JANUARY 11, 2018

Canadian Tax Laws: A Review of 2017 and a Look Ahead to 2018

Authors: Peter Glicklich, R. Ian Crosbie, Bobby J. Sood, Marie-Emmanuelle Vaillancourt, Elie Roth, Michael N. Kandev, Paul Lamarre, Raj Juneja and Gregg M. Benson

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.

Developments in 2017

1. ***Legislative Developments***

The Liberal government's second full calendar year in office saw a number of significant changes on the tax front. While the Trump government moved forward with tax reform in the United States, the Liberal government announced measures adversely affecting the taxation of private Canadian corporations and their shareholders. In addition, Canada (along with 71 other countries) became a signatory to the *Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting* (MLI), a significant step in the implementation of the international base erosion and profit shifting (BEPS) proposals developed by the Organisation for Economic Co-operation and Development (OECD).

Private Corporation Measures

Controversial private corporation measures were released on July 18, 2017, in the form of draft legislation dealing with income splitting, among other things, and a consultation paper on the taxation of passive investment income earned by private Canadian corporations. Revised draft legislation on income splitting was released on December 13, 2017. Other related measures included in the July 18 release, concerning access to the lifetime capital gains exemption and the taxation of transactions aimed at converting income into capital gains, have since been abandoned. Our comments on the July 18 release and the revised income splitting legislation can be found in our bulletins Canadian Government Proposes Major Changes to the Taxation of Private Corporations, July 18, 2017; Tax Proposals Target Canadian Business Owners, August 4, 2017; Department of Finance Releases Revised Income Splitting Rules, December 13, 2017.

Income Splitting

The *Income Tax Act* (Tax Act) contains a wide range of rules limiting income splitting between spouses and between parents and minor children, including the "tax on split income" (TOSI) rules, commonly known as the "kiddie tax." The July 18 proposals sought to extend the TOSI rules to all equity and debt returns to related persons, regardless of age. The December 13 draft legislation scaled back the July 18 proposals somewhat, but failed to clarify many of the uncertainties contained in the July 18 draft. If passed into law, the new TOSI rules will generally become effective as of January 1, 2018.

Subject to various safe harbours, the proposed new TOSI rules would apply the top marginal tax rate to income and gains of an adult individual in respect of equity and debt issued by a corporation, partnership or trust where the amounts are derived from a "related business" of the individual. The definition of related business is quite broad and includes a business carried on by a related person resident in Canada as well as a business carried on by a partnership of which the related person is a member and by a corporation in which the related person has a certain minimum interest.

There are a number of safe harbours from the application of the new TOSI rules:

- A person who is 65 years of age or older would be allowed to split income with a spouse without any TOSI restrictions.
- The splitting of capital gains realized on the disposition of property that would be eligible for the lifetime capital gains exemption would not be subject to TOSI.
- TOSI would not apply to a person who is actively engaged in the business on a regular, continuous and substantial basis, a test that in many cases will be difficult to apply.
- TOSI would also not apply to a person aged 24 or older who owns at least 10% of the votes and value of the corporation carrying on the business (except for professional corporations and other service businesses) where, generally, less than 10% of the income of the corporation is from one or more other related businesses.

Private Company Passive Investment Income

In the July 18 release, the Liberal government aired its concerns that individuals who carry on business through a corporation can obtain a tax-deferral advantage by retaining their business income in the corporation to make passive investments. This potential advantage arises because business income earned in a corporation is taxed at much lower rates than the rate applicable to business or employment income earned personally. As a result, if the after-tax business income is retained in the corporation, a larger sum is available to invest. While there are rules in place to tax passive income earned by a private corporation at a rate approximating personal rates by way of a refundable tax, as well as to tax dividends from private corporations at an integrated rate, the government is of the view that these rules do not adequately address the perceived advantages of incorporation.

The proposal being considered involves making the current refundable tax on passive investment income earned by a Canadian-controlled private corporation non-refundable in circumstances in which the passive investments were funded with business income earned after the effective date of the proposals. This would effectively impose tax at a combined corporate and personal rate as high as 73% on such passive investment income, once distributed. Furthermore, the non-taxable portion of capital gains funded from active business income would not be added to the capital dividend account of the corporation, so that this amount could not be paid out to an individual shareholder tax-free.

The July 18 proposals were set out in a consultation paper, with a request for input on potential approaches to neutralize the tax-deferral advantage associated with making passive investments through a private corporation. During the consultation period, which ended on October 2, the government received a large amount of feedback on the proposals – feedback that was almost entirely negative. The Standing Senate Committee on National Finance released a report on December 13 recommending that the proposals be withdrawn in their entirety. Nevertheless, the government has shown no sign that it intends to back away from the proposals other than indicating it would provide an exemption for up to $50,000 per year of income on passive investments that would otherwise be subject to the rules (i.e., income on passive investments funded with active business income earned after the effective date of the rules). Draft legislation to implement these proposals is expected to be released with the 2018 federal budget.

Reduction of Small Business Rate (and Increase of Non-Eligible Dividend Rate)

The first $500,000 of active business income earned in Canada by a Canadian-controlled private corporation is subject to a preferred rate of tax, the small business rate. For 2017, the federal small business rate was 10.5%. In part as a response to the backlash against the private corporation passive investment income proposals, the Liberal government announced on October 16 that it intends to lower the small business rate to 10% effective January 1, 2018, and to 9% effective January 1, 2019. (The province of Ontario also announced a reduction of the provincial corporate small business rate to 3.5%, from 4.5%, effective January 1, 2018.)

In connection with these rate reductions, the tax rate on "non-eligible" dividends has also been adjusted. In general terms, when a corporation pays a dividend out of income that has been taxed at the small business rate, the dividend is treated as a non-eligible dividend. A non-eligible dividend is taxed at a higher rate than an eligible dividend in order to provide "integration" between corporate and personal levels of tax – so that the combined rate of tax to the corporation and the individual approximates the amount that would be paid by the individual if he or she had earned the income directly. The increase to the non-eligible dividend rate will have the collateral result of increasing the combined rate of tax under the private corporation passive investment income proposals to more than 73%.

Budget 2017

The 2017 federal budget released on March 22, 2017, to some extent anticipated the private corporation measures discussed above and also contained changes affecting billed-based accounting for professionals, the timing of gain and loss recognition on derivatives and other technical changes. A few of the measures are discussed below and comments on the balance of the budget changes can be found in our bulletin 2017 Federal Budget: Tax Highlights. The budget changes (with some revisions) were included in draft legislation released on October 27, 2017, which received royal assent on December 14, 2017.

Elimination of Billed-Basis Reporting

Accountants, dentists, lawyers, doctors, veterinarians and chiropractors have been able to compute their income for tax purposes by including in income amounts that have been billed during the year and excluding work in progress that remains unbilled at the end of the year. These rules have been eliminated, so that such professionals will no longer be able exclude the cost of such work in progress from their income. While the original proposal included a transitional rule providing for a phase-in period of two years, the final version was relaxed to provide a five-year phase-in period. These rules are effective in the first taxation year that begins after March 21, 2017.

Timing of Recognition of Gains and Losses on Derivatives

Two measures aimed at addressing the timing of recognition of gains and losses on derivatives were introduced in Budget 2017. The first one addresses the outcome of the Federal Court of Appeal decision in *Kruger Inc. v. Canada* (for our comments on *Kruger* see The Federal Court of Appeal Permits Use of Mark-To-Market Tax Accounting). This case held that the taxpayer was entitled to use the mark-to-market method in computing its income for federal income tax purposes and, as a result, was entitled to recognize an accrued year-end loss on its book of foreign exchange option contracts. To provide a clear framework for exercising the choice of using the mark-to-market method and to ensure that this choice does not lead to avoidance opportunities, an elective mark-to-market regime for derivatives held on income account has been introduced. Specifically, the election will allow taxpayers to mark to market all of their eligible derivatives. Once made, the election will remain effective for all subsequent years unless revoked with the consent of Canada Revenue Agency (CRA).

A second measure deals with so-called straddle transactions. Typically, a straddle is a transaction in which a taxpayer concurrently enters into derivative positions that are expected to generate equal and offsetting gains and losses. Shortly before its taxation year-end, the taxpayer disposes of the position with the accrued loss, and shortly after the beginning of the following taxation year, the taxpayer disposes of the offsetting position with the accrued gain. There are several variations to this type of transaction, including combining it with an exit strategy that shifts the offsetting gain to a tax-indifferent investor. The government has been challenging these transactions using various rules and principles, including the general anti-avoidance rule. A stop-loss rule has now been introduced that will effectively defer the realization of any loss on the disposition of a position to the extent of any unrealized gain on an offsetting position. The stop-loss rule is subject to several exceptions, including for financial institutions and business hedging transactions. A carve-out is also available if none of the main purposes of the transactions is to defer or avoid tax.

Signing of the Multilateral Convention

On June 7, 2017, Canada, together with 67 other countries, became a signatory to the MLI. Another four countries signed later in 2017 and six more have indicated their intention to do so. With the notable exception of the United States, the vast majority of Canada's tax treaty partners have signed on to the MLI.

The MLI, which was developed as part of the OECD BEPS initiatives, is intended to be a framework that can be used to efficiently implement the BEPS recommendations regarding tax treaty policy and practice across thousands of bilateral tax treaties between participating jurisdictions. The key provisions of the MLI are aimed at treaty shopping, hybrid entities and instruments, artificial avoidance of permanent establishment status and dispute resolution procedures. 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. At present, Canada has reserved on most provisions of the MLI other than the treaty shopping provisions and dispute resolution procedures.

Parliament must ratify the MLI before its provisions can become binding in Canada, and the MLI will apply only to tax treaties entered into between Canada and another jurisdiction once it is ratified and in force in both jurisdictions. Although there is no set timeline for ratification, senior government officials have identified January 1, 2019 as a likely implementation date. If this proves to be correct, the MLI would come into force on that date for withholding taxes and for all other taxes for taxable periods beginning after June 1, 2019.

2. *Judicial Developments*

CRA Audit Powers

Two recent court rulings impose limits on the broad audit powers of CRA under subsection 231.1(1) of the Tax Act. In *BP Canada Energy Company v. MNR*, the Federal Court of Appeal refused to allow CRA access to a taxpayer's highly sensitive internal accounting documents, generally referred to as "tax accrual working papers" (which identify uncertain tax positions and establish contingent tax reserves for financial reporting under provincial securities legislation). Although auditors are entitled to be provided with "all reasonable assistance" in performing their audits, they cannot compel taxpayers to reveal their "soft spots."

In the second case, *MNR v. Cameco Corporation*, the Federal Court built upon the decision in BP Canada and refused CRA's request for oral interviews with approximately 25 personnel from Cameco and its subsidiaries. Throughout the audit, Cameco had complied with all of the Minister's requests but refused the demand for oral interviews; instead, Cameco offered to answer written questions. Consequently, the Minister brought a summary application for a compliance order under the Tax Act. In dismissing the application, the Court adopted a narrow interpretation of subsection 231.1(1) and held that the Minister's audit powers are broad but not unlimited. The Court found that Parliament could not have intended there to be no restraint on how the Minister questions taxpayers and that, on the facts of the case, written questions would provide the Minister with the information sought. The Court also expressed concern that the Minister's liberal interpretation of the provision imposed a broader form of examination for discovery than allowed in a Tax Court appeal, without any of the attendant procedural safeguards. The Minister has appealed the Cameco decision to the Federal Court of Appeal.

Settlement Agreements with CRA

In *Sifto Canada Corp. v. The Queen*, the Tax Court of Canada held that the Minister is precluded from reassessing contrary to a legally binding settlement agreement. From 2002 to 2006, Sifto had engaged in the sale of rock salt to a related corporation resident in the United States. Sifto later discovered that the sales had been at less than an arm's-length price and that it had therefore understated its income for Canadian tax purposes. Consequently, Sifto made a voluntary disclosure that was accepted by the Minister and reassessments were issued reflecting the additional income. Sifto and the related corporation applied to their respective competent authorities, requesting commensurate reduction in income recognized in the United States in order to prevent double taxation. Under the mutual agreement procedure, the competent authorities reached settlement, and Sifto accepted the terms.

Subsequently, the Minister audited the transfer price and reassessed to further increase Sifto's income from the sale transactions in issue. The Tax Court concluded that the competent authority proceedings resulted in a binding agreement between Sifto and the Minister that established the transfer price of the rock salt. In particular, the Court found that the requisite elements of an agreement were present – mutual intention to create legal relations, exchange of consideration, and sufficiently certain terms. Although the Minister cannot agree to an assessment that is indefensible on the facts and the law, that principle was not breached in this case. Further, the Court also held that the settlements were binding on the Minister by operation of Articles 26 and 27 of the *Vienna Convention on the Law of Treaties* and that the Minister was not permitted to assess in a manner inconsistent with the agreements. It is not open to one state to simply disregard the results of the mutual agreement procedure; it is antithetical to the very notion of an agreement between two treaty partners to suggest that either party may choose to ignore the agreement.

Hedging Transactions

In *MacDonald v. The Queen*, the Tax Court of Canada considered the tax treatment of a loss realized on a cash-settled forward contract. The case involved a taxpayer who had had a significant investment in Bank of Nova Scotia (BNS) shares since 1988. He had no intention of selling the shares, but in 1998 (anticipating a decline in the share price), he entered into a cash-settled forward contract relating to a large number of BNS shares. The BNS share price went up, the taxpayer settled the contract over time, and he suffered a loss. At issue was whether the loss was on capital or income account.

The Minister argued that the forward contract was entered into as a hedge against the taxpayer's investment in BNS shares; since the BNS shares were held on capital account, the Minister's view was that the forward contract was also held on capital account, so that the loss would be a capital loss. The Tax Court disagreed, holding that the forward contract was not a hedge and that the loss was on income account.

While CRA has indicated that it considers the *MacDonald* case to be irreconcilable with the *George Weston* case decided in 2015, this appears to ignore the fact that the Court came to very different findings regarding the intentions of the taxpayers in these two cases: in *George Weston* the Court found that the taxpayer's intention was to hedge, but in *MacDonald* the Court found that the taxpayer's intention was to speculate. *MacDonald* has been appealed to the Federal Court of Appeal.

Outlook for Canadian Tax Developments in 2018

1. *Private Company Passive Investment Income*

The government has indicated that legislation to implement the private company passive investment income proposals will be released with the 2018 federal budget. Numerous questions remain as to what this legislation will provide. For example:

- When will the legislation become effective – budget date or some date in the future, such as January 1, 2019?
- How will the legislation deal with the multiple investment accounts that will need to be tracked for grandfathered investments, investments made with funds earned from an active business within the $50,000 threshold, investments made with funds earned from an active business above the $50,000 threshold, investments made with funds received from the shareholder that have been subject to full individual tax (which should not be subject to the rules), etc.?
- Will the $50,000 threshold be fixed or indexed to inflation or, maybe, instead tied to a percentage of the corporation's capital?
- How will borrowed funds, investments in related entities and intercompany dividends be dealt with?
- How, if at all, will the rules apply to corporations that are not Canadian-controlled private corporations?
- Or will the government ultimately abandon the proposals, as recommended by The Standing Senate Committee on National Finance in its December 13 report?

All we know for certain is that, whatever the draft legislation provides, it will be long and very complicated. A worst-case scenario will be one in which the legislation is made effective as of budget date, leaving taxpayers scrambling to understand, adapt to and apply the rules.

2. *Other 2018 Budget Measures*

The Canadian government's focus is likely to be on the passive income proposals, and it has not signalled that it intends to introduce any other significant measures in the 2018 federal budget. It will be interesting to see if the government makes any changes in response to the passing of tax reform in the United States. Other countries such as the United Kingdom reduced their corporate tax rates prior to the passing of U.S. tax reform – the United Kingdom's corporate tax rate was reduced to 19%, from 20%, in April 2017 and will be further reduced to 17% in April 2020. Canada has long trumpeted its highly competitive corporate tax rates as a reason favouring investment in Canada. This will become more difficult without a response, although a further reduction in corporate tax rates would deepen the deferral advantage that gave rise to the government's passive income proposals.

3. *Further Developments on the Multilateral Convention*

There is a reasonable chance that the treaty shopping provisions in the MLI will become effective January 1, 2019, for a number of Canada's tax treaties, meaning that taxpayers will need to determine how the MLI might apply to their particular circumstances and, if relevant, restructure to avoid adverse or unintended results.

Canada has elected to adopt the "principal purpose" test in its covered agreements as an interim measure, intending, where possible, to adopt a limitation on benefits provision (in addition or in lieu of the principal purpose test) through bilateral negotiations with individual countries, as noted above. Although the United States has not signed the MLI, the *Canada-United States Income Tax Convention* already contains a limitation on benefits clause.

The principal purpose test provides, in general terms, that a benefit under the treaty will be denied if it is reasonable to conclude that obtaining the benefit was one of the principal purposes of any arrangement or transaction that resulted in that benefit, unless allowing the benefit is consistent with the purpose of the relevant provisions of the treaty. Say, for example, that a dividend is paid by a Canadian corporation to a non-resident person that is resident in a treaty country and, under the treaty, the withholding tax rate would be limited to 5%. If the arrangement fails the principal purpose test, the treaty rate will be unavailable and the domestic 25% rate will apply instead.

It will therefore be critical for taxpayers to understand the scope of this rule. In the context of the Tax Act, the Federal Court of Appeal (in *Group Honco Inc. v. The Queen*) held that the phrase "one of the main purposes" means that a taxpayer can have more than one main purpose for a given action. The same approach would almost certainly be taken in applying the principal purpose test in the MLI. Beyond this, there is currently little relevant guidance on how the test might be applied.

It is hoped that the CRA and/or the OECD will provide some guidance in this regard over the course of 2018, before Canada and other countries ratify the MLI. A practical approach to the consequences under the treaty shopping rules would be welcome as well. Take, for example, a situation in which the MLI applies to deny treaty benefits with respect to the direct parent of a Canadian corporation, but the MLI would not apply to deny treaty benefits with respect to the Canadian corporation's indirect parent. It seems reasonable, in that case, that the withholding tax rate should not jump to 25%, but that the Canadian corporation be able to look to "up the chain" and apply the treaty rate available to the indirect parent.

*Davies is pleased to welcome our new partner and co-author of this article, **Bobby Sood**, to the firm. With 19 years of experience in the Tax Services Division at the Department of Justice, Bobby brings a wealth of knowledge and specialized expertise to our team of 11 industry-leading tax dispute lawyers.*

Read our U.S. Tax Review and Outlook.

Key Contacts: R. Ian Crosbie, Marie-Emmanuelle Vaillancourt, Bobby J. Sood, Elie Roth, Paul Lamarre, Brian Bloom, Michael N. Kandev and Peter Glicklich