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Draft federal tax legislation package released

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On August 9, 2022, the Canadian federal government released a package of draft legislation to implement various tax measures, update certain previously released draft legislation, and make certain technical changes (Proposal). The draft legislation includes measures first announced in the 2022 Federal Budget, with updated versions of draft legislation released earlier this year, including the mandatory disclosure rules released in February 2022. The news release that accompanied the Proposal invites Canadians to make submissions with respect to the Proposal by September 30, 2022.

The federal government also opened a consultation on potential changes to Canada's General Anti-Avoidance Rule (GAAR), first proposed in the 2020 Fall Economic Statement, and released an accompanying consultation paper. Submissions for the consultation will be accepted until September 30, 2022.

This Update focuses on what is new in the Proposal compared to the original proposal or previously released draft legislation. For further details of the draft legislation released in February 2022, please see our Osler Update dated February 7, 2022. For further details about the proposal first made in Budget 2022, please see our Osler Update dated April 7, 2022.

A list of the other principal tax measures included in the Proposal, including various important proposed technical tax amendments, is included below at the end of this Update.

The following areas are covered in this Update:

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Mandatory disclosure rules

The Proposal amends the mandatory disclosure rules, first released in draft in February 2022, by delaying their application by one year. Those rules will now apply to transactions entered into or taxation years that begin, as applicable, after 2022.

The amended reportable transaction rules set out three generic hallmarks and provide that, where any one of those hallmarks apply, the transaction is a reportable transaction. Briefly, these three hallmarks are: (1) a promoter or tax advisor is entitled to contingent fees with respect to the transaction based on tax benefits obtained under the transaction or the number of taxpayers who participate; (2) a promoter or tax advisor requires “confidential protection” with respect to the transaction; and (3) the taxpayer or certain other persons obtain “contractual protection” with respect to the transaction, including certain forms of insurance against a failure to achieve the intended tax benefit.

The Proposal amends the second and third hallmarks to address concerns relating to the broad scope of confidential and contractual protection that can produce unintended results and affect *bona fide* transactions.

The Proposal narrows the second hallmark such that the confidential protection must now specifically involve the tax treatment of the avoidance transaction or series of transactions.

For the third hallmark regarding contractual protection, the Proposal clarifies which normal commercial transactions are carved out and therefore not reportable. The Proposal removes the requirement that such contractual protection be offered to a broad class of persons and adds a requirement that the contractual protection cannot be for a tax treatment with respect to an avoidance transaction. Unfortunately, certain technical issues remain with the exceptions that will hopefully be further clarified and amended in order to give effect to the intended tax policy result.

The Proposal also modifies the (re)assessment period applicable if information returns relating to reportable transactions, notifiable transactions, or uncertain tax positions are late filed. The original draft required any (re)assessment to be made within three years of the return being filed. The Proposal increases this period to four years for taxpayers that are mutual fund trusts or corporations that are not Canadian-controlled private corporations, which aligns with the normal reassessment periods in subsection 152(3.1) of the *Income Tax Act* (ITA).

The reportable transaction rules, both current and as amended, do not require the disclosure of solicitor-client privileged information. The rules use a modified definition of “solicitor-client privilege” that is narrower than the common law meaning of the term. This definition was held to be unconstitutional by the Supreme Court of Canada in 2016. The Proposal repeals the definition of “solicitor-client privilege” currently applicable to the reportable transaction rules. In the absence of a defined term, the common law definition of solicitor-client privilege should apply.

Persons that provide only clerical or secretarial services with respect to the planning are now excluded from filing information returns in respect of reportable and notifiable transactions.

Banks, insurance companies, and credit unions should usually be exempt from filing obligations with respect to notifiable transactions in respect of which they only act as an advisor or promoter (or do not deal at arm’s length with a relevant advisor or promoter and are entitled to a fee in respective of that notifiable transaction). However, this exemption does not apply where the financial institution knows (or would reasonably be expected to

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know but for circumstances amounting to gross negligence) that relevant transaction is a notifiable transaction.

Finally, the Proposal clarifies that, where an employer or a partnership files a required information return with respect to a notifiable transaction, each employee of the employer or partner of the partnership, as the case may be, is deemed to have made that filing.

GAAR consultation

In the 2020 Fall Economic Statement, the federal government announced its intention to initiate a public consultation on modernizing Canada's anti-avoidance rules, including the GAAR. In Budget 2022, the federal government maintained its intention to "strengthen" the GAAR to prevent abusive tax-avoidance transactions, but noted that the GAAR should not interfere with legitimate commercial and family arrangements. Nearly two years after announcing this public consultation, the government has now released a consultation paper and announced that it will accept "written representations on the relative merits of the approaches" that are submitted by September 30, 2022.

The consultation paper describes potential sweeping changes to the GAAR. While the government has identified a number of areas in which the scope of the GAAR could be expanded, in our view, it has not clearly articulated why it believes the current law falls short of meeting the objective of preventing abusive tax avoidance — nor has it grappled with the courts' attempts to balance this objective against the need for certainty, predictability and fairness, or why this balance has been inappropriately struck in the cases to date. Instead, the paper simply identifies 24 GAAR cases that the Crown has lost (while observing that the Canada Revenue Agency (CRA) has applied the GAAR as a basis for assessing in more than 1300 instances), and suggests a menu of revisions intended to reverse the judicial interpretation in those cases.

Many of the suggested revisions are likely to impact ordinary routine tax planning and effectively undermine the long-established principle recently upheld by the Supreme Court of Canada in *Loblaw Financial Holdings,* that a taxpayer is entitled to order its affairs to minimize tax. Organizations that have concerns about the government's proposal are urged to provide their comments to the Department of Finance by the September 30th deadline.

The consultation paper solicits input on five issues.

Existence of a tax benefit

Budget 2022 expanded the definition of a tax benefit to include the accumulation of tax attributes that may result in a future deferral or reduction of tax. This expansion is targeted at tax planning transactions designed to augment, but not immediately utilize, tax attributes such as paid-up capital (see e.g., *Wild*).

The government generally seeks input as to whether there are further changes required to the definition of a tax benefit in order to adequately capture aggressive tax planning.

Existence of an avoidance transaction

The avoidance transaction analysis considers whether each transaction or event at issue occurs primarily for *bona fide* non-tax reasons. If so, there is no avoidance transaction.

The consultation paper asserts that two cases — one of which was decided before the seminal *Canada Trustco* decision that set out the courts' current approach to the GAAR — illustrate a "fundamental problem" with the current purpose-based avoidance transaction test (*Spruce Credit and Canadian Pacific Ltd.*). Those cases affirm that the specific transaction will not be an avoidance transaction if it has a primary business purpose, notwithstanding that a different commercial transaction to achieve the same business purpose would give rise to higher taxes. The paper suggests the following possible measures to effectively override this well-established case law:

1. Providing an interpretive rule to specify what is not a "*bona fide*" purpose.
2. Extending the definition of "transaction" to include a choice.
3. Reducing the "primarily" threshold to align the GAAR with anti-avoidance rules of other jurisdictions and other specific anti-avoidance provisions of the ITA.

Each of the proposed measures significantly narrows taxpayers' ability to plan commercial transactions in a tax-efficient manner. The case law is clear that there is no obligation to structure a transaction in a manner that maximizes tax; "recharacterization" of transactions and imposing a results-oriented approach upon taxpayers should not be permitted for the purpose of determining the existence of an avoidance transaction. The consultation paper does not explain in what respect this tenet fails to strike an appropriate balance between legislative clarity and the prevention of abuse.

Misuse or abuse

A determination as to whether there has been misuse or abuse of the ITA by looking to the object, spirit and purpose of the provisions is not always straightforward. Generally, the Crown bears the onus to make submissions to explain why the transaction(s) undertaken are abusive, and the courts have held that it must do so in order to support a GAAR assessment.

The consultation paper suggests the following measures:

1. Preambulatory language and purpose statements in the ITA.
2. Emphasis on purpose in extrinsic documentation, such as explanatory notes.
3. Greater emphasis on the "abuse of the Act read as a whole".
4. Inclusion of an interpretive rule.
5. Shifting the burden of proof to the taxpayer.

Purpose statements and greater statutory clarity benefit everyone. However, the emphasis on purpose in extrinsic documentation enables the government to adopt, and subsequently rely on, its own self-serving language in connection with proposed legislation. Extrinsic documentation such as explanatory notes expresses the views of the government and not necessarily the will of Parliament. The shifting of the burden of proof to the taxpayer is also problematic. As the Supreme Court of Canada observed in *Canada Trustco,* "[t]he Minister is in a better position than the taxpayer to make submissions on legislative intent with a view to interpreting the provisions harmoniously within the broader statutory scheme that is relevant to the transaction at issue".

Economic substance

It is long settled that Canadian tax legislation focuses on the legal form and substance of the transactions undertaken and, absent a specific rule to the contrary, does not recharacterize such transactions according to a view of their economic substance (*Shell Canada*). GAAR cases before the Supreme Court of Canada have explicitly rejected arguments to the effect that any transaction that the Crown says "lacks economic substance" is inherently abusive as vague and lacking grounding in the ITA provisions that are alleged to have been abused.

The consultation paper asserts that the avoidance transaction test implicitly imports an economic substance test by looking to the primary purpose of a transaction because transactions that are purely tax-driven will lack economic substance. The paper solicits input on three measures in this regard:

1. Determining the meaning of economic substance, for example, by introducing a sole or dominant purpose test, assessing whether a transaction yields pre-tax profit, determining whether there are transfers of rights between the parties to a transaction, or comparing legal form and accounting treatment.
2. Integrating economic substance into the GAAR itself, for example, by importing it into the avoidance transaction test, adding it as its own deeming rule, forming an interpretive rule based on it or integrating it into the misuse or abuse analysis.
3. Imposing other consequences where a transaction is found to lack economic substance, for example, by automatically deeming the transaction to be abusive, shifting the burden of proof to the taxpayer with respect to misuse or abuse, applying a more stringent misuse or abuse test, or adjusting the reasonable tax consequences in subsection 245(5).

The consultation paper falls short of articulating the GAAR's shortcoming in addressing "economic substance" or why it would be appropriate to effectively abandon the discipline imposed by the misuse or abuse component of the GAAR.

Penalties

The government is concerned that there are insufficient deterrents for abusive tax planning measures and the "reasonable" tax consequences result does not, in its view, sufficiently dissuade taxpayers from engaging in abusive tax planning.

The consultation paper sets out several options to address the issue, including a penalty based on a percentage of the tax benefit, increasing the interest rate on GAAR assessments, and extending the reassessment period for GAAR assessments.

Hedging and short selling by Canadian financial institutions

The ITA provides that, where there is in respect of a share a "dividend rental arrangement" as defined in subsection 248(1) of the ITA, the inter-corporate dividend deduction will not apply to dividends received on the share. As described in our prior Update, Budget 2022 contained provisions that would expand the existing "dividend rental arrangement" definition to include newly defined "specified hedging transactions" that are carried out in whole or in part by registered securities dealers. The Proposal amends the "specified hedging transaction" definition and modifications to the "dividend rental arrangement" definition proposed in Budget 2022 in a number of respects, including:

- to clarify that, where a transaction or series of transactions satisfies the conditions in the definition of a "specified hedging transaction", the transaction or series will be a "dividend rental arrangement" as a result of proposed paragraph (b.1) (i.e., because it is a "specified hedging transaction") and not existing paragraph (c) of the "dividend rental arrangement"

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definition.

- to require that, in determining whether a "specified hedging transaction" has the effect, or would have the effect, of eliminating all or substantially all of the risk of loss and opportunity for gain or profit in respect of the relevant share, regard should not be had to any other transaction or series of transactions that may have been entered in respect of that share.
    - explanatory notes accompanying the Proposal provide an example of how this new proposed requirement is to be interpreted
- to require that, absent the application of the Proposal, a deduction would have been available to the registered securities dealer in respect of an amount paid by it under a "securities lending arrangement" as defined in subsection 260(1) of the ITA, where the amount relates to a taxable dividend paid on the share and is deemed to be received as a taxable dividend by the recipient of the amount
- to clarify that a transaction or series entered into by a registered securities dealer is not a "specified hedging transaction" unless the registered securities dealer or a person otherwise entitled to the inter-corporate dividend deduction that is related to or affiliated with the registered securities dealer knew or ought to have known that the transaction eliminated all or substantially all of the risk of loss and opportunity for gain or profit in respect of the share.

Canada Recovery Dividend and additional tax on banks and life insurers

The Proposal includes draft implementing legislation for the "Canada Recovery Dividend", the Budget 2022 proposal for a one-time 15% tax on the taxable income of certain bank or life insurer groups. The tax under draft Part VI.2 of the ITA would apply to every corporation that is a bank, a life insurance corporation that carries on business in Canada, or any financial institution (as defined for purposes of Part VI of the ITA) related to such an entity (a bank or life insurer group member).

Contrary to the Budget 2022 proposal that the Canada Recovery Dividend would be computed exclusively based on a bank or life insurer group member's taxable income for the 2021 taxation year, the draft legislation provides that the tax would be calculated on the average of the taxable incomes of the member for its 2020 and 2021 taxation years. Specifically, the draft rules provide for a tax of 15% on the excess of such average taxable income over a $1-billion exemption. The draft legislation includes provisions apparently intended to allow related groups of bank or life insurer group members to allocate the $1-billion exemption amongst them by filing an agreement in prescribed form with the Minister of National Revenue (Minister).

The proposed tax would be payable in equal instalments by the entity's balance-due day for its 2022 taxation year and the four subsequent taxation years. The draft legislation includes rules dealing with multiple taxation years ending within a relevant calendar year, amendments to reference draft Part VI.2 in other relevant provisions of the ITA (including the continuation of attributes following certain amalgamations and windings-up and the deduction from capital tax payable under Part VI of the ITA), and various provisions dealing with administration, enforcement, and disputes.

The additional tax on banks and life insurers is applicable to the same taxpayers as the

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Canada Recovery Dividend ("bank or life insurer group member" at any time in the taxation year). It will be an ongoing tax applicable to taxation years ending after April 7, 2022 (Budget Day), prorated for the first year based on the number of days in the taxation year that are after Budget Day.

The new tax consists of 1.5% of either taxable income for the year or taxable income earned in Canada if the corporation is a non-resident, less $100 million (prorated for short tax years). The $100 million exemption can be allocated amongst a related group of bank or life insurer group members in a similar manner to the Canada Recovery Dividend $1-billion exemption, namely by filing an agreement in prescribed form with the Minister.

The Proposal includes an anti-avoidance rule that reverses any deduction in computing the income of a corporation if (a) it is in respect of an amount that can reasonably considered to have been paid or payable directly or indirectly to a non-arm's length person or partnership, (b) the person or partnership was not a bank or life insurer group member, and (c) it can reasonably be considered that one of the purposes of the payment was to reduce tax payable under this provision.

Substantive CCPCs

The Proposal includes draft legislation implementing the Budget 2022 measures aimed at the perceived avoidance of the anti-deferral rules applicable to Canadian-controlled private corporations (CCPCs) earning investment income. To address this concern, Budget 2022 proposed to create a new category of corporation that, while not technically a CCPC, will be taxed as if it were a CCPC on the basis that the corporation is a "substantive CCPC." A substantive CCPC would be subject to the same additional refundable taxes that apply to a CCPC that earns investment income.

The Proposal is generally in line with the measures announced in Budget 2022, including the proposed addition of an anti-avoidance rule in subsection 248(3) that intends to deem a non-CCPC that would otherwise fall outside the definition of substantive CCPC, to be a substantive CCPC where it is reasonable to consider that one of the purposes of a transaction, or series of transactions, was to avoid substantive CCPC status. The explanatory notes that accompanied the Proposal provide two examples of when the Department of Finance would expect the anti-avoidance rule to apply.

In the first example, skinny voting shares are issued to the non-resident children of three Canadian individual shareholders of a corporation, thereby causing the corporation to lose its CCPC status shortly before the CCPC realizes a significant capital gain. The individual shareholders claim the skinny voting shares were issued for estate planning purposes. The Department of Finance appears to apply a results-based approach to the "one of the purposes" test in this example, stating that "absent clear facts indicating otherwise" the anti-avoidance rule should apply to deem the corporation to be a substantive CCPC at the time the capital gain is realized because, but for the issuance of the skinny voting shares, the corporation would have been a CCPC at that time.

The second example considers a situation where a corporation is owned by a limited partnership that is a "Canadian partnership" and of which the general partner is a Canadian resident corporation wholly owned by a Canadian individual (GPCo). In that example, the corporation loses its CCPC status shortly before realizing a capital gain because the sole Canadian shareholder of the GPCo sells the GPCo shares to a non-resident individual. The Department of Finance takes a similar approach in this example, asserting that the anti-avoidance rule should apply because, but for the sale of the GPCo shares, the corporation would not have lost its CCPC status.

In both examples, the Department of Finance also states that the corporation may become a substantive CCPC merely because one or more Canadian residents maintains *de facto* control over the corporation and therefore it is not necessary to apply subsection 248(23).

Finally, in keeping with the anti-avoidance nature of the substantive CCPC measures, the Proposal confirms that substantive CCPCs will not be eligible for certain benefits provided to CCPCs, such as the enhanced credit for scientific research and experimental development and the small business deduction.

If enacted, the draft legislation would generally apply to taxation years that end on or after April 7, 2022. However, the effective date of certain provisions is extended in the context of arm's length share sale transactions agreed to before April 7, 2022 that meet certain conditions.

Deferring tax using foreign-resident corporations

The Proposal also includes draft legislation implementing the measures announced in Budget 2022 targeting the perceived tax-deferral advantage of a CCPC earning investment income through a controlled foreign affiliate (CFA).

Under current rules, if a CFA of a CCPC earns investment income that is included in its foreign accrual property income (FAPI), that FAPI is attributed to the CCPC in the year it is earned by the CFA. Provided the CFA is subject to foreign tax at a rate of at least 25%, the CCPC is able to claim a "foreign accrual tax" (FAT) deduction to offset the FAPI income inclusion and effectively shelter the investment income from the CCPC anti-deferral taxes that would otherwise apply if the CCPC had earned the investment income directly. As announced in Budget 2022, the Proposal addresses this perceived advantage by applying the same relevant tax factor (which is used to calculate the FAT deduction) to CCPCs and substantive CCPCs as the relevant tax factor that currently applies to individuals. As a result, if a CFA of a CCPC (or a substantive CCPC) is paying foreign tax on its investment income at a rate lower than 52.63%, the FAT deduction should not fully offset the FAPI inclusion. The Proposal also includes amendments to address the integration of FAPI once repatriated to and distributed by CCPCs and substantive CCPCs to individual shareholders.

The draft legislation is generally consistent with the Budget 2022 announcement. One notable difference is that the draft legislation also reduces the relevant tax factor of a partnership where one or more members of which are CCPCs or substantive CCPCs.

Unfortunately, the draft legislation does not provide any carveouts for FAPI that would not qualify as aggregate investment income (and be subject to CCPC anti-deferral rules) if that income had been earned directly by the CCPC — for example, services income earned by a CFA that is included in FAPI because of the recharacterization rule in paragraph 95(2)(b), or income from foreign real estate development activities that qualify as an "investment business" (as defined in subsection 95(1)). At the Finance Roundtable at the IFA Canada Tax Conference in May 2022, the Department of Finance indicated it would consider taxpayer proposal for specific FAPI carveouts; affected taxpayers should consider making submissions to the Department of Finance by the September 30, 2022 deadline.

If enacted, the change in the relevant tax factor rule would apply to taxation years that begin on or after April 7, 2022.

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Borrowing by defined benefit plans

Budget 2022 proposed to amend the borrowing restrictions applicable to registered defined benefit pension plans that are not individual pension plans (a DB plan) to remove the 90-day borrowing limit and implement a new restriction for borrowings not related to the acquisition of real property. In particular, the Budget proposed that a DB plan may borrow money for purposes other than acquiring real property provided that the aggregate of all such borrowings is equal to the lesser of (i) 20% of plan net assets, computed as the excess, if any, of the value of the DB plan's assets over the amount of its outstanding borrowings (plan net assets); and (ii) the amount, if any, by which 125% of the DB plan's actuarial liabilities exceeds plan net assets (the Formulaic Borrowing Limit).

While making no changes to the draft legislation released with the Budget, the Department of Finance clarified two matters regarding the Formulaic Borrowing Limit in the newly released explanatory notes: (1) all outstanding borrowings, including real estate-related borrowings, must be deducted in computing plan net assets; and (2) going concern valuation (rather than, for example, a solvency or wind-up valuation) is used to determine actuarial liabilities.

Electronic filing

Budget 2021 proposed a number of measures to facilitate increased tax compliance and administration under the ITA and the *Excise Tax Act* (ETA) through electronic means. These measures were to come into force on royal assent of the enacting legislation or on specific dates if otherwise expressly provided. The Proposal makes a few modifications to previously released draft legislation and postpones some effective dates as follows:

- Where an individual taxpayer files their income return electronically, the Proposal provides that the Minister may only send certain notices of assessment under the ITA electronically if the individual authorizes that notices and other communications may be made available in this manner and has not revoked their authorization. The previous draft allowed the Minister to send notices of assessment electronically to any taxpayer that submits their income return electronically; this permission still applies to all non-individual taxpayers. This measure and the lowering of the threshold for mandatory electronic filing of income tax returns by certain tax preparers from 10 to five returns are postponed to January 1, 2024 instead of January 1, 2022.
- The effective date of the following previously proposed changes is postponed to taxation years beginning, payments and remittances made, or information returns filed after 2023 instead of 2021:
  - The lowering of the threshold for mandatory electronic filing of income tax information returns for a calendar year under the ITA from 50 to five returns, plus related penalty
  - The elimination of the thresholds for mandatory electronic filing of returns of corporations under the ITA and for most GST/HST registrants under the ETA
  - The clarification that payments required to be made at a financial institution under the ITA and the ETA include online payments through such institution
  - The requirement that remittances over $10,000 under the ITA must be made by electronic payment, plus related penalty

- The lowering of the threshold for mandatory remittances under the ETA to be made at a financial institution from $50,000 to $10,000, plus related penalty.

Avoidance of tax debts

As noted in our February 7, 2022 update, section 160 of the ITA is a tax debt collection provision applicable to persons who receive a transfer of property from a non-arm's length person for insufficient consideration. In these circumstances, section 160 makes the transferee jointly liable for the transferor's tax debts that arise before the end of the tax year in which the transfer was made, with such liability being limited to the lesser of (1) the insufficiency of the consideration given by the transferee; and (2) the amount of the transferor's tax debt.

The Proposal revises the calculation of the insufficiency of consideration given by the transferee to provide a continuity rule in cases where the consideration given is cancelled or extinguished and other property is substituted for the consideration. Under the Proposal, if the consideration given by the transferee is in a form that is cancelled or extinguished during the period beginning immediately prior to the transaction or series of transactions and ending immediately after the transaction or series of transactions, and any property is substituted for that consideration, then the lowest fair market value of the substituted property during that period will be considered in calculating the insufficiency of the consideration. If the consideration given by the transferee is in a form that is cancelled or extinguished in that period, and is not substituted for another property, then the insufficiency of the consideration will be calculated as if the fair market value of the consideration given was nil.

The Proposal also changes the scope of the third-party civil penalty regime for section 160 planning activity. Under the Proposal, a person may be subject to the penalty for section 160 avoidance planning activity where "one of the purposes" of the transaction or series of transactions was to reduce a transferee's section 160 liability or to reduce the person's or another person's ability to pay any amount owing or that may become owing under the ITA by that person. Under the previous proposal, the penalty could not apply unless the transaction or series had as "one of its main purposes" the reduction of a transferee's section 160 liability.

Fixing contribution errors in defined contribution pension plans

Budget 2021 proposed to give administrators of defined contribution (DC) pension plans more flexibility to correct prior years' errors with respect to the amounts contributed to a DC plan by employees or employers. Draft legislation for this proposal was released on February 4, 2022.

The Proposal doubles the time allowed to correct a contribution error from five years to 10 years and adjusts the formula for computing the maximum permitted corrective contribution. The Proposal also clarifies that, although the amendments are deemed to have come into force on January 1, 2021, the earliest due date for filing any required information forms is 60 days after royal assent.

Select Luxury Items Tax Regulations

The Proposal includes the Select Luxury Items Tax Regulations (Luxury Tax Regulations). The Luxury Tax Regulations follow on the announcement in Budget 2021 that the federal government would impose a new tax on certain vehicles, vessels, and aircraft. That proposal was given effect in the Select Luxury Items Tax Act (Luxury Tax Act), which received royal assent earlier this year and will generally come into effect on September 1, 2022.

The Luxury Tax Regulations prescribe certain additional details for purposes of the Luxury Tax Act. Specifically, these details include the following:

- **Exemption certificates for subject aircraft**: Under the Luxury Tax Act, if an "exemption certificate" applies with respect to the sale of a luxury item, luxury tax may not apply to the sale. The Luxury Tax Regulations prescribe certain additional circumstances wherein an exemption certificate may apply to a sale of a subject aircraft for export.
- **Information returns**: The Luxury Tax Regulations prescribe registered vendors of subject vehicles (to the extent not otherwise registered or required to be registered) as being excluded from the obligation to file certain information returns.
- **Agreements before 2022**: The Luxury Tax Regulations also provide that luxury tax is not payable in certain circumstances where a written agreement was entered into prior to 2022 for the sale of a subject item in the ordinary course of the vendor's business of selling that type of subject item.

The Luxury Tax Regulations also follow the release of materials in recent weeks by the CRA relating to the administration of the Luxury Tax Act. In particular, the CRA has released several forms and returns, as well as provided administrative guidance relating to registration for the tax and the application of the tax to vehicles specifically.

Flow-through shares for oil, gas, and coal activities

As set out in Budget 2022, the Proposal includes draft legislation eliminating the flow-through share regime for oil, gas, and coal activities.

Flow-through share agreements entered into by March 31, 2023 are grandfathered as originally announced.

Critical mineral exploration tax credit (CMETC)

The Proposal introduces the 30% investment tax credit for flow-through critical mineral mining expenditures as proposed in Budget 2022. The CMETC is only available to individuals with respect to specified surface "grass-roots" exploration for certain "critical minerals" — namely, copper, nickel, lithium, cobalt, graphite, rare earth elements, scandium, titanium, gallium, vanadium, tellurium, magnesium, zinc, platinum group metals, and uranium.

In general terms, expenditures must be "Canadian exploration expenses" incurred after April 7, 2022 by a corporation conducting mining exploration activity from, or above, the surface of the earth primarily targeting critical minerals (i.e., mineral deposits containing more than 50% critical minerals). Activities such as trenching, digging test pits, and preliminary sampling unless otherwise specified are not eligible expenses.

As expected, the CMETC generally follows the current rules in place for the 15% Mineral Exploration Tax Credit. Eligible expenditures are not permitted to benefit from both tax credits.

Eligible expenses must be renounced under a flow-through share agreement made after

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April 7, 2022 and on or before March 31, 2027.

Investment tax credit for carbon capture, utilization, and storage (CCUS)

The CCUS Credit

New section 127.44 and the accompanying regulations in the Proposal provide for a refundable investment tax credit with respect to expenditures relating to carbon capture, utilization, and storage projects (CCUS Credit). The CCUS Credit applies to qualifying expenditures incurred beginning January 1, 2022 and ending before January 1, 2041. As anticipated, Schedule II of the *Income Tax Regulations* is amended to introduce four new capital cost allowance (CCA) classes and rates that are deemed to have come into force on January 1, 2022.

The amount of the CCUS Credit that taxpayers can claim is limited to the specified percentage of each type of “qualified CCUS expenditure” incurred by that taxpayer in the year, which are: (a) a “qualified carbon capture expenditure”, (b) a “qualified carbon transportation expenditure”, (c) a “qualified carbon storage expenditure”, and (d) a “qualified carbon use expenditure”.

The Proposal is generally consistent with Budget 2022 and confirms:

- The CCUS Credit reduces a taxpayer’s Part I tax liability and is refundable in circumstances where the CCUS Credit exceeds the taxpayer’s liability under Part I of the ITA.
- The CCUS Credit rate depends on the type of qualified of CCUS expenditure and varies based on whether the carbon is captured directly from the ambient air. The rates in the Proposal follow those announced in Budget 2022 as described in our prior Update.
- A qualified “CCUS project” supports the capture of CO_2 in Canada. Although CO_2 must be captured in Canada, it may be stored or used outside Canada.
- Expenditures for property located outside of Canada are excluded from the CCUS Credit.
- Taxpayers must track the amount of CO_2 being captured and monitor the portions of CO2 for eligible and ineligible uses.
- Jurisdictions with sufficient regulations to permit dedicated geological storage to ensure the permanent storage of CO_2 currently include only Alberta and Saskatchewan.
- For storage in concrete, the CCUS Credit is available in all jurisdictions provided the appropriate process for storing CO_2 obtains regulatory approval and at least 60% of the CO_2 that is injected into the concrete is mineralized and locked into the concrete produced.
- Taxpayers must file a project plan for a qualified CCUS project with the Minister of Natural Resources detailing a front-end engineering study and describing the quantity of captured CO_2 that the project is expected to support for storage or use in eligible and ineligible uses over the life of the project.

To qualify as a CCUS project, the Proposal requires the proportion of CO_2 expected to be stored or used in an eligible use be at least 10% of the total CO_2 expected to be stored or used in either an eligible or ineligible use.

Additional clarification regarding different types of qualified carbon capture expenditures is provided in the Proposal. Notably, the portion of expenses that are “qualified carbon storage expenditures” or “qualified carbon transportation expenditures” can be prorated based on the eligible and ineligible uses over the first 20 years of the operation of the CCUS project. In comparison, “qualified carbon storage expenditures” and “qualified carbon use expenditures” must solely be used in a manner that meets requirements for eligible uses.

CCUS expenditures are reduced by certain amounts including: (a) expenditures incurred before 2022 or after 2040; (b) expenditures for property previously used or for which a CCUS Credit was previously deducted or claimed (or sought to be deducted or claimed); (c) expenditures for feasibility or front-end engineering studies; (d) amounts capitalized under section 21 of the ITA; and (e) non-government assistance that, at the time of the filing, the taxpayer received or was entitled to receive, with respect to the qualified CCUS expenditure for the year (including an expenditure incurred by a trust or partnership of which the taxpayer is a beneficiary or a member).

The Proposal clarifies that a new project plan is required to be filed if there is a change to the project or as requested by the Minister. If more than 5% of the quantity of captured carbon the project is expected to support for storage or use in eligible use during any five-year period over the life of the project is reduced, a new project plan is required to be filed. Reporting requirements related to the knowledge sharing and climate risk disclosure proposed in Budget 2022 were not addressed.

The Proposal provides the Minister with the authority to determine whether a process meets the definition of a “CCUS process” or “CCUS project” or alternatively whether a project should be characterized as multiple projects. Importantly, this can affect the portion of qualified expenditures claimed and the proportion of captured carbon for a particular qualified CCUS project.

CCA Classes

The new rules also provide details on the four new CCA classes:

1. Class 57 (8%) is a broad category and includes:
   1. equipment used solely to capture CO_2, transport captured CO_2 (and related preparation and compression equipment), or store CO_2 in a geological formation
   2. power or heat generation equipment solely used to support the CCUS process
   3. buildings and other structures, all or substantially of which are used to install or operate equipment used solely for CO_2 capture, transportation, or storage
   4. property used to convert property for use in CO_2 capture, transport, or storage It does not include storage for the purpose of enhanced oil recovery.
2. Class 58 (20%) includes equipment used solely for using CO_2 in industrial production, including storage for enhanced oil recovery, buildings and other structures all or substantially all of which are used for the installation or operation of equipment for using CO_2 in industrial production, and property solely used to convert other property for use of CO_2 in industrial production.
3. Class 59 (100%) includes expenditures with respect to the CCUS process that are similar to Canadian exploration expenses, including expenses to determine the existence, location, or quality of a geological formation for CO_2 storage, environmental studies or community

consultations, and expenses relating to enhanced oil recovery; expenses relating to enhanced oil recovery and described in Class 60 are excluded.

4. Class 60 (30%) includes expenses with respect to the CCUS process that are similar to Canadian development expenses, including those incurred in drilling, converting, or completing a well in Canada for permanent CO_2 storage or monitoring pressure and other changes, and expenditures for building a temporary access road or preparing a site with respect to wells for CO_2 storage; a well does not include a well that could also be used for enhanced oil recovery.

Technical amendments

The technical amendments included in the Proposal range widely in both their subject matter and in the significance of their change. While some amendments are to correct clear typographical errors, others are more substantive. Two of these substantive amendments are discussed below.

Umbrella Trusts and FAPI Rules

Where section 94.2 applies to a particular beneficiary's investment in a non-resident commercial trust (NRC Trust), subsection 94.2(2) deems the trust to be a controlled foreign affiliate (CFA) of a Canadian taxpayer that is either its beneficiary directly or that has a CFA that is the NRC Trust's beneficiary. As a result, the NRC Trust will be brought into the FAPI regime for the purposes of applying subsections 91(1) to (4), paragraph 94.1(1)(a), section 94.2, section 95, and section 233.4, and the beneficiary of the NRC Trust must include its portion of the NRC Trust's FAPI in its income under subsection 91(1). Subsection 94.2(3) is intended to prevent double taxation by recognizing and taking into account the ITA's income inclusion method for distributions of trust income to beneficiaries — subsection 104(13) — in computing the amounts that must be included in income as FAPI as a result of section 94.2.

Some NRC Trusts organized in certain jurisdictions outside Canada may issue multiple classes of trust interests, each tracking the returns of a separate and segregated portfolio. Where section 94.2 applies to one of these so-called umbrella trusts, there generally would be a single CFA comprised of all of the sub-funds, notwithstanding that the Canadian taxpayer may only have economic exposure to one sub-fund. Accordingly, for NRC Trusts that are structured as umbrella trusts, there are instances where the interaction of the FAPI rules and section 94.2 could result in a beneficiary picking up FAPI attributable to sub-funds of the umbrella trusts that they are not invested in. New subsection 94.2(5) is meant to ensure that, when subsection 94.2(2) applies to a NRC Trust organized as an umbrella trust and a Canadian taxpayer (or its CFA) as a beneficiary is exposed to a particular sub-fund, subsection 95(11) of the existing tracking interest rules applies (as modified). The result is that, when determining the portion of the umbrella trust's FAPI that is attributable to the beneficiary under subsection 91(1), it is only the income, gains and losses of the particular sub-fund that is picked up in the beneficiary's income.

A separate rule proposed in a prior Department of Finance comfort letter relating to the application of the tracking interest rules to umbrella corporations is not included in the Proposal and should be introduced as draft legislation at a future date.

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Prohibited Investments

The Proposal adds a new exception to the list of "prohibited investments" for registered pension plans (RPPs). The registered tax status of a RPP becomes revocable by the Minister if the plan holds property that is a "prohibited investment". Subject to certain listed exceptions, a prohibited investment includes an equity or debt investment in an employer that participates in the plan or a person that does not deal at arm's length with such an employer. The Proposal introduces an exception applicable with respect to employers who participate in a RPP and whose principal activity is to manage the investments or provide investment advice to: one or more RPPs, the federal or a provincial government or certain corporations owned by such governments, a municipality or a body performing a function of government. Under the new exception, a prohibited investment for a RPP would not include shares or debt of a person (or an interest in a partnership) that operates at non-arm's length from such an employer. This measure may provide relief, for example, to certain pension or governmental investment management companies whose employees include members of an RPP. Such an investment manager may in some cases not legally deal at arm's-length from pooled funds or partnerships that it has created. The new exception would mean that the RPP would not be prohibited from investing in those funds and partnerships.

Other Measures in the Proposal

The Proposal also includes a number of other important tax measures that are not addressed in this Update. Please contact any member of Osler's National Tax Group for further details on any of these measures.

Previously announced measures or updates to previously released draft legislation:

- The Tax-Free First Home Savings Account (FHSA)
- The First-Time Home Buyers' Tax Credit (HBTC)
- The Multigenerational Home Renovation Tax Credit
- The Residential Property Flipping Rule
- The Medical Expense Tax Credit for Surrogacy and Other Expenses
- Annual Disbursement Quota for Registered Charities
- Reporting Requirements for Registered Retirement Savings Plans (RRSPs) and Registered Retirement Income Funds (RRIFs)
- Clean Technology Tax Incentives – Air-Source Heat Pumps
- The Small Business Deduction
- International Financial Reporting Standards (IFRS 17)
- The Application of the General Anti-Avoidance Rule to Tax Attributes
- Interest Coupon Stripping
- Quarterly Remittances and Technical Amendments to the Cannabis Taxation Framework
- Enhanced Reporting Requirements for Trusts

Other technical tax amendments:

- Addition of subsection 13(43) as a new elective transitional rule for dispositions of eligible capital property before March 22, 2016 where some or all of the proceeds of disposition were receivable after 2016.
- Narrowing the exception in subsection 15(2.3) to the subsection 15(2) shareholder loan

rules to require that at least 90% of the outstanding loans of the relevant lending business must be with arm's length borrowers.

- Changes to subsections 85.1(4) and 87(8.3) of the ITA, which can prevent certain rollovers from applying on transfers of foreign affiliate shares or foreign mergers.
- Amendment to the suppression election in subsection 88(3.3) of the ITA so that it applies only to shares of foreign affiliates, and not other capital property, transferred to the Canadian parent on a liquidation of a foreign affiliate.
- Amendment to the exception from the upstream loan rules in paragraph 90(8)(b) of the ITA.
- Various amendments to certain rules for partnerships, including with respect to determining when partnerships deal at arm's length.
- Expansion of the rule in section 93.3 of the ITA, which will now apply to non-resident trusts in India (rather than only trusts in Australia).
- Changes to the FAPI rules in paragraph 95(2)(b) of the ITA related to the provision of services to investment funds.
- Addition of subsection 95(3.03) to the ITA related to the payment for certain services to a holding company.
- Amendment to the functional currency rules in ITA 261 to allow use of the Japanese Yen.
- Narrowing the ability to reinstate paid-up capital under subsection 212.3(9) where the foreign affiliate dumping rules previously reduced it.