was expanded by (i) extending their application to structures involving multiple intermediaries; (ii) extending their application to rents, royalties and similar payments (i.e., where there is no loan to a Canadian entity); and (iii) adding “character substitution” rules whereby the back-to-back arrangement to the intermediary involves shares or a lease, licence or similar arrangement rather than a loan. Payments made by Canadian residents under inbound investment structures should be carefully examined particularly in connection with the character substitution rules, which may apply where a non-resident holds shares of the intermediary on which the intermediary is obligated to pay dividends (the amounts of which are determined by reference to interest payments received) or which provide a redemption or retraction right. These new rules also may present significant issues in the context of arm’s-length leasing or licensing arrangements.

Second, the back-to-back rules have also been extended to outbound loans to capture circumstances in which a Canadian corporation attempts to circumvent the shareholder loan rules in the ITA by lending funds to an arm's-length person on condition that the person makes a loan to a shareholder of the corporation (or a connected person or partnership). Where they apply, the Canadian corporation will be deemed to have made a loan directly to the shareholder (or connected person or partnership) and the tax consequences associated with such a loan will follow. These rules have added additional complexity in the context of cash-pooling or notional cash-pooling arrangements involving Canadian and foreign group companies.

Tax Information Exchange

As a participant in the OECD work on base erosion and profit shifting (BEPS), the federal government has adopted country-by-country (CBC) reporting standards developed by the OECD for multinational enterprises (MNEs) in the OECD Report entitled *Action 13: Country-by-Country Reporting Implementation Package*. CBC reporting rules in the ITA apply to fiscal periods of MNE groups beginning on or after January 1, 2016, and are generally expected to apply where the group parent entity is resident in Canada and the group earns annual revenue of €750 million or more. Canada has also committed to spontaneous exchange of tax rulings with other tax administrations that started in 2016.

In addition, Canada has adopted the OECD's Common Reporting Standard (CRS) in new Part XIX of the ITA. The CRS, another product of the BEPS initiative, requires Canada to automatically exchange financial account information with foreign tax authorities and imposes certain due diligence procedures and reporting obligations on financial institutions to generate the required information. The CRS comes into effect on July 1, 2017.

Transfer Pricing and BEPS

In the 2016 budget, the Department of Finance, uniquely states that the CRA is now applying the revised OECD guidance on transfer pricing, which purportedly "provides an improved interpretation of the arm's-length principle." Significantly, however, it stated that the CRA will not adjust its administrative practices at this time in the two most controversial areas of the OECD's BEPS-related transfer pricing work: the proposed simplified approach to low-value-adding services and the treatment of so-called cash boxes that could affect outbound financings of foreign subsidiaries of Canadian multinationals. Canada will decide on a course of action regarding these measures after the OECD completes its follow-up work.

2. ***Judicial Developments***

Solicitor-Client Privilege

In *Canada (Attorney General) v. Chambre des notaires du Québec*, the Supreme Court of Canada considered the constitutionality of provisions in the ITA that permit the CRA to issue a requirement to provide documents or information in respect of a taxpayer to a third party and to enforce the requirement through a compliance order where the third party is a notary or lawyer. The dispute arose when the CRA issued requirements to Québec notaries to provide information regarding certain taxpayers that the notaries believed was protected by solicitor-client privilege (SCP). The CRA unsuccessfully argued at all levels of court that the requirements were valid on the basis of an accounting records exception in the definition of "solicitor-client privilege" in the ITA, which effectively states that accounting records of a lawyer are not communications that are protected by SCP.

The Supreme Court confirmed that SCP is a substantive rule of law and a principle of fundamental justice and must remain as close to absolute as possible. On this basis, the Court ruled that the impugned requirement provisions are unconstitutional and of no force and effect with respect to notaries and lawyers whose records are protected by SCP. With respect to the accounting records exception in the definition of SCP, the Court ruled that it is unconstitutional and invalid for all purposes because of the undue limits it places on SCP. In the companion case, *Canada (Minister of National Revenue) v. Thompson*, which arose in the context of the CRA's attempt to compel a particular lawyer to disclose documents from his law practice relating to particular clients, the Supreme Court affirmed its conclusion with respect to the unconstitutionality of the accounting records exception.

These decisions confirm the absolute nature of SCP and place clear limitations on the scope of information that the CRA can obtain using the requirement procedures in the ITA. Importantly, the Court noted that SCP is a right belonging to, and can only be waived by, a client, and that a lawyer or notary must be given the opportunity to assert SCP on behalf the client so that the client may determine whether an assertion of privilege will be maintained.

The Federal Court recently considered the scope of "common interest privilege" in the transactional context in *Iggillis Holdings Inc. v. Canada (National Revenue)* and concluded that common interest privilege was only available in the litigation context. Read our comments on this decision in Federal Court Refuses to Recognize Common Interest Privilege in the Transactional Context**.**

Interest Deductibility

In *TDL Group Co. v. The Queen,* the Federal Court of Appeal (FCA) confirmed that borrowed money used to make an equity investment in a subsidiary meets the test for interest deductibility under paragraph 20(1)(c) of the ITA, which requires that the funds be used for the purpose of earning income. The funds in question had been borrowed by the taxpayer (TDL) from a related non-resident corporation at interest and used to subscribe for additional shares in its subsidiary, Tim Donut U.S. Limited, Inc. (TDUS). TDUS in turn loaned the funds back to the group parent on an interest-free basis. The interest-free loan remained outstanding for seven months, after which TDUS transferred it to another entity that replaced it with an interest-bearing note. The Tax Court disallowed TDL's interest deduction for the seven-month period in which TDUS was not earning interest on its loan to the group parent. (The Tax Court considered only the interest payable over the initial seven-month period because the CRA had accepted the deductibility of that the interest after the period when the interest-bearing promissory note was put in place.)

The FCA reversed the decision, finding that the Tax Court erred in reading into the purpose test in paragraph 20(1)(c) a requirement that a taxpayer have a reasonable expectation of receiving income during the seven months in which the non-interest bearing loan was outstanding. The FCA held that the correct inquiry was determining TDL's purpose at the time it subscribed for the shares in TDUS. This approach meant that the reasoning of the Tax Court was flawed because it focused on the immediate indirect use of the funds rather than the purpose of the borrowing. The FCA's decision reaffirms that an equity investment in a subsidiary can qualify as having an income-earning purpose even where income may not immediately be realized.

Offshore Investment Fund Property

In *Gerbro v. R.*, the Tax Court of Canada considered whether investments in five offshore hedge funds constituted offshore investment fund property for purposes of subsection 94.1(1) of the ITA. The funds were corporate hedge funds and funds of funds that were managed in low-tax jurisdictions and generally invested in publicly traded securities, commodities or currencies. Subsection 94.1(1) applies where two conditions are met: (i) the taxpayer's investment derives its value primarily from portfolio investments in various assets (the Value Test); and (ii) it may reasonably be considered that one of the taxpayer's main reasons for making the investment was to reduce or defer Canadian taxes relative to a direct investment in the underlying assets (the Motive Test). Where it applies, the taxpayer is imputed a prescribed rate of return on the capital invested in the offshore funds. The CRA took the position that the taxpayer's investments were subject to subsection 94.1(1) and, as a result, substantially increased the taxpayer's income.

The Tax Court commented on both of these tests. For purposes of the Value Test, the Tax Court noted that the ordinary commercial meaning of "portfolio investment" is an investment in which the investor is not able to exercise significant control or influence over the property invested in. Indicators of a controlling stake in an investment included investment above a certain threshold and active involvement in management of the underlying operations. The Court also concluded that the term "portfolio investment" could include inventory of an active investment business.

With respect to the Motive Test, the Court indicated that it is not purely a subjective test and that a taxpayer's stated intention must be objectively reasonable and corroborated with factual evidence. The Motive Test is a "one of the main reasons" test and can be defeated by credible business reasons that demonstrate that obtaining a tax benefit was not one of the main reasons for a particular investment. The Court noted that the purpose of section 94.1 is to achieve capital export neutrality by ensuring that a taxpayer's decision to invest offshore is a neutral decision that is not tax-driven.

Although the particular funds met the Asset Test, the Tax Court allowed the taxpayer's appeal on the basis that the Motive Test under subsection 94.1(1) had not been met because none of the taxpayer's main reasons for investing in the funds was to defer or avoid Canadian taxes. Rather, clear evidence was presented to the Court demonstrating that compelling business reasons, including the reputation of the respective fund managers, drove the decision to invest in those particular funds. *Gerbro* contains instructive commentary regarding the purpose of section 94.1, and sets out a helpful framework for analyzing its application. *Gerbro* is currently on appeal to the FCA.

Rectification

Historically, rectification in common law jurisdictions was granted in limited circumstances in which the parties had reached a prior agreement, but the document evidencing the contract did not reflect the terms of the agreement.

A broader form of rectification was allowed in the Ontario Court of Appeal's 2000 decision in *Juliar v. Canada (Attorney General)*, which permitted rectification of a transaction where the transaction did not achieve the specific tax objective that the taxpayer had intended in undertaking the transaction. In addition, the Supreme Court of Canada in *Québec v. AES* and *Québec v. Riopel* in 2013 permitted rectification of transactions governed by the *Civil Code of Québec*.

After the *Juliar* decision, obtaining rectification orders to correct tax mistakes has become quite common in Canada. However, in reasons released on December 9, 2016, the Supreme Court of Canada tightened the criteria for obtaining rectification by siding with the government in the common law rectification case *Canada (Attorney General) v. Fairmont Hotels Inc.* and its companion civil law rectification case *Jean Coutu Group (PJC) Inc. v. Canada (Attorney General)*. The decision of the majority in *Fairmont* overruled the Ontario Court of Appeal's decision in *Juliar*. The extent of the impact of these decisions on the availability of rectification for tax matters moving forward remains to be seen.

B. Outlook for Canadian Tax Developments in 2017

1. *Changes to 30% Rule for Pension Plan Investments*

Federal legislation governing pension funds and their subsidiaries limits the ability of these entities to invest in shares of a corporation having more than 30% of the votes for the election of the directors of the corporation (the 30% Rule). This rule originated when pension funds were generally limited to passive investments and took no active role in the businesses in which they invested. However, changes in market conditions and the manner in which Canadian pension funds invest have prompted reconsideration of the need for this rule.

In the 2015 federal budget, the federal government announced its intention to review the 30% Rule. Further to that announcement, in June of 2016 it held a public consultation (see Pension Plan Investment in Canada: The 30 Per Cent Rule) in which it invited interested parties to make submissions regarding the policy behind the 30% Rule, the potential risks resulting from its abolishment and whether additional legislation may be required to reduce the effect of such risks. The Department raised the question whether associated tax changes would be appropriate in the context of any change to the 30% Rule. Comments were due on September 16, 2016, and 19 submissions have been published on the government website. No further information has been released to date. It is hoped that the government's response will be communicated in 2017.

The federal government's consultation followed the Ontario government's announcement in 2015 that it would eliminate the 30% Rule for Ontario regulated pension plans (see Ontario Proposes Abolishing the Pension Fund "30% Rule"). The Ontario government has not, to date, eliminated the Ontario 30% rule.

2. *Ratification of the OECD Multilateral Instrument*

In the 2016 budget, the government noted that amendments to Canada's tax treaties to include a treaty anti-abuse rule could be achieved through bilateral negotiations, the multilateral instrument that would be developed in 2016, or a combination of the two.

On November 24, 2016, members of an ad hoc group consisting of more than 100 jurisdictions under the aegis of the OECD concluded negotiations of the *Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting* (MLI). The MLI, developed through the BEPS process, is intended to be an instrument that can be used to uniformly and efficiently implement recommendations regarding tax treaty policy and practice across thousands of bilateral tax treaties between participating jurisdictions. The key provisions are aimed at (i) targeting certain “hybrid mismatch arrangements” by denying treaty benefits in certain circumstances and introducing an optional tie-breaker rule; (ii) preventing treaty abuse by introducing a principal purpose test and a limitation-on-benefits provision; (iii) preventing the artificial avoidance of permanent establishment (PE) status by lowering the PE threshold in certain circumstances; and (iv) improving dispute resolution between jurisdictions by introducing minimum standards for the mutual agreement procedure.

The MLI opened for signature on December 31, 2016, and will enter into force after it has been ratified by at least five countries. The instrument allows signatories to select among various options in respect of many of its provisions, and each country must choose which set of options it wishes to apply, which rights it intends to reserve and which of its tax treaties will be covered by the MLI. The MLI is intended to provide a streamlined process for the implementation of these BEPS measures and to avoid the lengthy bilateral negotiations between individual jurisdictions that would be required if proceeding treaty by treaty.

If Canada chooses to adopt the MLI, Parliament must ratify it before its provisions become binding in Canada. The Department of Finance was heavily involved in the negotiation of the MLI but has stated that it has not determined which aspects of the MLI it will adopt. It has stated that a government decision on which items it will adopt might be reported by the time of the next federal budget. It is expected that 2017 will bring about further developments in this regard, and provide some evidence more generally on whether the MLI will be widely adopted and whether it has in fact materially simplified the implementation of BEPS into bilateral tax conventions. A looming question in this regard is the position of the United States with respect to the MLI, because it is widely considered not to look favorably on a multilateral approach that is inconsistent in any material way with its own approach to tax treaties.

If you have any questions regarding the foregoing, please contact Ian Crosbie (416.367.6958) or Raj Juneja (416.863.5508), in our Toronto office; or Nathan Boidman (514.841.6409), Brian Bloom (514.841.6505), Marie-Emmanuelle Vaillancourt (514.841.6543) or Michael Kandev (514.841.6556) in our Montréal office.