Explanatory Notes Relating to the Income Tax Act and the Income Tax Regulations

Published by
The Honourable Chrystia Freeland, P.C., M.P.
Deputy Prime Minister and Minister of Finance

November 2023

Department of Finance Canada | Ministère des Finances Canada

Preface

These explanatory notes are provided to assist in an understanding of legislative proposals relating to the *Income Tax Act* and other legislation. These explanatory notes describe the proposed amendments, clause by clause, for the assistance of Members of Parliament, taxpayers and their professional advisors.

The Honourable Chrystia Freeland, P.C., M.P.,
Deupty Prime Minister and Minister of Finance

These notes are intended for information purposes only and should not be construed as an official interpretation of the provisions they describe.

Table of Contents

Clause in Legislative Proposals	Section Amended	Topic	Page
		Part 1 – Amendments to the Income Tax Act and the Income Tax Regulations	
		Income Tax Act	
2	12	Inclusions	4
3	12.7	Hybrid mismatch arrangements - Definitions	7
4	13	Recaptured depreciation	10
5	15	Benefit conferred on shareholder	12
6	18	General limitations	12
7	18.2, 18.21	Excessive interest and financing expenses limitation	13
8	18.4	Hybrid mismatch rules	96
9	20	Deductions permitted in computing income from business or property	161
10	40	General rules	162
11	53	Adjustments to cost base	163
12	66	Exploration and development expenses of principal business corporations	164
13	66.2	Amount to be included in income	165
14	66.8	Resource expenses of limited partner	166
15	80	Definitions	166
16	80.4	Loans	167
17	84.1	Non-arm's length sale of shares	167
18	87	Amalgamations	180
19	88	Winding-up	183
20	89	Definitions	187
21	91	Amounts to be included in respect of share of foreign affiliate	189
22	92	Adjusted cost base of share of foreign affiliate	190
23	94.2	Investments in non-resident commercial trusts	190
24	95	Definitions	191
25	96	General rules	195
26	108	Definitions	197
27	111	Losses deductible	197
28	112	Deduction of taxable dividends received by corporation resident in Canada	203
29	113	Deduction in respect of dividend received from foreign affiliate	207
30	122.8	Climate Action Incentive	211
31	123.3	Refundable tax on CCPC's investment income	212
32	123.4	Definitions	213
33	125.2	Definitions	214
34	127	Logging tax deduction	214
35	127.44	Carbon capture, utilization and storage tax credit	215
36	127.45	Clean technology investment tax credit	234
37	127.46	Labour requirements related to certain investment tax credits	243
38	127.47	Clean economy ITCs – partnership rules	252
39	128	Bankruptcies	258
40	129	Dividend refund to private corporation	259
41	135.2	Continuance of the Canadian Wheat Board – Eligible trust	261
42	137	Credit Unions - Definitions	261
43	146.01	Home Buyers' Plan	262
44	146.02	Lifelong Learning Plan	263
45	146.4	Registered Disability Savings Plans	263
46	146.6	First Home Savings Account	266
47	152	Assessment	272
48	153	Withholding	277
49	157	Payment by corporation	277
50	160	Joint liability – intergenerational business transfer	278
51	160.2	Joint and several liability—FHSA	279
52	163	False statements or omissions	279
53	183.3 and 183.4	Tax on repurchases of equity	280
54	204.2	Undeducted RRSP premiums	291

55	207.01	Taxes in respect of registered plans	291
56	207.5	Tax in Respect of Retirement Compensation Arrangements	299
57	207.71	Specified refundable tax	300
58	211.92 to 211.95	Carbon capture, utilization and storage tax credit	302
59	214	Deemed payments	321
60	216	Alternatives re rents and timber royalties	322
61	220	Exception	323
62	225.1	Collection-commencement day	323
63	227	Assessment	324
64	237.3	Definitions	325
65	241	Where taxpayer information can be disclosed	326
66	245	General Anti-Avoidance Rule	326
67	248	Interpretation	340
68	256	Associated corporations	355
69	256.1	Corporate tax-attribute trading	355
70	260	Subsections 112(2.01) and (2.3) — ordering	356
Excise Tax Act			
71	295	Where confidential information may be disclosed	358
Excise Act, 2001			
72	211	Where confidential information may be disclosed	357
Income Tax Regulations			
73	103	Non-Periodic Payments	358
74	204	Estates and Trusts	358
75	205	Date returns to be filed	358
76	205.1	Electronic filing	359
77	209	Distribution of taxpayers' portions of returns	359
78	304	Prescribed Annuity Contracts	359
79	1100	Deductions Allowed	360
80	4901	Interpretation	361
81	5202	Interpretation	361
82	5903	Deductible Loss	362
83	5907	Interpretation	362
84	9005	Prescribed Non-reporting Financial Institution	365
85	9006	Prescribed Excluded Accounts	365
86	Schedule II	Class 8	366
87	Schedule II	Class 17	366
88	Schedule II	Class 41	366
89	Schedule II	Class 41.1	366
90	Schedule II	Class 41.2	367
91	Schedule II	Class 43	367
92	Schedule II	Class 43.1	367
93	Schedule II	Class 49	368
94	Schedule II	Class 53	368
95	Schedule II	Class 57 to 60	368

Part 1 – Amendments to the Income Tax Act and the Income Tax Regulations

Amendments to the Income Tax Act (the "Act" or "ITA")

Clause 2

Partnership — interest and financing expenses add back

ITA
12(1)(l.2)

Section 12 provides for the inclusion of various amounts in computing the income of a taxpayer for a taxation year from a business or property.

New paragraph 12(1)(l.2) provides an income inclusion for a taxpayer that is a member of a partnership, as part of the new excessive interest and financing expenses limitation (EIFEL) regime. The core rules for this new regime are in new sections 18.2 and 18.21. For more information, see the commentary on those sections.

In general terms, new paragraph 12(1)(l.2) includes an amount in a taxpayer's income for a taxation year – in respect of the taxpayer's share of the interest and financing expenses for the year of partnerships of which the taxpayer is a member – if the taxpayer's total interest and financing expenses for the year exceed the amount of such expenses that the taxpayer is permitted to deduct, as determined under subsection 18.2(2). This income inclusion is in lieu of a denial of a deduction under subsection 18.2(2), but with similar effect, and is analogous to paragraph 12(1)(l.1) of the thin capitalization rules.

The reason the income inclusion under paragraph 12(1)(l.2) is needed is that income is calculated at the partnership level and allocated to partners on a net basis (i.e., after any deduction of amounts at the partnership level in respect of the interest and financing expenses). Consequently, deductions for the partnership's interest and financing expenses cannot be denied at the partner level under subsection 18.2(2). The income inclusion effectively adds back to the partner's income the relevant portion of the interest and financing expenses that are deducted at the partnership level.

The amount included under paragraph 12(1)(l.2) in a taxpayer's income for a taxation year is determined by the formula A x B.

Variable A is essentially the total of the taxpayer's share of the interest and financing expenses for the year of all partnerships of which the taxpayer is a member. All of these amounts are included in computing the taxpayer's interest and financing expenses under paragraph (h) of the description of A in the definition "interest and financing expenses" in subsection 18.2(1), with an exclusion for any amounts included in the taxpayer's income under paragraph 12(1)(l.1) of the thin capitalization rules.

There is no income inclusion under paragraph 12(1)(l.2) in respect of "excluded interest" or "exempt interest and financing expenses". For more information, see the commentary on the definitions "excluded interest" and "exempt interest and financing expenses".

Variable B integrates the income inclusion under paragraph 12(1)(l.2) with the excessive interest and financing expenses limitation in subsection 18.2(2).

By virtue of subparagraph (i) of variable B, no amount will be included in the taxpayer's income under paragraph 12(1)(l.2) if the taxpayer is an "excluded entity" for a taxation year (as defined in subsection 18.2(1)), as such entities are similarly not subject to the limitation in subsection 18.2(2).

If the taxpayer is not an excluded entity, the amount determined for B is the proportion determined under the first formula in subsection 18.2(2) in respect of the taxpayer for the year. This is the proportion of the taxpayer's interest and financing expenses that exceeds the maximum permitted under subsection 18.2(2). While this proportion is generally used to determine the proportion of the taxpayer's deductions in respect of interest and financing expenses that is denied under subsection 18.2(2), the proportion can nonetheless be computed and applied for purposes of paragraph 12(1)(l.2), even in a year when the taxpayer's only interest and financing expenses are derived from its share of partnership expenses.

Thus, paragraph 12(1)(l.2), in effect, includes in a taxpayer's income an amount representing the proportion, of the taxpayer's share of the interest and financing expenses of partnerships of which it is a member, that is determined to be "excessive" based on the limitation under subsection 18.2(2).

New paragraph 12(1)(l.2) applies in respect of taxation years beginning on or after October 1, 2023. However, it also applies in respect of a taxation year that begins before and ends after that date if any of the three immediately preceding taxation years is shorter as a result of a transaction or event or series of transactions or events and it can reasonably be considered that one of the purposes of the transaction, event or series was to defer the application of the EIFEL regime.

Retirement compensation arrangement

ITA
12(1)(n.3)

Paragraph 12(1)(n.3) requires amounts received by an employer from certain retirement compensation arrangements to be included in the employer's income.

Paragraph 12(1)(n.3) is amended consequential on the introduction of section 207.71 which, if certain conditions are met, provides for a refund of refundable tax paid in respect of a retirement compensation arrangement that is secured by a letter of credit or surety bond. Accordingly, where an amount is refunded to an employer under subsection 207.71(3), the amount is to be included in computing the employer's income for the taxation year in which the amount was received.

This amendment applies to the 2024 and subsequent taxation years.

Investment tax credit

ITA
12(1)(t)

The amount deducted from tax in respect of an investment tax credit may reduce the tax basis of a related expenditure — that is, the undepreciated capital cost of depreciable property, the adjusted cost base of certain interests in a partnership or a trust, the amount of deductible scientific research expenditures, or the amount of Canadian exploration expenses. To the extent that such reductions in tax basis do not take place, paragraph 12(1)(t) requires the amount of any credit claimed to be included in the taxpayer's income.

Paragraph 12(1)(t) is amended to reflect the introduction of the new CCUS tax credit and the clean technology investment tax credit, by adding references to new sections 127.44 and 127.45, under which the new credits are provided. References are also added to new subparagraphs 53(2)(c)(vi.1) and 53(2)(c)(vi.2), which apply cost base reductions to partners claiming the new credits.

This amendment applies to taxation years ending after 2021 with respect to the CCUS tax credit and after March 27, 2023 with respect to the clean technology investment tax credit.

Source of income

ITA
12(2.02)

Subsection 12(2.02) mainly ensures that any income inclusion under paragraph 12(1)(l.1) for a non-resident partner will be taxable in Canada to the same extent as income earned through the partnership.

This subsection is amended to provide for similar treatment in respect of any income inclusion under new paragraph 12(l)(l.2). For further information, see the commentary on paragraph 12(1)(l.2) and section 18.2.

This amendment applies in respect of taxation years beginning on or after October 1, 2023. However, it also applies in respect of a taxation year that begins before and ends after that date if any of the three immediately preceding taxation years is shorter as a result of a transaction or event or series of transactions or events and it can reasonably be considered that one of the purposes of the transaction, event or series was to defer the application of the EIFEL regime.

Definitions

ITA
12(11)

“investment contract”

Subsection 12(4) requires that the accrued interest on an investment contract be included in computing income on an annual basis. A number of arrangements are specifically excluded from these rules under the definition “investment contract” in subsection 12(11).

The definition “investment contract” is amended to add FHSAs to the list of exclusions. This ensures that an FHSA that is issued as a deposit will not be subject to the interest accrual rules.

This amendment comes into force on April 1, 2023.

Clause 3

Hybrid mismatch arrangements – definitions

ITA
12.7(1)

The definitions in subsection 18.4(1) apply in section 12.7.

Secondary rule – conditions for application

ITA
12.7(2)

New subsection 12.7(2) sets out the conditions for the application of subsection 12.7(3), the secondary operative rule of the hybrid mismatch rules.

For subsection 12.7(3) to include an amount in income in respect of a payment (as defined in subsection 18.4(1)) of which a taxpayer is the recipient, three conditions must be met. In general terms, these conditions target payments arising under hybrid mismatch arrangements that give rise to a deduction/non-inclusion mismatch (as determined under subsection 18.4(6)), where there is a foreign income tax deduction without a corresponding income inclusion for Canadian tax purposes.

The first condition is that the taxpayer must be a recipient of the payment. Under the broad definitions of “payment” and “recipient” in subsection 18.4(1), if an amount accrues to a taxpayer because of an entitlement to be paid, credited or conferred the amount (either immediately or in the future, and either absolutely or contingently), the taxpayer is considered a recipient of a payment, even if it has not actually received the amount or there is only a future or contingent obligation to pay the amount. In addition, where the taxpayer is the creditor under, for example, a low-interest or non-interest bearing loan, subsection 18.4(9) may deem the taxpayer to be the recipient of a notional interest payment if the relevant foreign law gives an entity a notional interest deduction in respect of the loan. See the commentary on subsection 18.4(9).

The second condition, in paragraph 12.7(2)(a), requires that the payment arise under a hybrid mismatch arrangement, which is defined in subsection 18.4(1) to comprise the various categories of arrangement to which the hybrid mismatch rules apply. For more information, see the commentary on that definition.

It is not intended that subsection 12.7(3) and subsection 113(5), which restricts deductions under section 113 in respect of certain dividends received by a taxpayer from a foreign affiliate, would apply in respect of the same payment. If subsection 113(5) applies to restrict a deduction in respect of a particular dividend, this would be expected to result in Canadian ordinary income (as defined in subsection 18.4(1)) in respect of the dividend, such that the dividend would not arise under a hybrid mismatch arrangement (because there would be no deduction/non-inclusion mismatch in respect of the dividend). For more information, see the commentary on the definition "Canadian ordinary income" and subsection 113(5).

Consistent with the BEPS Action 2 Report, subsection 12.7(3), as a secondary hybrid mismatch rule, does not apply if a foreign income tax deduction in respect of a payment is restricted by a "foreign hybrid mismatch rule" (as defined in subsection 18.4(1)). In effect, this gives priority to a foreign country's primary hybrid mismatch rule, which is a rule that is comparable to subsection 18.4(4). This ordering results from the fact that, if a foreign hybrid mismatch rule restricts a foreign tax deduction of an amount, the amount is not included when calculating foreign deductions for purposes of variable C of paragraph 18.4(6)(b). Provided the application of the foreign hybrid mismatch rule reduces the amount of the deduction/non-inclusion mismatch to nil, there would be no hybrid mismatch arrangement and thus the requirement in paragraph 12.7(2)(a) would not be met.

The third condition, in paragraph 12.7(2)(b), is generally intended to limit the rule to payments that are deductible for foreign income tax purposes. That paragraph requires that there be a "foreign deduction component" of the hybrid mismatch arrangement under which the payment arises. This refers to an amount that is "deductible", in respect of the payment, in computing an entity's "relevant foreign income or profits" (both as defined in subsection 18.4(1)). In other words, if the deduction side of a deduction/non-inclusion mismatch arising from the payment is a foreign tax deduction, there is a foreign deduction component of the hybrid mismatch arrangement and the third condition is met.

The existence of a foreign deduction component is determined under paragraphs 18.4(11)(c) (in respect of hybrid financial instrument arrangements), 18.4(13)(c) (in respect of hybrid transfer arrangements) and 18.4(15)(c) (in respect of substitute payment arrangements).

Finally, as noted elsewhere in this commentary, an effect of the broad definition of "payment" in subsection 18.4(1) is that multiple payments may arise in respect of the same amount at different points in time (e.g., one payment may arise when an entitlement to the amount arises because of an obligation to pay the amount in the future, and another may arise later when the amount is actually paid). Similarly, because the "recipient" definition tracks the breadth of the "payment" definition, a taxpayer may be a recipient of multiple payments in respect of the same amount.

However, as further discussed in the commentary on subsection 18.4(6), because only one of the payments would be expected to result in a foreign tax deduction (i.e., the foreign income tax laws would not allow multiple deductions in respect of the same amount), it is expected that only one of the payments would give rise to a deduction/non-inclusion mismatch. Thus, the broad meaning of "payment" and "recipient" would not cause subsection 12.7(3) to apply multiple times in respect of the same amount.

Secondary rule – consequences

ITA
12.7(3)

New subsection 12.7(3) is the secondary operative rule, which neutralizes a deduction/non-inclusion mismatch arising from a payment under a hybrid mismatch arrangement by including an amount in the income of a recipient of the payment. Subject to subsection 18.4(5), it applies if the conditions in subsection 12.7(2) are met in respect of the payment.

Subsection 18.4(5) provides an exception that, in general terms, applies where a payment is otherwise within the scope of the hybrid mismatch rules because it arises under a "structured arrangement" (as defined in subsection 18.4(1)), but a taxpayer was neither aware of the deduction/non-inclusion mismatch nor shared in any economic benefit resulting from the mismatch. For more information, see the commentary on subsection 18.4(5).

The amount included in income under subsection 12.7(3) is equal to the "hybrid mismatch amount" (as defined in subsection 18.4(1)) in respect of the payment. Very generally, the hybrid mismatch amount in respect of a payment arising under a hybrid mismatch arrangement is the portion of the deduction/non-inclusion mismatch in respect of the payment that is attributable to the "hybridity" of the arrangement (other than in the case of a substitute payment arrangement, which does not require hybridity). The hybrid mismatch amount is determined under:

- if the payment arises under a hybrid financial instrument arrangement, paragraph 18.4(11)(a);
- if the payment arises under a hybrid transfer arrangement, paragraph 18.4(13)(a); or
- if the payment arises under a substitute payment arrangement, paragraph 18.4(15)(a).

For more information, see the commentary on the definition "hybrid mismatch amount" in subsection 18.4(1) and on paragraph 18.4(7)(c).

Paragraph 12.7(3)(a) provides that the amount that is included in the taxpayer's income under subsection 12.7(3) in respect of a payment is considered to be from the same source as the payment.

Paragraph 12.7(3)(b) determines the timing of the income inclusion to a recipient of a payment by reference to the foreign taxation year in which the foreign tax deduction in respect of the payment is available. The amount is included in income for the last taxation year of the taxpayer that begins at or before the end of the "foreign taxation year" (as defined in subsection 18.4(1))

in which an amount in respect of the payment would be, or would reasonably expected to be, “deductible” by any entity in computing its “relevant foreign income or profits” (both as defined in subsection 18.4(1)), absent any “foreign expense restriction rule" (as defined in subsection 18.4(1)). If multiple entities are entitled to foreign tax deductions in respect of a given payment, an amount equal to the hybrid mismatch amount is included in the taxpayer’s income for its last taxation year that begins at or before the end of the first foreign taxation year of any entity in which an amount in respect of the payment would reasonably be expected to be deductible.

Clause 4

Deemed capital cost of certain property

ITA
13(7.1)

Section 13 provides a number of special rules related to the treatment of depreciable property. Generally, these rules apply for the purposes of sections 13 and 20 and the capital cost allowance (CCA) regulations.

Subsection 13(7.1) provides for reductions in the capital cost of a depreciable property equal to the amounts of deducted investment tax credits and certain other assistance from government in respect of the property.

Subsection (7.1) is amended by adding references to new sections 127.44 and 127.45, in the preamble and in paragraph (e). These amendments are consequential to the introduction of the new CCUS tax credit and the clean technology investment tax credit under sections 127.44 and 127.45.

This amendment applies to taxation years ending after 2021 with respect to the CCUS tax credit and after March 27, 2023 with respect to the clean technology investment tax credit.

Capital expenditures – Classes 59 and 60

ITA
13(7.6)

New subsection 13(7.6) deems a capital expenditure to have resulted in the acquisition of Class 59 or 60 property (as the case may be) of the taxpayer under certain circumstances.

In particular, if an expenditure would have been included in the cost of a Class 59 or 60 property, except that no property was actually acquired, the amount of the expenditure can still be added to the cost of a notional property.

So, for example, the cost of an environmental study to determine the quality of a geological formation which in the end resulted in no asset being acquired, but which is nevertheless viewed

as having been capital in nature, is included in the undepreciated capital cost of a Class 59 property under this rule. Such costs would otherwise have been included in Class 14.1.

This amendment applies to expenses or costs incurred or property acquired after 2021.

Definitions

ITA
13(21)

“undepreciated capital cost”

Element I of the definition of “undepreciated capital cost” (UCC) reduces the UCC of the depreciable property of a class by the amount of any investment tax credit claimed in respect of a property which was in the class in the year where that credit was claimed subsequent to the disposition of the property. Because an investment tax credit claim reduces the balance of the class and may cause it to become negative, thereby giving rise to an income inclusion for a year which, in turn, may affect the amount of the credit which can be claimed, this calculation can become circular where the credit reduces UCC in the same year as that in which the credit is claimed. Accordingly, a reduction of the UCC of the class is required only for taxation years following the year in which a related credit is claimed.

Element I of the definition is amended, by adding references to new subsections 127.44(3) and 127.45(6), consequential to the introduction of the CCUS tax credit and the clean technology investment tax credit.

This amendment applies to taxation years ending after 2021 with respect to the CCUS tax credit and after March 27, 2023 with respect to the clean technology investment tax credit.

Loss restriction event

ITA
13(24)(a)

Subsection 13(24) is a special rule that applies where a corporation or partnership of which a corporation is a majority interest partner has acquired a depreciable property within the 12-month period ending immediately before a change of control of the corporation and the property was not used, or acquired for use, in a business carried on before that period. Under this rule, the capital cost of property acquired in the 12-month period is not included in computing undepreciated capital cost until after the change of control. Also, for the purposes of the investment tax credit and refundable investment tax credit rules in sections 127 and 127.1, the property will be considered not to have been acquired until after the change of control.

Where the property was disposed of and not reacquired before the change of control, the property is treated for capital cost allowance purposes as having been acquired immediately before the disposition. The purpose of this special rule is to prevent the transfer of depreciable property in

contemplation of a change of control in order to reduce taxable income where the person acquiring control would not themselves be in a position to use the capital cost allowance or investment tax credit on the property.

Paragraph 13(24)(a) is amended to add references to new sections 127.44 and 127.45, consequential on the introduction of the CCUS tax credit and the clean technology investment tax credit.

This amendment applies to taxation years ending after 2021 with respect to the CCUS tax credit and after March 27, 2023 with respect to the clean technology investment tax credit.

Clause 5

When s. 15(2) not to apply – employee ownership trusts

ITA
15(2.51)

As a general rule, subsection 15(2) requires that certain indebtedness owed to a corporation by a shareholder, a person connected with a shareholder, or a member of a partnership or a beneficiary of a trust that is a shareholder of that corporation be included in the debtor's income in the year in which the indebtedness arose.

New subsection 15(2.51) provides an exception to the income inclusion rule in subsection 15(2) to facilitate qualifying business transfers to employee ownership trusts (as defined in subsection 248(1)). More specifically, this new provision allows a corporation that is a qualifying business (as defined in subsection 248(1)) to make a loan to the employee ownership trust (EOT) to facilitate the sale of the qualifying business to the EOT. Bona fide arrangements must be made to repay the balance of the shareholder loan within 15 years.

For more information on the definitions "employee ownership trust", "qualifying business" and "qualifying business transfer", see the commentary to these definitions in subsection 248(1).

This amendment comes into force on January 1, 2024.

Clause 6

Limitation on deduction of interest

ITA
18(4)

Subsection 18(4) provides thin capitalization rules to limit deductions, by corporations and trusts, in respect of interest on debt owing to certain specified non-residents. If the amount of debt owing to specified non-residents exceeds a debt-to-equity ratio of 1.5-to-1, subsection 18(4)

limits the deductibility of interest on that debt to the extent that the interest would otherwise be deductible (i.e., in the absence of subsection 18(4)).

Subsection 18(4) is amended, consequential on the introduction of new section 18.2, which contains the main operative provisions of the new excessive interest and financing expenses limitation regime. This amendment provides that the limitation under subsection 18(4) applies only in respect of interest that would, in the absence of section 18.2 (as well as subsection 18(4)), be deductible in computing income from business or property. This is intended to ensure that the thin capitalization rules apply in priority to the interest restriction in new section 18.2.

For more information, see the commentary on new section 18.2.

This amendment applies in respect of taxation years beginning on or after October 1, 2023. However, it also applies in respect of a taxation year that begins before and ends after that date if any of the three immediately preceding taxation years is shorter as a result of a transaction or event or series of transactions or events and it can reasonably be considered that one of the purposes of the transaction, event or series was to defer the application of the EIFEL regime.

Clause 7

Overview

New sections 18.2 and 18.21 of the Act, together with new paragraph 12(1)(l.2), are the core rules of the new excessive interest and financing expenses limitation ("EIFEL") regime. This regime comprises rules consistent with the recommendations in the report under Action 4 of the Group of 20 and Organisation for Economic Co-operation and Development's Base Erosion and Profit Shifting Project (the "BEPS Action 4 report"). The BEPS Action 4 report recommends certain limitations on the deductibility of interest and other financing costs to address BEPS.

Consistent with the BEPS Action 4 report, the objective of the EIFEL regime is to address BEPS issues arising from taxpayers deducting for income tax purposes excessive interest and other financing costs, principally in the context of multinational enterprises and cross-border investments. To this end, as recommended in the Action 4 report, the rules adopt an "earnings stripping" approach, which restricts a taxpayer's (or group's) deductions for interest expense and other financing costs to an amount that is commensurate with the taxable income generated by its activities in Canada. In general terms, the EIFEL rules limit the amount of net interest and financing expenses (being the taxpayer's interest and financing expenses net of its interest and financing revenues) that may be deducted in computing a taxpayer's income to no more than a fixed ratio of earnings before interest, taxes, depreciation and amortisation ("EBITDA"). For this purpose, the main elements are:

- *Fixed ratio*: Pursuant to the definition "ratio of permissible expenses" in new subsection 18.2(1), the applicable fixed ratio is 30%. In order to facilitate transition to the new regime, a fixed ratio of 40% applies only for taxation years beginning on or after October 1, 2023 and before January 1, 2024 (subject to an anti-avoidance rule that denies

a taxpayer the benefit of the 40% ratio, generally where the taxpayer undertakes a transaction to extend the period for which that ratio otherwise applies).

- *Interest and financing expenses and revenues*: The interest and other financing expenses of the taxpayer that are within scope of the new rules are set out in the definition "interest and financing expenses" in subsection 18.2(1) (which is the main definitions subsection for the new regime). Notably, they include, among other things, interest and financing expenses that are "capitalized" and deducted as capital cost allowance or as amounts in respect of resource expenditure pools; an imputed amount of interest in respect of certain finance leases; certain amounts (including certain capital losses) that are economically equivalent to interest or that can reasonably be considered part of the cost of funding; and various expenses incurred in obtaining financing. The definition "interest and financing revenues" captures the taxpayer's interest income, as well as other income and certain capital gains from the provision of financing. An anti-avoidance rule is included to ensure that certain amounts are excluded from interest and financing revenues or do not reduce interest and financing expenses.
- *EBITDA*: The taxpayer's EBITDA is referred to in the rules as "adjusted taxable income" (defined in subsection 18.2(1)), and is determined based on amounts taken into account in computing its tax liability under Part I of the Act, rather than amounts reported in its financial statements. A taxpayer's adjusted taxable income is its taxable income (or, in the case of a non-resident taxpayer, taxable income earned in Canada), determined under Part I of the Act, as adjusted for certain items. In general terms, the adjustments add amounts to taxable income to effectively reverse deductions for the taxpayer's interest and financing expenses, certain tax expenses and capital cost allowance, as well as certain other amounts; and subtract amounts to effectively reverse inclusions in taxable income for interest and financing revenues and untaxed income, as well as certain other amounts.

Notably, because it is based on taxable income, the taxpayer's adjusted taxable income reflects deductions for dividends received under section 112 (for inter-corporate dividends) and 113 (for dividends received from foreign affiliates). Thus, the new rules can limit the deductibility of interest expense incurred to invest in shares that produce such dividends. Adjusted taxable income is also reduced by losses deducted under section 111, except to the extent they are attributable to the taxpayer's net interest and financing expenses, or certain other deductible amounts that are excluded in computing adjusted taxable income, for a prior taxation year. The main operative rule of the EIFEL regime, which denies deductibility of net interest and financing expenses that exceed the permissible level, is in new subsection 18.2(2). That subsection applies to taxpayers that are corporations or trusts (the definition "taxpayer" in subsection 18.2(1) excludes natural persons and partnerships). It also applies in computing a non-resident taxpayer's taxable income earned in Canada.

Similar to the approach under the thin capitalization rules in the Act, the EIFEL rules also apply indirectly in respect of partnerships, as interest and financing expenses and revenues of a partnership are attributed to members that are corporations or trusts, in proportion to their interests in the partnership. Where a taxpayer has excessive interest and financing expenses, as determined under the rules, new paragraph 12(1)(l.2) – which is analogous to paragraph

12(1)(l.1) of the thin capitalization rules – includes an amount in the taxpayer's income in respect of the taxpayer's share of partnership interest and financing expenses.

The EIFEL rules generally apply mechanically; there is no avoidance or purpose condition for the operative rules to apply. They also apply after existing limitations on the deductibility of interest and financing expenses in the Act, including the thin capitalization rules (subsection 18(4) is amended to clarify this ordering). Any expenses whose deductibility is denied under such existing limitations are excluded from a taxpayer's interest and financing expenses for purposes of the new rules.

Exceptions

To ensure the new rules are appropriately targeted at significant BEPS risks, exceptions from the rules are provided for "excluded entities" (defined in subsection 18.2(1)), which generally comprise:

- Canadian-controlled private corporations that, together with any associated corporations, have taxable capital employed in Canada of less than $50 million (i.e., the top end of the phase-out range for the small business deduction);
- groups of corporations and trusts whose aggregate net interest expense among their Canadian members is $1,000,000 or less; and
- certain standalone Canadian-resident corporations and trusts, and groups consisting exclusively of Canadian-resident corporations and trusts that carry on substantially all of their businesses, undertakings and activities in Canada. This exclusion applies only if, in general terms, no non-resident is a material foreign affiliate of, or holds a significant interest in, any group member, and no group member has any significant amount of interest and financing expenses payable to a non-arm's length person that is "tax-indifferent" (as defined in subsection 18.2(1)).

Excluded interest

The EIFEL rules allow a taxable Canadian corporation or a partnership all of whose member are taxable Canadian corporations, to jointly elect with another such corporation or partnership that one or more payments of interest or lease financing amounts (as defined in subsection 18.2(1)) made between them in a taxation year be excluded from the new interest limitation under subsection 18.2(2). This exclusion applies if the conditions in the definition "excluded interest" in subsection 18.2(1) are met. Among other conditions, if the payer and payee are corporations, they must be "eligible group entities" in respect of each other, which is defined in subsection 18.2(1) as, essentially, corporations that are related or affiliated (in determining affiliation for these purposes, section 251.1 is to be read without reference to the definition "controlled" in subsection 251.1(3)). If either the payer or payee is a partnership, the "eligible group entity" requirement applies by looking through to the members of the partnership. This election is principally intended to ensure that the EIFEL rules do not negatively impact transactions that are commonly undertaken within Canadian corporate groups to allow the losses of one group member to be offset against the income of another group member.

Exempt interest and financing expenses

To ensure that the new rules do not apply to limit the deductibility of interest and financing expenses that are incurred in respect of certain Canadian public-private partnership infrastructure projects, where the economic cost of the expenses are borne by the public sector, an exception is provided for "exempt interest and financing expenses" (defined in subsection 18.2(1)).

The exception will generally apply to third-party interest and financing expenses that are incurred in respect of a borrowing or other financing that was entered into in respect of an agreement with a Canadian public sector authority to design, build and finance (or design, build, finance, operate and maintain) property that a Canadian public sector authority has an interest in, where those interest and financing expenses are economically borne by that (or another) Canadian public sector authority.

Group ratio rules

The "group ratio" rules are in new section 18.21. Where the conditions in new subsection 18.21(2) are met, the Canadian members of a group of corporations and/or trusts can jointly elect into the group ratio rules for a taxation year (special rules allow certain standalone entities that are not part of any group to also elect into the group ratio rules). In that case, instead of the maximum amount a group member is permitted to deduct in respect of interest and financing expenses for the year being determined by reference to the 30% fixed ratio (or 40%, for the transitional year, where applicable), it is determined in accordance with the group ratio rule in subsection 18.21(2).

In essence, the group ratio rules allow a taxpayer to deduct interest and financing expenses in excess of the fixed ratio, provided the taxpayer is a member of an accounting consolidated group whose ratio of net third-party interest expense to book EBITDA (with a 10% up-lift) exceeds the fixed ratio and the group is able to demonstrate this based on audited consolidated financial statements. The "consolidated group" is defined in subsection 18.21(1) as an ultimate parent and all the entities that are fully consolidated in the parent's consolidated financial statements, or that would be if the group were required to prepare such statements under IFRS.

The consolidated group's net third-party interest expense and book EBITDA are referred to in these rules as the "group net interest expense" ("GNIE") and "group adjusted net book income" ("GANBI"), respectively, and are defined in subsection 18.21(1). They are determined based on amounts in the group's audited consolidated financial statements, with appropriate adjustments. There is an exclusion from group net interest expense for certain interest payments to persons or partnerships that are outside the consolidated group but that do not deal at arm's length with one or more consolidated group members; that have a significant equity interest in any Canadian group member; or a significant equity interest in which is held by any Canadian group member. Where the consolidated group has positive GANBI, the group ratio is the ratio of GNIE to GANBI, multiplied by a factor of 1.1.

Under the group ratio rule in subsection 18.21(2), the maximum amount of interest and financing expenses the consolidated group members are collectively permitted to deduct is generally determined as the total of each Canadian group member's adjusted taxable income multiplied by group ratio. The group allocates this maximum deductible amount among its Canadian group members in its group ratio election. This "flexible" allocation mechanism allows taxpayers to allocate the group ratio deduction capacity where it is most needed.

The group ratio rules contain certain limitations that are mainly intended to account for the possibility that some group members may have negative book EBITDA, or the group as a whole may have negative book EBITDA, such that a simple formulaic determination of the group ratio could give unreasonably high or meaningless results. These limitations are found in the definition "group ratio", in subsection 18.21(1), and the "allocated group ratio amount" rule in subsection 18.21(2).

Excess capacity and cumulative unused excess capacity

If a taxpayer's net interest and financing expenses exceed the maximum permitted for a taxation year, there are two mechanisms that could nonetheless enable the taxpayer to deduct all or a portion of this excess.

The first applies to the extent the taxpayer has "excess capacity" (as defined in subsection 18.2(1)) for any of its three immediately preceding taxation years that it has not used for another purpose in any of those preceding years (the rules, in effect, provide a three-year carry-forward of excess capacity). In general terms, the taxpayer's "excess capacity" for a taxation year is the amount, if any, by which the maximum amount it is permitted to deduct in respect of interest and financing expenses for the year (determined as its fixed ratio multiplied by its adjusted taxable income, plus its interest and financing revenues for the year) exceeds its actual interest and financing expenses for the year. A taxpayer is treated as not having excess capacity for any taxation year in which it is subject to the group ratio. A taxpayer's unused excess capacity is the portion that has not been either used to deduct the taxpayer's own excess interest and financing expenses for another year or transferred by the taxpayer to another group member in a previous year.

The taxpayer's unused excess capacity carryforwards from the three taxation years immediately preceding a given taxation year are automatically applied to reduce the amount of interest and financing expenses whose deductibility would otherwise be denied under subsection 18.2(2) in the given year. The amount of excess capacity that is used in this manner is referred to as the taxpayer's "absorbed capacity" for the given taxation year (defined in subsection 18.2(1)). This mechanism is intended to "smooth" the impact of earnings volatility under the EIFEL rules.

The second mechanism applies where the taxpayer does not have sufficient unused excess capacity carryforwards of its own, but has one or more other Canadian group members that have "cumulative unused excess capacity" they can transfer to the taxpayer. A group member's cumulative unused excess capacity for a taxation year is the amount available to transfer to other group members in the year, and is essentially its excess capacity for the year plus its unused excess capacity carryforwards from the three immediately preceding taxation years. Transfers of

cumulative unused excess capacity require a joint election by the transferor and transferee under new subsection 18.2(4), and can only be made between two entities where each is either a taxable Canadian corporation or a fixed interest commercial trust, and the entities are "eligible group entities" in respect of each other (as defined in subsection 18.2(1)). The transferee's resulting "received capacity" amount can reduce the amount of interest and financing expenses whose deductibility is otherwise denied to the transferee under subsection 18.2(2). The transferor's cumulative unused excess capacity is reduced by any amounts transferred to other group members, as well as by the taxpayer's own absorbed capacity.

"Financial institution group entities" (defined in subsection 18.2(1)) are prohibited from transferring their cumulative unused excess capacity outside of their financial group. Financial institutions would be expected to often have excess capacity because their regular business activities tend to result in interest income exceeding their interest expense. This restriction is intended to ensure such net interest income cannot be used to shelter the interest and financing expenses of entities that do not carry on financial businesses or activities ancillary to those of a financial institution.

Carryforwards of denied interest and financing expenses

Interest and financing expenses that are denied under subsection 18.2(2), and amounts included in a taxpayer's income under paragraph 12(1)(l.2) in respect of the taxpayer's share of a partnership's interest and financing expenses, are carried forward indefinitely. There is no carry-back for such amounts; however, the three-year carry-forward of excess capacity (reflected in a taxpayer's "cumulative unused excess capacity") is in substance equivalent to a carry-back of denied interest and financing expenses.

The carry-forward of denied interest and financing expenses is provided under new paragraph 111(1)(a.1), which allows a taxpayer to deduct its prior-year "restricted interest and financing expenses" (defined in subsection 111(8)) in computing its taxable income. This deduction is available in two circumstances. First, a taxpayer can deduct its restricted interest and financing expenses to the extent of its excess capacity for a taxation year. Second, a taxpayer can deduct such amounts to the extent it has "received capacity" for a taxation year, as a result of having received a transfer out of the cumulative unused excess capacity of another group member.

A taxpayer's excess capacity or received capacity, as the case may be, is automatically reduced to the extent of its restricted interest and financing expense carryforwards. In effect, this reflects a mandatory "ordering rule", whereby those amounts must be applied to enable the deduction of prior-year restricted interest and financing expenses, before a taxpayer can transfer its excess capacity to another group member or use its received capacity to deduct its excess interest and financing expenses for the current year. Like the three-year carry-forward of excess capacity, the carry-forward of restricted interest and financing expenses is intended to smooth the impact of earnings volatility under the EIFEL rules.

Continuity rules for new tax attributes

In connection with the new EIFEL regime, amendments to sections 87 and 88 of the Act ensure that, where a particular corporation undergoes an amalgamation or winding-up, its carryforwards of restricted interest and financing expenses and cumulative unused excess capacity generally are inherited by the new corporation formed on the amalgamation or the parent corporation in respect of the winding-up.

Amendments are also made to sections 111 and 256.1, to address the impact of a change of control (or "loss restriction event") on a taxpayer's EIFEL tax attributes. Similar to the treatment of non-capital loss carryforwards under existing subsection 111(5), a taxpayer's carryforwards of restricted interest and financing expenses generally remain deductible following a loss restriction event, to the extent the taxpayer continues to carry on the same business following the loss restriction event. However, a taxpayer's cumulative unused excess capacity does not survive a loss restriction event.

Transitional rules

Transitional rules are included in the enacting legislation for the EIFEL regime. Under these rules, a taxpayer can elect, jointly with its other group members, if any, to have special rules apply for the purpose of determining the excess capacity of the taxpayer (and each group member, if any) for each of the three taxation years (referred to as the "pre-regime years") immediately preceding its first taxation year in respect of which the EIFEL rules apply. Absent these transitional rules, a taxpayer would not have excess capacity for any of the pre-regime years because the EIFEL rules otherwise do not apply in respect of the pre-regime years. The transitional rules, in effect, allow electing taxpayers a three-year carry-forward of their excess capacity (as determined under the special transitional rules) for pre-regime years, as this excess capacity is included in computing a taxpayer's cumulative unused excess capacity.

In determining a taxpayer's excess capacity for pre-regime years, the transitional rules seek to approximate what would have been the unused portion of the taxpayer's excess capacity – after being used for transfers to other group members with excess interest and financing expenses over the maximum permitted, and to deduct the taxpayer's own excess interest and financing expenses for any pre-regime years – had the EIFEL rules applied in respect of the pre-regime years.

Effective date

The EIFEL rules generally apply in respect of taxation years that begin on or after October 1, 2023. An anti-avoidance rule applies, to cause the EIFEL rules to apply earlier for a particular taxpayer, if the taxpayer undertakes a transaction or series of transactions to trigger an early taxation year-end for the purpose of deferring the application of the EIFEL rules. The rules apply with respect to existing as well as new borrowings.

Definitions

ITA
18.2(1)

New subsection 18.2(1) defines a number of terms that apply for the purposes of sections 18.2 and 18.21 in determining the application of the new excessive interest and financing expenses limitation.

“absorbed capacity”

A taxpayer’s absorbed capacity for a taxation year is essentially the amount of its excess capacity, carried forward from previous years, that is used in a taxation year to reduce or eliminate a denial of deductions in respect of interest and financing expenses that would otherwise occur under subsection 18.2(2).

More specifically, the taxpayer’s excess capacity for its three immediately preceding taxation years is included in its cumulative unused excess capacity for a taxation year, and its absorbed capacity is essentially the lesser of its cumulative unused excess capacity for the year (determined before the reduction resulting from the taxpayer’s absorbed capacity for the year) and its amount of interest and financing expenses that would otherwise be denied in the year.

The taxpayer’s absorbed capacity is automatically included in variable E of the formula in subsection 18.2(2), thus reducing or eliminating a denial of interest and financing expenses that would otherwise arise under that subsection. The taxpayer’s cumulative unused excess capacity is reduced to the extent of the taxpayer’s absorbed capacity.

In effect, the consequences of an amount of absorbed capacity under the rules reflect a mandatory “ordering rule”, whereby a taxpayer is required to use its own excess capacity carryforwards first to deduct its own otherwise denied interest and financing expenses, before it can use any remaining excess capacity (reflected in its cumulative unused excess capacity) to effect a transfer to another group member by way of an election under subsection 18.2(4). Consequently, a taxpayer cannot transfer an amount of cumulative unused excess capacity to another group member to deduct their otherwise denied interest and financing expenses for the year in priority to the taxpayer using its carryforwards to deduct its own otherwise denied interest and financing expenses for the year.

Notably, a taxpayer cannot have excess capacity for a taxation year if it has absorbed capacity for that year. This is because a taxpayer has absorbed capacity only for a year where it has interest and financing expenses that exceed its capacity to deduct those expenses in the year. For more information, see the commentary on the definition “excess capacity”.

“adjusted taxable income”

A taxpayer’s adjusted taxable income (ATI) is a measure of its earnings before interest, taxes, depreciation and amortization (EBITDA) and is determined based on tax, rather than accounting, concepts.

In basic terms, a taxpayer’s adjusted taxable income for a taxation year is its taxable income (or, in the case of a non-resident, its taxable income earned in Canada) for the year, adjusted to reverse: (i) any deductions for interest and financing expenses, certain tax expenses and capital

cost allowance; and (ii) income inclusions for interest and financing revenues, untaxed income, and certain other amounts.

Since the starting point in determining adjusted taxable income is a taxpayer's taxable income, notably, it effectively excludes dividends that are deductible under section 112 or 113 (being inter-corporate dividends and certain dividends received from foreign affiliates, respectively). It is also generally reduced by losses deducted by the taxpayer under section 111 (subject to an add-back under paragraph (h) of variable B to the extent a non-capital loss is attributable to deductions in respect of interest and financing expenses or other amounts described in paragraphs (b) to (g) or (j) to (m) of variable B, or deductions in respect of restricted interest and financing expenses, as discussed below).

A taxpayer's adjusted taxable income is relevant principally in determining the maximum amount a taxpayer is permitted to deduct in respect of interest and financing expenses, under the limitation in new subsection 18.2(2), in computing its income for a taxation year. Generally under subsection 18.2(2), a taxpayer's deductions in respect of such expenses (net of the taxpayer's interest and financing revenues) for a year are limited to no more than a fixed ratio of its adjusted taxable income for the year (although the limit is also a function of any carryforwards of excess capacity, or transfers of excess capacity received by the taxpayer in the year). For more information, see the commentary on new subsection 18.2(2).

Adjusted taxable income is also relevant in determining a taxpayer's absorbed capacity or excess capacity for a taxation year (both as defined in this new subsection 18.2(1)). For more information, see the commentary on those definitions.

Adjusted taxable income for a taxation year is determined by the formula: A + B – C.

Variable A is capable of being a positive or negative number. It is determined by taking either (i) the taxpayer's taxable income (or, for non-residents, taxable income earned in Canada) for the year, or (ii) the negative number equal to its non-capital loss, and then subtracting the foreign accrual property losses (FAPLs) of any controlled foreign affiliates of the taxpayer (or a partnership of which the taxpayer or another controlled foreign affiliate of the taxpayer is a member) to the extent the FAPLs derive from net relevant affiliate interest and financing expenses (as further discussed below).

Allowing variable A to be a negative number where the taxpayer has a non-capital loss ensures that the add-backs under variable B do not generate excessive adjusted taxable income. For example, if a taxpayer had a non-capital loss for a taxation year and its amount for variable A were treated as nil (instead of as a negative number), when its interest and financing expenses were added back under variable B, this could give the taxpayer adjusted taxable income – thus allowing it to deduct interest and financing expenses under subsection 18.2(2) – generated from the interest and financing expenses themselves, as opposed to operating earnings. This result would be inappropriate in policy terms.

Consistent with this rationale, in determining a taxpayer's variable A amount, it is similarly necessary to subtract an amount equal to the lesser of (i) a FAPL of a controlled foreign affiliate

of the taxpayer for an affiliate taxation year, and (ii) the excess of the affiliate's relevant affiliate interest and financing expenses over its relevant affiliate interest and financing revenues for the affiliate taxation year.

The amounts in variable A are determined without regard to any denial of deductions for interest and financing expenses under subsection 18.2(2), or relevant affiliate interest and financing expenses of a controlled foreign affiliate under subclause 95(2)(f.11)(ii)(D)(I). Variable A is also determined without regard to income inclusions in respect of partnership-level interest and financing expenses under paragraph 12(1)(l.2) or subclause 95(2)(f.11)(ii)(D)(II). Thus, these denied amounts and income inclusions do not increase adjusted taxable income. Variable A is also determined without regard to deductions of restricted interest and financing expenses under paragraph 111(1)(a.1) since adjusted taxable income, by its inclusion in the computation of excess capacity, is a component in the determination of the maximum deduction that can be claimed under paragraph 111(1)(a.1).

Variable B "adds back" a number of amounts to, in effect, reverse the impact on the taxpayer's adjusted taxable income of a taxpayer's deductions for interest and financing expenses, certain tax expenses and capital cost allowance, among other deductions, all of which are reflected in its taxable income included under variable A. The amounts added back under variable B include:

- the taxpayer's interest and financing expenses for the year (paragraph (a) of variable B);
- any amount deducted under paragraph 20(1)(a) as capital cost allowance, or under the various provisions enumerated in paragraph (b) of variable B in relation to resource expenses, other than any portion of those amounts that is capitalized and therefore already added back under paragraph (a) of variable B as interest and financing expenses (paragraph (b) of variable B);
- any amount deducted under subsection 20(16) as a terminal loss for the year, other than any portion of that amount that can reasonably be considered to be attributable to interest and financing expenses and therefore is already added back under paragraph (a) of variable B (paragraph (c) of variable B);
- any amounts deducted, in computing the taxpayer's taxable income for the year, under paragraph 110(1)(k) (in respect of Part VI.1 tax) (paragraph (f) of variable B);
- any amount deducted by the taxpayer under subsection 104(6), other than any portion of that amount that has been designated under subsection 104(19) for the year (i.e., deemed to be a taxable dividend received by the beneficiary and, for certain purposes, not by the trust), in order to ensure that deductions for interest and financing expenses of a trust are not denied solely because the trust claims a deduction in respect of income distributed to its beneficiaries (paragraph (g) of variable (b);
- the amount that would be the loss of the taxpayer, or would be the taxpayer's share of the loss of a partnership of which it is a member, if the taxpayer or partnership had no income or loss other than that which can reasonably be considered to be derived or realized from activities funded, in whole or in part, by a borrowing that results in exempt interest and financing expenses (paragraph (k) of variable B); and
- certain amounts deducted as tax credits or received as government assistance that reduced the cost or capital cost of certain properties (paragraphs (l) and (m) of variable B).

In the case of amounts deducted under paragraph 20(1)(a) or subsection 20(16) in computing the income of a partnership of which the taxpayer is a member, paragraph (d) of variable B adds back an amount in respect of the taxpayer's share of those deducted amounts (other than any capitalized interest and financing expenses portion of those amounts), in computing the taxpayer's adjusted taxable income for its taxation year in which the partnership's fiscal period ends. This provision applies on a source-by-source basis, with the partnership's deduction under paragraph 20(1)(a) or subsection 20(16) in computing its income from each source being attributed to the taxpayer based on its pro rata share of the partnership's income or loss from the source.

Adjusted taxable income is calculated without reference to any income or loss derived from activities funded by a borrowing that results in exempt interest and financing expenses. Losses are added back to adjusted taxable income under paragraph (k) of variable B, and income is deducted from adjusted taxable income under paragraph (j) of variable C. Amounts described in the remaining paragraphs of variable B are not added back under those paragraphs to the extent that they can reasonably be considered to be in respect of a borrowing that results in exempt interest and financing expenses, as these amounts are already included in the adjustments under paragraph (k) of variable B and paragraph (j) of variable C. For more information, see the commentary on the definition "exempt interest and financing expenses".

Variable H in the formula in paragraph (d) reduces the amount of the add-back in respect of amounts that were deducted under paragraph 20(1)(a) or subsection 20(16) in computing a partnership's loss, to the extent the taxpayer is denied a deduction in respect of its share of the loss under the partnership "at-risk" rule in subsection 96(2.1).

To the extent the taxpayer deducts an amount, in respect of the previously denied loss, under paragraph 111(1)(e) in a later year, paragraph (e) of variable B in turn provides relief by way of an add-back in the later year. Where the previously denied loss was for a pre-regime year, the add-back applies in the same manner as in the case of denied losses for regime years. This is consistent with the intended application of the add-back under paragraph (h) of variable B in respect of non-capital losses for pre-regime years (see the commentary below).

Paragraph (h) of variable B adds back the portion of a non-capital loss for another taxation year (referred to in that paragraph as the "taxpayer loss year") that is deducted by the taxpayer under paragraph 111(1)(a). The add-back applies to the extent that the loss can reasonably be considered to derive from amounts deducted by the taxpayer in the taxpayer loss year in respect of its interest and financing expenses, its restricted interest and financing expenses or other amounts described in paragraphs (b) to (g) or (j) to (m) of variable B of the definition "adjusted taxable income" (notably, including capital cost allowance and amounts in respect of resource expenses). The add-back is reduced by the taxpayer's interest and financing revenues and any amounts described in paragraphs (b) to (f), (h) or (j) of variable C of the definition "adjusted taxable income" for the taxpayer loss year, as well as any inclusion in the taxpayer's income for the taxpayer loss year under paragraph 12(1)(l.2).

If the non-capital loss is for a taxpayer loss year that ends before February 4, 2022, the taxpayer may elect to treat the loss as a "specified pre-regime loss" (as defined in subsection 18.2(1)). In

that case, paragraph (h) does not apply and paragraph (i) will add back 25% of the amount deducted by the taxpayer in the year under paragraph 111(1)(a) in respect of the specified pre-regime loss. This election is intended to ease compliance in respect of non-capital losses for taxation years that ended before the release of the initial draft legislation of the EIFEL rules.

Variable Y further reduces a taxpayer's add-back in respect of a non-capital loss by any FAPL of a controlled foreign affiliate for an affiliate taxation year ending in the taxpayer loss year, to the extent that the FAPL derives from the affiliate's relevant affiliate interest and financing expenses net of its relevant affiliate interest and financing revenues. This reduction also applies in the case of a FAPL of a controlled foreign affiliate of a partnership of which the taxpayer or another controlled foreign affiliate of the taxpayer is a member.

The add-back under paragraph (h) of variable B is consistent with the add-backs under variable B in respect of a taxpayer's interest and financing expenses and other deductible amounts. Just as the add-backs under the other paragraphs of variable B, in effect, ensure that these deductible amounts do not reduce the taxpayer's adjusted taxable income for the taxpayer loss year in which they were deducted, the add-back under paragraph (h) ensures that the application of a non-capital loss deriving from these amounts does not affect the taxpayer's adjusted taxable income for a taxation year in which the loss is deducted.

The add-back under paragraph (h) of variable B applies not only where a taxpayer deducts a non-capital loss carried forward (or carried back) from a taxation year in respect of which the EIFEL rules apply, but also where a taxpayer claims a deduction in respect of a non-capital loss carried forward from a pre-regime taxation year that derives from an amount described in variable B. In this regard, although the EIFEL rules do not apply in respect of a pre-regime taxation year, it is intended that a taxpayer can nevertheless be considered to have interest and financing expenses and interest and financing revenues for those years, to the extent such amounts are relevant for the purposes of applying the EIFEL rules for a taxation year in respect of which the rules apply. In particular, those definitions are intended to apply in determining the extent to which a pre-regime loss derives from a variable B amount.

Notably, because a taxpayer's interest and financing expenses do not include "excluded interest" or "exempt interest and financing expenses" (both as defined in subsection 18.2(1)), this add-back does not apply to the extent the loss derives from excluded interest or exempt interest and financing expenses.

Paragraph (j) of variable B provides for an add-back where a FAPL of a controlled foreign affiliate for an affiliate taxation year (referred to as the "affiliate loss year") is applied under variable F of the definition "foreign accrual property income" in subsection 95(1) in computing the affiliate's FAPI for another affiliate taxation year that ends in the taxpayer's taxation year (or in the fiscal period of a partnership of which the taxpayer or a controlled foreign affiliate of the taxpayer is a member at any time). The rationale for this add-back is similar to the rationale for the add-back in paragraph (h) of variable B. Generally, it applies to the extent that a FAPL derives from deductions in respect of the affiliate's relevant affiliate interest and financing expenses (net of its relevant affiliate interest and financing revenues and any amount included in respect of the affiliate under subclause 95(2)(f.11)(ii)(D)(II) for the affiliate loss year).

Paragraph (k) of variable B adds back the taxpayer's loss, or the taxpayer's share of a partnership's loss, that can reasonably be considered to be derived from activities funded by a borrowing that results in exempt interest and financing expenses. Paragraph (j) of variable C similarly reduces the taxpayer's adjusted taxable income by the amount of any income derived from activities funded by a borrowing that results in exempt interest and financing expenses. For more information, see the commentary to the definition "exempt interest and financing expenses".

Paragraphs (l) and (m) of variable B provide add-backs for certain amounts that are not included in income under paragraph 12(1)(t) or (x). Paragraphs 12(1)(t) and (x) include in income, subject to certain exceptions, amounts that are deducted under subsections 127(5) or (6), 127.44(3) or 127.45(6), or that are received as certain forms of government assistance. If these amounts are included in income, they are included in adjusted taxable income under variable A.

However, paragraphs 12(1)(t) and (x) do not include in income amounts that reduce the cost or capital cost of certain properties, and such amounts therefore would not otherwise be included in adjusted taxable income. Paragraphs (l) and (m) include these amounts in adjusted taxable income, ensuring that the receipt of government assistance and the deduction of certain tax credits do not erode interest deductibility capacity.

Paragraph (l) includes in adjusted taxable income an amount deducted under subsection 127(5) or (6), 127.44(3) or 127.45(6) that was not included in income under paragraph 12(1)(t) and was not included in calculating adjusted taxable income for a preceding year, to the extent to the amount is included in an amount determined under paragraph 13(7.1)(e), subparagraphs 53(2)(c)(vi) to (c)(vi.2) or (h)(ii), or for I in the definition "undepreciated capital cost" in subsection 13(21).

Paragraph (m) adds back an amount received as government assistance under clause 12(1)(x)(i)(C) or subparagraph 12(1)(x)(ii) that reduces the cost or capital cost of property and is not included in income solely by operation of subparagraph 12(1)(x)(vi) or (vii).

Variable C effectively reverses income inclusions for several amounts that are included in computing the taxpayer's taxable income (and thus income under variable A), by reducing the taxpayer's adjusted taxable income for the year by the following amounts:

- the taxpayer's interest and financing revenues for the year (paragraph (a) of variable C);
- an amount included in the taxpayer's income for the year as "recapture" of capital cost allowance under subsection 13(1), including an amount included indirectly in the taxpayer's income as the taxpayer's share of a recapture amount of a partnership (paragraphs (b) and (c) of variable C);
- certain amounts included in the taxpayer's income for the year in respect of the disposition of resource properties or other recovery of resource expenses (paragraph (d) of variable C);

- the taxpayer's foreign-source income, to the extent it is sheltered from Canadian tax by foreign tax credits under subsection 126(1) (in respect of non-business income) or subsection 126(2) (in respect of business income) (paragraphs (e) and (f) of variable C);
- notional income included in the taxpayer's income under section 110.5 (paragraph (g) of variable C);
- an amount included in the income of a taxpayer as a beneficiary of a trust under subsection 104(13), to reflect that this amount is effectively included in the adjusted taxable income of the trust by virtue of the add-back under paragraph (g) of variable B (paragraph (h) of variable C), other than any portion of that amount that
    - has been designated under subsection 104(19) for the year (i.e., deemed to be a taxable dividend received by the beneficiary and, for certain purposes, not by the trust), or
    - gives rise to a deduction under paragraph 94.2(3)(a) in computing the foreign accrual property income of a controlled foreign affiliate of the taxpayer;
- any amount of the taxpayer's taxable income that is not subject to tax under Part I of the Act, because it is exempt from tax under the Act or any other Act of Parliament (paragraph (i) of variable C); and
- the amount that would be the income of the taxpayer, or would be the taxpayer's share of the income of a partnership of which it is a member, if the taxpayer or partnership had no income or loss other than income that can reasonably be considered to be derived from activities funded by a borrowing that results in exempt interest and financing expenses (paragraph (j) of variable C).

"affiliate taxation year"

An affiliate taxation year of a controlled foreign affiliate means the period for which the affiliate's accounts have been ordinarily made up, but no such period may exceed 53 weeks. This is the same as the definition of "taxation year" of a foreign affiliate in subsection 95(1).

"cumulative unused excess capacity"

A taxpayer's cumulative unused excess capacity for a particular year is the total of the taxpayer's unused excess capacity for the year and the three immediately preceding years. Thus, cumulative unused excess capacity is the attribute that enables a three-year carry-forward of the taxpayer's excess capacity. The term "excess capacity" is also defined in new subsection 18.2(1).

This definition reflects the taxpayer's "unused" excess capacity in that the taxpayer's excess capacity for the three immediately preceding years is reduced, under this definition, by amounts of transferred capacity (which are amounts that the taxpayer has previously transferred to eligible group corporations under subsection 18.2(4)) and amounts of absorbed capacity (which are amounts that have been used to reduce or eliminate a denial under subsection 18.2(2) of the taxpayer's interest and financing expenses). The resulting balance, which is the taxpayer's cumulative unused excess capacity for the year, is the maximum amount that the taxpayer may transfer to other eligible group corporations in that year.

An amount of transferred capacity reduces the taxpayer's cumulative unused excess capacity for the year following a transfer year, whereas the reduction for absorbed capacity occurs in the same year in which the amount of absorbed capacity arises. This is because the taxpayer's cumulative unused excess capacity for a particular year represents the total amount available for transfer in that year. Consequently, although any amount transferred in that year effectively comes out of the taxpayer's excess capacity for that year and unused excess capacity for the three immediately preceding years, the consequent reductions to excess capacity apply for the purposes of determining the taxpayer's cumulative unused excess capacity for years following the transfer year.

Because a taxpayer's absorbed capacity for a taxation year reduces its cumulative unused excess capacity for that year, the total amount that a taxpayer can transfer to another group member in a year, by way of an election under subsection 18.2(4), is reduced by the taxpayer's absorbed capacity in that year. Thus, there is in effect a mandatory "ordering rule", whereby a taxpayer is required to use its excess capacity carryforwards first to deduct its own otherwise denied interest and financing expenses, before it can use any remaining excess capacity (reflected in its cumulative unused excess capacity) to effect a transfer to another taxpayer.

The reductions to excess capacity, in determining the taxpayer's cumulative unused excess capacity, are made under subparagraph (b)(i) (in respect of transferred capacity) and (b)(ii) (in respect of absorbed capacity). Both subparagraphs follow the same general structure:

- First, they provide the total amount by which excess capacity is to be reduced, being the taxpayer's total transferred capacity amount or absorbed capacity for the year when those amounts arose.
- Second, they specify the taxation years (each referred to as a "relevant year") for which excess capacity is to be reduced. In the case where the taxpayer has one or more amounts of transferred capacity for a taxation year, there are to be reductions (in a total amount equal to the total of the taxpayer's transferred capacity amounts for the year) to the taxpayer's excess capacity for one or more of that year and the three immediately preceding years. Where the taxpayer has an amount of absorbed capacity for a taxation year, the reductions (in a total amount equal to the absorbed capacity) are made to the taxpayer's excess capacity for one or more of the three immediately preceding years. Notably, in all cases, the relevant years are determined by reference to the transfer year or absorbed capacity year, as the case may be, rather than by reference to the taxation year for which the taxpayer's cumulative unused excess capacity is being determined.
- Third, they provide that the reductions are made to the unused portion of the taxpayer's excess capacity for the relevant years. The unused portion is the excess capacity remaining after reductions to reflect amounts of transferred capacity and amounts of absorbed capacity for the taxpayer's taxation years preceding the transfer year or absorbed capacity year, as the case may be. In addition, reductions to excess capacity resulting from absorbed capacity that arises in the transfer year are also effected in determining the taxpayer's unused excess capacity for the relevant years in respect of the transfer year. All of these reductions in determining the unused portion of excess capacity for the relevant years are made in accordance with the rules in paragraph (b) of this definition.

- Finally, they provide "ordering rules" to determine for which of the taxpayer's relevant years its unused excess capacity will be reduced. The ordering rules are in paragraph (b) of the definition and ensure that a reduction will apply first to the earliest relevant year; then to the next-earliest relevant year; and so on.

In determining a taxpayer's cumulative unused excess capacity for a particular taxation year, where one or more of the three taxation years immediately preceding the particular year is a taxation year in respect of which the EIFEL rules did not yet apply (subject to certain anti-avoidance rules, the EIFEL rules apply in respect of taxation years beginning on or after October 1, 2023), there are elective transitional rules that apply for the purpose of determining the taxpayer's excess capacity for those preceding years. For more information, see the commentary on the transitional rules, following the commentary on new subsection 18.21(8).

Example

Assumptions

- At all relevant times, a taxable Canadian corporation ("Canco1") is a member of a group of related corporations (collectively, the "group") consisting of one other taxable Canadian corporation ("Canco2") and several non-resident corporations.
- At no time is Canco1 or Canco2 an excluded entity or a financial institution group entity.
- Canco1 and Canco2 both have a December 31 taxation year-end.
- Canco1 and Canco2 do not elect to have the group ratio rule in subsection 18.21(2) to apply for any taxation year.
- For both Canco1 and Canco2, the 2024 taxation year is the first year in respect of which section 18.2 applies. Canco1 and Canco2 both have nil excess capacity for taxation years preceding 2024.
- Canco1 has interest and financing expenses of $15 million for each taxation year.
- Neither Canco1 nor Canco2 has any interest and financing revenues for any taxation year.
- For the 2024 taxation year, Canco1 has the deductibility of $10 million of its interest and financing expenses denied under subsection 18.2(2).
- For the 2025 taxation year, Canco1 has base deduction capacity (which, in this example, means a taxpayer's ratio of permissible expenses for the year multiplied by its adjusted taxable income for the year) of $50 million.
- For the 2026 taxation year, Canco1 has base deduction capacity of $35 million.
- For the 2027 taxation year, Canco1 has base deduction capacity of $5 million.
- For its 2024 to 2027 taxation years, Canco2's interest and financing expenses and base deduction capacity are such that a "transfer" under subsection 18.2(4) of Canco1's cumulative unused excess capacity for any of those years would not increase the amount of interest and financing expenses or restricted interest and financing expense deductible by Canco2 in any of those years.
- For the 2028 taxation year:
    - Canco1 has base deduction capacity of $30 million.
    - Canco2 has excess interest (determined as the excess of its interest and financing expenses over its base deduction capacity) of $20 million and does not have any cumulative unused excess capacity.

- For the 2029 taxation year:
    - Canco1 has no base deduction capacity for the year.
    - Canco2 has excess interest of $10 million.

Analysis

2025

In 2025, Canco1's base deduction capacity of $50 million exceeds its interest and financing expenses of $15 million by $35 million. Thus, Canco1's $10 million restricted interest and financing expense carryforward from 2024 is deductible under paragraph 111(1)(a.1). Canco1's excess capacity for its 2025 taxation year is $25 million, calculated as A – B – C where:

- A is its base deduction capacity of $50 million;
- B is its interest and financing expenses of $15 million; and
- C is its deductible restricted interest and financing expense of $10 million.

Canco1's cumulative unused excess capacity for its 2025 taxation year is also $25 million, since it did not have any excess capacity for prior years.

2026

In 2026, Canco1's base deduction capacity of $35 million exceeds its interest and financing expenses of $15 million by $20 million, and it has no remaining restricted interest and financing expense carryforwards. Therefore, Canco1's excess capacity for the 2026 taxation year is $20 million.

Canco1's cumulative unused excess capacity for its 2026 taxation year is $45 million, being the total of its excess capacity of $20 million for 2026 and $25 million for 2025.

Canco1's cumulative unused excess capacity for its 2026 taxation year is $45 million, being the total of its excess capacity of $20 million for 2026 and $25 million for 2025.

2027

In 2027, Canco1's base deduction capacity of $5 million is less than its $15 million of interest and financing expenses for the year. Therefore, Canco1 has no excess capacity for the year.

Canco1 has absorbed capacity of $10 million for its 2027 taxation year, being the lesser of:

- its cumulative unused excess capacity of $45 million for 2027 (which, for the purpose of determining a taxpayer's absorbed capacity for a year, is always computed before the reduction for that absorbed capacity); and

- the amount by which its interest and financing expenses exceed the total of its base deduction capacity and interest and financing revenues (which, in this case, are nil) for the year, which excess is $10 million for 2027.

Canco1's base deduction limit under subsection 18.2(2) is increased by its absorbed capacity, which is reflected in variable E of the formula in that subsection, allowing it to deduct all of its interest and financing expenses for 2027.

Canco1's cumulative unused excess capacity for 2027 is $35 million, calculated as A + B where:

- A is its excess capacity for 2027, which is nil; and
- B is the total of its excess capacity for 2024, 2025 and 2026. However, for the purpose of computing its cumulative unused excess capacity, its excess capacity for 2025 is reduced by its absorbed capacity for 2027. The relevant excess capacity amounts are as follows:
    - Canco1's excess capacity for 2024 is nil;
    - Canco1's 2025 excess capacity of $25 million is reduced to $15 million;
        - The reduction is the lesser of its 2025 excess capacity and its absorbed capacity for 2027, which is $10 million; and
    - Canco1's 2026 excess capacity is $20 million.
        - It is not reduced to reflect Canco1's absorbed capacity for 2027, since the reduction applies first to the earliest year in which there is unused excess capacity, being 2025.

2028

In 2028, Canco1 can fully deduct its interest and financing expenses and has excess capacity of $15 million for the year (determined as its base deduction capacity of $30 million minus its interest and financing expenses of $15 million).

Canco1's cumulative unused excess capacity for its 2028 taxation year is $50 million, calculated as A + B where:

- A is its excess capacity for 2028, which is $15 million; and
- B is the total of its excess capacity for 2025, 2026 and 2027, with its excess capacity for 2025 being reduced to reflect its absorbed capacity for 2027.
    - Canco1's excess capacity for 2025 is $15 million (after the $10 million reduction for its absorbed capacity for 2027);
    - Canco1's excess capacity for 2026 is $20 million; and
    - Canco1's excess capacity for 2027 is nil.

Canco1 and Canco2 can jointly elect under subsection 18.2(4) to "transfer" $20 million of Canco1's cumulative unused excess capacity for 2028 to Canco2. This results in Canco2 having received capacity of $20 million for 2028, which increases Canco2's base deduction limit under subsection 18.2(2) (by being reflected in variable D of that subsection) and allows Canco2 to deduct all of its interest and financing expenses for the year.

2029

In 2029, as in 2027, Canco1's interest and financing expenses exceed its base deduction capacity for the year. Thus, as in 2027, Canco1 will have absorbed capacity – provided it has a positive cumulative unused excess capacity for the year (determined before any reduction for its absorbed capacity for 2029).

For the purpose of determining Canco1's absorbed capacity for 2029, its cumulative unused excess capacity for 2029 – which, for this purpose, is determined before the reduction for its absorbed capacity for 2029 – is $30 million, calculated as A + B where:

- A is Canco1's excess capacity for 2029, which is nil; and
- B is the total of Canco1's excess capacity for 2026, 2027 and 2028, taking into account reductions for its absorbed capacity of $10 million for 2027 and its transferred capacity of $20 million for 2028. The relevant excess capacity amounts are as follows:
    - Canco1's excess capacity for 2025 is not included (reflecting the three-year carry-forward period). However, its 2025 taxation year is a "relevant year" for the purpose of determining the reductions for its absorbed capacity for 2027 and transferred capacity for 2028, such that:
        - Its excess capacity for 2025 continues to be treated as having been reduced to $15 million, to reflect its $10 million absorbed capacity for 2027; and
        - This remaining $15 million of its excess capacity for 2025 is reduced to nil, to reflect its transferred capacity for 2028;
    - Canco1's $20 million excess capacity for 2026 is reduced to $15 million. This reduction is for the $5 million by which its $20 million transferred capacity for 2028 exceeds the $15 million reduction made to its excess capacity for 2025 in respect of that transferred capacity;
    - Canco1's excess capacity for 2027 is nil
    - Canco1's excess capacity for 2028 is $15 million;

Canco1's absorbed capacity for 2029 is, therefore, $15 million, being the lesser of:

- its cumulative unused excess capacity for the year (as determined above, before any reduction for its absorbed capacity for 2029), which is $30 million; and
- the excess of its interest and financing expenses over the total of its base deduction capacity and interest and financing revenues (which in this case, are nil) for the year, which excess is $15 million.

As a result of its absorbed capacity for 2029, Canco1's cumulative unused excess capacity for 2029 is $15 million (being its $30 million cumulative unused excess capacity calculated above, before the reduction for its absorbed capacity, minus its $15 million absorbed capacity). More specifically, for the purpose of determining Canco1's cumulative unused excess capacity for 2029, the 2029 absorbed capacity reduces the remaining portion of Canco1's excess capacity for 2026 (after the $5 million reduction for its transferred capacity for 2028) from $15 million to nil.

Canco1 and Canco2 can jointly elect under subsection 18.2(4) to "transfer" $10 million of Canco1's cumulative unused excess capacity for 2029 to Canco2. This results in Canco2 having received capacity of $10 million for 2029, which allows Canco2 to deduct all of its interest and financing expenses for the year. It also results in Canco1 having a $10 million transferred capacity for 2029, which will be applied as a reduction to its excess capacity for 2028 for the purpose of determining its cumulative unused excess capacity in subsequent taxation years.

"eligible group entity"

An eligible group entity, in respect of a taxpayer resident in Canada, at any time, is in general terms a corporation or trust that is resident in Canada and that the taxpayer is, at that time, related (other than because of a right referred to in paragraph 251(5)(b)) to or affiliated with.

For purposes of paragraphs (a) and (b) of this definition, subsections 18.2(16) and (17) contain supporting rules in determining whether persons are related or affiliated, specifically addressing trustees, control by His Majesty in right of Canada or a province or by an entity referred to in any of paragraphs 149(1)(c) to (d.6) (such as municipalities and Crown corporations), and beneficiaries that are arm's length registered charities or non-profit organizations. In addition, persons are not considered to be affiliated if they otherwise would be solely because of the definition "controlled" in subsection 251.1(3). The applicable standard of corporate control for these purposes is *de jure* control.

Paragraphs (c) and (d) are special rules for discretionary trusts. Paragraph (c) applies when the entity whose connection to the taxpayer is being tested is a trust, whereas paragraph (d) applies when the taxpayer itself is a trust. In either case, discretionary beneficiaries of a trust are effectively treated as meeting the requisite connection standard in respect of the trust, except, where the taxpayer is a trust, beneficiaries of the trust that are arm's length registered charities or non-profit organizations. A discretionary interest in a trust is an interest that is not a fixed interest as defined in subsection 94(1). Thus, the rules provide that a trust and a beneficiary with a discretionary interest in the trust are generally eligible group entities in respect of one another. This definition is relevant for, among other things, the purposes of applying the definition "excluded entity", the transfer of cumulative unused excess capacity in subsection 18.2(4) and the group ratio rule in subsection 18.21(2).

An anti-avoidance rule is included in subsection 18.2(9) to address certain circumstances where a taxpayer is, becomes or ceases to be an eligible group entity in respect of another taxpayer. For more information, see the commentary on subsection 18.2(9).

"excess capacity"

A taxpayer's excess capacity for a taxation year is essentially a measure of the amount by which the taxpayer's "capacity" for deducting interest and financing expenses under the EIFEL rules, generated by its own taxable income and interest and financing revenues for the year, exceeds the amount of its actual interest and financing expenses for the year plus its carryforwards of restricted interest and financing expenses from previous years. Thus, the taxpayer's excess capacity for a taxation year is determined without regard to its excess capacity carried forward

from preceding years, or any "received capacity" of the taxpayer resulting from transfers from other group entities in the year.

More specifically, a taxpayer's excess capacity for a taxation year is the amount determined by the formula A – B – C, where:

- Variable A represents the taxpayer's capacity to deduct interest and financing expenses for the year, measured as its ratio of permissible expenses multiplied by its adjusted taxable income, plus its interest and financing revenues for the year (subject to the reduction described below).
- Variable B is the taxpayer's total interest and financing expenses for the year; and
- Variable C is the amount of restricted interest and financing expenses from previous years that are deductible by the taxpayer under paragraph 111(1)(a.1) in the year.

In determining a taxpayer's deduction capacity under variable A for a taxation year, there is a reduction that applies if:

- the taxpayer has net interest and financing revenues for the year (i.e., its interest and financing revenues exceed its interest and financing expenses), and
- the taxpayer would have "negative" adjusted taxable income for the year if the definition of that term allowed it to be a negative amount (i.e., if it contained an override of section 257).

The amount of this reduction is determined as the taxpayer's ratio of permissible expenses multiplied by the lesser of the absolute value of the amount that would be its negative adjusted taxable income for the year and its net interest and financing revenues for the year (i.e., variable H multiplied by variable I).

Absent this reduction, the amount that would be the taxpayer's negative adjusted taxable income would not, in these circumstances, be appropriately reflected in its deduction capacity.

In general, negative adjusted taxable income is reflected as a non-capital loss, which reduces the "positive" adjusted taxable income – and thus the taxpayer's deduction capacity – that would otherwise arise in the year in which the non-capital loss carry-over is deducted. This ensures the taxpayer does not have deduction capacity to the extent it does not have adjusted taxable income on a net basis across those years.

If a taxpayer has net interest and financing revenues for a taxation year, however, its non-capital loss, if any, will be less than the absolute value of its negative adjusted taxable income. Thus, the deduction of the non-capital loss carry-over by the taxpayer in another year will not reduce the taxpayer's deduction capacity by an amount commensurate with its negative adjusted taxable income. The reduction described above ensures that the portion of the negative adjusted taxable income that is not reflected as a non-capital loss is nonetheless reflected as a reduction to deduction capacity.

For an illustration of this reduction in determining a taxpayer's excess capacity, see the example in the commentary to the definition "excluded interest".

A taxpayer's excess capacity can be used for three purposes.

First, pursuant to paragraph 111(1)(a.1), a taxpayer's restricted interest and financing expense carryforwards from previous years are deductible to the extent of the taxpayer's excess capacity for the year (as determined without regard to such deductions). By virtue of variable C in the definition "excess capacity", a taxpayer's deductible restricted interest and financing expense carryforwards from previous years automatically reduce its excess capacity for the year. This reduction occurs regardless of whether the taxpayer in fact deducts these amounts in the year, to ensure that it cannot choose to effectively preserve its cumulative unused excess capacity to transfer to other group members, in preference to deducting its restricted interest and financing expense carryforwards. This reflects a mandatory "ordering rule", whereby a taxpayer is, in effect, required to first apply its excess capacity against its restricted interest and financing expense carryforwards from previous years (to enable their deduction), before it can use any remaining excess capacity to effect a transfer of excess capacity to another group member by way of an election under subsection 18.2(4).

Second, a taxpayer's excess capacity for a taxation year is included in its cumulative unused excess capacity for the year and for the three immediately following years, which a corporate taxpayer can effectively transfer to an eligible group corporation in respect of the taxpayer for the year by designating it as "received capacity" of the transferee in an election under subsection 18.2(4). For more information, see the commentary on the definition "cumulative unused excess capacity" and subsection 18.2(4).

Third, a taxpayer can use its excess capacity to allow the deduction of interest and financing expenses for a later taxation year that would otherwise be denied under subsection 18.2(2). More specifically, a taxpayer's cumulative unused excess capacity for a taxation year – which, as noted, includes the taxpayer's excess capacity from the three immediately preceding years – is automatically applied to enable the taxpayer to deduct amounts of interest and financing expenses that would otherwise have been denied in the year. This occurs by virtue of the taxpayer's "absorbed capacity" for the year being included in variable E of the formula in subsection 18.2(2). For more information, see the commentary on the definition "absorbed capacity".

A taxpayer that elects, along with its corporate group, to have the group ratio rules in section 18.21 apply for a taxation year is treated as having nil excess capacity for that year. This reflects, first, that the group ratio rules in subsection 18.21(2) provides a separate mechanism for calculating the capacity to deduct interest and financing expenses at the group level and then allocating this capacity among group members for a year. Second, it reflects an intention that, for any taxation year in respect of which a taxpayer is subject to the group ratio, it cannot accrue excess capacity that is carried forward to later years as cumulative unused excess capacity.

"excluded entity"

A taxpayer that is an excluded entity for a taxation year is not subject to the deduction restrictions under new subsection 18.2(2), nor an income inclusion under new paragraph 12(1)(l.2), in respect of its interest and financing expenses for the year.

Excluded entities generally do not pose significant base erosion and profit shifting risks targeted by the new EIFEL rules.

A taxpayer is an excluded entity for a particular taxation year if it satisfies the conditions in any of paragraphs (a) to (c).

Under paragraph (a), a taxpayer is an excluded entity for a particular taxation year if, throughout the particular year, it is a Canadian-controlled private corporation that, together with any associated corporations, has taxable capital employed in Canada of less than $50 million (i.e., the top end of the phase-out range for the small business deduction). These entities are relieved from the application of the EIFEL rules because they are Canadian controlled and are small or medium sized businesses.

Under paragraph (b), a taxpayer is an excluded entity for a taxation year if it is part of a group whose Canadian members have total interest and financing expenses (net of interest and financing revenues) for the year of $1,000,000 or less. These taxpayers are excluded from the application of the EIFEL rules because they do not have significant net interest and financing expenses on a Canadian group-wide basis. The group can include corporations and trusts. Notably, the interest and financing revenues of any group member that is a financial institution group entity are excluded to ensure their net interest and financing revenues do not shelter the interest and financing expenses of other group members.

Exempt interest and financing expenses are included in determining if the group's net interest and financing expenses exceed $1,000,000. For more information, see the commentary on the definition "exempt interest and financing expenses".

Under paragraph (c), a particular Canadian-resident taxpayer is an excluded entity if it is a standalone entity or a member of a group (defined to include all "eligible group entities" in respect of the particular taxpayer) that consists exclusively of Canadian-resident taxpayers, provided that four conditions are met.

The first condition is that the particular taxpayer and all other group members carry on all or substantially all of their businesses, if any, undertakings and activities in Canada. This requirement is intended to ensure that all or substantially all of the aggregate economic activity of the taxpayer and each group member is carried on in Canada, regardless of whether that activity is carried on through one or more businesses and regardless of whether that activity rises to the level of carrying on a business. The holding, by the taxpayer or another eligible group entity of indebtedness or shares of a foreign affiliate is not an undertaking or activity that is taken into consideration in applying this condition. For example, where a Canadian holding company's only activity is the holding of shares or debt of a foreign affiliate, it will be considered to carry on all or substantially all of its businesses, undertakings and activities in Canada.

The second condition is that the group's foreign affiliate holdings, if any, are *de minimis*, meaning the greater of the book cost of all foreign affiliate shares held by the group and the fair market value of the assets of all foreign affiliates held by the group does not exceed $5,000,000. This includes any foreign affiliates held through partnerships. For this purpose, book value is to be determined by reference to the taxpayer's (or taxpayer group's) ownership interest, and only the amount that can reasonably be considered to be the taxpayer's (or taxpayer group's) proportionate share of the value of an affiliate's assets is considered.

The third condition is that no person or partnership is

- a specified shareholder or specified beneficiary (both as defined in subsection 18(5), for the purposes of the thin capitalization rules) of the particular taxpayer, or any eligible group entity, that is a non-resident; or
- a partnership where more than 50% of the fair market value of the interests in the partnership are held by non-residents, and the property of the partnership includes more than 25% of the equity in the particular taxpayer or any eligible group entity; and

The final condition is that all or substantially all of the interest and financing expenses of the particular taxpayer and each eligible group entity in respect of the particular taxpayer, are paid or payable to persons or partnerships that are not tax-indifferent (as defined in subsection 18.2(1)) and that do not deal at arm's length with the particular taxpayer or any eligible group entity.

Subsection 18.2(14) provides an anti-avoidance rule that deems certain recipients of interest and financing expenses to be non-arm's length and tax-indifferent. For more information, see the commentary on subsection 18.2(14).

"excluded interest"

The definition "excluded interest" sets out the conditions that must be satisfied in order for two members of the same corporate group to elect to have a payment of interest or a lease financing amount (as defined in subsection 18.2(1)) made from one to the other excluded from the limitation under subsection 18.2(2). This election is principally intended to ensure that the EIFEL rules do not negatively impact on corporate transactions that are often undertaken within Canadian corporate groups to allow the losses of one group member to be offset against the income of another group member.

More specifically, excluded interest is not included in determining the interest and financing expenses (as defined in subsection 18.2(1)) of a taxpayer for a taxation year. As a result, a deduction in respect of excluded interest will not be denied under subsection 18.2(2) or result in an income inclusion under paragraph 12(1)(l.2). However, excluded interest is also not included in the interest and financing revenues of the payee, which limits the extent to which it can "shelter" the payee's interest and financing expenses from the limitation under subsection 18.2(2) or increase the payee's excess capacity (as defined in subsection 18.2(1)), as the case may be.

In general, interest expenses and interest income are disregarded in computing a taxpayer's adjusted taxable income. This occurs by virtue of the "add-back" for interest and financing expenses under variable B of the definition "adjusted taxable income" in subsection 18.2(1), and the exclusion of interest and financing revenues under variable C of that definition. Because excluded interest is not reflected in the payer's interest and financing expenses or the payee's interest and financing revenues, however, it is not disregarded in computing adjusted taxable income, but rather generally reduces that of the payer and increases that of the payee.

For an amount of interest or a lease financing amount to be excluded interest it must satisfy a number of conditions.

Notably, the amount must be paid or payable by a corporation or partnership to another corporation or partnership (referred to as the "payer" and "payee", respectively) in respect of a debt or lease. Throughout the period during which the amount accrued (referred to as the "relevant period"), the debt must be owed by the payer to the payee, or the lease must be between them. Thus, excluded interest treatment is not available, for example, where interest accrues during a period when the debt is held by another person or partnership, and the debt is subsequently transferred to the payee, or assumed by the payer, before the interest is paid or payable.

In addition, throughout the relevant period and at the time of payment, the payer and payee must both be taxable Canadian corporations, and eligible group entities (as defined in subsection 18.2(1)) in respect of one another, unless one or both are partnerships. If the payer or payee is a partnership, similar conditions apply in respect of the members of the partnership. If the payer is not a "financial institution group entity" (as defined in subsection 18.2(1)), the election will only be available if the payee is also not such an entity.

Finally, the payer and payee (or, if the payer or payee is a partnership, each member of the payer or payee) are required to jointly elect in writing in prescribed manner and specify the amount of interest, or the lease financing amount, which they wish to have treated as excluded interest, as well as the amount of the debt at the beginning and end of the relevant period or the fair market value of the leased property at the time the lease began. Taxpayers may treat all or any portion of an interest payment, or lease financing amount, as excluded interest. The result of this election is that the amount is excluded interest for the single taxation year in respect of which the election was filed.

The joint election must be filed in respect of the taxation year or fiscal period of the payer and payee in which the amount of interest or the lease financing amount is paid, or in respect of which the amount is payable. It is intended that the election be filed for the year or fiscal period when the amount paid or payable is deductible or is included in income. For example, if accrued interest is deductible in a particular taxation year but becomes paid or payable in a later taxation year, the election must be filed for the particular year.

Example

Assumptions

- Canco is a wholly-owned subsidiary of Forco, a non-resident corporation.
- For its taxation year ending December 31, 2025, Canco has a non-capital loss carryforwards balance of $50 million, consisting of losses incurred as a result of transactions entered into in the ordinary course of its retail sales business.
- Canco is the sole shareholder of CanSub, which is expected to have significant income from its wholesale business in its taxation year ending December 31, 2025.
- Canco and CanSub enter into a series of transactions, the effect of which is that CanSub becomes indebted to Canco and has $10 million in interest (the "Interest") paid and payable in 2025 in respect of the debt. The series of transactions has no material interprovincial effects.
- In 2025, CanSub would have taxable income of $10 million, before taking into account the Interest.
- Canco deducts $10 million under paragraph 111(1)(a) in respect of its non-capital loss carryforwards, in computing its taxable income for 2025.
- Throughout the period during which Interest accrues, both Canco and CanSub are taxable Canadian corporations and Canco is an eligible group corporation in respect of CanSub.
- The group ratio rule in subsection 18.21(2) does not apply in respect of Canco or CanSub for their 2025 taxation year.

Analysis – with "excluded interest" election

If CanSub and Canco duly elect under paragraph (e) of the definition "excluded interest" in respect of the Interest, this amount is treated as excluded interest.

Because excluded interest is not included in computing CanSub's interest and financing expenses, subsection 18.2(2) does not limit the amount that CanSub may deduct in respect of the Interest in computing its income for its 2025 taxation year.

As a result of the Interest, CanSub's taxable income for 2025 is nil. Consequently, in computing CanSub's adjusted taxable income, the amount determined for variable A in the definition "adjusted taxable income" is nil. No amount in respect of the Interest is added back under paragraph (a) of variable B of that definition, since excluded interest is not included in CanSub's interest and financing expenses. Thus, assuming CanSub does not have any other amounts described in variable B (e.g., interest and financing expenses) or C (e.g., interest and financing revenues) of that definition, its adjusted taxable income for 2025 is nil.

The Interest is included in computing Canco's income for its 2025 taxation year. Canco's $10 million deduction in respect of its non-capital loss carryforwards reduces its taxable income – and thus the amount determined for variable A in computing its adjusted taxable income for the year – to nil. In addition, since excluded interest is not included in computing Canco's interest and financing revenues, the Interest is not subtracted in computing Canco's adjusted taxable income, under variable C of the definition of that term. Assuming Canco does not have any amounts described in variable B or C of that definition, Canco's adjusted taxable income for 2025 is nil.

Because excluded interest is not included in computing Canco's interest and financing revenues, the Interest does not increase Canco's deduction capacity (under variable C in subsection 18.2(2)) or its excess capacity (under variable F of the definition of that term).

Analysis – without "excluded interest" election

If CanSub and Canco do not jointly elect to treat the Interest as excluded interest, $10 million will be included in CanSub's interest and financing expenses and in Canco's interest and financing revenues for their 2025 taxation year.

As a result, the amount that CanSub may deduct in respect of the Interest is subject to the limitation in subsection 18.2(2).

In determining CanSub's adjusted taxable income for 2025, the amount determined for variable A of the definition of that term (which is determined without regard to any interest deductions denied under subsection 18.2(2)) is nil, since CanSub's taxable income is nil. However, because the Interest is included in CanSub's interest and financing expenses, it is added back under paragraph (a) of variable B in computing CanSub's adjusted taxable income. Thus, assuming CanSub does not have any other amounts described in variable B or C, its adjusted taxable income for 2025 is $10 million.

CanSub's adjusted taxable income of $10 million results in $3 million of deduction capacity under subsection 18.2(2) (determined, under paragraph (b) of variable B of that subsection, by multiplying $10 million of adjusted taxable income by a ratio of permissible expenses of 30%). In order for CanSub to deduct the remaining $7 million of the Interest, absent any cumulative unused excess capacity or interest and financing revenues of its own, CanSub will require a transfer, under the election in subsection 18.2(4), out of Canco's cumulative unused excess capacity.

In determining Canco's adjusted taxable income, Canco's $10 million deduction in respect of its non-capital loss carryforwards reduces its taxable income – and thus the amount determined for variable A in the definition "adjusted taxable income" – to nil. The $10 million included in Canco's interest and financing revenues in respect of the Interest (as a result of not electing "excluded interest" treatment) is subtracted under variable C in computing its adjusted taxable income. In the absence of section 257, this would cause Canco's adjusted taxable income for 2025 to be negative $10 million. However, because of section 257, Canco's adjusted taxable income cannot be a negative amount and is thus nil.

Although Canco has nil adjusted taxable income, it nonetheless has excess capacity, derived from its interest and financing revenues, by virtue of variable F in paragraph (b) of the definition "excess capacity". However, because Canco's adjusted taxable income would, absent section 257, be negative $10 million, variables H and I of the "excess capacity" definition reduce Canco's excess capacity deriving from its interest and financing revenues from $10 million to $7 million (i.e., $10 million minus the product of 30% and $10 million). For further information on this reduction, see the commentary to the definition "excess capacity".

Assuming Canco does not have any interest and financing expenses or deductible restricted interest and financing expense for the year, its excess capacity for 2025 is $7 million. This amount is included in determining Canco's cumulative unused excess capacity for 2025, under paragraph (a) of the definition of that term.

Provided that the requirements of subsection 18.2(4) are met, Canco and CanSub may jointly elect to designate Canco's $7 million cumulative unused excess capacity as an amount of transferred capacity of Canco and received capacity of CanSub for the 2025 taxation year. In computing CanSub's interest deduction limit for the year under subsection 18.2(2), this $7 million received capacity is, under variable D in that subsection, added to CanSub's $3 million deduction capacity deriving from its adjusted taxable income, such that CanSub is entitled to deduct $10 million in respect of the Interest.

"excluded lease"

A "lease financing amount", representing an implicit interest expense in respect of a lease, is included in the lessee's interest and financing expenses, and the lessor's interest and financing revenues, unless the lease is an excluded lease.

A lease to which subsection 16.1(1) applies is treated as an excluded lease, because the effect of the lessor and lessee jointly electing under that subsection is that the lessee has a deemed interest expense in respect of the lease, which is already included in its income and financing expenses (as defined under subsection 18.2(1)).

In recognition that the specified leasing property rules in the Regulations, like the new EIFEL rules, generally seek to distinguish leases that are (or are more likely to be) used as substitutes for financing from those that are used for operational purposes (which are generally excluded from the rules), the other categories of excluded lease are based on exclusions from the "specified leasing property" definition in of subsection 1100(1.11) of the Regulations. Generally, these other categories of excluded lease are leases with a term of less than one year, leases of property with a fair market value of $25,000 or less, and leases in respect of "exempt property".

The reason that paragraphs (b) and (c) of the definition "excluded lease" refer to leases or property that would (or would not) be considered, for the purposes of the specified leasing property rules, to satisfy certain requirements for exclusions from the definition "specified leasing property", is to ensure that various anti-avoidance and application rules in section 1100 also apply for the purposes of determining whether a lease or property satisfies the requirements in the definition "excluded lease". These include, for example, the various rules relating to exempt property in paragraphs 1100(1.13)(a) to (a.2); and the anti-avoidance rules in paragraphs 1100(1.13)(b) and (c), relating to leases with a term of less than one year and leases of property with a fair market value of $25,000 or less, respectively.

Certain other types of lease (or leases in respect of certain types of property) that are excluded from the "specified leasing property" definition are not excluded leases for the EIFEL rules. For example, leases in respect of non-depreciable property and intangible property, and leases entered into between non-arm's length persons, are specifically excluded from "specified leasing

property" but are not excluded leases (unless they meet the specific requirements in the definition “excluded lease”).

“exempt interest and financing expenses”

The definition of “exempt interest and financing expenses” is relevant for purposes of providing an exemption from the EIFEL rules for interest and financing expenses incurred in respect of the financing of typical Canadian public-private partnership (P3) projects.

Expenses that would otherwise be interest and financing expenses of a taxpayer will be exempt interest and financing expenses to the extent they were incurred by the taxpayer or a partnership of which the taxpayer is a member in respect of a borrowing or other financing where

- the taxpayer or partnership entered into an agreement with a “public sector authority” (as defined in subsection 18.2(1)) to design, build and finance, or design, build, finance, maintain and operate, property that a public sector authority (which may be a different public sector authority than the one that entered into the agreement) owns, or has a leasehold interest in or a right to acquire;
- the borrowing or other financing was entered into in respect of the agreement;
- it can reasonably be considered that all or substantially all of the expenses were economically borne by the public sector authority that has the interest in the property or that entered into the agreement with the taxpayer or partnership (for example, where the public sector authority makes capital payments under a project agreement to cover the financing expenses of the project); and
- the expenses were paid or payable to arm’s length persons, or paid or payable to a particular non-arm’s-length person in a back-to-back financing arrangement where it may reasonably be considered that the particular person paid all or substantially all of the amount on to one or more persons that deal at arm’s length with the taxpayer or partnership (for example, where for commercial or regulatory purposes a subsidiary entity of the taxpayer or partnership borrows from arm’s length third parties and on-lends to the taxpayer or partnership).

Exempt interest and financing expenses do not pose significant base erosion and profit shifting risks targeted by the new EIFEL rules. Exempt interest and financing expenses, as well as any income or loss derived from activities funded by borrowings that give rise to exempt interest and financing expenses, are effectively excluded from the EIFEL rules.

Pursuant to variable A of the definition “interest and financing expenses”, exempt interest and financing expenses are not included in a taxpayer’s interest and financing expenses. Accordingly, they are not subject to a deduction denial under subsection 18.2(2) or an income inclusion under paragraph 12(1)(l.2).

Income or losses derived from borrowings that give rise to exempt interest and financing expenses are similarly excluded from the calculation of adjusted taxable income, ensuring that activities that are funded by borrowings that give rise to exempt interest and financing expenses do not generate adjusted taxable income that could be used to shelter additional (non-exempt)

interest and financing expenses and do not generate losses that would reduce a taxpayer's ability to deduct interest and financing expenses in respect of its other businesses or activities.

Specifically, losses that may reasonably be considered to arise in respect of activities funded by a borrowing that results in exempt interest and financing expenses are added-back under paragraph (k) of variable B of the definition of adjusted taxable income, and income that may reasonably be considered to arise in respect of activities funded by such a borrowing is deducted under paragraph (j) of variable C of that definition.

Exempt interest and financing expenses are not added-back to adjusted taxable income, but may indirectly impact the calculation of adjusted taxable income to the extent that they contribute to the calculation of an add-back or deduction under paragraph (k) of variable B or paragraph (j) of variable C, respectively, of the definition of adjusted taxable income.

Where activities are funded both by borrowings that result in exempt interest and financing expenses and by other sources of funding – such as equity funding or borrowings that do not result in exempt interest and financing expenses – the extent to which a taxpayer's income or loss can reasonably be considered to be derived from activities funded by exempt interest and financing expenses will be a question of fact.

However, it would generally be reasonable to consider that the proportion of the overall income or loss attributable to activities funded by exempt income and financing expenses is equal to the proportion that the borrowing that results in exempt interest and financing represents of the total financing of the activities. For example, where an activity is funded 50% by a borrowing that results in exempt interest and financing expenses, 25% by other debt financing, and 25% by equity financing, it would generally be reasonable to consider that 50% of the income or loss in respect of the total activity is derived from activities funded by a borrowing that results in exempt interest and financing expenses.

"financial holding corporation"

The definition "financial holding corporation" is relevant for the purposes of the restrictions on the ability of financial institution group entities to transfer their cumulative unused excess capacity under subsection 18.2(4), and for the purposes of the anti-avoidance rule in subsection 18.2(13). For more information, see the commentary on those provisions.

"financial institution group entity"

The definition "financial institution group entity" is relevant mainly in applying the restrictions on the ability of such an entity to transfer its cumulative unused excess capacity to other members of its corporate group under subsection 18.2(4). These restrictions are intended to address anomalies in applying the EIFEL rules in respect of corporate groups that include financial institutions. For certain financial institutions, the nature of their regular business activities is such that interest income and expenses may more appropriately be considered as in the nature of operating amounts. Relatedly, the interest income of these entities will often exceed their interest expense. The restrictions on transfers by financial institution group entities are

intended to ensure that this net interest income cannot be used to inappropriately shelter the interest and financing expenses of taxpayers that are members of the same corporate group, but which do not principally carry on financial businesses or activities.

In general terms, financial institution group entities are entities whose regular business activities involve the lending of money, dealing or investing in indebtedness or other financing transactions, or that are eligible group entities in respect of such an entity and, generally, either provide regulated financial services or similar services in respect of real estate, or carry on activities all or substantially all of which support the activities or business of other financial institution group entities. This would include, for example, an entity that is an eligible group entity in respect of a bank and provides routine or specialized "back office" services to the bank, such as information technology or risk analysis.

There are three restrictions imposed in respect of financial institution group entities.

First, for the purpose of paragraph (b) in the definition "excluded entity" in subsection 18.2(1), which generally provides an exclusion from the limitation in subsection 18.2(2) for taxpayers that are members of groups with net interest and financing expenses of $1,000,000 or less in a taxation year, the interest and financing revenues of a financial institution group entity are excluded in computing the group's net interest and financing expenses.

Second, a financial institution group entity can only transfer, under subsection 18.2(4), its cumulative unused excess capacity to another financial institution group entity or, subject to certain limitations, to a financial holding corporation or a special purpose loss corporation.

Third, under the anti-avoidance rule in subsection 18.2(13), payments received by a taxpayer that is not a financial institution group entity or a financial holding corporation from a non-arm's length financial institution group entity (or financial holding corporation) are excluded from the taxpayer's interest and financing revenues (and do not reduce the taxpayer's interest and financing expenses).

Additionally, under the transitional rules, the "group net excess capacity" (essentially the excess capacity available to be carried forward into the EIFEL regime) is determined without reference to any income or expense amounts of financial institution group entities.

For more information, see the commentary on the definition "excluded entity" in this subsection and on subsection 18.2(4).

"fixed interest commercial trust"

The definition "fixed interest commercial trust" is relevant for purposes of the transfer of cumulative unused excess capacity between certain eligible group entities under subsection 18.2(4), as only entities that are taxable Canadian corporations or fixed interest commercial trusts may make or receive transfers under that subsection. The definition relies on concepts and conditions found in subsection 94(1), specifically the definition "fixed interest" and clauses (h)(ii)(A) to (C) of the definition "exempt foreign trust". Essentially, a fixed interest commercial

trust is a trust resident in Canada that is a non-discretionary trust (i.e., a fixed interest trust) and meets any of the conditions in the above-noted clauses of the definition "exempt foreign trust", which generally test the commerciality of the trust.

"foreign accrual property loss"

The definition "foreign accrual property loss" has the meaning assigned by subsection 5903(3) of the Regulations. This definition is relevant in applying the EIFEL rules in respect of controlled foreign affiliates of taxpayers.

"interest and financing expenses"

The definition "interest and financing expenses" includes interest and various other financing-related expenses and losses, but does not include any exempt interest and financing expenses (which are generally expenses incurred in respect of certain public-private partnership infrastructure projects). For more information, see the commentary on the definition "exempt interest and financing expenses".

The deductibility of a taxpayer's interest and financing expenses that are described in any of paragraphs (a) to (g) or (i) of variable A of this definition is potentially subject to denial under new subsection 18.2(2). If the expenses are incurred at the level of a partnership and attributed to the taxpayer under paragraph (h) of variable A of this definition, they may instead give rise to an income inclusion to the taxpayer under new paragraph 12(1)(l.2).

A taxpayer's interest and financing expenses are "added back" in determining its adjusted taxable income for the year, under paragraph (a) of variable B of that definition.

A taxpayer's interest and financing expenses for a particular taxation year are the total of the amounts described in paragraphs (a) to (j) of variable A, minus the total of the amounts described in variable B.

Variable A

Paragraph (a) of variable A includes, in a taxpayer's interest and financing expenses for a particular taxation year, amounts paid or payable as, on account of, in lieu of payment of or in satisfaction of, interest. This description is similar to that in paragraph 12(1)(c), which is the rule requiring a taxpayer to include interest received or receivable in computing its income. For greater certainty, it includes amounts that are deemed or treated as interest under the Act (e.g., under subsection 16(1)), but specifically excludes amounts that are paid or payable by a credit union in respect of its shares and are deemed to be interest under subsection 137(4.1).

The amounts described in subparagraph (a)(i) are included if, absent the new limitation under subsection 18.2(2), they would be deductible in the particular year. The year in which they are deductible need not be the same year in, or in respect of which, they are paid or payable.

These amounts are included regardless of the particular provision of the Act under which they are deductible, except that paragraph (a) does not include amounts that are deductible under a

provision referred to in subparagraph (c)(i). In addition to preventing double-counting in computing interest and financing expenses, this exception is intended to ensure that certain discretionary deductions in respect of mainly capitalized interest and financing expenses are included in interest and financing expenses (by virtue of paragraph (c) in this definition) only to the extent that a deduction is in fact claimed for the year.

The following amounts are not included in the taxpayer's interest and financing expenses under paragraph (a):

- "Excluded interest", which is generally interest, or a lease financing amount, paid or payable by the taxpayer to another member of its corporate group that the parties have jointly elected to treat as such. For more information, see the commentary on the definition "excluded interest";
- An amount deemed to be interest under subsection 137(4.1); and
- An amount that is interest and financing expenses under another paragraph of the definition, to prevent double-counting of such amounts in determining interest and financing expenses.

Paragraph (b) of variable A includes in a taxpayer's interest and financing expenses for the particular year amounts that, absent subsection 18.2(2), would otherwise be deductible in the particular year

- under any of subparagraphs 20(1)(e)(ii) to (ii.2) and paragraphs 20(1)(e.1) and (e.2), in respect of various financing-related expenses; or
- under paragraph 20(1)(f), for amounts paid in respect of the principal amount of certain debt obligations issued at a discount.

In certain cases, financing expenses may be otherwise described in, for example, paragraph 20(1)(e) but a taxpayer may take the position that the expenses are deductible under another provision of the Act (such as section 9), such that they are not deductible under paragraph 20(1)(e). In paragraph (b), the phrase "and on the assumption that [the amount] is not deductible under another provision of this Act" is intended to ensure that these expenses are nonetheless included in a taxpayer's interest and financing expenses.

Paragraph (c) of variable A includes in interest and financing expenses amounts that are in respect of interest, or any of the various financing-related expenses that would otherwise be included in the taxpayer's interest and financing expenses for some year by virtue of paragraph (b) of this definition, but that generally have been "capitalized" or otherwise included in resource-expense pools (for example, by virtue of subsection 18(3.1) for certain costs in relating to construction; or as a result of an election under any of subsections 21(1) to (4), in respect of interest or various financing expenses). These amounts are included in the taxpayer's interest and financing expenses for the particular year in which the taxpayer claims them as deductions in respect of capital cost allowance under paragraph 20(1)(a), or in respect of resource expenses under any of the provisions listed in subparagraph (c)(i). This includes where the taxpayer claims a deduction under section 66.7 in respect of amounts that have been included in successor pools. Because amounts are included in interest and financing expenses under paragraph (c) only in the

year in which they are claimed, they are not included for any year in which they have become deductible but have not yet been claimed as deductions by the taxpayer.

To facilitate compliance, paragraph (c) only includes in interest and financing expenses capitalized amounts that are paid or payable on or after February 4, 2022.

Since a taxpayer's undepreciated capital cost, or remaining balance in its resource expense pools, generally will not be attributable exclusively to interest and financing expenses, paragraph (c) of variable A requires that the taxpayer determine the portion of an amount it claims in respect of its capital cost allowance or resource expenses for a particular year that can "reasonably be considered" to be attributable to the interest or financing expenses. It is expected that this portion would generally correspond to the proportion of the claimed amount that the interest and financing expenses included in the relevant expense pool are of the taxpayer's undepreciated capital cost or undeducted balance of a resource expense pool, as the case may be.

If subsection 18.2(2) denies a deduction for any portion of an amount included in the taxpayer's interest and financing expenses by virtue of paragraph (c) or (d) of variable A of this definition, then the rule provided in subsection 18.2(3) ensures that the taxpayer's undepreciated capital cost or resource expense pool is reduced to the extent of the denied portion. For more information, see the commentary on subsection 18.2(3).

Under paragraph (d) of variable A, where a taxpayer suffers a terminal loss in a year, any portion that can reasonably be considered to represent capitalized interest or financing expenses described in subparagraph (c)(ii) of variable A is included in the taxpayer's interest and financing expenses.

Paragraph (e) of variable A includes in interest and financing expenses certain amounts that are not included under any of the other paragraphs in this definition, but can reasonably be considered to be part of the cost of funding with respect to a borrowing or other financing of the taxpayer or a non-arm's length person or partnership. This is intended to include amounts that are, in economic terms, part of the costs incurred in relation to the funding of a business or investment. This would include, for example, an amount that is not included under paragraph (a) because it does not have the legal character of interest, but which is economically equivalent to interest.

An amount is included in a taxpayer's interest and financing expenses for a particular taxation year under paragraph (e) only if all the conditions in that paragraph are met.

First, subparagraph (e)(i) requires that the amount be paid or payable by, or a loss of, the taxpayer and deductible in computing its income for the particular year (absent section 18.2). Alternatively, the amount must be a capital loss that is offset against the taxpayer's taxable capital gains for the particular year, or is deductible under paragraph 111(1)(b) in computing its taxable income for the particular year. As a result, allowable capital losses that otherwise meet the requirements of paragraph (e) and that are not used to offset taxable capital gains become interest and financing expenses in the year in which they are deducted under paragraph 111(1)(b) – not in the year in which they are incurred.

It is not expected that equity financings would satisfy all the requirements of paragraph (e). These types of financings do not typically give rise to a deduction, a loss or a capital loss that would satisfy the requirement in subparagraph (e)(i), and that subparagraph specifically excludes amounts that are deductible under subparagraph 20(1)(e)(i) (as expenses incurred in the course of issuing equity interests in the taxpayer).

Second, subparagraph (e)(ii) requires that the amount arise under or as a result of an agreement or arrangement that is entered into as, or in relation to, a borrowing or other financing of the taxpayer or a non-arm's length person or partnership. Thus, the agreement or arrangement can either itself constitute or provide a financing, or be ancillary to a financing. The reference to "borrowing or other financing" is intended to describe a range of agreements or arrangements that procure financing, in an economic sense.

The agreements and arrangements contemplated by subparagraph (e)(ii) include, among other things, derivative contracts used in a wide range of situations. For example, it can include a derivative contract that is entered into for the purpose of hedging any risk in relation to a borrowing or other financing (including currency, interest rate or payment risk), and a derivative contract that itself includes a material financing or funding component. The types of derivative contracts that can meet the conditions in paragraph (e) of this definition include cash or physically-settled swap agreements, forward purchase or sale agreements, forward rate agreements, futures agreements, securities lending agreements, sale and repurchase agreements ("repos"), and option agreements.

Derivative contracts can be considered to include a financing or funding component, for example, where they have mismatched payment or delivery requirements, which can, in economic terms, result in a financing or funding of either party during all or part of the term of the particular contract. This can result from either party having the right to use any cash, cash equivalents or other securities transferred or delivered to them during the term of the particular agreement or arrangement (net of any amounts they are obligated to transfer or deliver to the other party during the term of the particular agreement or arrangement). Examples include (i) forward agreements with material prepayment or pre-delivery obligations, (ii) swap agreements with material mismatched payment or collateralization requirements, and (iii) securities lending agreements or repos (whether or not they are "securities lending arrangements" for the purposes of section 260).

An amount under a derivative contract could satisfy the necessary conditions in subparagraph (e)(ii) of variable A even where the derivative contract is in relation to a borrowing or other financing that is anticipated to be entered into sometime in the future, and even if it is subject to a contingency, since subparagraph (e)(ii) provides that the borrowing or financing can be entered into "currently or in the future, and absolutely or contingently".

Third, to be included in interest and financing expenses under paragraph (e) of variable A, the amount paid or payable or the loss or capital loss must satisfy the requirement in subparagraph (e)(iii) such that it can reasonably be considered to increase or be "part of" the "cost of funding"; this includes amounts that increase the cost of funding as a result of any hedge of the cost of

funding or of the borrowing or other financing. For example, in the case of an agreement that is itself a borrowing, a foreign currency loss on the repayment of the principal amount of the borrowing would increase the cost of funding. In the case of a derivative contract entered into for the purpose of hedging a risk in relation to a borrowing or other financing, an amount paid or payable under, or a loss resulting from, the contract constitutes a cost of funding. The phrase "cost of funding" would include any amount that can reasonably be considered compensation for the time value of money. In the context of the derivative contracts examples outlined above, where the effect of the agreement or arrangement is to fund a business or investment, the combined cash flows must economically include an amount that can reasonably be considered to be in respect of compensation for the use of the cash, cash equivalents or securities that constitute the funding.

While not definitive for purposes of paragraph (e) of variable A, the manner in which an amount is characterized under the applicable generally accepted accounting principles may provide guidance with respect to the types of amounts considered economically equivalent to interest or otherwise treated as financing expenses.

Paragraph (f) of variable A includes in interest and financing expenses generally any expenses or fees, in respect of agreements or arrangements described in paragraph (e) of variable A, that would, in the absence of section 18.2, be deductible by the taxpayer in the year and are not included in the taxpayer's interest and financing expenses under paragraph (b) of variable A of this definition. The policy is that expenses and fees in respect of an agreement or arrangement that is treated as a financing transaction should themselves be included in the taxpayer's interest and financing expenses. Because these agreements or arrangements may, in many cases, not be described in any of the provisions listed in paragraph (b) of variable A, the associated expenses and fees would consequently not be included under that paragraph. Including these expenses and fees in a taxpayer's interest and financing expenses ensures neutrality between taxpayers' choice of financing arrangements. These expenses and fees are included if they are incurred in contemplation of, in the course of entering into or in relation to, the agreement or arrangement. Expenses or fees incurred "in relation to the agreement or arrangement" would include, for example, those incurred in making payments under the agreement or arrangement, taking steps to secure the receipt of payments under the agreement or arrangement, or modifying the terms and conditions of the agreement or arrangement.

Paragraph (g) of variable A includes in interest and financing expenses the portion, of any lease payment that would be deductible in the absence of subsection 18.2(2), that is a "lease financing amount". This essentially imputes a financing cost to lessees in respect of their lease payments. Lease payments made in respect of excluded leases, or in respect of which an "excluded interest" election is made, do not give rise to interest and financing expenses under paragraph (g). For more information, see the commentary on the definitions "lease financing amount", "excluded interest" and "excluded lease".

Paragraph (h) of variable A essentially includes in a taxpayer's interest and financing expenses its share of the interest and financing expenses of a partnership of which the taxpayer is a member. This includes interest and financing expenses described in paragraphs (a) to (g) of variable A that are deducted in computing the income of a partnership. It also includes the

relevant affiliate interest and financing expenses of a controlled foreign affiliate (described in paragraph (j) of variable A) held through a partnership.

The attribution of partnership-level interest and financing expenses applies on a source-by-source basis, with the partnership's interest and financing expenses in respect of each source being attributed to the taxpayer based on its pro rata share of the partnership's income or loss from the source. These amounts are included in the taxpayer's interest and financing expenses for its taxation year in which the partnership's fiscal period ends.

The amount included under paragraph (h) of variable A is subject to reductions under variable E and F of that paragraph, if applicable. The reduction under variable E ensures that, if paragraph 12(1)(l.1) of the thin capitalization rules applies to include an amount in the taxpayer's income in respect of the taxpayer's share of partnership-level interest and financing expenses, that amount reduces the amount that is included in the taxpayer's interest and financing expenses under paragraph (h).

The reduction under variable F applies where the partnership deducts interest and financing expenses in computing its loss from a source, and the limited partnership "at-risk" rule in subsection 96(2.1) applies to restrict the taxpayer's ability to deduct its share of the partnership loss.

Paragraph (i) of variable A is related to variable F of paragraph (h). It applies where the taxpayer claims an amount under paragraph 111(1)(e), in respect of a partnership loss, that was previously denied under subsection 96(2.1) for a preceding taxation year. In that case, the portion of the amount claimed that would, in the absence of subsection 18.2(2), be deductible under paragraph 111(1)(e) that is attributable to a variable F amount from a previous taxation year is included in the taxpayer's interest and financing expenses.

Paragraph (j) of variable A essentially includes in the taxpayer's interest and financing expenses for the particular year its share of a controlled foreign affiliate's relevant affiliate interest and financing expenses for an affiliate taxation year ending in the particular year.

In general terms, relevant affiliate interest and financing expenses consists of the amounts described in the definition "interest and financing expenses" that are taken into account in determining the foreign accrual property income of a controlled foreign affiliate for an affiliate taxation year. The extent to which the relevant affiliate interest and financing expenses are attributed to a taxpayer is determined by reference to the taxpayer's specified participating percentage in respect of the affiliate for the affiliate taxation year.

For more information, see the commentary on the definitions "relevant affiliate interest and financing expenses" and "specified participating percentage".

Variable B

The amounts described in variable B are deducted from the amounts described in variable A and reduce the amount of interest and financing expenses of a taxpayer for a particular taxation year.

Paragraph (a) of variable B includes amounts received or receivable (other than as a dividend or an amount in respect of exempt interest and financing expenses) by the taxpayer in a year, or a gain for a year, in connection with an agreement or arrangement entered into as or in relation to a borrowing or other financing of the taxpayer, or a non-arm's length person or partnership. Thus, the agreement or arrangement can either itself constitute or provide a financing, or be ancillary to a financing. Where the agreement or arrangement is ancillary to the financing, the agreement or arrangement must additionally have been entered into to hedge the cost of funding with respect to the borrowing or other financing or to hedge the borrowing or other financing. The amounts must be included in computing the income of the taxpayer for the year and must reasonably be considered to reduce the cost of funding with respect to the borrowing or other financing. In effect, the amounts described in paragraph (a) are limited to taxable gains on the repayment of a borrowing or other financing (such as a foreign currency gain) and amounts received or receivable in respect of a hedge, including any gain realized on a derivative contract that hedges a risk (including currency, interest rate or payment risk) in relation to the borrowing or other financing. Subparagraph (a)(iv) ensures that such an amount does not reduce a taxpayer's interest and financing expenses to the extent the amount is effectively sheltered from Canadian tax by virtue of a credit or deduction in respect of foreign taxes (other than foreign withholding taxes).

Paragraph (b) of variable B ensures that a taxpayer's interest and financing expenses are reduced where an amount that would be described under paragraph (a) of variable B, if it were received by the taxpayer, is received or receivable by a partnership of which the taxpayer is a member.

"interest and financing revenues"

The interest and financing revenues of a taxpayer for a taxation year include interest income and certain other financing-related income and gains, to the extent that these amounts are included in computing the taxpayer's income for the year.

This definition is relevant in two key respects. First, a taxpayer's interest and financing revenues for a taxation year increase the amount of interest and financing expenses it is permitted to deduct in that year under subsection 18.2(2). In effect, the limitation under that subsection applies to the taxpayer's net interest and financing expenses (i.e., its interest and financing expenses minus its interest and financing revenues).

Second, interest and financing revenues are included in computing a taxpayer's "excess capacity" for a taxation year. For more information, see the commentary on the definition "excess capacity".

A taxpayer's interest and financing revenues for a year are subtracted in determining the taxpayer's adjusted taxable income for the year, under paragraph (a) of variable C of that definition.

A taxpayer's interest and financing revenues for a taxation year are the total of the amounts described in paragraphs (a) to (g) of variable A, minus the amount described in variable B.

Variable A

Variable A is the total of all amounts described in paragraphs (a) to (g), other than any amount described in variable B of the definition “interest and financing expenses” (this exclusion is to prevent taxpayers from, in effect, double-counting certain amounts). For more information, see the commentary on the definition “interest and financing expenses”.

Paragraph (a) of variable A includes amounts received or receivable as, on account of, in lieu of payment or in satisfaction of interest, but does not include:

- “Excluded interest”, which is generally interest, or a lease financing amount, received or receivable by the taxpayer from another member of its corporate group that the parties have jointly elected to treat as such. For more information, see the commentary on the definition “excluded interest”.
- Amounts paid or payable by a credit union, in respect of its shares, that are deemed to be interest under subsection 137(4.1).
- An amount that is interest and financing revenues under another paragraph of this definition, to prevent double-counting of such amounts in determining interest and financing revenues.

Paragraph (b) includes in a taxpayer’s interest and financing revenues for the year amounts included in the taxpayer’s income because of the deeming rule in subsection 12(9) or section 17.1, which would not otherwise be included under paragraph (a) (or any other paragraph of this definition).

Paragraph (c) of variable A includes in a taxpayer’s interest and financing revenues for the year amounts in respect of a guarantee, or similar credit support, to the extent they are included in computing the taxpayer’s income for the year.

Paragraph (d) of variable A includes in interest and financing revenues certain amounts that are received or receivable by the taxpayer, or that are gains of the taxpayer, and that are not included under any of the other paragraphs in this definition, but that effectively increase, or are part of, the return of the taxpayer, or a person or partnership that does not deal at arm’s length with the taxpayer, on a loan or other financing owing to or provided by the taxpayer or the person or partnership that does not deal at arm’s length with the taxpayer, including from any hedge of the return on the loan or other financing or of the loan or other financing. These amounts are roughly the converse of the amounts included in a taxpayer’s interest and financing expenses under paragraph (e) of variable A of that definition, and include amounts that are not included under paragraph (a) of variable A of this definition because they do not have the legal character of interest, but which are economically equivalent to interest. See the commentary on paragraph (e) of variable A of the definition “interest and financing expenses”.

The amounts under paragraph (d) of variable A are included in the taxpayer’s interest and financing revenues for a taxation year only if all of the conditions in that paragraph are met. The amount must be included in computing the taxpayer’s income for the year (if the amount is a capital gain, only the taxable portion will be included in interest and financing revenues). In addition, the amount must be received or receivable (other than as a dividend), or be a gain,

under or as a result of an agreement or arrangement that is entered into as, or in relation to, a loan or financing owing to or provided by the taxpayer or a person or partnership that does not deal at arm's length with the taxpayer. An example of such an agreement or arrangement is a derivative contract entered into to hedge a risk (including currency, interest and payment risk) in relation to a loan or other financing.

Paragraph (e) of variable A includes in a taxpayer's interest and financing revenues the portion of a lease payment included in the taxpayer's income that is a "lease financing amount" (as defined in subsection 18.2(1)). This essentially imputes a financing return on lease payments received by lessors. Lease payments received in respect of excluded leases, or in respect of which an "excluded interest" election has been made, do not give rise to interest and financing revenues. For more information, see the commentary on the definitions "lease financing amount", "excluded interest" and "excluded lease".

Paragraph (f) of variable A essentially includes in a taxpayer's interest and financing revenues its share of interest and financing revenues of a partnership of which the taxpayer is a member. This includes interest and financing revenues described in paragraphs (a) to (e) of variable A that are included in computing the income of a partnership. It also includes the relevant affiliate interest and financing revenues of a controlled foreign affiliate held through a partnership.

The attribution of partnership-level interest and financing revenues applies on a source-by-source basis, with the partnership's interest and financing revenues in respect of each source being attributed to the taxpayer based on its pro rata share of the partnership's income or loss from the source. These amounts are included in the taxpayer's interest and financing revenues for its taxation year in which the partnership's fiscal period ends.

Paragraph (g) of variable A essentially includes in the taxpayer's interest and financing revenues for the year its share of a controlled foreign affiliate's relevant affiliate interest and financing revenues for an affiliate taxation year ending in the year.

In general terms, relevant affiliate interest and financing revenues consist of the amounts described in the definition "interest and financing revenues" that are taken into account in computing the foreign accrual property income of a controlled foreign affiliate for an affiliate taxation year. The extent to which these amounts are attributed to the taxpayer is determined by reference to the taxpayer's specified participating percentage in respect of the affiliate for the affiliate taxation year.

For more information, see the commentary on the definitions "relevant affiliate interest and financing revenues" and "specified participating percentage".

Under variable G of the formula in paragraph (g), any deduction under subsection 91(4) in respect of foreign accrual tax (within the meaning of subsection 95(1)) – other than any portion that is in respect of Canadian withholding tax paid under subsection 212(1) – reduces the amount included in the taxpayer's interest and financing revenues in respect of the relevant affiliate interest and financing revenues to which the foreign accrual tax relates. A tracing approach is to

be used to determine the extent to which an amount of foreign accrual tax is in respect of a particular amount of relevant affiliate interest and financing revenues.

The reduction under variable G applies if an amount is deducted under subsection 91(4) in any taxation year. Thus, if relevant affiliate interest and financing revenues are included in a taxpayer's interest and financing revenues for a particular taxation year and the taxpayer deducts an amount (other than any portion of the amount that is in respect of Canadian withholding tax) under subsection 91(4) for foreign accrual tax in respect of those revenues in a subsequent taxation year, the amount included in the taxpayer's interest and financing revenues for the particular year is reduced to reflect the subsection 91(4) deduction in the subsequent year.

Variable B

The amounts described in variable B are deducted from the amounts described in variable A and reduce the amount of interest and financing revenue of a taxpayer for a taxation year.

Paragraph (a) of variable B applies if a taxpayer has an amount paid or payable, or a loss or capital loss, under or as a result of an agreement or arrangement entered into as or in relation to a loan or other financing owing to or provided by the taxpayer, or a person or partnership that does not deal at arm's length with the taxpayer. Thus, the agreement or arrangement can either itself constitute or provide a loan or other financing, or be ancillary to a loan or other financing. Where the agreement or arrangement is ancillary to the loan or other financing, the agreement or arrangement must additionally have been entered into to hedge the return in respect of the loan or other financing. This amount is subtracted in computing the taxpayer's interest and financing revenues, to the extent it was deductible in computing the taxpayer's income and can reasonably be considered to reduce the return of the taxpayer, or a person or partnership that does not deal at arm's length with the taxpayer, in respect of the loan or other financing. In effect, the amounts described in paragraph (a) are limited to allowable capital losses on a loan or other financing and amounts paid or payable in respect of a hedge, including any loss realized on a derivative contract that hedges a risk (including currency, interest rate or payment risk) in relation to the loan or other financing.

Paragraph (b) of variable B ensures that a taxpayer's interest and financing revenues are reduced where an amount that would be described under paragraph (a) of variable B, if it were received by the taxpayer, is received or receivable by a partnership of which the taxpayer is a member.

Paragraph (c) of variable B reduces an amount otherwise included in a taxpayer's interest and financing revenues under variable A, to the extent the amount is effectively sheltered from Canadian tax by virtue of a credit or deduction in respect of foreign taxes. The reduction under this paragraph in computing a taxpayer's interest and financing revenues does not apply if the credit or deduction is in respect of foreign withholding taxes. As a result, where a Canadian parent company borrows funds and on-lends to a foreign subsidiary, which in turn pays interest to the Canadian parent that is subject to foreign withholding tax, the reduction under paragraph (c) generally does not apply in respect of the withholding tax.

Paragraph (d) of variable B ensures that amounts that are exempt from tax under Part I of the Act are not included in a taxpayer's interest and financing revenues.

In addition, there is an anti-avoidance rule in subsection 18.2(13) that can cause an amount not to be included in interest and financing revenues. For more information, see the commentary on that subsection.

"lease financing amount"

The portion of any lease payment (other than in respect of an excluded lease) that is a lease financing amount that would, absent subsection 18.2(2), be deductible by a lessee or included in income of a lessor, is included in the lessee's interest and financing expenses and the lessor's interest and financing revenues, respectively. For more information, see the commentary on the definition "excluded lease".

A lease financing amount is an implicit financing expense that is imputed in respect of certain lease payments for purposes of determining a taxpayer's interest and financing expenses or interest and financing revenues. This approach is intended to reflect that, economically, a lease and a loan may be readily substitutable for one another.

The quantum of the lease financing amount is calculated in accordance with the rules and assumptions set out in paragraphs (a) to (c) of the definition. Essentially, the lease is treated as a notional loan with a principal amount equal to the fair market value of the leased property, and the lease payments are re-characterized as blended payments of principal and interest, with the interest (which is the lease financing amount) being calculated in accordance with the prescribed rate in effect at the time the lease began, determined under section 4302 of the Regulations.

"public sector authority"

This definition is relevant for the purpose of determining a taxpayer's exempt interest and financing expenses for a taxation year. For more information, see the commentary on that definition in this subsection.

A public sector authority includes His Majesty in right of Canada or a province, certain government authorities or entities described in paragraphs 149(1)(c) to (d.6) of the Act, as well as hospital authorities as defined in subsection 123(1) of the *Excise Tax Act*, and certain registered charities that are public colleges, school authorities or universities, also as defined in subsection 123(1) of the *Excise Tax Act*.

"ratio of permissible expenses"

A taxpayer's ratio of permissible expenses is the percentage that is multiplied by the taxpayer's adjusted taxable income in determining the taxpayer's capacity to deduct interest and financing expenses under the formula in subsection 18.2(2), before amounts in respect of a taxpayer's interest and financing revenues, received capacity and absorbed capacity for the year are added. A taxpayer's ratio of permissible expenses is also relevant to the determination of its excess

capacity and absorbed capacity for a taxation year. For more information, see the commentary on the definitions of those terms.

For most years and for most purposes, a taxpayer's ratio of permissible expenses is 30%.

To facilitate the transition to the EIFEL rules, however, this percentage is 40% for any taxation year of the taxpayer that begins on or after October 1, 2023 and before January 1, 2024, subject to an anti-avoidance rule that is included in transitional rules in the enacting legislation for the EIFEL rules. The anti-avoidance rule applies a ratio of 30% (instead of 40%) for a taxpayer's taxation years beginning on or after October 1, 2023 and before January 1, 2024, if a transaction or event, or series of transactions or events, results in the taxpayer having an "early" year-end in that calendar year, and it is reasonable to consider that one of the reasons for the transaction, event or series was to delay the application of the 30% ratio (in other words, to have the 40% ratio apply for a longer period, or for more taxation years, than it otherwise would have).

Because the purpose of providing a 40% ratio for the 2023 transitional year is to facilitate taxpayers' adjustment to the new EIFEL regime, rather than to allow the creation of additional tax attributes that can be realized in later years, the 40% ratio does not apply for the purpose of determining the taxpayer's cumulative unused excess capacity for any taxation year in which the 30% ratio applies (i.e., any taxation year beginning after 2023). Instead, for any such taxation year, the taxpayer's cumulative unused excess capacity is determined on the basis that its excess capacity for any taxation year beginning on or after October 1, 2023 and before January 1, 2024 is computed using the 30% ratio. In effect, this ensures that a taxpayer does not accumulate excess capacity based on a 40% ratio and then carry this forward (through its cumulative unused excess capacity) to a year in which a 30% ratio applies.

"received capacity"

A taxpayer has received capacity for a taxation year if the taxpayer is the transferee in respect of an election under subsection 18.2(4) for the year and all the conditions of subsection 18.2(4) are met. In that case, the amount designated in the election is an amount of received capacity of the taxpayer for the year. A taxpayer can have multiple amounts of received capacity for a taxation year, if it is the transferee under multiple elections filed under subsection 18.2(4) for the year.

A taxpayer's received capacity for a taxation year is relevant in determining the amount the taxpayer can deduct in the year under paragraph 111(1)(a.1) in respect of its carryforwards of restricted interest and financing expense. It is also relevant in determining the amount of a taxpayer's restriction for interest and financing expenses under subsection 18.2(2) (received capacity is variable D in the formula in that subsection).

For more information, see the commentary on subsections 18.2(2) and 18.2(4), and paragraph 111(1)(a.1).

"relevant affiliate interest and financing expenses"

A controlled foreign affiliate's relevant affiliate interest and financing expenses is, essentially, the amount that would be its interest and financing expenses if the affiliate were considered a taxpayer resident in Canada (and thus subject to the EIFEL rules) for the purpose of computing its foreign accrual property income (FAPI) (this hypothetical is set out in paragraph (b) of this definition, which requires a determination of the amount that would be the affiliate's interest and financing expenses, if clause 95(2)(f.11)(ii)(A) were read without regard to its reference to subsection 18.2(2)).

Relevant affiliate interest and financing expenses generally includes the affiliate's interest and various other financing-related expenses described in variable A of the definition "interest and financing expenses", less the amounts described in variable B of that definition, to the extent that those amounts described in variables A and B are taken into account in computing the amounts referred to in subparagraph 95(2)(f)(i) or (ii). The one exception is that, for this purpose, amounts described in paragraph (j) of variable A of the definition "interest and financing expenses" are excluded, to ensure that a lower-tier controlled foreign affiliate's relevant affiliate interest and financing expenses are not, in effect, double-counted by also being included in those of an upper-tier controlled foreign affiliate.

If the affiliate has an amount of "relevant inter-affiliate interest" (as defined in subsection 18.2(1)), its relevant affiliate interest and financing expenses in respect of the amount are determined under new paragraph 18.2(19)(a). For more information, see the commentary on the definition "relevant inter-affiliate interest" and subsection 18.2(19).

A taxpayer's share of the relevant affiliate interest and financing expenses of its controlled foreign affiliates for affiliate taxation years ending in a taxation year of the taxpayer is included in the taxpayer's interest and financing expenses for the year. To the extent that the deductibility of the taxpayer's interest and financing expenses is denied under subsection 18.2(2), clause 95(2)(f.11)(D) will generally apply to deny the deductibility of relevant affiliate interest and financing expenses of a controlled foreign affiliate of the taxpayer in computing FAPI.

For more information, see the commentary on paragraph (j) of variable A of the definition "interest and financing expenses" and new clause 95(2)(f.11)(D).

Interest and various other financing-related expenses that are deductible in computing a foreign accrual property loss of a controlled foreign affiliate are included in the affiliate's relevant affiliate interest and financing expenses. This is because the amounts referred to in subparagraph 95(2)(f)(ii) include an affiliate's loss from a property, from a business other than an active business or from a non-qualifying business.

To avoid circularity, paragraph (a) of this definition ensures that an affiliate's relevant affiliate interest and financing expenses is determined without regard to any deductions denied, or amounts included in income, under clause 95(2)(f.11)(ii)(D).

Only amounts that are deductible in computing income or loss that is included in determining FAPI are included in relevant affiliate interest and financing expenses. As a result, amounts that are deductible in computing an income or loss that is re-characterized as income or loss from an

active business under paragraph 95(2)(a) are not included. Also excluded are amounts paid or payable under financing structures described in clause 95(2)(a)(ii)(D) and treated as nil for the purposes of determining an amount for variable A or D in the formula in the definition "foreign accrual property income" in subsection 95(1).

Finally, the references to taxpayer in this definition are to be read as though the definition "taxpayer" in this subsection did not exclude partnerships. This ensures that a controlled foreign affiliate of a partnership of which a taxpayer (as defined in this subsection) is a direct or indirect member has relevant affiliate interest and financing expenses for the purposes of determining the impact of any foreign accrual property loss (FAPL) of the affiliate on the taxpayer's "adjusted taxable income" (as defined in this subsection).

For more information, see the commentary on the definition "adjusted taxable income" and new clause 95(2)(f.11)(ii)(E).

In these cases, relevant affiliate interest and financing expenses are attributed as partnership-level interest and financing expenses and, as such, can be restricted by way of an income inclusion under new paragraph 12(1)(l.2). However, because a proportion under the formula in subsection 18.2(2) is not determined in respect of a partnership, clause 95(2)(f.11)(ii)(D) does not restrict the relevant affiliate interest and financing expenses of an affiliate of a partnership at the affiliate level.

For more information, see the commentary on paragraph (h) of variable A of the definition "interest and financing expenses" and clause 95(2)(f.11)(ii)(D).

"relevant affiliate interest and financing revenues"

A controlled foreign affiliate's relevant affiliate interest and financing revenues is, essentially, the amount that would be its interest and financing revenues if the affiliate were considered a taxpayer resident in Canada (and thus subject to the EIFEL rules) for the purpose of computing its FAPI (i.e., if the reference to subsection 18.2(2) in clause 95(2)(f.11)(ii)(A) were disregarded).

Relevant affiliate interest and financing revenues generally includes the affiliate's interest income and certain other financing-related income and gains described in variable A of the definition "interest and financing revenues", less the amounts described in variable B of that definition, to the extent that those amounts are taken into account in computing the amounts referred to in subparagraph 95(2)(f)(i) or (ii). The one exception is that, for this purpose, amounts described in paragraph (g) of variable A of the definition "interest and financing revenues" are excluded, to ensure that a lower-tier controlled foreign affiliate's relevant affiliate interest and financing revenues are not, in effect, double-counted by also being included in those of an upper-tier controlled foreign affiliate.

If the affiliate has an amount of "relevant inter-affiliate interest" (as defined in subsection 18.2(1)), its relevant affiliate interest and financing revenues in respect of the amount are

determined under new paragraph 18.2(19)(b). For more information, see the commentary on the definition “relevant inter-affiliate interest” and subsection 18.2(19).

A taxpayer’s share of the relevant affiliate interest and financing revenues of its controlled foreign affiliates for affiliate taxation years ending in a taxation year of the taxpayer is included in the taxpayer’s interest and financing revenues for the year.

For more information, see the commentary on paragraph (g) of variable A of the definition “interest and financing revenues”.

Because the affiliate’s relevant affiliate interest and financing revenues are included in determining the taxpayer’s interest and financing revenues, the specific anti-avoidance rule in new subsection 18.2(13) applies in determining the amount that is the relevant affiliate interest and financing revenues and the portion of that amount that is attributable to the taxpayer.

Only amounts that are actually included in computing FAPI are included in relevant affiliate interest and financing revenues. As a result, amounts that are re-characterized as income or loss from an active business under paragraph 95(2)(a) or (2.44)(b) are not included.

Finally, as in the definition “relevant affiliate interest and financing expenses”, the references to “taxpayer” in this definition are to be read as though the definition “taxpayer” in this subsection did not exclude partnerships. This ensures that a controlled foreign affiliate of a partnership of which a taxpayer (as defined in this subsection) is a direct or indirect member has relevant affiliate interest and financing revenues.

For more information, see the commentary on the definition “relevant affiliate interest and financing expenses”.

“relevant inter-affiliate interest”

The relevant inter-affiliate interest of a controlled foreign affiliate of a taxpayer for an affiliate taxation year is, essentially, an amount of interest that is paid or payable by the affiliate to – or that is received or receivable by the affiliate from – a controlled foreign affiliate of the taxpayer or of an eligible group entity in respect of the taxpayer.

An amount of interest is only considered relevant inter-affiliate interest to the extent that it would, absent new subsection 18.2(19), be included in the payer affiliate’s relevant affiliate interest and financing expenses and the recipient affiliate’s relevant affiliate interest and financing revenues. In general terms, this means the amount must be interest that, in the absence of the EIFEL rules, would be deductible in computing the FAPI of the payer affiliate, and that is included in computing the FAPI of the recipient affiliate.

The definition “relevant inter-affiliate interest” is relevant in determining what portion of the amount of interest is excluded and what portion of that amount is included in determining both the payer affiliate’s relevant affiliate interest and financing expenses under paragraph 18.2(19)(a)

and the recipient affiliate's relevant affiliate interest and financing revenues under paragraph 18.2(19)(b). For more information, see the commentary on subsection 18.2(19).

"special purpose loss corporation"

The definition "special purpose loss corporation", together with the rules under subsection 18.2(4) regarding cumulative unused excess capacity transfers from financial institution group entities, enables certain loss utilization transactions between financial institution group entities, or financial institution group entities and financial holding corporations. In order to qualify as a special purpose loss corporation for a taxation year, a corporation must be an eligible group entity in respect of a financial holding corporation. The special purpose loss corporation also must be formed or exist solely for the purpose of generating a loss, typically by borrowing at interest from the corporate group's financial holding corporation and investing in preferred shares of a related financial institution group entity, the dividends on which are used by the special purpose loss corporation to fund its interest payments to the financial holding corporation but do not generate taxable income (because of the inter-corporate dividend deduction) and thus do not create capacity to deduct the interest under the EIFEL rules. Finally, that loss must be used by another eligible group entity of the special purpose loss corporation that is a financial institution group entity.

In order to ensure that such loss utilization strategies do not enable the cumulative unused excess capacity of financial institution group entities to be used to support the deductibility of interest expense used to fund the businesses of eligible group entities that are not financial institution group entities, paragraph 18.2(4)(g) restricts the amount of cumulative unused excess capacity that may be transferred to a special purpose loss corporation from a financial institution group entity. For more information, see the commentary on subsection 18.2(4).

"specified participating percentage"

A taxpayer's specified participating percentage in respect of a controlled foreign affiliate for an affiliate taxation year is the percentage that is the taxpayer's aggregate participating percentage (as defined in subsection 91(1.3) of the stub-period FAPI rules) in respect of the affiliate for the affiliate taxation year, determined without regard to any deductions denied or amounts included in income under new clause 95(2)(f.11)(ii)(D) in computing FAPI. Paragraphs (a) and (b) of the definition "specified participating percentage", in effect, ensure that a taxpayer has a specified participating percentage in respect of an affiliate where the affiliate's FAPI is less than $5,000 or the affiliate has a FAPL.

A taxpayer's specified participating percentage in respect of a controlled foreign affiliate for an affiliate taxation year is relevant in determining, among other things, the taxpayer's share of the affiliate's relevant affiliate interest and financing expenses for the affiliate taxation year (which is included in the taxpayer's interest and financing expenses), and the taxpayer's share of the affiliate's relevant affiliate interest and financing revenues (which is included in determining the taxpayer's interest and financing revenues).

For more information, see the commentary on the definitions “interest and financing expenses” and “interest and financing revenues”, as well as the definition “restricted interest and financing expense” in amended subsection 111(8).

“specified pre-regime loss”

A taxpayer’s specified pre-regime loss, in respect of a taxation year in which it is subject to the EIFEL rules (the “regime year”), is the taxpayer’s loss for a taxation year that ends before February 4, 2022 (the release date of the initial draft legislation for the EIFEL rules) in respect of which the taxpayer files an election for the regime year and deducts an amount under paragraph 111(1)(a). The effect of the election is that 25% of the amount deducted is added back in computing the taxpayer’s adjusted taxable income for the regime year under paragraph (i) of variable B of the definition “adjusted taxable income”.

For more information, see the commentary on the definition “adjusted taxable income”.

“tax-indifferent”

The definition “tax-indifferent” refers to person that is exempt from tax under section 149 or is a non-resident (paragraphs (a) and (b)), as well as a partnership or trust the interests in which are primarily held by persons exempt from tax under section 149 or who are non-residents (paragraphs (c) and (d)).

The definition “tax-indifferent” is relevant to subparagraph (c)(iv) of the “excluded entity” definition, which requires that all or substantially all of the interest and financing expenses of the taxpayer and of each eligible group entity of the taxpayer be payable to person or partnerships that are not tax-indifferent and who do not deal at arm’s length with the taxpayer.

“taxpayer”

The definition “taxpayer” provides that references to a taxpayer in sections 18.2 and 18.21 do not include a natural person or a partnership. As a result, the limitation on deductions for interest and financing expenses in subsection 18.2(2) applies only to corporations and trusts, including in respect of their share of the interest and financing expenses of any partnerships of which they are members.

For further information on the application of the EIFEL rules in relation to corporations and trusts that are members of partnerships, see the commentary on paragraph (h) of the definition “interest and financing expenses”, as well new paragraph 12(1)(l.2).

“transaction”

The definition “transaction” provides that a transaction includes an arrangement or an event. This is relevant for the purposes of the anti-avoidance rules in new subsections 18.2(13) and (14), and subsection 18.21(8).

“transferred capacity”

A taxpayer has an amount of transferred capacity for a taxation year if the taxpayer is the transferor in respect of an election under subsection 18.2(4) for the year and all the conditions of subsection 18.2(4) are met. In that case, the amount designated in the election is an amount of transferred capacity of the taxpayer for the year. A taxpayer can have multiple amounts of transferred capacity for a taxation year, if it is the transferor under multiple elections filed under subsection 18.2(4) for the year.

A taxpayer’s transferred capacity for a taxation year reduces the taxpayer’s cumulative unused excess capacity, starting in the following year. The total of a taxpayer’s amounts of transferred capacity for a taxation year can never exceed its cumulative unused excess capacity for that year.

For more information, see the commentary on the definition “cumulative unused excess capacity” and subsection 18.2(4).

Excessive interest and financing expenses limitation

ITA
18.2(2)

New subsection 18.2(2) is the main operative rule of the new EIFEL regime, which implements the recommendations of the BEPS Action 4 report to limit certain taxpayers’ deductions for interest and financing expenses to a proportion of their earnings. It applies to taxpayers that are corporations or trusts (“taxpayer” is defined in subsection 18.2(1) to exclude natural persons and partnerships), including non-resident corporations and trusts. The rule does not apply to a taxpayer for a taxation year if the taxpayer is an excluded entity for the year. For more information, see the commentary on the definition “excluded entity” in subsection 18.2(1).

In general terms, subsection 18.2(2) denies a deduction for a proportion (determined under the formula in that subsection) of each of a taxpayer’s interest and financing expenses. So, for example, if the formula calculates to 1/5 in respect of a taxpayer for a particular taxation year, and the taxpayer’s interest and financing expenses for the year consist of $180 million of interest payable in respect of a particular loan and a $50 million guarantee fee payable, then $36 million of the interest expense and $10 million of the guarantee fee are non-deductible under new subsection 18.2(2) (and become a restricted interest and financing expense within the meaning of new subsection 111(8)).

However, subsection 18.2(2) does not apply to a taxpayer’s share of the interest and financing expenses of any partnerships of which it is a member, which is included in the taxpayer’s interest and financing expenses under paragraph (h) of that definition in subsection 18.2(1). Instead, the taxpayer is subject to an income inclusion under new paragraph 12(1)(l.2) in respect of such expenses. For more information, see the commentary on that paragraph.

The proportion determined for the taxpayer under subsection 18.2(2) also applies under new subclause 95(2)(f.11)(ii)(D)(I) in determining the deductibility of the “relevant affiliate interest

and financing expenses" (defined in subsection 18.2(1)) of a controlled foreign affiliate of the taxpayer in computing the affiliate's FAPI. Thus, using the example above, if a controlled foreign affiliate of the taxpayer had $50 million of relevant affiliate interest and financing expenses for its affiliate taxation year ending in the taxpayer's taxation year, then $10 million of the relevant affiliate interest and financing expenses is non-deductible in computing the affiliate's FAPI under subclause 95(2)(f.11)(ii)(D)(I). The same proportion is also applied in determining the amount included in FAPI under subclause 95(2)(f.11)(ii)(D)(II) in respect of the interest and financing expenses of a partnership of which the affiliate is a member.

For more information, see the commentary on clause 95(2)(f.11)(ii)(D).

Subsection 18.2(2) only denies a deduction in respect of amounts of interest and financing expenses that would be deductible absent section 18.2. Thus, if another provision of the Act (e.g., the thin capitalization rules in subsection 18(4)) denies a deduction for a portion of an interest or financing expense, subsection 18.2(2) does not apply in respect of that non-deductible portion, which is not included in the taxpayer's interest and financing expenses for the purposes of these rules.

In addition to denying deductions for interest and financing expenses in computing income from a business or property, subsection 18.2(2) excludes certain allowable capital losses from the computation of taxable capital gains under paragraph 3(b), and denies deductions in computing taxable income (under subdivision C of Part I). With respect to the calculation of taxable capital gains, subsection 18.2(2) limits the extent to which allowable capital losses included under paragraph (e) of variable A of the definition "interest and financing expenses" can be netted against capital gains under paragraph 3(b). In computing taxable income, subsection 18.2(2) limits the deductibility of net capital losses and limited partnership losses, included under paragraphs (e) and (i) of variable A of the definition "interest and financing expenses".

The proportion of a taxpayer's interest and financing expenses that are denied is determined by the formula (A – (B + C + D + E))/F. In general terms, variable A is the taxpayer's total interest and financing expenses for the year, and B + C + D + E represents the maximum amount the taxpayer is permitted to deduct in the year in respect of interest and financing expenses. Thus, the numerator in the formula represents the taxpayer's "excessive" interest and financing expenses: the amount by which the taxpayer's expenses exceed the amount it is allowed to deduct in the year.

Variable F is the denominator and represents the total of the otherwise deductible amounts in respect of interest and various other financing-related expenses that are included in computing the taxpayer's interest and financing expenses under variable A of that definition and that may be subject to limitation under subsection 18.2(2). Thus, variable F does not take into account any reductions, under variable B of the definition "interest and financing expenses", for income or gains that reduce the taxpayer's cost of funding. This is to ensure that the proportion determined under the formula represents the proportion of each of the taxpayer's interest and other financing-related expenses for which deductibility is denied under subsection 18.2(2), which would in many cases be overstated if variable F took into account the reductions under variable B of the definition "interest and financing expenses".

Consistent with this general approach in variable F, where the taxpayer's interest and financing expenses for the year includes any amount in respect of the relevant affiliate interest and financing expenses of a controlled foreign affiliate, paragraph (b) of variable F, in effect, excludes from variable F any reductions that apply in computing the relevant affiliate interest and financing expenses by virtue of variable B of the definition "interest and financing expenses".

The proportion determined by the formula is, therefore, the proportion of the otherwise deductible interest and financing expenses for the year that exceed the amount of deductions in respect of such expenses that it is permitted under subsection 18.2(2) for the year.

As noted, variable A is the taxpayer's total interest and financing expenses for the year. Notably, this amount includes the taxpayer's share of the interest and financing expenses of a partnership (included under paragraph (h) of that definition); thus, these expenses are relevant in determining the proportion under the formula, notwithstanding that subsection 18.2(2) does not deny a deduction in respect of these expenses (but, as noted, they are instead subject to an income inclusion under new paragraph 12(1)(l.2)).

The taxpayer's interest and financing expenses do not include "excluded interest", which is generally interest, or a "lease financing amount", paid or payable to another taxable Canadian corporation in the same group that the taxpayer and the other corporation jointly elect to have treated as such (and that satisfies the other conditions in the "excluded interest" definition in subsection 18.2(1)). Thus, subsection 18.2(2) does not restrict the deductibility of such intra-group payments of interest or lease financing amounts. For more information, see the commentary on the definitions "excluded interest" and "lease financing amount".

A taxpayer's interest and financing expenses also exclude its "exempt interest and financing expenses", such that the latter are not restricted under subsection 18.2(2). In general terms, exempt interest and financing expenses are interest and various other financing-related expenses that are paid to third parties and that are incurred in respect of certain Canadian public-private partnership infrastructure projects. For more information, see the commentary on the definition "exempt interest and financing expenses".

Variable B reflects the "earnings stripping" approach of the new rules, which generally limit the amount of interest and financing expenses (net of interest and financing revenues) that may be deducted in computing a taxpayer's income to no more than a fixed ratio of the taxpayer's "adjusted taxable income" (defined in subsection 18.2(1)). A taxpayer's adjusted taxable income is a version of earnings before interest, taxes, depreciation and amortization (EBITDA) that is based on tax, rather than accounting, concepts.

Unless the taxpayer is a member of a corporate group that elects into the "group ratio" rules for a taxation year, the amount determined for variable B for the year is the taxpayer's adjusted taxable income for the year multiplied by its ratio of permissible expenses for the year (being 40%, if the year begins on or after January 1, 2023 but before January 1, 2024; and 30% for all subsequent years).

If the taxpayer is a member of a group that elects to apply the group ratio for a taxation year, then the amount for variable B is determined under subsection 18.21(2). In essence, the group ratio rules allow a taxpayer to deduct interest and financing expenses in excess of the 30% fixed ratio (or 40% for the transitional year) where the taxpayer is able to demonstrate that the ratio of its consolidated group's net third-party interest expense to book EBITDA (referred to as the "group ratio") exceeds the fixed ratio. For more information, see the commentary on section 18.21.

If the taxpayer's interest and financing expenses for a taxation year exceed the applicable ratio of its adjusted taxable income, the taxpayer may nonetheless be able to avoid having the deductibility of this excess denied under subsection 18.2(2). There are three additional sources of "capacity" to deduct interest and financing expenses, reflected in variables C, D and E, respectively.

Variable C is the taxpayer's interest and financing revenues for the year. It reflects that the EIFEL regime is intended to limit a taxpayer's net interest and financing expenses (i.e., its interest and financing expenses net of interest and financing revenues) to a fixed percentage of adjusted taxable income.

Variable D is only available to corporate taxpayers and fixed interest commercial trusts, and is the taxpayer's total received capacity for the year, which essentially represents any amounts of excess capacity of another group member that have been "transferred" to the taxpayer for the year under the joint election in new subsection 18.2(4). This amount must, however, first be reduced by any amounts deductible by the taxpayer in the year under new paragraph 111(1)(a.1) in respect of restricted interest and financing expense for a preceding taxation year. In effect, these rules require the taxpayer to apply its received capacity first against its restricted interest and financing expenses from previous years, before it can apply received capacity to enable the deduction of current-year interest and financing expenses that would otherwise be non-deductible under the EIFEL rules.

For more information, see the commentary on the definition "cumulative unused excess capacity" in subsection 18.2(1), subsection 18.2(4) and paragraph 111(1)(a.1).

Variable E of the formula is relevant where the taxpayer would otherwise have interest or financing expenses denied under subsection 18.2(2) for the year but has excess capacity carried forward from any of the three immediately preceding taxation years that it has not yet used. In these circumstances, the taxpayer has "absorbed capacity" for the year, which increases its deduction capacity and thereby reduces the amount of its interest and financing expenses that are denied under subsection 18.2(2) for the year. The absorbed capacity essentially is the portion of the taxpayer's excess capacity carryforwards that are automatically applied to allow the taxpayer to deduct interest and financing expenses that would otherwise be denied under subsection 18.2(2). For more information, see the definition "absorbed capacity" in subsection 18.2(1).

Amount deemed deducted

ITA
18.2(3)

Subsection 18.2(3) applies where new subsection 18.2(2) denies the deductibility, in computing a taxpayer's income for a taxation year, of all or a portion of a particular amount that is described in paragraph (c) or (d) of the definition "interest and financing expenses". The amounts described in those paragraphs are generally amounts of interest or other financing-related expenses that are capitalized or otherwise included in resource-expense pools, and are claimed by the taxpayer as deductions in respect of capital cost allowance, foreign exploration and development expenses, foreign resource expenses, Canadian exploration expenses, Canadian development expenses, Canadian oil and gas property expenses or section 66.7 successor expenses, or as a terminal loss. For more information, see the commentary on the definition "interest and financing expenses" in subsection 18.2(1).)

Subsection 18.2(3) deems the denied portion of the particular amount to have been deducted by the taxpayer, to ensure it is deducted in computing a taxpayer's total depreciation allowed for property of a prescribed class (as defined in subsection 13(21)) or the balance of its undeducted resource expenses, as the case may be. This is intended to ensure that the taxpayer does not get a "double benefit", by retaining these amounts within its undepreciated capital cost or undeducted resource expenses and deducting them in a future year, while at the same time deducting an amount under paragraph 111(1)(a.1) in a later year as a restricted interest and financing expense in respect of the denied portion.

The deeming rule in this subsection applies for the purposes of determining the amounts referred to in paragraphs 18.2(3)(a) to (g) in respect of any taxpayer at any time, and not only the taxpayer that incurred the expense or had its deduction denied under subsection 18.2(2). This ensures the rule applies, for example, in relation to "successor pools" of resource expenses, as well as in cases where expense pools are "inherited" by a new corporation on an amalgamation or by a parent corporation on a winding-up.

Transfer of cumulative unused excess capacity

ITA
18.2(4)

New subsection 18.2(4) provides an election that allows a taxable Canadian corporation or a fixed interest commercial trust (referred to as the "transferor") to effectively transfer all or a portion of its cumulative unused excess capacity to another taxable Canadian corporation or fixed interest commercial trust (referred to as the "transferee") that is a member of the same corporate group. This transfer mechanism is intended to accommodate misalignments between net interest and financing expenses and adjusted taxable income among the Canadian group members, which could result in some group members exceeding the 30% fixed ratio (or 40% fixed ratio, for the transitional year) permitted under the EIFEL rules, and other group members having ratios below the permitted fixed ratio.

Where all of the conditions of subsection 18.2(4) are met, the amount that a transferor and a transferee designate in their joint election is an amount of "transferred capacity" of the transferor and an amount of "received capacity" of the transferee for their respective taxation years.

A transferor's transferred capacity for a taxation year reduces its cumulative unused excess capacity for the following year. For more information, see the commentary to the definition "cumulative unused excess capacity" in subsection 18.2(1).

To ensure the integrity of the rules, paragraph 18.2(4)(e), in effect, renders all of the transferor's transfers for the year invalid if the total of the transferred capacity amounts designated by the transferor in elections for the year exceeds its cumulative unused excess capacity for that year. As a consequence, all of the amounts of received capacity otherwise accruing to the transferees under those elections would be nullified. To accommodate situations where a reassessment results in an over-transfer (e.g., by increasing the amount of the transferor's interest and financing expenses for its taxation year in which the transfer election was made), paragraphs 18.2(4)(d), (h) and (i) provide for the filing of an amended election. Paragraph 18.2(4)(h) ensures that an amended election supersedes the prior election.

However, the ability to file an amended election is provided for the sole purpose of allowing taxpayers to alter the amount designated in the election in cases where a reassessment results in a change in the transferor's cumulative unused excess capacity, or in the transferee's interest and financing expenses or restricted interest and financing expense; it is not intended to be used for retroactive tax planning. In particular, paragraph 18.2(4)(i) provides that an amended election is not available in respect of a taxation year if the transferor "over-transferred" in a prior election for that year, where the over-transfer does not result from any change under a reassessment. An amended election is also not available where subsection 18.2(9) applies because there has been a manipulation of entity status in order to obtain a tax benefit, unless the Minister grants permission to amend the prior election under subsection 18.2(5).

Although the mechanism under subsection 18.2(4) is described as a "transfer", the transferred amount is not included in the transferee's excess capacity or cumulative unused excess capacity. Thus, the transferee cannot carry it forward for use in later years or transfer it to other taxpayers. Rather, as noted, the transferred amount is "received capacity" of the transferee, which can be used only in the taxation year of the transferee in respect of which it was received – and in only two ways.

First, received capacity is automatically applied against any restricted interest and financing expense of the transferee (which is defined in subsection 111(8) generally as carryforwards of interest and financing expenses denied under subsection 18.2(2) in a previous year), thereby allowing the taxpayer to deduct these under paragraph 111(1)(a.1).

Second, any remaining received capacity is included in variable D of the formula in subsection 18.2(2), which has the effect of reducing the amount of the transferee's interest and financing expenses for which deductibility is denied under that subsection.

Because received capacity can only be used by the transferee in the year in respect of which it is received, and for only the two purposes described above, if, by virtue of one or multiple transfers under subsection 18.2(4) in a taxation year, a transferee is transferred received capacity in excess of the amount it can use in the year, this excess reduces the transferor's cumulative unused excess capacity but cannot be used by the transferee for any purpose (and thus is of no benefit).

The deduction of restricted interest and financing expense under paragraph 111(1)(a.1) is discretionary. However, the fact that the amount of received capacity of the taxpayer that is included in variable D of subsection 18.2(2) is reduced for amounts deductible in the year under paragraph 111(1)(a.1) effectively creates an "ordering rule", which prevents a transferee from using its received capacity to deduct its current-year interest and financing expenses in priority to any restricted interest and financing expense carryforwards.

Notable aspects of the conditions in paragraphs 18.2(4)(a) to (j), all of which must be met to have an effective transfer, are as follows:

- Paragraph (a) requires that the transfer is of the cumulative unused excess capacity of the transferor for a taxation year that ends in the taxation year of the transferee in which the transferee receives the received capacity. Paragraph 249(2)(a) allows this condition to be met where the taxation year of the transferor is coterminous with that of the transferee.
- Paragraph (b) requires that the transferor and transferee be eligible group entities (as defined in subsection 18.2(1)) in respect of one another at the end of their respective taxation years, which is intended to ensure they are members of the same corporate group. The taxpayers are not required to be eligible group entities in respect of one another throughout the entirety of their respective taxation years, since such a requirement would not accommodate certain corporate reorganizations. However, the manipulation of eligible group entity status in order to meet this condition and be eligible to make an election under subsection 18.2(4) could trigger the application of the anti-avoidance rule in subsection 18.2(9).
- Paragraph (c) provides that a transferor that is a financial institution group entity or a financial holding corporation is permitted to transfer only to other financial institution group entities or financial holding corporations, or to special purpose loss corporations, subject to certain limitations. For more information, see the commentary on the definition "financial institution group entity" in subsection 18.2(1).
- Paragraph (d) provides certain filing requirements in respect of the election, including that it must specify the amount of transferred capacity, which will also be received capacity of the transferee. Subparagraph (d)(ii) requires that the joint election be filed by the transferor, which is intended to facilitate filing in cases where one transferor transfers cumulative unused excess capacity to multiple transferees.
- Paragraphs (f) and (g) are special rules applicable where a financial institution group entity transfers to either a financial holding corporation or a special purpose loss corporation, respectively. In these cases, the amount of cumulative unused excess capacity that may be transferred to these entities is capped, essentially, at the amount that is necessary to give effect to certain loss consolidation (or "debt push-down") transactions within financial institution groups. The caps are intended to ensure that a financial institution group entity's cumulative unused excess capacity can only be used

(through the transfer mechanism) to support the deductibility of interest expense that has been shifted into financial institutions group entities and that relates to debt used to fund the financial businesses, and not to interest expense that has been shifted into related group entities that are not financial institution group entities.
- Paragraph (h) in effect provides that the transfer is not valid and effective unless the transferee files (or is deemed by subsection 18.2(7) to have filed) an information return that meets the requirements of subsection 18.2(6). This essentially requires reporting of all the transfers under subsection 18.2(4) received by group members within the calendar year. For more information, see the commentary on subsections 18.2(6) and (7).

Late or amended election

ITA
18.2(5)

New subsection 18.2(5) enables an election under subsection 18.2(4) to be late-filed, or amended in circumstances beyond those in which subsection 18.2(4) allows for amended elections, with Ministerial permission.

Summary – cumulative unused excess capacity transfers

ITA
18.2(6)

New subsection 18.2(6) applies if a transferor and a particular transferee jointly elect under subsection 18.2(4) to designate all or a portion of the transferor's cumulative unused excess capacity to be received capacity of the particular transferee for a taxation year.

The particular transferee is required to file an information return within six months after the end of the calendar year in which its taxation year, in respect of which it has received capacity, ends. The return must contain the information required by the Canada Revenue Agency to be reported in respect of all elections under subsection 18.2(4) that are filed by:

- the particular transferee for the year; or
- any other transferee that is an eligible group entity in respect of the particular transferee for a taxation year ending in the calendar year.

Summary – filing by designated filer

ITA
18.2(7)

New subsection 18.2(7) allows transferees that are eligible group entities in respect of one another to jointly elect to designate a taxpayer (referred to as the "designated filer") to file an information return required by subsection 18.2(6) for a calendar year. The effect of designating a

designated filer is to relieve the electing transferees (other than the designated filer) of the reporting requirement under subsection 18.2(6) for the calendar year.

Assessment

ITA
18.2(8)

New subsection 18.2(8) requires the Minister of National Revenue to assess or reassess any taxpayer to take into account an election or amended election filed under subsection 18.2(4), even where the assessment or reassessment would otherwise be statute-barred.

Anti-avoidance – group status

ITA
18.2(9)

New subsection 18.2(9) is an anti-avoidance provision that prevents the manipulation of eligible group entity, financial institution group entity or financial holding corporation status where it is reasonable to consider that one of the main purposes of being, becoming or ceasing to be an eligible group entity in respect of another taxpayer, a financial institution group entity or a financial holding corporation is to enable any taxpayer to obtain a "tax benefit", as that term is defined in subsection 245(1).

There are a number of scenarios in which the manipulation of eligible group entity, financial institution group entity or financial holding corporation status could give rise to a tax benefit and thus trigger the application of this subsection. For example, a taxpayer may seek to become an eligible group entity in respect of another taxpayer in order to be eligible to elect to make or receive a transfer of cumulative unused excess capacity under subsection 18.2(4), to treat certain interest payments or "lease financing amounts" (as defined in subsection 18.2(1)) as "excluded interest" or to have the group ratio rule in subsection 18.21(2) apply. Conversely, a taxpayer may seek to cease being an eligible group entity in respect of another taxpayer in order to qualify (or allow another taxpayer to qualify) as an "excluded entity" for the year. Another example is that a taxpayer could seek to either become or cease to be an eligible group entity in respect of one or more other taxpayers in order to obtain a certain advantage under the transitional rules (contained in the enacting legislation for section 18.2) that apply for the purposes of determining taxpayers' excess capacity for pre-regime years. As transfers of cumulative unused excess capacity from a financial institution group entity or a financial holding corporation are generally limited to other financial institution group entities or financial holding corporations, taxpayers may seek to manipulate financial institution group entity or financial holding corporation status in order to become eligible to receive such a transfer, or to avoid the restrictions applicable where a transferor is a financial institution group entity or financial holding corporation.

In all of these scenarios, tax benefits would generally result, directly or indirectly, in the absence of this anti-avoidance rule.

The reference in subsection 18.2(9) to enabling "any taxpayer" to obtain a tax benefit allows the anti-avoidance rule to apply whether the tax benefit sought is that of either of the taxpayers that have become or ceased being eligible group entities in respect of one another, the taxpayer that has become or ceased to be a financial institution group entity or a financial holding corporation, or that of any other taxpayer.

Benefits conferred

ITA
18.2(10)

New subsection 18.2(10) provides that, for the purpose of Part I, a benefit is not considered to have been conferred on a transferee as a consequence of an election or amended election under subsection 18.2(4) between the transferor and the transferee. This new subsection applies whether or not property is acquired by the transferor as consideration for filing the election or amended election.

Consideration for election

ITA
18.2(11)

New subsection 18.2(11) provides rules that apply where property is acquired by a transferor as consideration for filing an election or amended election under subsection 18.2(4). If the property is owned by the transferee immediately before that time, the transferee is deemed to have disposed of the property at its fair market value but is not entitled to deduct any amount in respect of the transfer except any loss resulting from the deemed disposition. The cost at which the property was acquired by the transferor is considered to be equal to the property's fair market value. Neither the transferor nor the transferee is required to add any amount in computing income only because of the acquisition of the property or because of the filing of the election or amended election under subsection 18.2(4) (although the deemed disposition could result in an amount being added in computing the transferee's income).

Partnerships

ITA
18.2(12)
New subsection 18.2(12) is intended to effectively "look through" tiers of partnerships for the purposes of subsection 18.2.

Subsection 18.2(12) provides that a person or partnership that is a member of a partnership that is in turn a member of another partnership is also deemed to be a member of the other partnership. It also provides that a person's share of a partnership's income or loss includes the person's direct or indirect, through one or more other partnerships, share of that income or loss. In other words, a member's share of the income or loss of a lower-tier partnership includes the amount to which it is directly or indirectly entitled.

Anti-avoidance – interest and financing revenues and expenses

ITA
18.2(13)

New subsection 18.2(13) is an anti-avoidance rule that is intended to prevent a taxpayer's interest and financing revenues from being inflated, or its interest and financing expenses from being understated, as a result of certain types of transactions. If it applies, a particular amount that would otherwise be included in a taxpayer's interest and financing revenues under variable A of the definition of that term is not so included, or a particular amount that would otherwise be deducted in computing its interest and financing expenses under variable B of definition of that term is not so deducted.

Amounts included in a taxpayer's interest and financing revenues, or deducted in computing its interest and financing expenses, generally reduce a taxpayer's net interest and financing expenses that may be subject to the limitation in subsection 18.2(2) (or, in other cases, increase the taxpayer's "excess capacity", which can be used to allow the taxpayer to deduct interest and financing expenses from prior or future years, or to allow other group members to deduct interest and financing expenses). Although these amounts are included in computing the taxpayer's income or loss, the purpose of the anti-avoidance rule is to ensure these amounts are not taken into account in determining interest and financing revenues or expenses in appropriate circumstances.

The anti-avoidance rule applies if any of the requirements set out in paragraphs 18.2(13)(a) to (c) are satisfied. However, even if none of these requirements is satisfied in respect of a particular amount, the general anti-avoidance rule in section 245 may apply in appropriate circumstances.

Paragraph (a)

Paragraph 18.2(13)(a) addresses transactions involving non-controlled foreign affiliates. It applies if the particular amount is connected with a deduction in computing the foreign accrual property income (FAPI) of a corporation that is a foreign affiliate, but not a controlled foreign affiliate, of the taxpayer or of a person or partnership not dealing at arm's length with the taxpayer. This would be the case where, for example, a taxpayer receives an interest payment directly from a non-controlled foreign affiliate of the taxpayer, or indirectly from such an affiliate through an intermediary, and the interest payment is deductible in computing the affiliate's FAPI. These transactions raise integrity concerns in the context of the EIFEL rules in that, if they were to result in interest and financing revenues (or reductions to interest and financing expenses), this could effectively convert amounts that would otherwise have been included in an affiliate's taxable surplus or reduced an affiliate's taxable deficit – and thus could ultimately have resulted in an increase to the amount included in the taxpayer's adjusted taxable income on a subsequent distribution from the affiliate – into interest and financing revenues, while the affiliate's interest expense would not be included in computing the taxpayer's interest and financing expenses. This would provide an inappropriate tax benefit, since a dollar of

interest and financing revenues results in greater capacity to deduct interest and financing expenses than a dollar of adjusted taxable income.

Paragraph (b)

Paragraph 18.2(13)(b) applies if the particular amount is, directly or indirectly and in whole or in part, received or receivable by the taxpayer (or a partnership of which it is a member) from

- a non-arm's length person that is
    - not subject to the EIFEL regime by reason of being an "excluded entity" (as defined in subsection 18.2(1)) or a natural person; or
    - if the taxpayer is not a "financial institution group entity" or a "financial holding corporation" (both as defined in subsection 18.2(1)), a financial institution group entity or a financial holding corporation; or
- a partnership, any member of which is a non-arm's length person that is an excluded entity, a natural person or, if the taxpayer is not a financial institution group entity or financial holding corporation, a financing institution group entity or a financial holding corporation.

The transactions described in paragraph (b) raise integrity concerns because, absent subsection 18.2(13), they would allow payments between non-arm's length persons that have the effect of increasing the recipient's capacity to deduct interest and financing expenses (e.g., by generating interest and financing revenues), while a payer is indifferent to any corresponding increase in their interest and financing expenses because they are not subject to the EIFEL rules (e.g., an excluded entity or a natural person). In the case of a payment from a financial institution group entity to a non-arm's length person that is not such an entity, if an amount in respect of the payment were included in the payee's interest and financing revenues, this could allow, in substance, the same result as a transfer of cumulative unused excess capacity that is prohibited by paragraph 18.2(4)(c). A similar concern arises with respect to payments from a financial holding corporation, given that the financial holding corporation can receive capacity-increasing payments from a financial institution group entity and could in turn use the proceeds to fund interest payments to an entity that is not a financial institution group entity.

Paragraph (c)

Unlike paragraph (b), paragraph (c) is not limited to transactions among non-arm's length persons. In addition, the requirements set out in paragraph 18.2(13)(c) are conditioned on a "main purpose" requirement.

In particular, one of the main purposes of a transaction (defined in subsection 18.2(1) to include an arrangement or event) or series of transactions must be to include the particular amount under variable A of the definition "interest and financing revenues", in computing the taxpayer's interest and financing revenues, or under variable B of the definition "interest and financing expenses", in computing the taxpayer's interest and financing expenses. If a main purpose of any transaction in a series, or of the series as a whole, is to achieve one of these effects, this purpose test is met.

It is not necessary that all participants in a transaction or series intend that the transaction or series cause the amount to increase interest and financing revenues or reduce interest and financing expenses. Rather, the focus is on whether it is reasonable to consider that one of its main purposes is to have this effect. This would generally be determined from the perspective of the taxpayer whose interest and financing revenues and interest and financing expenses are being determined, or any other person or partnership that would benefit from an increase to the taxpayer's interest and financing revenues or a decrease in its interest and financing expenses (e.g., a person that may receive a transfer from the taxpayer's cumulative unused excess capacity as a result of an election under subsection 18.2(4)).

Two types of transactions or series of transactions are targeted by paragraph 18.2(13)(c).

Subparagraph (i)

The first is a transaction or series that results in a deductible amount that effectively offsets, in whole or in part, the income inclusion to the taxpayer in respect of the particular amount, where there is an asymmetry in treatment between that deductible amount and the particular amount under the EIFEL regime.

More particularly, the test is satisfied if the deduction is available to the taxpayer, or a person or partnership not dealing at arm's length with the taxpayer, in computing its income or loss for a taxation year, and the amount (for which the deduction is available) is not included in variable B of the "interest and financing revenues" definition or variable A of the "interest and financing expenses" definition. In other words, the test in this subparagraph is met if the deductible amount does not reduce interest and financing revenues or increase interest and financing expenses, such that there is an asymmetry between the treatment of the deductible amount and the particular amount under the EIFEL regime. This could occur, for example, where a taxpayer that is otherwise subject to an interest limitation under subsection 18.2(2) receives an interest payment (which, absent subsection 18.2(13), would be included in its interest and financing revenues) from a person or partnership that is indifferent to an increase in its interest and financing expenses (for example, because it has unused interest deduction capacity, or it is an excluded entity, a tax-exempt entity, a natural person or a non-resident) and, as part of the same transaction or series, the taxpayer makes a deductible payment back to the person or partnership that is not included in the taxpayer's interest and financing expenses (e.g., a service fee or royalty).

These transactions (or series) raise integrity concerns in that, absent subsection 18.2(13), the overall result is an increase to the taxpayer's interest and financing revenues in an amount that exceeds the net income inclusion to the taxpayer (or a person or partnership that does not deal at arm's length with the taxpayer). This result is, in substance, contrary to the basic principle that an amount is to be included in interest and financing revenues only to the extent it is included in computing income subject to tax.

Subparagraph (ii)

The second type of transaction targeted by paragraph 18.2(13)(c) is a transaction or series in which an amount that does not increase interest and financing revenues (or reduce interest and financing expenses) is converted, replaced or otherwise substituted with another amount that does. In other words, this subparagraph addresses transactions or series that put taxpayers in a more favorable position in terms of determining results under the EIFEL regime without otherwise materially altering the computation of income or loss for a taxation year.

This test is satisfied if two conditions are met, both of which compare how the particular amount, or an amount for which the particular amount is substituted, may reasonably be considered to have been treated had the transaction or series not occurred.

The first requires that the particular amount – or, if the particular amount was substituted for another amount, the other amount – would have been included in computing the income or loss of the taxpayer or a non-arm's length person or partnership. This condition is not satisfied if the particular amount or other amount, as the case may be, would have been included in computing the income or loss as a dividend. Thus, the rule does not apply where, for example, an equity instrument is replaced with a debt instrument.

The second test requires that the particular amount or other amount would not be included under variable A of the "interest and financing revenues" definition, or variable B of the "interest and financing expenses" definition. This ensures that the application of subparagraph 18.2(13)(c) is limited to cases where the transaction or series effectively converts or substitutes amounts that would not increase interest and financing revenues (or reduce interest and financing expenses) with amounts that, absent subsection 18.2(13), would result in such an increase or reduction.

For example, subparagraph (ii) may apply where one of the main purposes of the transaction or series was for the particular amount to increase interest and financing revenue or reduce interest and financing expenses and, absent the transaction or series, an amount would have been included in income but would not have increased interest and financing revenues or reduced interest and financing expenses. This can occur, for example, where the transaction or series results in a service or royalty agreement being replaced with a loan agreement.

GAAR

Subsection 18.2(13) does not purport to address all scenarios in which a transaction or series that increases interest and financing revenues or reduces interest and financing expenses is considered not to be appropriate in policy terms. It is intended that the general anti-avoidance rule may apply to any transaction that results in an increase of interest and financing revenues or a reduction in interest and financing expenses in appropriate circumstances, even where new subsection 18.2(13) may not otherwise apply.

Anti-avoidance – excluded entity

ITA
18.2(14)

New subsection 18.2(14) is an anti-avoidance rule for the definition “excluded entity” in new subsection 18.2(1). In general terms, an excluded entity is not subject to the deduction restrictions under new subsection 18.2(2), nor an income inclusion under paragraph 12(1)(l.2), in respect of its interest and financing expenses for the year.

The new definition “excluded entity” contains a condition, in subparagraph (c)(iv), that requires that, in order for a taxpayer to be an excluded entity, all or substantially all of the interest and financing expenses of the taxpayer and of any eligible group entity in respect of the taxpayer must be paid or payable to persons or partnerships that are not tax-indifferent and non-arm’s length. For this purpose, new subsection 18.2(14) deems a person or partnership to be tax-indifferent and non-arm’s length if an amount of interest and financing expenses is paid or payable to the person or partnership as part of a transaction or event or series of transactions or events, and it can reasonably be considered that one of the main purposes of the transaction, event or series is to avoid that amount being paid or payable to a non-arm’s length tax-indifferent person or partnership.

See also the commentary to the definition of “tax indifferent” in subsection 18.2(1).

Example – Back-to-Back Transaction

Assumptions

- Canco1 is a corporation resident in Canada;
- Pensionco is a Canadian pension fund that is tax-indifferent;
- Canco2 is a corporation resident in Canada that is not tax-indifferent;
- Pensionco and Canco1 do not deal with each other at arm’s length;
- Pensionco enters into a transaction with Canco2, and Canco2 enters into a transaction with Canco1 (the “Back-to-Back Transactions”); and
- Under the Back-to-Back Transactions, Pensionco loans funds to Canco2, and Canco2 loans funds to Canco1 on which interest is paid or payable to Canco2.

Analysis

If it can reasonably be considered that one of the main purposes of either of the Back-to-Back Transactions, or of the series that includes those transactions, is to avoid any portion of the interest and financing expenses of Canco1 being paid or payable to a non-arm’s length tax-indifferent (in this case Pensionco), Canco2 will be deemed to be a non-arm’s length tax-indifferent in respect of Canco1.

Example – Interest Strip Transaction

Assumptions

- Canco1 is a corporation resident in Canada;
- Forco is a non-resident corporation that is tax-indifferent;
- Canco1 and Forco do not deal with each other at arm’s length;

- Canco2 is a corporation resident in Canada that is not tax-indifferent;
- Forco loans funds to Canco1 on which interest is paid or payable (the "Loan"); and
- Canco2 enters into a transaction with Forco (the "Interest Strip Transaction"), whereby Canco2 acquires the right to receive the amount of interest paid or payable on the Loan from Canco1, but not the principal amount of the Loan.

Analysis

If it can reasonably be considered that one of the main purposes of the Interest Strip Transaction is to avoid any portion of the interest and financing expenses of Canco1 being paid or payable to a non-arm's length tax-indifferent (in this case Forco), Canco2 will be deemed to be a non-arm's length tax-indifferent in respect of Canco1.

Deemed eligible group entities

ITA
18.2(15)

New subsection 18.2(15) is a deeming rule for the definition "eligible group entity" in new subsection 18.2(1). It deems two taxpayers to be eligible group entities in respect of each other where they are eligible group entities in respect of the same third taxpayer. The use of the term "taxpayer" in this provision is meant to include both corporations and trusts.

Eligible group entities – related

ITA
18.2(16)

New subsection 18.2(16) provides two rules relevant in determining whether entities are eligible group entities in respect of each other by reason of being related. For these purposes, a reference to a trust does not include the trustee (this rule is provided for greater certainty and based on paragraph 251.1(4)(c) in respect of "affiliated persons") and entities are not deemed to be related solely because of control by the Crown or an entity referred to in paragraphs 149(1)(c) to (d) (such as municipalities and Crown corporations).

Eligible group entities – affiliated

ITA
18.2(17)

New subsection 18.2(17) provides two rules relevant in determining whether entities are eligible group entities in respect of each other by reason of being affiliated. For these purposes, entities are deemed not to be affiliated solely because of control by the Crown or an entity referred to in paragraphs 149(1)(c) to (d) (such as municipalities and Crown corporations), or because an entity is a beneficiary that is a "majority-interest beneficiary" (within the meaning of subsection 251.1(3)) that is also an arm's-length registered charity or non-profit organization.

Filing Requirement

ITA
18.2(18)

New subsection 18.2(18) requires taxpayers to file in their return of income for the year a prescribed form containing prescribed information for the purpose of determining the deductibility of their interest and financing expenses and for determining their exempt interest and financing expenses. New paragraph 152(4)(b.8) permits the Minister to reassess taxpayers who fail to file the prescribed form, or who file the prescribed form without including all of the information required by the form, outside of the normal reassessment period. For more information, see the commentary on paragraph 152(4)(b.8).

Relevant inter-affiliate interest

ITA
18.2(19)

New subsection 18.2(19) provides rules for determining the portion of relevant inter-affiliate interest that is included in a controlled foreign affiliate's relevant affiliate interest and financing expenses or relevant affiliate interest and financing revenues.

Relevant inter-affiliate interest (defined in subsection 18.2(1)) refers, generally, to interest paid or payable by a controlled foreign affiliate (referred to in subsection 18.2(19) as the "payer affiliate") of a taxpayer to another controlled foreign affiliate (referred to in subsection 18.2(19) as the "recipient affiliate") of the taxpayer, or of an eligible group entity in respect of the taxpayer.

Although subsection 18.2(19) is similar to the excluded interest election available for certain interest payments between taxable Canadian corporations, it differs from that election in several respects. In particular, subsection 18.2(19) applies automatically rather than electively, does not provide a full exclusion in all cases and does not necessarily provide for symmetrical treatment in respect of the payer affiliate and recipient affiliate (as discussed below).

Paragraph 18.2(19)(a) determines the portion of the relevant inter-affiliate interest that is included in the payer affiliate's relevant affiliate interest and financing expenses for an affiliate taxation year (referred to in subsection 18.2(19) as the "payer affiliate year"). This portion is determined by the formula A + B.

Variable A is essentially the portion of the relevant inter-affiliate interest that can be regarded as eroding the tax base by reducing an income inclusion in respect of foreign accrual property income ("FAPI") under subsection 91(1). This erosion occurs where the total of the specified participating percentages (determined without regard to the payment of the relevant inter-affiliate interest), in respect of the payer affiliate, of the taxpayer and any eligible group entities in respect

of the taxpayer (each referred to in this commentary as a "relevant taxpayer") exceeds the total of the specified participating percentages, in respect of the recipient affiliate, of relevant taxpayers.

By virtue of variable A, the portion of the relevant inter-affiliate interest that can be seen as reducing the subsection 91(1) income inclusion in this manner is included in the relevant affiliate interest and financing expenses of the payer affiliate. In contrast, the remaining portion is excluded, subject to variable B.

If the total of the specified participating percentages, in respect of the payer affiliate, of relevant taxpayers is less than that in respect of the recipient affiliate, the amount determined for A is nil (by application of section 257). Thus, all of the relevant inter-affiliate interest is excluded from relevant affiliate interest and financing expenses in these cases, subject to variable B.

Variable B includes a portion of the relevant inter-affiliate interest in the payer affiliate's relevant affiliate interest and financing expenses, where the portion so included is equal to the net relevant affiliate interest and financing revenues of the payer affiliate allocable to that relevant inter-affiliate interest. In effect, this ensures the payer affiliate must treat the relevant inter-affiliate interest as relevant affiliate interest and financing expenses to the extent these would offset against net relevant affiliate interest and financing revenues.

The payer affiliate's net relevant affiliate interest and financing revenues are determined as F – G, and are equal to its relevant affiliate interest and financing revenues for the payer affiliate year, net of the amount that would be its relevant affiliate interest and financing expenses for the payer affiliate year if that amount were determined without regard to all amounts of relevant inter-affiliate interest of the payer affiliate for the payer affiliate year. A portion of these net relevant affiliate interest and financing revenues is allocated to each amount of relevant inter-affiliate interest of the payer affiliate for the payer affiliate year, based on the proportion that that amount of relevant inter-affiliate interest is of the total of all amounts of relevant inter-affiliate interest of the payer affiliate for the payer affiliate year that would, in the absence of paragraph 18.2(19)(a), be included in the payer affiliate's relevant affiliate interest and financing expenses. This *pro rata* allocation occurs under the formula (F – G) x H ÷ I.

Paragraph 18.2(19)(b) determines the portion of the relevant inter-affiliate interest that is included in the recipient affiliate's relevant affiliate interest and financing revenues for the recipient affiliate's affiliate taxation year.

If the payer affiliate does not have net relevant affiliate interest and financing revenues for the payer affiliate year, none of the relevant inter-affiliate interest will be included in the recipient affiliate's relevant affiliate interest and financing revenues. This will be so even if a portion of the relevant inter-affiliate interest is included in the payer affiliate's relevant affiliate interest and financing expenses by virtue of variable A of the formula in paragraph 18.2(19)(a).

If the payer affiliate has net relevant affiliate interest and financing revenues, the portion of the relevant inter-affiliate interest included in the recipient affiliate's relevant affiliate interest and financing revenues is equal to the lesser of the relevant inter-affiliate interest and the portion of the payer affiliate's net relevant affiliate interest and financing revenues that is allocated to the

relevant inter-affiliate interest under variable B of the formula in paragraph 18.2(19)(a), as adjusted to reflect the total specified participating percentages of relevant taxpayers in respect of the payer affiliate and recipient affiliate. Paragraph 18.2(19)(b) ensures the payment of the relevant inter-affiliate interest does not inappropriately convert net relevant affiliate interest and financing revenues of the payer affiliate into FAPI that does not have that character in the hands of the recipient affiliate.

Example

Assumptions

- Canco is a corporation resident in Canada with a taxation year ending December 31, 2025.
- CFA 1 and CFA 2 are controlled foreign affiliates of Canco at all relevant times.
- In the affiliate taxation year ending December 31, 2025, CFA 1's only income is $70 million in relevant affiliate interest and financing revenues and $40 million in dividends that are included in its income from property and are from corporations that are not foreign affiliates of any taxpayer.
- In its 2025 affiliate taxation year, CFA 1 makes the following interest payments, which are its only expenses for the year and are deductible (determined without regard to the EIFEL rules) in computing its FAPI:
    - $50 million to CFA 2 (Payment 1);
    - $50 million to CFA 2 (Payment 2); and
    - $10 million to a non-resident lender that is not a controlled foreign affiliate of Canco or of an eligible group entity in respect of Canco (Payment 3).
- CFA 2 has no expenses and its only income for its 2025 affiliate taxation year is from Payments 1 and 2.
- As a result of the interest payments (and before applying the EIFEL rules),
    - CFA 1's FAPI for its 2025 affiliate taxation year is nil; and
    - CFA 2's FAPI for its affiliate taxation year ending December 31, 2025 is $100 million.
- The total of the specified participating percentages of Canco and all eligible group entities of Canco is,
    - in respect of CFA 1 for its 2025 year, 80% (determined as if Payments 1 and 2 were not paid or payable); and
    - in respect of CFA 2 for its 2025 year, 60%.

Analysis

Payments 1 and 2 are relevant inter-affiliate interest of CFA 1 for its 2025 year and of CFA 2 for its 2025 year.

Payment 3, however, is not relevant inter-affiliate interest and is included in CFA 1's relevant affiliate interest and financing expenses for its 2025 year.

The amount included, in respect of Payment 1, in CFA 1's relevant affiliate interest and financing expenses for its 2025 year under variable A of the formula in subparagraph 18.2(19)(a)(ii) is determined by the formula (C – D) x E ÷ C, where:

- C is Canco's specified participating percentage in respect of CFA 1, which is 80%;
- D is Canco's specified participating percentage in respect of CFA 2, which is 60%; and
- E is the amount of Payment 1, which is $50 million.

Accordingly, in respect of Payment 1, the amount determined for variable A is $12.5 million. This amount will be included in CFA 1's relevant affiliate interest and financing expenses for purposes of determining Canco's interest and financing expenses.

The amount determined for variable B of the formula in subparagraph 18.2(19)(a)(ii)) is determined by the formula (F – G) x H ÷ I, where:

- F is CFA 1's relevant affiliate interest and financing revenues for its 2025 year, which is $70 million;
- G is the amount that would be CFA 1's relevant affiliate interest and financing expenses for its 2025 year if CFA 1 had no relevant inter-affiliate interest, which is $10 million;
- H is the amount of Payment 1, which is $50 million; and
- I is CFA 1's total relevant inter-affiliate interest for its 2025 year, which is $100 million.

Accordingly, in respect of Payment 1, the amount determined for variable B is $30 million. This amount will be included in CFA 1's relevant affiliate interest and financing expenses.

As a result, $42.5 million of Payment 1 is included in CFA 1's relevant affiliate interest and financing expenses for its 2025 year.

Applying the same calculations under the same formulas, $42.5 million of Payment 2 is also included in CFA 1's relevant affiliate interest and financing expenses for its 2025 year.

The amount included, in respect of Payment 1, in CFA 2's relevant affiliate interest and financing revenues for its 2025 year is the lesser of the amount of Payment 1 and the amount determined under paragraph 18.2(19)(b) by the formula J x K ÷ L, where:

- J is the amount included in CFA 1's relevant affiliate interest and financing expenses for its 2025 year under variable B of subparagraph 18.2(19)(a)(ii) in respect of Payment 1, which is $30 million.
- K is Canco's specified participating percentage in respect of CFA 1, which is 80%; and
- L is Canco's specified participating percentage in respect of CFA 2, which is 60%.

Accordingly, CFA 2's relevant affiliate interest and financing revenues, in respect of Payment 1, are $40 million. CFA 2's relevant affiliate interest and financing revenues, in respect of Payment 2, are also $40 million.

CFA 1's relevant affiliate interest and financing expenses for its 2025 year are $95 million and its relevant affiliate interest and financing revenues are $70 million. CFA 2's relevant affiliate interest and financing revenues for its 2025 year are $80 million.

Based on Canco's 80% specified participating percentage in respect of CFA 1,

- $76 million is included in Canco's interest and financing expenses for its 2025 taxation year under paragraph (j) of variable A of the formula in the definition of that term; and
- $56 million is included in Canco's interest and financing revenues for its 2025 taxation year under paragraph (g) of variable A of the formula in the definition of that term.

Based on Canco's 60% specified participating percentage in respect of CFA 2, $48 million is included in Canco's interest and financing revenues for its 2025 taxation year.

Accordingly, in respect of its combined shareholdings in CFA 1 and CFA 2, Canco's interest and financing expenses are $76 million and its interest and financing revenues are $104 million for its 2025 year.

Allocated Group Ratio Amount

Section 18.21 sets out the "group ratio" rules that are available to potentially reduce a taxpayer's excessive interest and financing expenses limitation under subsection 18.2(2). In general terms, the group ratio rules allow a taxpayer to deduct interest in excess of the fixed ratio where the taxpayer is able to demonstrate that the ratio of the consolidated group's net third-party interest expense (referred to in the rules as "group net interest expense", as defined in subsection 18.21(1)) to the consolidated group's book EBITDA (referred to in the rules as the "group adjusted net book income", also defined in subsection 18.21(1)) exceeds the fixed ratio. In that case, Canadian group members can jointly elect to determine their deductible amount of interest and financing expenses based on the consolidated group's ratio multiplied by the adjusted taxable incomes of the Canadian group members, subject to certain limitations. The group then allocates this deductible amount among the Canadian group members in the form that effects the election. This "flexible" allocation mechanism allows taxpayers to allocate the group ratio deduction capacity where it is most needed. The amount so allocated, referred to in these notes as the "allocated group ratio amount" or AGRA, replaces the fixed ratio amount otherwise applicable for variable B of the formula in subsection 18.2(2).

The group ratio rules contain certain limitations that are mainly intended to account for the possibility that some group members may have negative book EBITDA, or the group as a whole may have negative book EBITDA, such that a simple formulaic determination of the group ratio could give unreasonably high or meaningless results. Paragraph 18.21(2)(c) limits the AGRA to the lesser of the consolidated group's net third-party interest expense and the net adjusted taxable income of the Canadian group members.

Group ratio – definitions

ITA
18.21(1)

Subsection 18.21(1) sets out definitions that apply in determining the "allocated group ratio amount" (AGRA) of a taxpayer. Certain definitions in subsection 18.2(1) also apply in determining AGRA.

"acceptable accounting standards"

The definition "acceptable accounting standards" is relevant for the definition "consolidated financial statements" and, by virtue of subsection 18.21(6), the definitions "consolidated group", "equity-accounted entity", "group adjusted net book income", "specified interest expense", "specified interest income" and "ultimate parent". It means International Financial Reporting Standards (IFRS) and generally accepted accounting principles in Canada, Australia, Brazil, member states of the European Union or the European Economic Area, Hong Kong (China), Japan, Mexico, New Zealand, the People's Republic of China, the Republic of India, the Republic of Korea, Singapore, Switzerland, the United Kingdom and the United States. This list is predicated on the notion that differences between IFRS and generally accepted accounting principles in these jurisdictions would not provide a material competitive advantage or disadvantage to any entity using these standards.

"consolidated financial statements"

The definition "consolidated financial statements" is relevant for the definitions "consolidated group", "equity-accounted entity", "fair value amount", "group adjusted net book income", "net fair value amount", "relevant period", "specified interest expense", "specified interest income" and "ultimate parent". It is also referred to in subsections 18.21(2), (6) and (7). It means financial statements prepared in accordance with a relevant "acceptable accounting standard", also defined in subsection 18.21(1), in which the assets, liabilities, income, expenses and cash flows of two or more entities are presented as those of a single economic entity.

For greater certainty, the consolidated financial statements include, for these purposes, the notes to the financial statements. The use of the word "relevant" before "acceptable accounting standards" is meant to ensure that there must be a logical connection between the entities so consolidated and the accounting standards that are used to present their economic results. For example, generally accepted accounting principles in New Zealand would not likely be relevant for presenting the financial results of a group of companies based entirely in North America.

This definition is subject to the interpretation rule in paragraph 18.21(6)(a), as described below.

"consolidated group"

The definition "consolidated group" is central to the AGRA rules in section 18.21.

A consolidated group means two or more entities in respect of which "consolidated financial statements" (also defined in subsection 18.21(1)) are required to be prepared for financial

reporting purposes, or would be so required if the entities were subject to IFRS. Within the "consolidated group" definition, a "member of the consolidated group" is also defined for the purposes of section 18.21, being each such entity of the group, which includes an "ultimate parent" (also defined in subsection 18.21(1)). An "equity-accounted entity", also defined in subsection 18.21(1), is not considered a member of the group.

There are interpretive rules in paragraph 18.21(6)(a) and subsection 18.21(7) that apply for the purposes of this definition.

"equity-accounted entity"

The definition "equity-accounted entity" is relevant for the definitions "consolidated group", "group adjusted net book income", "specified interest expense" and "specified interest income". It means an entity the net income or loss of which is included in the consolidated financial statements of a consolidated group under the equity method of accounting. In general terms, these entities are not accounted for on a line-by-line basis in consolidated financial statements.

This definition is subject to the interpretive rule in paragraph 18.21(6)(a).

"equity interest"

The definition "equity interest" is relevant for the definition "specified non-member", also defined in subsection 18.21(1). It means a share of the capital stock of a corporation, an interest as a beneficiary under a trust, an interest as a member of a partnership or any similar interest in respect of any entity.

"fair value amount"

The definition "fair value amount" is relevant for the definition of "net fair value amount", which in turn, is relevant in the computation of "group adjusted net book income" (GANBI). It means an amount reflected in the net income or loss reported in the consolidated financial statements of the consolidated group where the carrying value of any asset or liability is measured using the fair value method of accounting and the amount reflects a change in the carrying value of the asset or liability that is included in either variable C (net income reported in the consolidated financial statements) or H (net loss reported in the consolidated financial statements) of GANBI.

This definition is subject to the interpretive rule in paragraph 18.21(6)(a).

"group adjusted net book income"

The definition "group adjusted net book income" (GANBI) is a key term in the AGRA rules as it is the amount used as the denominator in the "group ratio" determination. In essence, it is a consolidated group's EBITDA, as adjusted for certain items. It is based on the consolidated financial statements of the group for a relevant period.

GANBI is calculated by formula, in a similar fashion to the calculation of EBITDA in that items in respect of interest, tax, depreciation and amortization are added back to the net profit or loss of the enterprise to obtain an adjusted net profit or loss amount. The items identified to determine the GANBI, or the information required to determine the amount of certain items, generally will be found in the consolidated financial statements of the group, or may be found in the notes to such statements. Further work to determine amounts in the relevant working papers or from other sources may be necessary in order to properly calculate the GANBI.

Variables C, D, E, F and G are additions, and variables H, I, J, K, L, M and N are subtractions, in determining GANBI.

Variable C is the amount, if any, of the group's net income for the year as reported in its consolidated financial statements for the relevant period. If the group has a net loss for the year, it is picked up in variable H. "Relevant period" is also defined in subsection 18.21(1) and is described below.

Representing the "T" in EBITDA, variable D adds back the income tax expense of the group as reported in the consolidated financial statements.

Representing the "I" in EBITDA, variable E adds back the group's interest expense, by reference to the definition "specified interest expense", as described below. However, the latter definition is modified for GANBI purposes so that capitalized interest is not included in the add back, as it should be taken into account in the group's depreciation and amortization amount, because it is generally added to the capital cost of an asset and depreciated over time.

Variable F is generally intended to represent the "DA" in EBITDA, being the add backs for depreciation and amortization. Variable F also adds back charges taken in computing profit that are in respect of the impairment or the write-off of a fixed asset, any loss from the disposition of a fixed asset and, if the Canadian group members have elected to exclude fair value amounts from the calculation of GANBI in accordance with subsection 18.21(4), a negative net fair value amount. Finally, variable F adds back any expenses, charges, deductions or losses that are similar to those specifically enumerated.

Variable G relates to equity-accounted entities. As a general matter, the AGRA rules are intended to recognize the income (or loss) generated by such entities for purposes of GANBI. However, consistent with the EBITDA concept, the portions of such income or loss that relate to the typical EBITDA addbacks must also be accounted for. As such, it is necessary to obtain information in respect of the income tax (per variable D) and depreciation and amortization (per variable F) amounts of any equity-accounted entities and to add back the consolidated group's share of these amounts in the calculation of GANBI. As the definition "specified interest expense" already includes interest and related expenses in respect of equity-accounted entities, no further adjustment is required in this regard.

Variable H is the first of the negative adjustments in GANBI and addresses net losses reported in the consolidated financial statements.

Variables I to M essentially mirror the addback items but reflect income or receipts rather than expenses or charges that have been taken into account in the computation of the group's net profit or loss. In particular, variable K allows Canadian group members that have elected to exclude fair value amounts from the calculation of GANBI in accordance with subsection 18.21(4) to add back a positive net fair value amount.

Variable N excludes in calculating GANBI any portion of net income reported in the consolidated financing statements that can reasonably be considered to be derived from activities funded, in whole or in part, by a borrowing resulting in exempt interest and financing expenses.

If the result of the GANBI formula is negative, it is intended that section 257 would make GANBI nil.

This definition is subject to the interpretive rule in paragraph 18.21(6)(a) in respect of the use of accounting terms.

"group net interest expense"

The definition "group net interest expense" (GNIE) is a key term in the AGRA rules as it is the amount used as the numerator in the "group ratio" determination. In essence, it is a consolidated group's net third party interest expense for a relevant period.

Variable A is the main component of the GNIE and is the amount by which the "specified interest expense" of the group exceeds the "specified interest income" of the group, for a relevant period. For more information, see the commentary on these defined terms.

Variable B represents the amount by which the variable A amount is reduced in arriving at the GNIE. It is generally meant to back out any interest paid to "specified non-members", which are essentially entities that are not members of the consolidated group but that have a significant connection with the group. For more information, see the commentary on that defined term.

Variable E is the main component of variable B in that it adds up all amounts of "specified interest expense" that are paid or payable to specified non-members of the group. Variable F represents the amount by which the variable E amount is reduced for "specified interest income" received or receivable from the specified non-member in respect of which "specified interest expense" is paid or payable. Section 257 is intended to make E minus F nil in respect of a particular "specified non-member" where the amount for variable F is greater than the amount for variable E. In other words, "specified interest income" in respect of a "specified non-member" is only taken into account to the extent that it does not exceed "specified interest expense" in respect of the "specified non-member".

"group ratio"

The definition "group ratio", as its name suggests, is a key component of the group ratio rules in section 18.21. However, it is only one component of the AGRA – determined under subsection

18.21(2) – which is the ultimate amount that is used in the EIFEL provision in subsection 18.2(2).

The "group ratio" definition contemplates two scenarios. Paragraph (a) provides that, if GANBI is a positive amount, the "group ratio" is determined as the ratio of GNIE to GANBI, multiplied by a factor of 1.1. For example, a taxpayer with GNIE of $50 and GANBI of $100 would have a group ratio of 0.55 (1.1 x 50/100). The formula includes a 10% up-lift to account for book-tax timing differences. GNIE and GANBI are based on an accounting measure of income and expenses, while the calculation of the fixed ratio in section 18.2 is based on tax measures. The 10% up-lift is recommended in the BEPS Action 4 Report to mitigate against book-tax timing differences that may arise from the group ratio calculation. If GANBI is not a positive amount, paragraph (b) provides that the group ratio is nil.

"net fair value amount"

The definition "net fair value amount" is relevant for paragraph (d) of variable F, and variable K, in the computation of "group adjusted net book income" (GANBI). It means the positive or negative total amount of all positive or negative fair value amounts in the consolidated financial statements.

"relevant period"

The definition "relevant period" refers to the period for which the consolidated financial statements of a consolidated group are presented. It is essentially the period in respect of which the amounts under section 18.21 are computed.

"specified interest expense"

The definition "specified interest expense" is a key component of the numerator (i.e., the GNIE) in the group ratio determination. It generally includes amounts of interest and similar types of financing expenses, as determined for financial reporting purposes.

Variable A adds up the various interest and financing expenses referred to in paragraphs (a) to (d). Variable B backs out any dividends included in those variable A amounts.

Paragraph (a) is the principal component of "specified interest expense" and includes all amounts of interest expense, whether reported as a line item itself in the consolidated financial statements or included in determining other such amounts.

Paragraph (b) deals with capitalized interest. This is generally intended to capture interest that is included in the balance sheet value of an asset.

Paragraph (c) includes guarantee fees, standby charges and arrangement or similar fees. These expenses are not interest but are similar in nature in that they are generally related to borrowings or other credit facilities.

Paragraph (d) includes the consolidated group's share of the interest and similar expenses of equity-accounted entities.

Exempt interest and financing expenses in respect of a Canadian public-private partnership infrastructure project are not included in "specified interest expenses". For more information, see the commentary on the definition "exempt interest and financing expenses" in subsection 18.2(1).

Variable B is the total amount of dividends included in the determination of the amounts referred to in paragraphs (a) to (d) of variable A. It addresses the fact that some shares of corporations may be treated as debt for financial reporting purposes. Thus, any payment of dividends on such shares may be treated as a payment of interest expense for financial reporting purposes. However, these dividend payments are not deductible in computing the income of the paying corporation for tax purposes. As such, these dividends are excluded from "specified interest expense".

This definition is subject to the interpretation rules in paragraphs 18.21(6)(a) and (b).

"specified interest income"

The definition "specified interest income" is the income analogue to the definition "specified interest expense" and is structured in a similar manner. The only exception is that capitalized interest has no income analogue.

"specified non-member"

The definition "specified non-member" is relevant for the GNIE definition. GNIE does not include any amount of "specified interest expense" that is paid or payable to a specified non-member. (These excluded amounts are reduced by "specified interest income" that is received or receivable from the specified non-member). Essentially, the concept of a "specified non-member" is intended to identify those persons or partnerships that are considered to have a close connection to a consolidated group, while not being members of the group.

Paragraph (a) includes certain persons or partnerships that do not deal at arm's length with a member of the consolidated group.

Paragraph (b) looks up an ownership chain and targets certain situations where a person or partnership, alone or together with non-arm's length parties, has "equity interests" (as defined, and discussed elsewhere in these notes) that give it 25% or more of the votes or value of a member of the consolidated group.

Paragraph (c) looks down an ownership chain and targets certain situations where a member of the consolidated group, alone or together with non-arm's length parties, has "equity interests" (as defined, and discussed elsewhere in these notes) that give it 25% or more of the votes or value of another entity.

This definition is subject to the anti-avoidance rule in subsection 18.21(8).

“ultimate parent”

The definition “ultimate parent” is mainly relevant in relation to the definition “consolidated group” and refers to the top entity in the group’s organizational structure. It is the entity in respect of which the consolidated financial statements of the group are prepared. Where the top entity in a group’s organizational structure is the Crown or an entity referred to in any of paragraphs 149(1)(c) to (d.6) (such as a Crown corporation or municipality), the ultimate parent is the highest-level entity that is not the Crown or an entity referred to in any of paragraphs 149(1)(c) to (d.6).

This definition is subject to the interpretation rule in paragraph 18.21(6)(a).

Allocated group ratio amount

ITA
18.21(2)

Subsection 18.21(2) is the operative provision of the group ratio rule in section 18.21 and determines the “allocated group ratio amount” (AGRA) that may be used as an alternative to the fixed ratio’s interest deduction capacity under subsection 18.2(2).

If all conditions in subsection 18.21(2) are satisfied, corporations and trusts that are “eligible group entities” in respect of each other and that are members of the same consolidated group throughout a relevant period may elect to allocate an amount to each such entity (referred to as a “Canadian group member”) under paragraph 18.21(2)(b) for each taxation year ending in the relevant period (referred to as a “relevant taxation year”). That amount (referred to in these notes as the “allocated group ratio amount” or AGRA) becomes, subject to the limitations set out in paragraph 18.21(2)(c), the amount determined under this subsection that replaces the amount otherwise used in variable B of subsection 18.2(2) under the fixed ratio rules. The joint election may be filed by the taxpayer or by any Canadian group member of the taxpayer, allowing one Canadian group member to file the election on behalf of the entire group.

A taxpayer that is a single member group under subsection 18.2(7) does not have any Canadian group members and therefore must file an election, rather than a joint election, for subsection 18.2(2) to apply.

“Eligible group entity” is defined in subsection 18.2(1) and requires each such entity to be resident in Canada.

Paragraph 18.21(2)(c) sets a limit on the total amount allocated. If that limit is exceeded, the AGRA is nil.

The AGRA limitation is the least of the following amounts:

i. The total of each amount that is a Canadian group member's adjusted taxable income multiplied by the "group ratio" of the consolidated group.
ii. The "group net interest expense" (GNIE) of the consolidated group.
iii. The total of the "adjusted taxable income", determined without reference to section 257, of each Canadian group member for the year. The override of section 257 is intended to ensure that aggregate taxable income is reduced by losses of any Canadian group members.

Similar to the transfer mechanism in subsection 18.2(4), subsection 18.21(2) allows for amended elections, subject to conditions, where a Canadian group member is reassessed, necessitating a reallocation of the allocated group ratio amount. For more information, see the commentary to subsection 18.2(4).

Late or amended election

ITA
18.21(3)

New subsection 18.21(3) authorizes the Minister to allow late-filed, amended or revoked elections under subsection 18.21(2) where the Canadian group members meet certain conditions and the Minister considers that it would be just and equitable to permit the change. This provision may be needed where, for example, the financial statements of the group are restated such that amounts relevant to the group ratio must be re-determined.

Fair value amounts – election

ITA
18.21(4)

Subsection 18.21(4) is the election required for "fair value amounts" to be excluded by Canadian group members from the calculation of GANBI. See the commentary to the definitions of "fair value amount", "group adjusted net book income" and "net fair value amount".

There is only one opportunity for Canadian group members to jointly make this election – which is the first time that a joint election is made under subsection 18.21(2) for the group ratio to apply. If this election under subsection 18.21(4) is made, an election under subsection 18.21(4) is deemed to have been made in each subsequent taxation year of each Canadian group member, and if such an election is not made, an election under subsection 18.21(4) is deemed not to have been made in each subsequent taxation year of each Canadian group member.

Assessment

ITA
18.21(5)

New subsection 18.21(5) requires the Minister of National Revenue to assess or reassess any taxpayer to take into account an election or amended election filed under subsection 18.21(2), even where the assessment or reassessment would otherwise be statute-barred.

Use of accounting terms

ITA
18.21(6)

Subsection 18.21(6) ensures that the allocated group ratio amount (AGRA) is determined largely by reference to accounting concepts. For the purposes of the definitions listed in subsection 18.21(6), a term that is not defined under the Act is given its meaning for financial accounting purposes, while a term that is defined under the Act – such as the term "dividend", as used in the definitions "specified interest expense" and "specified interest income – is given its meaning for the purposes of the Act.

Single member group

ITA
18.21(7)
Subsection 18.21(7) provides a number of deeming rules in respect of a "single member group". These rules are intended to enable the application of the group ratio rules in section 18.21 to taxpayers resident in Canada that are not members of a consolidated group.

Anti-avoidance

ITA
18.21(8)

Subsection 18.21(8) provides an anti-avoidance rule in respect of the "group net interest expense" (GNIE) computation. It is intended to address the risk that the allocated group ratio amount could be deliberately inflated with amounts of interest and similar expenses that are paid or payable to certain third parties outside the consolidated group.

Specifically, where a portion of "specified interest expense" is paid or payable by a member of a consolidated group to a person or partnership that is not a member of the group as part of a transaction or a series of transactions, and it can reasonably be considered that one of the main purposes of the transaction or series is to avoid that portion being carved out of GNIE (which is what variable E of that definition would otherwise do), then the person or partnership is deemed to be a "specified non-member" in respect of the group for the relevant period. This would bring that portion and any other amount of specified interest expense paid or payable by a group member to that person or partnership for the relevant period squarely into variable E of the GNIE definition.

Example – Back-to-Back Transactions

Assumptions

- Canco is a corporation resident in Canada that is a member of a consolidated group (the "Group");
- Forco1 is a non-resident corporation that is not a member of the Group nor is it (absent the application of subsection 18.21(8)) a specified non-member of the Group;
- Forco2 is a non-resident corporation that is not a member of the Group but is a specified non-member of the Group;
- Forco2 loans funds to Forco1, and Forco1 loans funds to Canco on which interest is paid or payable to Forco1.

Analysis

If it can reasonably be considered that one of the main purposes of these transactions is to avoid the inclusion of any portion of the interest paid or payable by Canco in the amount for variable E in the GNIE definition, Forco1 will be deemed to be a specified non-member. If this is the case, the interest would be included in variable E of GNIE.

Example – Interest Strip Transaction

Assumptions

- Canco is a corporation resident in Canada that is a member of a consolidated group (the "Group");
- Forco1 is a non-resident corporation that is not a member of the Group nor is it (absent the application of subsection 18.21(8)) a specified non-member of the Group;
- Forco2 is a non-resident corporation that is not a member of the Group but is a specified non-member of the Group;
- Forco2 loans funds to Canco on which interest is paid or payable (the "Loan");
- Forco2 enters into a transaction with Forco1 (the "Interest Strip Transaction") whereby Forco1 acquires the right to receive the amount of interest paid or payable on the Loan from Canco, but not the principal amount of the Loan.

Analysis

If it can reasonably be considered that one of the main purposes of the Interest Strip Transaction is to avoid the inclusion of any portion of the interest paid or payable by Canco on the Loan in the amount for E in the GNIE definition, Forco1 will be deemed be a specified non-member. If this is the case, the interest would be included in variable E of GNIE.

Coming Into Force

New sections 18.2 and 18.21 apply in respect of taxation years of a taxpayer that begin on or after October 1, 2023, subject to an anti-avoidance rule and a transitional election.

Where applicable, the anti-avoidance rule accelerates the application of sections 18.2 and 18.21, as well as various related provisions, to a taxation year that begins before 2023 and ends in that year. The anti-avoidance rule applies if, as a result of a transaction or event, or series of transactions or events, any of the taxpayer's three taxation years immediately preceding its first taxation year that begins on or after January 1, 2023, is a "short" taxation year, and it is reasonable to consider that one of the purposes for the transaction, event or series was:

- to defer the application of the EIFEL rules to the taxpayer, or
- in effect, to increase the amount of any taxpayer's excess capacity, as determined under the transitional rules discussed below, for a taxation year preceding the effective date of the EIFEL rules.

Transitional Rules

There are two separate sets of transitional rules included in the enacting legislation for the EIFEL rules. The first is an anti-avoidance rule that denies a taxpayer the benefit of the 40% ratio of permissible expenses otherwise applicable for taxation years that begin on or after October 1, 2023 and before January 1, 2024, generally where the taxpayer undertakes a transaction to extend the period for which the 40% ratio applies. For more information, see the commentary on the definition "ratio of permissible expenses" in subsection 18.2(1).

The second set of transitional rules applies for the purpose of determining the cumulative unused excess capacity of a taxpayer that is a corporation or a fixed interest commercial trust for a taxation year, which is by definition determined based on the taxpayer's excess capacity for the year plus its excess capacity for the three immediately preceding taxation years (reflecting a three-year carry-forward of excess capacity). Absent these transitional rules, such a taxpayer would not have excess capacity for any of the three taxation years (referred to as the "pre-regime years") immediately preceding its first taxation year (referred to as the "first regime year") in respect of which the EIFEL rules apply, because the EIFEL rules otherwise do not apply in respect of the pre-regime years. These transitional rules, in effect, allow taxpayers to elect to determine their excess capacity for the pre-regime years in accordance with special rules and carry forward their excess capacity so determined for a pre-regime year for three taxation years, by including it in computing their cumulative unused excess capacity.

In order to benefit from these transitional rules, a taxpayer and all eligible group entities in respect of the taxpayer that are also corporations or fixed interest commercial trusts (referred to in the transitional rules as "eligible pre-regime group entities") must jointly elect to have these rules apply. Absent a valid joint election, the taxpayer's excess capacity for all its pre-regime years is deemed to be nil. For the purposes of these transitional rules, the eligible pre-regime group entities in respect of the taxpayer are determined at the end of the taxpayer's first regime year. The joint election must be filed by the filing-due date of the group member with the earliest filing-due date for the first regime year. In recognition that subsequent events – e.g., a loss carryback or other reassessment – may change amounts relevant to the determination of excess capacity carried forward under these transitional rules, provision is made for amended elections in such circumstances. Otherwise, and similarly to subsection 18.2(5), an election may be late-filed or amended with Ministerial permission.

The joint election may be filed by the taxpayer or by any of its eligible pre-regime group entities, allowing one eligible pre-regime group entity to file the completed joint election on behalf of the entire group. The election must allocate the "group net excess capacity" (described below) for the pre-regime years among the taxpayer and eligible pre-regime group entities in respect of the taxpayer, and these allocated amounts are treated as their excess capacity for the specific pre-regime years to which they are allocated. The rules governing these allocations are explained in more detail below. If a valid joint election is filed, a taxpayer's excess capacity for the pre-regime years is determined in accordance with special rules, which are required because a taxpayer's cumulative unused excess capacity for a taxation year is intended to include only the unused portions of its excess capacity for the three immediately preceding taxation years. In the steady-state system after the rules apply generally, the unused portion of excess capacity is determined, under the definition "cumulative unused excess capacity", by reducing excess capacity by the taxpayer's "absorbed capacity" and "transferred capacity", which represent the portions of its excess capacity that the taxpayer has already used to deduct its own excess interest and financing expenses (i.e., such expenses exceeding the amount it would have been permitted to deduct for the year under subsection 18.2(2)) or to allow other group members to deduct their excess interest and financing expenses in prior years. Since the EIFEL rules do not otherwise apply in respect of the pre-regime years, however, the taxpayer necessarily will not have used any of its excess capacity for pre-regime years for these purposes.

Special transitional rules are therefore provided to determine the taxpayer's unused excess capacity for the pre-regime years, in order to ensure consistency with the usual rules for determining a taxpayer's cumulative unused excess capacity and prevent it from being overstated. They are intended to approximate what the taxpayer's unused excess capacity would have been had the EIFEL rules applied in respect of the pre-regime years. Thus, they seek to replicate, in a relatively simple and administrable way, the extent to which the excess capacity of the taxpayer and eligible pre-regime group entities for pre-regime years would have been used to allow for the deduction of the excess interest and financing expenses of the taxpayer and eligible pre-regime group entities for pre-regime years.

In effect, the transitional rules net any excess interest and financing expenses of the taxpayer and eligible pre-regime group entities in respect of the taxpayer for any pre-regime years against any excess capacity of the taxpayer and those eligible pre-regime group entities for those years, in determining a taxpayer's excess capacity (as well as the excess capacity of the eligible pre-regime group entities). This is intended to approximate reductions for transfers of excess capacity to other group members that have excess interest and financing expenses in pre-regime years, which would have occurred had the EIFEL rules applied for pre-regime years, as well as reductions for where a taxpayer's excess capacity for one pre-regime year would have been used to allow the taxpayer to deduct its own excess interest and financing expenses in another pre-regime year.

The special rules for determining the taxpayer's excess capacity for each pre-regime year (which is, notionally, the unused portion of its excess capacity) can be broken down into three main steps.

The first step is to determine the "excess capacity otherwise determined" or "excess interest" of the taxpayer and each eligible pre-regime group entity for each pre-regime year. A taxpayer's "excess capacity otherwise determined" for a pre-regime year is the amount that would be determined as its excess capacity for that year if that definition applied in respect of the pre-regime year. A taxpayer's "excess interest" for a pre-regime year is the amount by which its interest and financing expenses for the year exceed the amount of interest and financing expenses that it would have been permitted to deduct for that year had subsection 18.2(2) applied in respect of that year. Subject to any group ratio election made by the taxpayer, the amount the taxpayer would have been permitted to deduct is determined as its ratio of permissible expenses multiplied by its adjusted taxable income, plus its interest and financing revenues.

In determining the excess capacity otherwise determined or excess interest of the taxpayer and each eligible pre-regime group entity for each pre-regime year:

- If a taxpayer was subject to a loss restriction event in a pre-regime year, its excess capacity otherwise determined or excess interest for any pre-regime year preceding that event is deemed to be nil.
- The ratio of permissible expenses that is to be used in determining these amounts is the one that, under the definition "ratio of permissible expenses" in subsection 18.2(1) (and subject to the above-noted anti-avoidance rule provided in the transitional rules), applies for the taxation year for which the taxpayer's cumulative unused excess capacity is being determined. Thus, for some corporate groups, the excess capacity otherwise determined or excess interest of the taxpayer and each eligible pre-regime group entity for each pre-regime year must be determined twice: once using the 40% ratio of permissible expenses that generally applies for taxation years beginning on or after October 1, 2023 and before January 1, 2024, for the purpose of determining the taxpayer's cumulative unused excess capacity for those years; and a second time using the 30% ratio that applies for subsequent taxation years, for the purpose of determining the taxpayer's cumulative unused excess capacity for those subsequent years (this will generally be relevant for taxation years that begin in 2024 and 2025, and in 2026 for many taxpayers, given the three-year carry-forward period for excess capacity).
- As an alternative to using the applicable ratio of permissible expenses in determining excess capacity otherwise determined or excess interest, corporate groups can elect to have the group ratio rule in subsection 18.21(2) apply for one or more pre-regime years, provided they meet the conditions in that subsection (but with the filing deadline for the requisite election being determined by reference to the first regime year rather than a pre-regime year). While a group ratio election results in the taxpayer and eligible pre-regime group entities having nil excess capacity for the group ratio year, electing into the group ratio for a pre-regime year can nonetheless be beneficial in certain cases, in that it generally results in lower amounts of excess interest of the taxpayer or eligible pre-regime group entities for a pre-regime year.

The reason that taxpayers for which the 40% transitional fixed ratio applies for their first regime year are required to determine excess capacity otherwise determined and excess interest twice – once using the 40% ratio, and then again using the 30% ratio – is that no excess capacity that derives from the 40% transitional fixed ratio (in excess of what would be derived under a 30%

ratio) is permitted to be carried forward to a taxation year in which the 30% ratio applies. Thus, these amounts must be computed using the 30% ratio in determining cumulative unused excess capacity for any taxation year for which the 30% ratio applies.

The second step is to determine the "group net excess capacity" for the pre-regime years, which is the total of the excess capacity otherwise determined of the taxpayer and all eligible pre-regime group entities for all pre-regime years, net of the total of the excess interest of the taxpayer and eligible pre-regime group entities for all pre-regime years. Thus, the group net excess capacity represents the net excess capacity of the corporate group for the period spanning the pre-regime years. Consistent with the approach under the EIFEL rules more generally, the excess interest or excess capacity otherwise determined of any financial institution group entity or any tax exempt person is excluded in the determination of group net excess capacity.

In the case of taxpayers for whom the 40% ratio applies for their first regime year, the group net excess capacity is computed twice: the first time based on the excess capacity otherwise determined and excess interest of the taxpayer and each eligible pre-regime group entity for each pre-regime year as determined using the 40% ratio, and the second time based on those amounts determined using the 30% ratio.

The third step is to allocate, in the joint election under the transitional rules, the group net excess capacity to the taxpayer and the eligible pre-regime group entities for specific pre-regime years. The portion of the group net excess capacity that is allocated to a taxpayer or eligible pre-regime group entity for a pre-regime year is deemed to be the excess capacity of the taxpayer or eligible pre-regime group entity, as the case may be, for that pre-regime year. The allocated amount for a given pre-regime year thus effectively replaces the amount that would otherwise have been determined as the taxpayer's excess capacity (the taxpayer's "excess capacity otherwise determined") for the given pre-regime year under the definition "excess capacity" in subsection 18.2(1), if that definition applied in respect of pre-regime years. The taxpayer's deemed excess capacity for a pre-regime year is, in effect, subject to both the usual three-year carry-forward by virtue of being included in the taxpayer's cumulative unused excess capacity, and the ordinary rules under that definition that reduce excess capacity to reflect its utilization in the form of amounts of transferred capacity and absorbed capacity.

Where applicable, the group must make two allocations in its joint election: one for the group net excess capacity as determined using the 40% ratio, and the other for the group net excess capacity determined using the 30% ratio. The first allocation determines the excess capacity, for each pre-regime year, of the taxpayer and each eligible pre-regime group entity, for the purpose of determining their respective cumulative unused excess capacity for taxation years in which the 40% ratio applies (generally, taxation years beginning on or after October 1, 2023, and before January 1, 2024). The second allocation applies for the purpose of determining the respective cumulative unused excess capacity of the taxpayer and eligible pre-regime group entities for subsequent taxation years (given the three-year carry-forward period for excess capacity, this will generally be relevant for taxation years beginning in 2024 and 2025, and in 2026 for taxpayers whose first regime year is 2024). This means that, for some taxpayers, the amount deemed to be their excess capacity for a given pre-regime year will be different for the purpose

of computing their cumulative unused excess capacity for their first regime year than for the purpose of computing their cumulative unused excess capacity for subsequent years.

In addition, these allocations must meet three specific requirements set out in the transitional rules, or else the taxpayer's excess capacity for a pre-regime year is deemed to be nil. The first requirement is that the total amount of excess capacity that a taxpayer is allocated for its pre-regime years, from the group net excess capacity, cannot exceed its net excess capacity for its pre-regime years. A taxpayer's net excess capacity for its pre-regime years is the amount, if any, by which the total of all amounts each of which is its excess capacity otherwise determined for any pre-regime year exceeds the total of all amounts each of which is its excess interest for any pre-regime year. Thus, if a taxpayer's total excess interest for its pre-regime years is greater than or equal to its total excess capacity otherwise determined for its pre-regime years, then it cannot be allocated any excess capacity for any pre-regime years, and thus its excess capacity for each of those years will be nil for the purpose of determining its cumulative unused excess capacity for any taxation year. In that case, any net group excess capacity for the pre-regime years can be allocated only to eligible pre-regime group entities in respect of the taxpayer that have net excess capacity for the pre-regime years.

The second requirement is that the excess capacity allocated to a taxpayer for a given pre-regime year cannot exceed its excess capacity otherwise determined for that pre-regime year.

The third requirement is that the total excess capacity allocated to the taxpayer and eligible pre-regime group entities for their pre-regime years cannot exceed the group net excess capacity. If the corporate group allocates a total amount greater than the group net excess capacity, then the excess capacity of the taxpayer and all of the eligible pre-regime group entities for each of their pre-regime years is deemed to be nil.

Clause 8

Overview

New sections 12.7 and 18.4 and of the *Income Tax Act* (the "Act"), together with new subsection 113(5), are the core provisions of the new hybrid mismatch rules. These rules are intended to implement the recommendations in, and be generally consistent with, the report under Action 2 of the Group of 20 and Organisation for Economic Co-operation and Development's Base Erosion and Profit Shifting Project (the "BEPS Action 2 Report"), titled *Final Report on Neutralising the Effects of Hybrid Mismatch Arrangements*, with appropriate adaptations to the Canadian income tax context. The BEPS Action 2 Report recommends a number of specific rules for countries to implement in their domestic laws, which are intended to neutralize mismatches in tax results arising from "hybrid mismatch arrangements".

Hybrid mismatch arrangements are cross-border arrangements that exploit differences in the income tax treatment of business entities or financial instruments under the laws of two or more countries to produce mismatches in tax results (referred to as "hybrid mismatches"). The two main forms of hybrid mismatch addressed by the recommendations in the BEPS Action 2 Report are:

- *Deduction/non-inclusion mismatches*: In general terms, these arise where a country allows a deduction in respect of a cross-border payment, the receipt of which is not fully included in ordinary income in the other country (where "ordinary income" generally means income that is subject to income tax at the recipient's full tax rate and is not effectively sheltered from tax).
- *Double deduction mismatches*: These arise where a tax deduction is available in two or more countries in respect of a single economic expense.

Consistent with the recommendations in the BEPS Action 2 Report, the hybrid mismatch rules eliminate hybrid mismatches and align the tax results in Canada and the other relevant country in respect of a mismatch, by restricting the amount deductible by a taxpayer in respect of a payment under a hybrid mismatch arrangement, or including an amount in income of a taxpayer who receives such a payment, as the case may be.

The legislative amendments introduced at this time implement the recommendations in Chapter 1 of the BEPS Action 2 Report, addressing deduction/non-inclusion mismatches that arise from payments under three types of arrangements: "hybrid financial instrument arrangements", "hybrid transfer arrangements" and "substitute payment arrangements". In addition, these amendments implement Recommendation 2.1 in Chapter 2 of the report, by restricting the dividends received deduction in section 113 to the extent that the dividend is deductible for foreign income tax purposes.

The 2021 budget announced that amendments implementing other recommendations of the BEPS Action 2 Report will be introduced at a later date.

Summary of main provisions

The legislative amendments introduced at this time include the following key provisions:

- *Interpretive rule*: Subsection 18.2(2) provides that the hybrid mismatch rules are to be interpreted consistently with the BEPS Action 2 Report published by the OECD (as amended from time to time), unless the context otherwise requires (such as where the hybrid mismatch rules depart from recommendations in the report). Accordingly, these explanatory notes are intended to be read together with the report.
- *Primary operative rule*: Consistent with Recommendation 1.1(a) of the BEPS Action 2 Report, subsection 18.4(4) neutralizes a deduction/non-inclusion mismatch arising from a payment under hybrid mismatch arrangement by restricting a deduction in respect of the payment.
- *Secondary operative rule*: Consistent with Recommendation 1.1(b), subsection 12.7(3) neutralizes a deduction/non-inclusion mismatch arising from a payment under a hybrid mismatch arrangement by including an amount in the income of a recipient of the payment. It is a "defensive" rule that applies only to the extent the hybrid mismatch is not otherwise neutralized by way of a restriction of a deduction under the hybrid mismatch rules of a foreign country.
- *Deduction/non-inclusion mismatch*: Subsection 18.4(6) determines if a payment gives rise to a deduction/non-inclusion mismatch. This generally occurs if the total amount deductible in respect of the payment for Canadian income tax purposes exceeds the total amount included in respect of the payment in taxable income for foreign income tax purposes, or if the total amount deductible for foreign income tax purposes exceeds the total amount included for Canadian income tax purposes. This accords with Recommendation 1.1 and the recommendations in Chapter 12 of the report.
- *Notional interest expense*: Subsection 18.4(9) ensures the hybrid mismatch rules address deduction/non-inclusion mismatches arising because of an income tax deduction under foreign law for a notional interest expense in respect of a debt.
- *Hybrid financial instrument arrangement*: Subsection 18.4(10) determines if a payment arises under a hybrid financial instrument arrangement. Consistent with the recommendations in Chapter 1 of the report, this generally occurs if a payment under a financial instrument results in a deduction/non-inclusion mismatch, and the mismatch arises because of differences in income tax treatment under the laws of different countries that are attributable to the terms or conditions of the financial instrument or related transactions. Subsection 18.4(11) determines the amount of the hybrid financial instrument mismatch, and ensures that subsection 12.7(3) or18.4(4) applies only to the extent that the deduction/non-inclusion mismatch results from the hybridity of the arrangement.
- *Hybrid transfer arrangement*: Subsection 18.4(12) determines if a payment arises under a hybrid transfer arrangement. Consistent with the recommendations in Chapter 1 of the report, this generally occurs if a payment under an arrangement for the transfer of a financial instrument gives rise to a deduction/non-inclusion mismatch, and the mismatch arises because the tax laws of different countries treat different entities as owning returns under the transferred financial instrument. Subsection 18.4(13) determines the amount of the hybrid transfer mismatch and is analogous in function to subsection 18.4(11).
- *Substitute payment arrangement*: Subsection 18.4(14) determines if a payment arises under a substitute payment arrangement. Consistent with the recommendations in Chapter 1 of the report, this generally occurs if a payment under or in connection with the

transfer of a financial instrument (1) functions as a substitute for returns under the instrument, and (2) gives rise to a deduction/non-inclusion mismatch that would otherwise undermine the integrity of the rules on hybrid financial instrument arrangements and hybrid transfer arrangements in subsections 18.4(10) to (13). Subsection 18.4(15) determines the amount of the substitute payment mismatch and ensures subsection 12.7(3) or 18.4(4) applies only to the extent the deduction/non-inclusion mismatch arises from the portion of the payment that is a substitute.

- *Anti-avoidance rule*: Subsection 18.4(20) is an anti-avoidance rule that is intended to capture situations that, in substance, meet the essential characteristics of a hybrid mismatch arrangement, notwithstanding that one or more of the precise technical requirements of the hybrid mismatch rules is not met.
- *Limitation of dividends received deduction*: Consistent with Recommendation 2.1 of the BEPS Action 2 Report, subsection 113(5) restricts a taxpayer's ability to deduct certain amounts under section 113 in respect of dividends received by the taxpayer from a foreign affiliate out of the affiliate's exempt, hybrid, taxable and pre-acquisition surpluses, generally to the extent that a foreign income tax deduction is available in respect of the dividend to the affiliate or certain other entities.

Consistent with Recommendation 1.4 of the BEPS Action 2 Report and the recommendations in Chapters 10 and 11 of the report, sections 12.7 and 18.4 apply in respect of payments under hybrid financial instrument arrangements, hybrid transfer arrangements and substitute payment arrangements, only if the relevant parties satisfy a relationship test, or the payment arises under a structured arrangement.

The relationship test is met if the parties do not deal at arm's length, or if they are "specified entities", as defined in subsection 18.4(1), with reference to subsection 18.4(17). In general terms, parties are specified entities if one has a 25% equity interest in the other, or another entity has a 25% equity interest in both.

An arrangement is a structured arrangement if its pricing reflects the hybrid mismatch or if the arrangement is otherwise designed to produce a hybrid mismatch. However, even if a payment arises under a structured arrangement, subsection 18.4(5) ensures that the hybrid mismatch rules do not apply if it is reasonable to conclude that a taxpayer was unaware of the mismatch and derives no benefit from it (i.e., the payment was at fair market value).

Key differences from recommendations in the BEPS Action 2 Report

The hybrid mismatch rules differ from or supplement the recommendations in the BEPS Action 2 Report in the following key ways:

- The rules use Canadian income tax concepts in defining the requisite relationships between the parties to arrangements that are within the scope of the rules on hybrid financial instrument arrangements, hybrid transfer arrangements and substitute payment arrangements.
- The rules adopt a modified causal (or "hybridity") test in the context of the hybrid transfer arrangement rules.

- The rules provide for a deduction, under paragraph 20(1)(yy), where subsection 18.4(4) has restricted a deduction in respect of a payment and the taxpayer demonstrates that an amount has actually been included in income for foreign tax purposes in respect of the payment.
- The rules apply where a foreign country allows an income tax deduction for a notional interest expense in respect of a debt and this results in a deduction/non-inclusion mismatch, by virtue of subsection 18.4(9).
- The rules treat interest expense of a corporation resident in Canada that is not deductible because of the hybrid mismatch rules as a deemed dividend for the purposes of Part XIII of the Act.

Effective date

These amendments generally apply in respect of payments arising on or after July 1, 2022, including payments under arrangements entered into before that date.

There are three narrow exceptions to this general effective date:

- Subsection 12.7(3) does not apply to the portion of a payment arising under subsection 18.4(9) that relates to a portion of a notional interest expense that is computed in respect of a period of time that precedes January 1, 2023.
- The reporting requirements in subsections 18.4(21) and 113(7) apply in respect of payments arising, and dividends received by a corporation resident in Canada on a share of a foreign affiliate, after June 30, 2023.
- The provisions of the hybrid mismatch rules that apply in computing the foreign accrual property income of a foreign affiliate of a taxpayer apply only in respect of payments arising after June 30, 2024.

Hybrid mismatch arrangements – definitions

ITA
18.4(1)

New subsection 18.4(1) defines a number of terms that apply for the purposes of section 18.4 and paragraph 20(1)(yy) in determining the application of the hybrid mismatch rules.

"Canadian ordinary income"

"Canadian ordinary income" of a taxpayer for a taxation year in respect of a payment essentially refers to amounts that are included in respect of the payment in the taxpayer's income (or its taxable income earned in Canada, if the taxpayer is non-resident) for the year, without any offsetting relief (other than relief that applies generally and not in respect of the payment, as discussed below).

Canadian ordinary income is principally relevant in determining if there is a corresponding inclusion in income that is taxable in Canada in respect of a payment that is deductible for

foreign tax purposes. More particularly, this definition is relevant in determining if a payment gives rise to a deduction/non-inclusion mismatch and the amount of any such mismatch, under subsections 18.4(6) and (7), respectively. For more information, see the commentary on those subsections.

The definition is also relevant for the purposes of paragraph (g) of subsection 18.4(14), in determining if a payment arises under a substitute payment arrangement.

Canadian ordinary income of a taxpayer that is not a partnership is determined under paragraph (a) of the definition. Paragraphs (b) and (c) determine, respectively, Canadian ordinary income of a partnership and Canadian ordinary income resulting from an inclusion in the foreign accrual property income ("FAPI") of a controlled foreign affiliate of a taxpayer.

Under paragraph (a), an amount in respect of a payment is Canadian ordinary income of a Canadian-resident taxpayer if the amount is included in the taxpayer's income for the purposes of Part I of the Act. In the case of a non-resident taxpayer, only amounts included in the taxpayer's taxable income earned in Canada in respect of the particular payment are considered Canadian ordinary income.

Canadian ordinary income includes not only amounts that are included in computing income from a business or property, but also the taxable portion of any capital gain that is included in computing a taxpayer's income.

By virtue of subparagraph (a)(i), an amount is not included in Canadian ordinary income under paragraph (a) if it is included in Canadian ordinary income of a partnership or in a taxpayer's Canadian ordinary income as a result of being included in FAPI of a controlled foreign affiliate. This ensures that amounts included in Canadian ordinary income under paragraphs (b) and (c) are counted only once. For example, if an amount in respect of a payment is included in computing income of a partnership that is allocable to a member of the partnership under paragraph 96(1)(f), that amount only gives rise to Canadian ordinary income of the partnership under paragraph (b) and is not included in Canadian ordinary income of the member.

Subparagraph (a)(iii) provides that Canadian ordinary income in respect of a payment does not include an amount to the extent that the amount can reasonably be considered to be effectively sheltered from Part I tax because the amount, or the payment giving rise to the amount, is entitled to some form of relief under the Act. This exclusion applies regardless of the specific form that the relief takes, including an exemption, exclusion, deduction, credit (other than a foreign tax credit for foreign withholding tax, since such a credit is for tax actually paid) or other form of relief. Only the portion of any amount included in income that cannot reasonably be considered to be sheltered from tax because of the relief is considered Canadian ordinary income.

Subparagraph (a)(ii) addresses a specific form of relief that is common under hybrid mismatch arrangements, by reducing Canadian ordinary income to the extent a deduction under section 112 (for intercorporate dividends) or section 113 (for dividends received from foreign affiliates) is available in respect of a payment. Any deduction restriction under subsection 113(5) is taken into

account in determining whether a taxpayer is entitled to a deduction in respect of the dividend under section 113. It is therefore expected that the hybrid mismatch rule in section 12.7 and the rule in subsection 113(5) would not have duplicative effects in respect of the same dividend payment.

Relief will result in a reduction in determining Canadian ordinary income only if it either (i) applies specifically in respect of the amount included in income in respect of the payment and not in computing income generally, or (ii) arises in respect of the payment. The reference to "arises in respect of the payment" in subparagraph (a)(iii) and in variable D of the definition "foreign ordinary income" requires a connection between the form of relief and the payment. Therefore, there is no reduction in Canadian ordinary income simply because a taxpayer that receives interest from a subsidiary also pays deductible interest in respect of an arm's length borrowing that funded the loan to the subsidiary. In any event, it is unlikely that such an arrangement would meet the causation test in paragraph 18.4(10)(d) or (12)(d).

As determined under paragraph (b), Canadian ordinary income of a partnership in respect of a payment is essentially the amount included in respect of the payment in computing the partnership's income or loss (subject to any reductions where the amount or payment is entitled to some form of relief), pro-rated based on the share of that income or loss that is allocated to Canadian-resident members or included in computing the taxable income earned in Canada of non-resident members.

More specifically, variable A of paragraph (b) is the amount included in respect of the payment in the partnership's income in accordance with the principles in subsection 96(1), subject to reduction pursuant to subparagraphs (i) and (ii) of variable A. Subparagraph (i) prevents double counting where an amount in respect of a payment is included in computing FAPI attributable to the partnership under subsection 91(1). In that case, Canadian ordinary income in respect of the payment will arise only under paragraph (c). In the case of a chain of tiered partnerships, a "no double counting" rule in subsection 18.4(8) ensures that an amount in respect of a payment is not Canadian ordinary income of more than one partnership in the chain.

Subparagraph (ii) provides a reduction to reflect any portion of the amount included in the partnership's income that is effectively sheltered due to a form of relief described in subparagraph (a)(iii) (i.e., a form other than a deduction under section 112 or 113). This relief could apply at either the partnership or partner level, and in either case can reduce the variable A amount to the extent it effectively provides shelter from Part I taxation.

Variable A is multiplied by the proportion B/C to effectively limit the portion of the variable A amount that is included in Canadian ordinary income, based on the share of the partnership income (in which the payment is included) of members that are persons resident in Canada, or non-resident persons to the extent the income is included in their taxable income earned in Canada. Subsection 18.4(18) provides a "look-through" rule for tiered partnerships to address cases where a person is a member of an upper-tier partnership that is a member of a lower-tier partnership in whose income the payment is included. For more information, see the commentary on that subsection.

Variable D of paragraph (b) reduces a partnership's Canadian ordinary income in respect of a payment that is a dividend included in partnership income, to the extent that members are entitled to a deduction under section 112 or 113 in respect of the payment.

Paragraph (c) of this definition includes as Canadian ordinary income amounts that are included in computing the FAPI of a controlled foreign affiliate of a taxpayer, but only to the extent the FAPI is not effectively sheltered from tax and is included in computing the taxpayer's income for the year under subsection 91(1). The overall effect of variable F of paragraph (c) is that, if the taxpayer is a partnership, the partnership will only have Canadian ordinary income under paragraph (c) to the extent of the proportion of the FAPI that is included in the income of ultimate members that are persons resident in Canada.

"controlled foreign company tax regime"

The definition "controlled foreign company tax regime" is relevant in determining an entity's foreign ordinary income for a foreign taxation year in respect of a payment. Under variable A in the definition "foreign ordinary income", amounts that are included in relevant foreign income or profits in respect of which the entity is subject to tax under a controlled foreign company tax regime are excluded from foreign ordinary income.

This definition is modelled on the definition of the same term in the Global Anti-Base Erosion Model Rules (Pillar Two) published by the Organisation for Economic Co-operation and Development. It describes a set of tax rules that impose tax on a direct or indirect shareholder (referred to in this commentary as the "shareholder") in respect of income of an entity outside that jurisdiction (referred to in this commentary as the "foreign entity"). The foreign accrual property income rules in section 91 (and related provisions) are an example of such a regime. Although controlled foreign company tax regimes vary in their exact application and operation from jurisdiction to jurisdiction, the general effect of these rules is to subject the shareholder to current taxation on a share of certain income earned by the foreign entity, despite the fact that the income may not be actually distributed to and received by the shareholder.

Controlled foreign company tax regimes generally apply where the shareholder has a sufficiently high level of ownership or investment in the foreign entity (directly or indirectly), often measured by reference to the shareholder's ability to exercise control over the foreign entity. Typically, only certain types of income earned or derived by the foreign entity are subject to the controlled foreign company tax – for example, investment income or other income from property. Tax is computed by the shareholder in respect of this income, notwithstanding that the foreign entity is generally recognized as a separate entity for tax purposes under the laws of the shareholder's jurisdiction. This tax is often effected by means of an income inclusion to the shareholder in proportion to the shareholder's ownership interest.

Because controlled foreign company tax regimes are often among the most complicated and variable tax provisions of a jurisdiction's tax laws, the above description of common features is not intended to be read in an overly technical manner. For example, while this definition describes a regime under which a direct or indirect shareholder of a foreign entity is subject to taxation, this is not intended to exclude regimes that also apply in other situations, such as

controlled foreign company tax regimes that, in certain circumstances, subject members of partnerships, beneficiaries under trusts or head offices in respect of foreign branches, to current taxation in respect of income of the partnership, trust or branch, respectively. Such regimes are within the scope of this definition.

However, this definition does not encompass fiscal transparency regimes, in which a shareholder is considered to earn income derived by another entity because that entity is fiscally transparent. Similarly, the definition is not intended to encompass specified minimum tax regimes, in which a shareholder may be liable to tax because of insufficient tax paid by its subsidiaries, rather than because of the attribution of income to the shareholder. Such a regime would generally be covered by the definition "specified minimum tax regime".

For more information, see the commentary on the definitions "foreign ordinary income", "relevant foreign income or profits" and "specified minimum tax regime" in this subsection.

"deductible"

The definition of "deductible", in respect of a payment in computing relevant foreign income or profits, is an inclusive one. It is intended by implication to include the ordinary meaning of that term, but is broadened so as to also capture any relief that is broadly equivalent in effect to granting a deduction in computing relevant foreign income or profits. This includes, but is not limited to, circumstances where a payment gives rise to a refund of, or an exemption, exclusion or credit that can be set-off against, a foreign income tax liability. A refund, exemption, exclusion or credit can have the same net effect on tax paid or payable as a deduction that reduces the overall amount of relevant foreign income or profits.

Imputation or franking credits available under certain foreign income tax laws to ensure integration between the corporate and shareholder levels of taxation would not be considered "relief equivalent in effect to a deduction" to the extent that such credits represent tax paid by the recipient.

"entity"

The definition of "entity" has the same meaning as in subsection 95(1). It includes an association, a corporation, a fund, a natural person, a joint venture, an organization, a partnership, a syndicate and a trust. This is a broad, non-exhaustive definition and is intended to describe entities or arrangements that exist under Canadian law as well as foreign entities or arrangements as they exist under the foreign law.

"equity interest"

An "equity interest" is defined to include a share of the capital stock of a corporation, an income or capital interest as a beneficiary under a trust, an interest as a member of a partnership or any similar interest in any entity. This includes any right that can generally be considered to equate to an ownership interest or similar right or entitlement in an entity – including any right, whether absolute or contingent, to receive, either immediately or in the future, an amount that can

reasonably be regarded as all or any part of the capital, of the revenue or of the income of the entity. However, this does not include a right to receive an amount as creditor.

Subsection 18.4(17) contains deeming rules that are relevant to determining equity interests for the purposes of the definition “specified entity”. For more information, see the commentary on subsection 18.4(17) and the definition of “specified entity”.

The definition “equity interest” is also relevant for the definitions “financial instrument” and “foreign ordinary income”. For more information, see the commentary on those definitions in this section.

“equity or financing return”

The definition “equity or financing return” is relevant in determining whether an arrangement falls within the definition “financial instrument” in this subsection. Any arrangement that provides for such a return is a financial instrument.

As noted in the commentary on the definition “financial instrument” under this subsection, the BEPS Action 2 Report recommends that jurisdictions apply their hybrid mismatch rules with respect to payments under any arrangement that gives rise to an equity or financing return (and that meets the other conditions for being a “hybrid mismatch arrangement” set out in that report).

Under this definition, if a payment under an arrangement can reasonably be considered to be in respect of, or determined by reference to, any of the amounts or criteria described in paragraphs (a) to (c), the payment is an equity or financing return because it is, in substance, dependent on the success of a business or investment, or compensation for the use (or “time-value”) of money. Notably, the term “payment” is broadly defined under this subsection to include, among other things, an amount payable or a contingent payment obligation; for more information, see the commentary on that definition.

Paragraph (a) ensures that an arrangement that provides for a return based on an amount or benchmark that may generally be considered to be a reasonable proxy for an entity’s profits is treated as a financial instrument.

Paragraphs (b) describes any distributions out of an entity’s income, profits or capital. These are returns typically derived from equity instruments.

Paragraph (c) describes returns under financing arrangements, including amounts that are not legally interest but that are compensation for the use of money.

Among other things, this definition is intended to ensure that derivative instruments are treated as financial instruments, to the extent that any payment under or in respect of the derivative instrument can reasonably be considered to be determined by reference to any of the amounts or criteria in paragraphs (a) to (c).

While it is expected that many arrangements that give rise to an equity or financing return are already described in the definition "financial instrument", the definition "equity or financing return" backstops that definition, as required particularly in light of the continually evolving market for derivative instruments. For more information, see the commentary on the definition "financial instrument" in this subsection.

"exempt dealer compensation payment"

The definition "exempt dealer compensation payment" relates to the hybrid transfer arrangement rule in subsection 18.4(12). A hybrid transfer is essentially a transaction or series of transactions involving a transfer of a financial instrument, where a deduction/non-inclusion mismatch (as determined under new subsection 18.4(6)) typically results from different entities being treated as the owner of returns on the transferred instrument under the tax laws of different countries. For more information, see the commentary on subsection 18.4(12).

Consistent with the analysis under Example 1.34 in the BEPS Action 2 Report, an exempt dealer compensation payment is relieved from the application of subsection 18.4(12). The conditions that a payment must meet to be considered an exempt dealer compensation payment are intended to reflect the commentary on that example, with appropriate adaptations to the Canadian income tax context.

The first condition, in paragraph (a) of the definition, limits relief to a "dealer compensation payment" (as defined in subsection 260(1)), which effectively requires that the recipient (i) receive the payment in the ordinary course of its business of trading in securities and (ii) be a registered securities dealer (as defined in subsection 248(1)) resident in Canada.

The second condition, in subparagraph (b)(i), is that the payment be received as compensation, for a taxable dividend paid on a share of the capital stock of a public corporation, from a controlled foreign affiliate (referred to in this commentary as the "payer affiliate") of the recipient or of a non-arm's length taxpayer.

The conditions in subparagraphs (b)(ii) to (iv) relate to the business activities of the payer affiliate and its status as a regulated financial institution. In general terms, the payer affiliate must make the payment in the ordinary course of a business of trading in securities with arm's length persons in a particular foreign country, and there must be a strong nexus between the business and the particular country, as reflected in the requirements that:

- the payer affiliate has a substantial market presence in the particular country;
- the payer affiliate trades in securities with arm's length persons that are resident, or carry on business through a permanent establishment, in the particular country;
- the business is carried on in competition with arm's length entities that also have a substantial market presence in the particular country; and
- the activities of the business are regulated under the laws of the particular country or certain other countries.

These conditions generally describe a financial institution that operates a regulated securities trading business in a competitive financial services market of a foreign country.

The final condition, in paragraph (c), is that the payment does not arise under, or in connection with, a "structured arrangement" (as defined in this subsection). For more information, see the commentary on the definition "structured arrangement".

Even if a payment is an exempt dealer compensation payment, any deduction/non-inclusion mismatch arising from it may still be neutralized under the substitute payment arrangement rule in subsection 18.4(14). This may occur, for example, if the payer affiliate is not taxable on the underlying dividend or would not have been taxable on the dividend had it received the dividend instead of on-loaning the shares on which the dividend was paid.

It is expected that this definition will have limited application following the introduction of new subsection 112(2.01), which denies the dividend received deduction under section 112 on certain dividends received (including as dividend compensation payments) after 2023 by financial institutions (including registered securities dealers). The application of subsection 112(2.01) in respect of a dealer compensation payment will result in "Canadian ordinary income" (as defined in this subsection), such that the payment will not give rise to a deduction/non-inclusion mismatch under subsection 18.4(6).

"financial instrument"

The definition "financial instrument" is relevant for the rules on hybrid financial instrument arrangements, hybrid transfer arrangements and substitute payment arrangements, as set out in subsections 18.4(10), (12) and (14), respectively. In general, each of those arrangements involves a payment under, or in connection with, a financial instrument or transfer of a financial instrument, that gives rise to a deduction/non-inclusion mismatch.

A financial instrument is defined to be any of:

- a debt or "equity interest" (as the latter term is defined in this subsection);
- a right that replicates a right to participate in profits or gain of any entity; or
- any other right or arrangement that gives rise to an "equity or financing return" (as defined in this subsection).

This definition therefore comprises both a "legal form" analysis, in the determination of whether an instrument is a debt or equity interest, and an "economic substance" test that considers whether, in effect, the arrangement gives the holder a right that replicates an equity-holder's right to participate in profits, or the type of economic rights or returns generally provided under a debt or equity interest.

This definition is consistent with the recommendations in the BEPS Action 2 Report, which defines a financial instrument as any arrangement that is taxed as debt, equity or derivatives. However, because jurisdictions differ in the tax treatment of financial instruments, and given the complexity and continuing evolution of financial products, the report recommends that

jurisdictions ensure their hybrid mismatch rules apply in respect of any arrangement that gives rise to an equity or financing return, so as to give full effect to the underlying policy of aligning the tax treatment of payments made under all equity or financing instruments between jurisdictions and to ensure that all such instruments are within the scope of the rules.

Consistent with the Action 2 Report, the "financial instrument" definition is not intended to include arrangements for the supply of services, ordinary operating leases, licensing agreements, arrangements for the assumption of non-financial risk (such as insurance) or asset transfers that do not involve any equity or financing return.

In determining whether a particular instrument or arrangement is a financial instrument, this definition first considers whether it presents the essential characteristics of a debt or equity interest. Because the hybrid mismatch rules generally apply to instruments that are characterized differently for tax purposes between jurisdictions, certain instruments tested under this definition will necessarily demonstrate essential characteristics of more than one formal legal category, this being generally the very cause of the differential treatment. For example, instruments such as subordinated debt, profit participating loans and convertible debt may present characteristics of both debt and equity interests (although they may generally be characterized as debt for purposes of the Act), and a finance lease may present characteristics of both debt and lease. Therefore, a flexible and purposive interpretation of this definition is required to ensure that the very hybridity of a given arrangement does not by itself frustrate its characterization as a financial instrument.

Paragraph (b) of the definition considers whether there exists any right that may reasonably be considered to replicate a right to participate in profits or gain of any entity. This is intended to ensure that any arrangement providing a right equivalent to, for example, a shareholder's right to receive dividends from a corporation – even where no payment has yet arisen under the arrangement – is considered to be a financial instrument. Such an arrangements exists, for example, where a person holds a right under a derivative contract entitling the holder to amounts determined by reference to dividends paid on shares of a corporation, whether or not any such dividends are ever paid. Although that person does not hold an equity interest in the corporation, the right under the derivative contract constitutes a financial instrument because it replicates a shareholder's right to participate in corporate distributions.

Paragraph (c) requires an analysis of the nature of the return under an arrangement (i.e., the payments arising under the arrangement) and seeks to ensure that any arrangement that provides a return based on the success of a business or investment, or on compensation for the use (or "time-value") of money, is a financial instrument. For more information, see the commentary on the definition "equity or financing return".

"foreign expense restriction rule"

The definition "foreign expense restriction rule" is used throughout the hybrid mismatch rules when calculating foreign deductions. Where used, generally the deductible amount in respect of a payment must be calculated as if any foreign expense restriction rule did not apply. This effectively allows the hybrid mismatch rules to apply in circumstances where a payment would

have given rise to an actual mismatch (e.g., a deduction/non-inclusion mismatch) if another country had not denied a deduction under a foreign expense restriction rule.

"Foreign expense restriction rule" means a rule, regulation or other tax provision under the laws of a foreign country that either:

- has an effect, or is intended to have an effect, that is substantially similar to subsection 18(4) or 18.2(2); or
- implements either
    - any of the recommendations regarding the deductibility of interest and other financing expenses in the report under Action 4 of the Group of 20 and Organisation for Economic Co-operation and Development's Base Erosion and Profit Shifting Project, or
    - the Global Anti-Base Erosion Model Rules (Pillar Two).

Any rules, regulations or other tax provisions will be considered to have an effect that is substantially similar to subsection 18(4) or 18.2(2) if they limit the deductibility of interest or financing expenses based on a measure of excessive interest or financing expenses or excessive debt relative to a given benchmark, including, for example, shareholder equity (as in the thin-capitalization rules in the Act) or corporate earnings (as in the excessive interest and financing expenses limitation in section 18.2).

A foreign law will generally be considered to have an effect that is substantially similar to subsection 18(4) or 18.2(2) even if, for example, it is mechanically different from those rules or has a different scope from those rules, provided the ultimate effect of the foreign law is or is intended to be similar.

Subparagraph (b)(ii) of this definition is expected to be relevant in the case where a foreign deduction is denied because of the application of a provision of a foreign law that implements, or is intended to implement, the UTPR component of the Global Anti-Base Erosion Model Rules (Pillar Two).

"foreign hybrid mismatch rule"

The "foreign hybrid mismatch rule" definition is principally relevant for the computation of foreign ordinary income, which is also defined in subsection 18.4(1). To ensure the appropriate coordination of Canadian and foreign hybrid mismatch rules, it is necessary, in computing foreign ordinary income of an entity, to disregard amounts included in computing the entity's income for foreign tax purposes as a result of the application of a foreign hybrid mismatch rule (other than any rule that is substantially similar in effect to subsection 113(5)). For more information, see the commentary on the definition "foreign ordinary income".

The term "foreign hybrid mismatch rule" is defined broadly to include any rules, regulations, or other foreign tax provisions that are intended to implement the BEPS Action 2 Report (in whole or in part, and as amended from time to time) or that have substantially the same effect as section 12.7 or 18.4, or subsection 113(5). The reference to "in whole or in part" in paragraph (a) allows

for flexibility, including with respect to any departures from the recommendations or guidance in the BEPS Action 2 Report as a result of different policy or system design choices by a foreign country. The reference to "as amended from time to time" recognizes that foreign hybrid mismatch rules may evolve to take into consideration future revisions or updates to the BEPS Action 2 Report.

Any rule, regulation or other foreign tax provision will be considered to have an effect that is substantially similar to a hybrid mismatch rule in section 12.7 or 18.4, or subsection 113(5), if it forces an income inclusion, or denies a deduction or other relief, to eliminate the tax benefits of hybrid mismatch arrangements. This is a macro-level inquiry: even if the foreign tax provision departs significantly from, or predates, the BEPS Action 2 Report, it looks at whether the rule applies similar general concepts to eliminate the mismatch in tax outcomes or has an effect that is substantially similar to the hybrid mismatch rules in the Act. For example, this includes a foreign tax provision that denies a participation exemption or other relief (e.g., an exemption, deduction or credit) in respect of a dividend, consistent with recommendation 2.1 of the BEPS Action 2 Report, notwithstanding that the denied relief may take a different form from the relief denied under subsection 113(5) or that the foreign tax provision predates the BEPS Action 2 Report.

The definition is also relevant for the conditions of application of the substitute payment rule in subsection 18.4(14). Finally, it is relevant for the deduction restriction rule in subsection 113(5).

"foreign ordinary income"

"Foreign ordinary income" of an entity for a foreign taxation year in respect of a payment essentially refers to an amount that is included in respect of the payment in the income of the entity that is taxable in a foreign country, without any offsetting relief (other than relief that applies generally and not in respect of the payment, as discussed below).

The "foreign ordinary income" concept is the foreign analogue to "Canadian ordinary income" (as defined in this subsection) and is principally relevant in determining if there is a corresponding inclusion in foreign taxable income in respect of a deductible payment. This definition is thus relevant in determining whether a payment gives rise to a deduction/non-inclusion mismatch and the amount of the mismatch under subsections 18.4(6) and (7), respectively.

As with Canadian ordinary income, foreign ordinary income is also relevant in determining if a payment arises under a substitute payment arrangement under paragraph (g) of subsection 18.4(14).

Foreign ordinary income is determined by the formula: A – B – C – D – E – F.

Variable A essentially describes an amount (referred to as a "relevant amount") that, in respect of the payment, is included in income in respect of which the entity is subject to foreign income or profits tax.

An amount is included under variable A in two scenarios.

The first is where the entity is a “recipient” (as defined in this subsection) of the payment. In this case, an amount is a relevant amount to the extent it is included in respect of the payment in computing the entity’s “relevant foreign income or profits” (as defined in this subsection), which are income or profits in respect of which the entity is subject to an income or profits tax imposed by a country other than Canada.

The second scenario is where the entity is not a recipient of the payment, but an amount in respect of the payment is nonetheless included in its relevant foreign income or profits because it has a direct or indirect “equity interest” (as defined in this subsection) in the recipient. This addresses cases where a recipient of a payment is fiscally transparent under foreign income tax law, or is otherwise not subject to foreign income or profits tax (e.g., by virtue of a foreign corporate consolidation system) in respect of the payment, but the payment is included in relevant foreign income or profits of an entity by virtue of its equity interest in the recipient. For example, this would include an income inclusion to an investor in a fiscally-transparent recipient or a member of a recipient partnership.

In either scenario, an amount is included under variable A in computing an entity’s foreign ordinary income in respect of the payment only if the entity is actually subject to income or profits tax of a foreign country in respect of the income or profits in which the payment is included. This is inherent to the concept of “relevant foreign income or profits”. As a result, if, for example, the recipient of the payment is classified as a partnership under Canadian law, an amount is only foreign ordinary income of the recipient if the recipient is actually subject to foreign income or profits tax in respect of the payment (i.e., the partnership is fiscally opaque for purposes of the foreign income or profits tax).

It is intended that a given amount is only counted once in determining an entity’s foreign ordinary income in respect of a payment. A “no double counting” rule in subsection 18.4(8) ensures that an amount in respect of a payment that has already been included as foreign ordinary income of an entity is not to be included again in computing foreign ordinary income of that entity or any other entity.

The effect of the reference in variable A to “a tax substantially similar to tax under Part XIII” is that the application of foreign withholding tax to a payment does not result in foreign ordinary income (just as Canadian withholding tax applicable to a payment to a non-resident does not result in Canadian ordinary income).

Amounts included in income or profits subject to a “controlled foreign company tax regime” or a “specified minimum tax regime” (both as defined in this subsection) are not relevant amounts for the purposes of variable A. This approach differs from the approach in respect of Canadian ordinary income, which can include amounts included in “foreign accrual property income” (as defined in subsection 95(1)). For more information, see the commentary on the definitions “controlled foreign company tax regime” and “specified minimum tax regime” in this subsection.

Variable B reduces the amount computed as foreign ordinary income in respect of the relevant amount to nil if the relevant amount is included in computing relevant foreign income or profits in respect of which income or profits tax is charged at a nil rate, in recognition that such income or profits are only nominally subject to tax.

Any deduction/non-inclusion mismatch resulting from the reduction to foreign ordinary income under variable B must satisfy the causal test in the hybrid financial instrument or hybrid transfer rule, or the various conditions in the substitute payment rule, in order for the payment to be considered to arise under a "hybrid mismatch arrangement" that is subject to the rules. This is also the case for any reduction to foreign ordinary income under other variables of this definition. If, for example, the sole reason that foreign ordinary income in respect of a payment is nil is because the recipient of the payment is a tax-exempt entity, the operative hybrid mismatch rules do not apply in respect of the payment.

Variable C is, in effect, an ordering rule that is intended to give the operative rule in subsection 18.4(4) priority over a "foreign hybrid mismatch rule" (as defined in this subsection), other than any rule that is substantially similar in effect to subsection 113(5) (as discussed below). This reflects the recommendation in the BEPS Action 2 Report that a country's "primary rule" (denying a deduction in respect of a payment under a hybrid mismatch arrangement) should apply in priority to another country's secondary (or "defensive") rule (requiring an income inclusion in respect of such payment) in order to coordinate countries' hybrid mismatch rules. If any portion of a relevant amount is included in relevant foreign income or profits as a result of a foreign country applying its hybrid mismatch rules, that portion is effectively disregarded in computing foreign ordinary income. This can result in subsection 18.4(4) denying a deduction in respect of a payment, notwithstanding that another country's secondary rule simultaneously neutralizes the deduction/non-inclusion mismatch. For more information, see the commentary on the definition "foreign hybrid mismatch rule".

As noted, variable C does not apply if a relevant amount is included in relevant foreign income or profits because of a foreign tax provision "substantially similar in effect to subsection 113(5)". Subsection 113(5) is introduced in connection with the hybrid mismatch rules in this section and section 12.7 and implements recommendation 2.1 of the BEPS Action 2 Report. It restricts a deduction under section 113 for dividends received from foreign affiliates that are deductible for foreign income tax purposes. This carve-out from variable C is consistent with the recommendation in the BEPS Action 2 Report that if, in accordance with recommendation 2.1, a country adopts a rule that restricts its "participation exemption" (or equivalent relief, regardless of the particular mechanism used to provide such relief) in respect of "deductible" dividends received from foreign corporations, such a rule ought to take precedence over another country's primary rule. This carve-out from variable C ensures this order of priority by, in effect, "turning off" subsection 18.4(4) where an amount has been included in relevant foreign income or profits because of a foreign tax provision implementing recommendation 2.1.

Variable D provides for another reduction in computing foreign ordinary income, which applies to the extent some form of foreign tax relief results in the payment being effectively sheltered from foreign tax despite having been included in relevant foreign income or profits. Accordingly,

the reduction under variable D applies only if the relief is somehow linked to the payment or relevant amount, in that it:

- applies specifically in respect of all or a portion of the relevant amount and not in computing the relevant foreign income or profits of the entity in general; or
- arises in respect of the particular payment, for example where the relief is available as a result of the payment.

Variable D is intended to capture the wide range of ways in which a payment or a relevant amount could receive relief from taxation, including among other things: a participation exemption for dividends received by a parent corporation that owns a threshold equity interest in a subsidiary resident in another country; deductions for dividends received; dividend tax credits for underlying tax paid in another country; and deductions, exclusions or exemptions specific to a category of income or payment (e.g., payments re-characterized as exempt stock dividends).

The reduction under variable D applies if the relevant amount can reasonably be considered to be sheltered from tax, without requiring the sheltering to apply in respect of the income or profits of any particular entity. Thus, for example, the relief could apply in computing relevant foreign income or profits of the entity that received the payment or of another entity that has an equity interest in the recipient.

A relevant amount is not excluded, reduced, offset or otherwise effectively sheltered because of a deduction (e.g., for depreciation or operating losses) that applies generally in computing relevant foreign income or profits.

Variable E provides a reduction in computing foreign ordinary income to the extent a refund is available for foreign income or profits tax paid or payable in respect of the relevant foreign income or profits in which the relevant amount is included. A refund of income or profits tax in respect of a refundable credit will also result in a reduction under variable E, whether the refund is paid to the entity that is liable to pay the foreign income or profits tax or some other entity. However, no such reduction will occur in the case of a refund resulting from a loss carryover.

While a reduction under variable E may result in a deduction/non-inclusion mismatch, the operative rule in 18.4(4) will apply to deny a deduction only to the extent the other requirements in this section are met (most notably, the causal tests in paragraphs 18.4(10)(d) and (12)(d), which assess the “hybridity” of a financial instrument or transfer arrangement). An example of an arrangement involving a refund of foreign tax that could satisfy these other requirements is one where the refund is available because an entity receives income of a specified character.

Finally, variable E includes an ordering rule, the effect of which is that any reduction under variable E is determined after the reductions in variables C and D have been taken into account.

Variable F provides for a reduction in computing foreign ordinary income if a payment is taxed at a preferential rate in certain circumstances. This is consistent with the BEPS Action 2 Report, which recommends that payments give rise to a deduction/non-inclusion mismatch if they are not taxed at the taxpayer’s full marginal rate (see, in particular, paragraphs 413 to 415 of the BEPS

Action 2 Report). The report specifies, however, that not all preferential tax rates give rise to a deduction/non-inclusion mismatch. For example, a mismatch should not be considered to arise simply because a foreign country taxes business or employment income at a higher rate than payments under financial instruments. Rather, the test is whether the reduced rate is less than the highest rate of income or profits tax the foreign country applies to payments under financial instruments in the same context in which the instrument in question is held. Accordingly, the reduction under variable F applies only if the rate at which a foreign income or profits tax is charged in respect of the relevant amount is lower than the highest rate of income or profits tax that would be expected to be charged by the country in respect of income from a financial instrument. An example of a preferential rate within the scope of variable F is where a country taxes a payment that it treats as a dividend at a lower rate than it would charge if it treated the payment as interest.

A preferential tax rate that applies to payments received on the disposition of a capital asset may also fall within the scope of variable F. However, if only a portion of the payment is included in relevant foreign income or profits (e.g., the taxable portion of a capital gain), this would be reflected under variable A. Any resulting deduction/non-inclusion mismatch could result in a payment being considered to arise under a hybrid transfer arrangement or a substitute payment arrangement under subsection 18.4(12) or (14), respectively. For more information, see the commentary on those subsections.

Variable F includes an ordering rule, the effect of which is that any reduction in computing foreign ordinary income under this variable is determined after the reductions under variables C, D and E have been taken into account. Therefore, if, for example, a payment under a financial instrument is taxed at a preferential rate and is also entitled to another form of relief described in variable D, the reduction under variable F is determined after first taking into account the reduction under variable D.

"foreign taxation year"

The "foreign taxation year" definition is principally relevant to the calculation of foreign ordinary income, which must be done for a foreign taxation year in determining whether a payment gives rise to a deduction/non-inclusion mismatch.

The term is also relevant in paragraph 20(1)(yy). For more information, see the commentary on that paragraph.

This definition is modelled on the definition of "taxation year" in relation to a foreign affiliate in subsection 95(1), with appropriate modifications to apply the definition in the context of the hybrid mismatch rules (including applying the term for the purpose of computing an entity's relevant foreign income or profits, as defined in this subsection). In general terms, the foreign taxation year is the taxation year of the entity under the taxation laws of a country in which the entity is subject to tax on its income or profits, which in most cases would be its country of residence.

"hybrid mismatch amount"

The definition “hybrid mismatch amount” is used in the operative rules in subsections 12.7(3) and 18.4(4). Where the operative rules apply, the hybrid mismatch amount determines the amount of the deduction that will be denied (in the case of the primary rule in subsection 12.7(3)) or the amount that will be included in income (in the case of the secondary rule in 18.4(4)) in respect of a payment.

There are separate categories of hybrid mismatch amount, each corresponding to a particular category of hybrid mismatch arrangement (hybrid financial instrument arrangements, hybrid transfer arrangements, and so on) and calculated in accordance with the rules in section 18.4 that apply to that particular type of hybrid mismatch arrangement. However, very generally, in the case of any hybrid mismatch arrangement that involves a deduction/non-inclusion mismatch, the hybrid mismatch amount in respect of a payment arising under the arrangement represents the amount by which amounts deductible in respect of the payment exceed income inclusions in respect of the payment, to the extent this excess is attributable to “hybridity” of the arrangement (other than in the case of a substitute payment arrangement, which does not require hybridity).

“hybrid mismatch arrangement”

The definition of “hybrid mismatch arrangement” comprises the various categories of arrangements to which the hybrid mismatch rules apply. The definition is used in the conditions of application of the operative rules in subsections 12.7(3) and 18.4(4). In order for the operative rules to apply to a payment, the payment will need to arise under at least one category of hybrid mismatch arrangement. There are separate provisions in this section setting out the conditions for each type of hybrid mismatch arrangement.

The term includes a hybrid financial instrument arrangement, a hybrid transfer arrangement and a substitute payment arrangement as described in subsections 18.4(10), (12) and (14), respectively. It is intended that additional categories of hybrid mismatch arrangement will be added in future legislative amendments.

“payer”

The definition “payer” follows the broad definition of “payment” that applies for the purposes of the hybrid mismatch rules. Accordingly, in addition to the ordinary meaning of the term, a payer is also any entity that has any obligation, including any future or contingent obligation, to make a payment. As a consequence, there can in some cases be multiple payers in respect of a single payment for the purposes of these rules.

For more information, see the commentary on the definition “payment” under this subsection.

“payment”

The existence of a payment is a threshold condition for the hybrid mismatch rules, in that the operative rules in subsections 12.7(3) and 18.4(4) apply in respect of payments arising under hybrid mismatch arrangements.

The definition “payment” is an inclusive one, which is intended by implication to include the ordinary meaning of that term, but is broadened to also include any amount or benefit that an entity has an obligation, including any future or contingent obligation, to pay, credit or confer.

As a threshold condition, “payment” is intended to be broadly interpreted. This is to ensure that the hybrid mismatch rules, which necessarily take into account the tax treatment of amounts under the laws of foreign countries, can apply in a wide range of circumstances where a foreign country allows a deduction in respect of an obligation to pay.

For example, where an entity resident in a particular country accrues an amount, under its accounting standard, as a deemed discount on a non-interest bearing loan, and the entity is allowed a corresponding deduction in the particular country, no actual payment arises at the time of the deduction because neither the deemed discount nor the loan principal is paid or payable at that time. Thus, absent the extended definition of “payment” in this subsection, the hybrid mismatch rules could not apply even if there were a mismatch resulting from the creditor’s country not requiring an income inclusion in respect of this arrangement. The broad definition of “payment”, however, allows for the deduction to be considered in respect of a payment because the taxpayer has a future obligation to pay the principal. Consequently, the arrangement can be tested to determine whether the other elements of a hybrid mismatch arrangement are satisfied.

Under this definition, more than one payment can arise in respect of the same payment obligation – for example, first when the obligation comes into existence, and then again when an amount in respect of that obligation is actually paid. However, this would not be expected to result in multiple applications of the hybrid mismatch rules, since it is expected that only one deduction would be available in respect of the payment obligation.

Subsections 18.4(9) and (19) provide deeming rules to address particular issues with respect to the concept of a “payment” under the hybrid mismatch rules. Subsection 18.4(9) ensures that deductions for notional interest expense on a loan (e.g., a non-interest bearing loan), which are available under the tax laws of some countries, are deemed to be payments for the purposes of the hybrid mismatch rules. Absent this deeming rule, such a deduction would not be in respect of a payment – and thus would not be within the scope of the hybrid mismatch rules – since there is no corresponding actual payment obligation.

Subsection 18.4(19) applies in a situation where there would otherwise be multiple recipients of a particular payment, and deems the particular payment to instead be multiple payments, each corresponding to a given recipient’s share of the particular payment. For more information, see the commentary on that subsection.

“recipient”

The definition “recipient” follows the broad definition of “payment” that applies for the purposes of the hybrid mismatch rules. Accordingly, in addition to the ordinary meaning of the term, a recipient is also any entity that has any entitlement, including any future or contingent entitlement, to be paid, credited or conferred a payment.

In cases where there would otherwise be multiple recipients in respect of a single payment, subsection 18.4(19) provides that each recipient's portion of the payment is treated as a separate payment.

For more information, see the commentary on the definition "payment" under this subsection and on subsection 18.4(19).

"relevant foreign income or profits"

"Relevant foreign income or profits" of an entity refers to income or profits in respect of which the entity is subject to an income or profits tax that is imposed by the government of a country other than Canada. To qualify as such, the income or profits tax must be imposed by the national government of the country and not by that of a state, province or other political subdivision of the country.

This definition is relevant in several respects in applying the hybrid mismatch rules in sections 12.7 and 18.4 and the restriction on deductions for certain dividends received from foreign affiliates in subsection 113(5). Most notably, for an amount to be "foreign ordinary income" of an entity in respect of a payment, or a foreign deduction to be relevant in the context of the hybrid mismatch rules, it must be included or deductible, as the case may be, in computing the entity's relevant foreign income or profits.

"specified entity"

The "specified entity" definition provides a relationship rule that is relevant to determining whether transactions between particular entities are within the scope of the hybrid mismatch rules. More specifically, it is relevant to determining whether the relevant parties to a transaction have the requisite relationship to be within the scope of the rules on financial instrument arrangements, hybrid transfer arrangements or substitute payment arrangements. This is consistent with the recommendations of the BEPS Action 2 Report, under which each category of hybrid mismatch rule has its own relationship rule, with the hybrid mismatch rules relating to financial instruments (set out in Chapter 1 of the BEPS Action 2 Report) generally applying where one party has a 25% or greater equity interest in another (or certain other tests are met, which largely correspond to non-arm's length relationships and "structured arrangements").

In general terms, the definition provides that two entities will be treated as specified entities in respect of one another if one entity, directly or indirectly, holds a 25% equity interest in the other entity, or a third entity, directly or indirectly, holds a 25% equity interest in both entities (in all cases taking into consideration the rules in subsection 18.4(17)). Specifically:

- Paragraph (a) applies where a particular entity (entity A), alone or together with non-arm's length parties, owns, directly or indirectly, equity interests that give it 25% or more of the value of another entity (entity B). If entity B is a corporation, paragraph (a) will also apply if entity A owns 25% or more of the voting shares of entity B. Where a condition in paragraph (a) is satisfied, entity A is a specified entity in respect of entity B.

- Paragraph (b) applies where the other entity (entity B), alone or together with non-arm's length parties, owns, directly or indirectly, equity interests that give it 25% or more of the value of the particular entity (entity A). If entity A is a corporation, paragraph (b) will also apply if entity B owns 25% or more of the voting shares of entity A. Where a condition in paragraph (b) is satisfied, entity B is a specified entity in respect of entity A.
- Paragraph (c) applies where a third entity, alone or together with non-arm's length parties, owns, directly or indirectly, equity interests that give it 25% or more of the value of both the particular entity and the other entity (entities A and B). Where entity A or B is a corporation, the third entity can also meet the test in paragraph (c) in respect of entity A or B if the third entity owns 25% or more of the voting shares of entity A or B, respectively. Where the conditions in paragraph (c) are satisfied, entity A and entity B will be specified entities in respect of one another. They will also be specified entities in respect of the third entity, and vice versa, due to the application of paragraphs (a) and (b).

The term "equity interest" is defined separately in this subsection. Subsection 18.4(17) contains deeming rules that are also relevant to determining equity interests. For more information, see the commentary on the definition "equity interest" and on subsection 18.4(17).

"specified minimum tax regime"

The "specified minimum tax regime" definition applies for the purpose of determining an entity's foreign ordinary income for a foreign taxation year. Variable A in the definition "foreign ordinary income" excludes amounts that are included in the entity's relevant foreign income or profits because of a specified minimum tax regime.

A set of tax provisions is a specified minimum tax regime if it is the global intangible low-taxed income ("GILTI") regime applicable to American persons under the United States *Internal Revenue Code of 1986*, or it can reasonably be considered to have been enacted with the intention to implement either the Global Anti-Base Erosion Model Rules (Pillar Two) published by the OECD or a Qualified Domestic Minimum Top-up Tax (within the meaning of the model rules). This reflects both the similar purpose and scope of these regimes.

An amount included in computing relevant foreign income or profits of an entity as a result of the application of a specified minimum tax regime is excluded from the entity's foreign ordinary income because global minimum taxes and domestic minimum top-up taxes are in substance alternative minimum taxes and do not subject income to tax at a country's general corporate income tax rate (or the rate otherwise applicable to income from the source of the payment in question). Accordingly, allowing such an inclusion to constitute foreign ordinary income would undermine the policy of the hybrid mismatch rules.

"structured arrangement"

The "structured arrangement" definition is relevant to the scope of the hybrid mismatch rules. In general terms, the hybrid mismatch rules apply to transactions between entities that satisfy a particular relationship test (e.g., the hybrid mismatch rules relating to financial instruments apply if either the entities do not deal at arm's length or a 25% ownership threshold is met). Structured

arrangements are an exception to this general rule. Where there is a structured arrangement, a payment may be treated as arising under a hybrid mismatch arrangement, notwithstanding that the relevant entities may deal at arm's length and not meet the relevant ownership threshold. Among many other situations, the structured arrangement test can apply where a transaction or series of transactions is designed to avoid the application of the hybrid mismatch rules by manipulating ownership to avoid satisfying the relationship test.

The rules on hybrid financial instrument arrangements, hybrid transfer arrangements and substitute payment arrangements can apply to payments arising under structured arrangements.

A structured arrangement is an arrangement where a payment gives rise to a deduction/non-inclusion mismatch and it can reasonably be considered, having regard to all the facts and circumstances, that any economic benefit arising from the deduction/non-inclusion mismatch is priced into the terms or conditions or the arrangement is otherwise designed to produce a mismatch. Whether a deduction/non-inclusion mismatch is reflected in the pricing or is a design feature of the transaction or series are objective tests.

The structured arrangement definition is modelled on the recommendations in Chapter 10 of the BEPS Action 2 Report and is intended to be interpreted consistently with the general definition of a structured arrangement in recommendation 10.1 and the list of factors in recommendation 10.2.

Whether a deduction/non-inclusion mismatch is considered to be reflected in the pricing will depend on the facts and circumstances surrounding the transaction or series. The examples in the BEPS Action 2 Report demonstrate that a deduction/non-inclusion mismatch can be reflected in the pricing of the transaction or series explicitly (see example 10.1, where the interest rate the borrower pays has been discounted over the term of the arrangement) or implicitly (see example 10.2, which involves back-to-back lending through an unrelated intermediary where the tax benefit is returned to the parent through above-market pricing). These examples demonstrate that off-market pricing can indicate that the deduction/non-inclusion mismatch is reflected in the pricing. In addition, certain factors listed in recommendation 10.2 may also indicate that the deduction/non-inclusion mismatch is reflected in the pricing (see, in particular, factors (e) and (f), listed below).

Whether an arrangement is considered to be otherwise designed to produce a mismatch will also depend on the facts and circumstances surrounding the transaction or series. This is a broader test than whether the deduction/non-inclusion mismatch is considered to be reflected in the pricing and is focused on whether the hybrid mismatch was an intended outcome. Consistent with the BEPS Action 2 Report, this broader test looks at whether it is reasonable to conclude that the facts and circumstances (including the terms and conditions) indicate that the arrangement has been designed to produce a hybrid mismatch.

The following list of factors in recommendation 10.2, along with the examples demonstrating these considerations in practice (including, but not limited to, examples 1.31, 1.33, 6.1, 10.1.10.2, 10.3, 10.4 and 10.5), should be used as a guide when considering relevant facts and

circumstances that may suggest that a transaction or series of transactions has been designed to result in a deduction/non-inclusion mismatch:

(a) an arrangement that is designed, or is part of a plan, to create a hybrid mismatch;
(b) an arrangement that incorporates a term, step or transaction used in order to create a hybrid mismatch;
(c) an arrangement that is marketed, in whole or in part, as a tax-advantaged product where some or all of the tax advantage derives from the hybrid mismatch;
(d) an arrangement that is primarily marketed to taxpayers in a jurisdiction where the hybrid mismatch arises;
(e) an arrangement that contains features that alter the terms under the arrangement, including the return, in the event that the hybrid mismatch is no longer available; or
(f) an arrangement that would produce a negative return absent the hybrid mismatch.

These factors, either alone or in combination, may indicate that the arrangement has been designed to produce a hybrid mismatch. However, the list of factors in recommendation 10.2 is not exhaustive and no one factor is determinative. In considering whether or not a transaction or series of transactions can reasonably be considered to have been designed to result in a deduction/non-inclusion mismatch, the facts and circumstances surrounding the transaction or series must be considered objectively and in their full and proper context.

When examining the facts and circumstances surrounding a particular transaction to determine whether the deduction/non-inclusion mismatch is a design feature, the presence or absence of any one factor listed in recommendation 10.2 of the BEPS Action 2 Report is not necessarily dispositive, and the relevant paragraphs of the BEPS Action 2 Report and related examples should be read in light of this clarification.

For example, notwithstanding paragraph 335 and example 10.3 of the BEPS Action 2 Report, while the fact that the anticipated tax consequences are set out in an offering document, or that the instrument is marketed primarily (or even exclusively) to investors in jurisdictions that could benefit from the mismatch, would tend to suggest that the instrument has been designed to produce the resulting deduction/non-inclusion mismatch, those facts are not dispositive as there may be other facts and circumstances that indicate the terms and conditions of the instrument were designed based exclusively on considerations other than the mismatch in tax outcomes. This may be the case, for example, where the terms and conditions are the same or similar to other instruments in the market and are designed exclusively to achieve certain commercial or regulatory objectives of the issuer and holders. The relevant factors may vary from case to case.

While the determination will depend on the facts and circumstances, the following example involving convertible debentures demonstrates a deduction/non-inclusion mismatch which would generally not be considered a structured arrangement for the purposes of the hybrid mismatch rules.

Example

Assumptions

- A taxable Canadian corporation (the "issuer") issues convertible debentures to arm's length parties, including Canadian residents, non-residents and tax-exempts.
- The payment of interest arising under the convertible debentures results in a deduction/non-inclusion mismatch when beneficially owned by certain non-resident holders.
- The tax treatment to these non-resident holders under the applicable foreign law is described in the tax disclosure for the issuance.
- The convertible debentures are traded in the secondary market.
- The interest rate and conversion premium on the convertible debentures are the same for all holders (whether Canadian residents, non-residents, or tax-exempts), and are consistent with the market rates offered by comparable issuers of convertible debentures in the Canadian market.
- While there are no specific terms or conditions contained in the convertible debentures that were specifically included to create a deduction/non-inclusion mismatch (the terms and conditions of the convertible debentures are the same as other convertible debentures offered in the Canadian market), certain terms and conditions of the convertible debentures result in a deduction/non-inclusion mismatch in respect of holders resident in certain foreign jurisdictions.
- The convertible debentures are not primarily marketed to non-resident holders in those jurisdictions where a deduction/non-inclusion mismatch arises.
- The convertible debentures are not beneficially owned primarily by non-resident holders where a deduction/non-inclusion mismatch arises.
- The issuer, and the non-resident holders of the convertible debentures in those jurisdictions where a deduction/non-inclusion mismatch results, are aware of the deduction/non-inclusion mismatch.

Analysis

The analysis of whether or not a transaction, or series of transactions (for example, the issuance of, the acquisition of an interest in, and the payment of interest on, the convertible debentures) is a structured arrangement is only relevant where a payment arises in respect of that transaction or series that results in a deduction/non-inclusion mismatch.

However, the fact that a deduction/non-inclusion mismatch may result from the payment of interest in respect of the convertible debentures does not mean that the transaction or series is a structured arrangement. It must also be reasonable to consider that any economic benefit arising from the deduction/non-inclusion mismatch is reflected in the pricing of the convertible debentures or that the convertible debentures were otherwise designed to result in the deduction/non-inclusion mismatch.

It is not expected that the payment of interest on the convertible debentures in this example would be considered to arise under, or in connection with, a structured arrangement.

The convertible debentures would not appear to have been designed to result in the deduction/non-inclusion mismatch since (i) the terms and conditions of the convertible

debentures are the same for all holders and are the same as other convertible debentures offered in the Canadian market, (ii) the convertible debentures are not marketed primarily to holders that are resident in jurisdictions that give rise to a hybrid mismatch, and (iii) the convertible debentures are not beneficially owned primarily by holders resident in jurisdictions that give rise to a hybrid mismatch. Similarly, there is nothing in the facts that indicates that any economic benefit from the deduction/non-inclusion mismatch has been priced into the terms of the convertible debentures.

The fact that the issuer and non-resident holders in jurisdictions where a mismatch arises are aware of the mismatch does not, in itself, lead to a conclusion that there is a structured arrangement in this example. The presence or absence of any one factor listed in recommendation 10.2 is not necessarily dispositive.

Although this analysis is based on an objective consideration of the limited facts and circumstances outlined above for this example, in all cases, all available facts surrounding a particular transaction or series must be considered in their full and proper context.

"transaction"

The definition "transaction" includes an arrangement or event. This is the same definition used for, among other purposes, sections 245 and 247. This definition allows the hybrid mismatch rules to apply to the broad range of situations contemplated by the recommendations in the BEPS Action 2 Report.

Interpretation

ITA
18.4(2)

Subsection 18.4(2) provides an interpretive rule that applies for the purposes of this section, section 12.7 and subsection 113(5). These provisions implement the recommendations in, and are intended to be generally consistent with, the BEPS Action 2 Report. This is a key part of the context and purpose in light of which the text of the hybrid mismatch rules is to be interpreted.

This subsection clarifies that, unless the context otherwise requires (e.g., subsection 18.4(9), which clearly deviates from the recommendations of the BEPS Action 2 Report, by applying the rules in respect of notional interest expenses), the hybrid mismatch rules should be interpreted consistently with the BEPS Action 2 Report published by the OECD (as amended from time to time), available at http://www.oecd.org/tax/beps/beps-actions/action2/.

For the purposes of providing guidance on the application of the recommendations in the BEPS Action 2 Report to various forms of hybrid mismatch arrangements, examples were included in Annex B of the BEPS Action 2 Report (and referenced throughout that report). Unless the context otherwise requires, these examples are instructive as to the intended scope and application of the hybrid mismatch rules.

Subsection 18.4(2) is an interpretive rule that gives the report an enhanced status as an interpretive source, in applying a textual, contextual and purposive analysis of provisions included in sections 12.7 and 18.4 and subsection 113(5), as well as other provisions of the Act and *Income Tax Regulations* that implement the hybrid mismatch rules (e.g., certain provisions that apply those rules or similar principles in computing the foreign accrual property income of foreign affiliates of taxpayers). As such, a particular commentary or example in the report is only relevant if it can reasonably be considered to bear on the interpretation or application of a provision of the hybrid mismatch rules. Similarly, while the rules are intended to be interpreted and applied in light of any supplementary commentary or changes that are made to the BEPS Action 2 Report following enactment (as indicated by the ambulatory reference to the report "as amended from time to time"), any such supplementary commentary is a relevant interpretive source only to the extent it can reasonably be considered to bear on the interpretation or application of a provision of the hybrid mismatch rules.

Primary rule – conditions for application

ITA
18.4(3)

New subsection 18.4(3) sets out conditions for the application of subsection 18.4(4), the primary operative rule of the hybrid mismatch rules.

For subsection 18.4(4) to restrict a deduction in respect of a payment, three main conditions must be met. These conditions target the rule at payments arising under hybrid mismatch arrangements that give rise to deduction/non-inclusion mismatches (as determined under subsection 18.4(6)).

First, paragraph 18.4(3)(a) requires that an amount be deductible in respect of the payment in computing a taxpayer's income from a business or property for a taxation year. There is no requirement that the taxpayer be the payer of the payment. In addition, the broad scope of "in respect of" ensures that subsection 18.4(4) restricts a range of deductions connected with the payment (e.g., a capital cost allowance deduction in respect of a "capitalized" interest payment).

For the purposes of paragraph 18.4(3)(a), whether an amount is deductible is determined without regard to the application of the hybrid mismatch rules (in order to prevent circularity), as well as the thin capitalization rule in subsection 18(4) and the excessive interest and financing expenses limitation in section 18.2. Thus, subsection 18.4(4) applies in priority to those general interest restrictions.

Second, paragraph 18.4(3)(b) requires that the payment arise under a hybrid mismatch arrangement, which is defined in subsection 18.4(1) to comprise the various categories of arrangement to which the hybrid mismatch rules apply. For more information, see the commentary on that definition.

The final condition, also set out in paragraph 18.4(3)(b), requires that the amount that would otherwise be deductible in respect of the payment be the "deduction component" of the hybrid mismatch arrangement under which the payment arises. A deduction component of a hybrid

mismatch arrangement essentially refers to an amount that is deductible, in respect of the payment, in computing income from a business or property under Part I of the Act, and that is taken into consideration in determining the deduction/non-inclusion mismatch. In other words, if the deduction side of the deduction/non-inclusion mismatch arising from the payment under the hybrid mismatch arrangement is a Canadian income tax deduction, there is a deduction component of the hybrid mismatch arrangement.

The existence of a deduction component is determined under paragraph 18.4(11)(b) (in respect of hybrid financial instrument arrangements), 18.4(13)(b) (in respect of hybrid transfer arrangements) or 18.4(15)(b) (in respect of substitute payment arrangements).

Subsection 18.4(4) is subject to subsection 18.4(5), which, in general terms, provides an exception in certain cases where a payment is otherwise within the scope of the hybrid mismatch rules because it arises under a "structured arrangement" (as defined in subsection 18.4(1)), but a taxpayer was neither aware of the deduction/non-inclusion mismatch nor shared in any economic benefit resulting from the mismatch. For more information, see the commentary on subsection 18.4(5).

Primary rule – consequences

ITA
18.4(4)

New subsection 18.4(4) is the primary operative hybrid mismatch rule, which neutralizes a deduction/non-inclusion mismatch arising from a payment under a hybrid mismatch arrangement by restricting the amount that is deductible in respect of the payment. It applies if the conditions in subsection 18.4(3) are met in respect of a payment.

The deduction is restricted to the extent of the "hybrid mismatch amount" (as defined in subsection 18.4(1)) in respect of the payment. The effect is that the amount deductible in respect of the payment is the amount that would otherwise have been deductible less the amount of the hybrid mismatch amount.

Very generally, in the case of any hybrid mismatch arrangement that involves a deduction/non-inclusion mismatch, the hybrid mismatch amount in respect of a payment arising under the arrangement represents the amount by which amounts deductible in respect of the payment exceed income inclusions in respect of the payment, to the extent this excess is attributable to "hybridity" of the arrangement (other than in the case of a substitute payment arrangement, which does not require hybridity). The hybrid mismatch amount depends on the type of hybrid mismatch arrangement under which the payment arises. It is calculated under:

- paragraph 18.4(11)(a), if the payment arises under a hybrid financial instrument arrangement described in new subsection 18.4(10);
- paragraph 18.4(13)(a), if the payment arises under a hybrid transfer arrangement described in new subsection 18.4(12); or

- paragraph 18.4(15)(a), if the payment arises under a substitute payment arrangement described in subsection 18.4(14).

For more information, see the commentary on the definition “hybrid mismatch amount” and paragraph 18.4(7)(c).

If subsection 18.4(4) restricts a deduction in respect of only a portion of an amount in respect of an interest payment, a deduction in respect of the remaining portion may nonetheless be restricted under the thin capitalization rule in subsection 18(4) or the excessive interest and financing expenses limitation in section 18.2.

Structured arrangements – exception

ITA
18.4(5)

Broadly speaking, structured arrangements are an exception to the general rule that the relevant parties to a hybrid mismatch arrangement must meet a relationship test. Where there is a structured arrangement, a payment may be treated as arising under a hybrid mismatch arrangement notwithstanding that the relevant parties may deal at arm’s length and may not meet the applicable ownership threshold in respect of one another. A structured arrangement is an arrangement where the deduction/non-inclusion mismatch is priced into the arrangement or that is otherwise designed to produce a mismatch. For more information, see the commentary on that definition in subsection 18.4(1).

Where an arrangement would, in the absence of new subsection 18.4(5), be within the scope of the hybrid mismatch rules because there is a structured arrangement, the relieving rule in subsection 18.4(5) provides an exception from the application of the hybrid mismatch rules. This exception does not apply if the parties to the arrangement meet the relationship test.

In general terms, the exception in subsection 18.4(5) applies if the taxpayer – and all entities that do not deal at arm’s length with, or are specified entities in respect of, the taxpayer – are both unaware of the deduction/non-inclusion mismatch and derive no economic benefit from the mismatch. More specifically, paragraph 18.4(5)(b) requires that, at the time the taxpayer entered into – or acquired an interest in any part of – a transaction that is the structured arrangement, or that is part of the structured arrangement, it could not reasonably have been expected that the taxpayer was aware of the deduction/non-inclusion mismatch, or that any entity that is non-arm’s length with or is a specified entity in respect of the taxpayer had such awareness. The reference to “acquired an interest in any part of a transaction” is intended to ensure that in the case where, for example, an investor acquires securities in the secondary market, the “awareness” test applies at the time of this acquisition and not at the time of the original issuance.

Paragraph (c) requires that the taxpayer, and any entity that is non-arm’s length with or a specified entity in respect of the taxpayer, did not share in the value of any economic benefit arising from the deduction/non-inclusion mismatch.

Subsection 18.4(5) is intended to be interpreted consistently with recommendation 10.3 of the BEPS Action 2 Report, which excludes a taxpayer from the application of the structured arrangement rule if the taxpayer is not considered a "party" to the structured arrangement (where a taxpayer is generally a "party" if, based on the information available, the taxpayer or parties that meet a relationship test in relation to the taxpayer could reasonably have been expected to be aware of the mismatch or the taxpayer derives a benefit from it).

In considering whether it can reasonably be considered that an entity was aware of a deduction/non-inclusion mismatch, and whether an entity shared in the value of any economic benefit resulting from a deduction/non-inclusion mismatch, the facts and circumstances surrounding the transaction or series must be considered objectively and in their full and proper context. In particular, whether the taxpayer and any relevant entities were aware of the deduction/non-inclusion mismatch is an objective test measured at the time that the taxpayer entered into, or acquired an interest, in any part of the transaction. This determination is based on the information that would reasonably be available at that time. This should not require a taxpayer to undertake any additional commercial due diligence beyond that of a reasonable person.

Sharing in the value of any economic benefit that arises from a deduction/non-inclusion mismatch would generally be expected to be reflected in the pricing of a structured arrangement, especially in an arrangement that is not on fair market value terms or conditions. For example, an economic benefit arising from a deduction/non-inclusion mismatch may be shared through the payment of a lower rate of interest than would otherwise be paid where a deduction/non-inclusion mismatch does not arise.

Conversely, if payments arising under a structured arrangement are at fair market value, it would be reasonable to conclude that the parties derive no benefit from the mismatch. However, the conditions in subsection 18.4(5) are conjunctive, such that even if the payments are at fair market value, the exception will not apply unless the other conditions – including the "awareness" condition in paragraph (b) – are met.

Where the structured arrangement definition has been met in respect of a financial instrument, it is not expected that the issuer would be able to rely on the exception in subsection 18.4(5). The issuer would be expected to be aware of the design (i.e., the structuring), such that it would be reasonable to conclude that the issuer was aware of the tax consequences.

The BEPS Action 2 Report includes an example that demonstrates circumstances where a holder may be able to rely on the exception in 18.4(5). In example 10.3, the initial purchaser subscribes for bonds issued by an unrelated company where the interest payments give rise to a deduction/non-inclusion mismatch. In this case, the analysis in the report concludes that there is a structured arrangement as the bonds are marketed as a tax-advantaged product and are primarily marketed in jurisdictions where the deduction/non-inclusion mismatch arises. The initial purchaser subsequently sells the bonds to an unrelated entity on arm's length terms. The analysis concludes that the initial purchaser is a party to the structured arrangement because it can reasonably be expected to have been aware of the tax consequences at the time it subscribed for the bonds (based, in part, on the description in the investment memorandum, which describes

the tax consequences for the holder). The entity that purchases the bonds from the initial purchaser may not be a party to the structured arrangement, however, even if the entity is resident in a jurisdiction where a deduction/non-inclusion mismatch arises, as it may not be aware of the mismatch since it acquired the bonds on arm's length terms in the secondary market.

The exception in subsection 18.4(5) may be available to a purchaser in the secondary market on the facts described in example 10.3. However, the exception is not intended to be limited to the secondary market. Depending on the facts, the exception may also be available to taxpayers who subscribe for a financial instrument if the taxpayer and any relevant entities are unaware of the deduction/non-inclusion mismatch and derive no benefit from such mismatch.

Deduction/non-inclusion mismatch – conditions

ITA
18.4(6)

New subsection 18.4(6) sets out the conditions for determining if a payment gives rise to a deduction/non-inclusion mismatch.

Very generally, a payment gives rise to a deduction/non-inclusion mismatch if the total amount deductible in respect of the payment for Canadian income tax purposes exceeds the total amount included in respect of the payment in taxable income for foreign income tax purposes (more specifically, the total amount of "foreign ordinary income" in respect of the payment), or if the total amount deductible for foreign income tax purposes exceeds the total amount included for Canadian income tax purposes (more specifically, the total amount of "Canadian ordinary income" in respect of the payment).

Consistent with the BEPS Action 2 Report, subsection 18.4(1) includes an extended definition of the term "deductible", which essentially includes any relief that is broadly equivalent to a deduction. For more information, see the commentary to the definition of "deductible" in subsection 18.4(1).

"Foreign ordinary income" of an entity in respect of a payment is defined in subsection 18.4(1) as, essentially, an amount included in respect of the payment in the income of the entity that is taxable in a foreign country, without any offsetting relief (other than relief that applies generally and not specifically in respect of the payment). For more information, see the commentary on that definition.

"Canadian ordinary income" of a taxpayer in respect of a payment is essentially an amount included in respect of the payment in the taxpayer's income (or its taxable income earned in Canada, if the taxpayer is a non-resident), without any offsetting relief (other than relief that applies generally and not specifically in respect of the payment). Special rules apply in determining if amounts included in partnership income or FAPI are Canadian ordinary income. For more information, see the commentary on the "Canadian ordinary income" definition.

That a payment gives rise to a deduction/non-inclusion mismatch is a precondition to the existence of a hybrid financial instrument arrangement (under paragraph 18.4(10)(d)), a hybrid transfer arrangement (under paragraph 18.4(12)(d)) and a substitute payment arrangement (under paragraph 18.4(14)(f)). Thus, such a mismatch is a precondition to the application of the operative rules in subsections 12.7(3) and 18.4(4). However, it is not a sufficient condition, as several other conditions must be met before any of those rules apply.

A payment gives rise to a deduction/non-inclusion mismatch if either paragraph 18.4(6)(a) or (b) is satisfied.

Paragraph (a) is relevant where an amount is deductible in respect of a payment for Canadian income tax purposes. In that case, if the payment is determined to give rise to a deduction/non-inclusion mismatch under paragraph (a) (and meets the other conditions for a hybrid mismatch arrangement), the operative rule in subsection 18.4(4) neutralizes the mismatch by restricting all or part of the Canadian income tax deduction.

A payment gives rise to a deduction/non-inclusion mismatch under paragraph (a) if the amount determined for variable A exceeds the amount determined for variable B.

Variable A aggregates all amounts deductible in respect of the payment in computing the income of a taxpayer from a business or property for a taxation year (referred to as a “relevant year”) under Part I of the Act.

For the purposes of variable A, the application of the thin capitalization rules and the excessive interest and financing expenses limitation are disregarded in determining whether an amount is deductible. This ensures that the hybrid mismatch rules apply in priority to these general interest restriction rules.

Variable B essentially measures the total taxable income inclusions, if any, in respect of the payment for the purposes of Canadian or foreign income tax. More specifically, it aggregates all amounts in respect of the payment that

- can reasonably be expected to be, and actually are, “foreign ordinary income” of an entity (under subparagraph (i)); or
- are “Canadian ordinary income” of a taxpayer (under subparagraph (ii)).

An amount is not included under subparagraph (i) of variable B if it cannot reasonably be expected to be foreign ordinary income. This reflects the fact that, consistent with the BEPS Action 2 Report, deduction/non-inclusion mismatches are determined based on the expected characterization and treatment of payments under the relevant foreign tax laws, in light of the terms or conditions of the financial instrument, or the transaction or series of transactions, under which the payment arises.

The identification of an amount as foreign ordinary income is, therefore, primarily a question of foreign law, requiring an analysis of the relevant foreign tax rules (e.g., foreign statutes, regulations and case law, as well as administrative positions of the relevant foreign tax authority)

that apply in determining the foreign tax treatment, including the character, amount and timing of payments. If the relevant foreign tax laws are such that foreign ordinary income cannot typically be expected to arise in respect of a payment under a given arrangement, no amount is included under subparagraph (i) (regardless of whether there actually is foreign ordinary income).

This analysis requires knowing the identity of the relevant counterparty to a hybrid mismatch arrangement (typically, the recipient of the payment) and the rules that apply under the laws of the foreign country in which that counterparty is tax resident. However, neither taxpayers nor the Canada Revenue Agency need to know the foreign tax status of a relevant counterparty (e.g., if a recipient is tax-exempt under the relevant foreign tax laws) or review its foreign income tax return to identify a mismatch, since it is not necessary to know precisely how a specific payment was taken into account in computing an entity's foreign taxable income. Rather, if the payment cannot reasonably be expected to give rise to foreign ordinary income, this is sufficient to exclude the amount from variable B and can potentially result in a mismatch.

Whether an amount can reasonably be expected to be foreign ordinary income in respect of a payment is an objective test. This determination must be based on a correct understanding of the terms and conditions of the arrangement, transaction or series, as well as the relevant foreign laws and how they typically apply in relation to such arrangements, transactions or series.

Finally, it is possible that in some cases, foreign ordinary income may be reasonably expected to arise in respect of a payment but not actually arise. For example, this could occur where a payment is not included in taxable income due to an unforeseen outcome under the relevant foreign tax law, such as where a foreign taxpayer takes a filing position that is inconsistent with the prevailing interpretation of the foreign law or the published positions of the foreign tax administration. In this case, no amount is included under variable B. This is because subparagraph (i) requires that foreign ordinary income is not only reasonably expected to arise in respect of the payment, but actually does arise.

Subparagraph (ii) of variable B also allows for amounts of Canadian ordinary income in respect of a payment to be included in determining if there is a deduction/non-inclusion mismatch in respect of a payment that is deductible for Canadian income tax purposes. This may be relevant, for example, where a Canadian taxpayer makes a deductible payment to a controlled foreign affiliate that is not included in the affiliate's income that is subject to foreign income tax but is included in its FAPI attributable to the taxpayer or another taxpayer under subsection 91(1).

Payments between Canadian-resident taxpayers may give rise to a deduction/non-inclusion mismatch to the extent the Canadian income tax deduction exceeds Canadian ordinary income in respect of the payment. However, it is not expected that purely domestic mismatches would satisfy the causation test in paragraph 18.4(10)(d) (for hybrid financial instruments) or paragraph 18.4(12)(d) (for hybrid transfers) since those tests focus on differences in tax treatment between different countries.

Amounts are included in variable B only if they are foreign ordinary income of entities for foreign taxation years, or Canadian ordinary income of taxpayers for taxation years, that begin no more than 12 months after the end of the relevant year. Thus, variable B does not include any

foreign ordinary income or Canadian ordinary income arising for a foreign taxation year or taxation year, respectively, that begins more than 12 months after the taxation year in which an amount was deductible in respect of the payment. However, paragraph 20(1)(yy) may provide relief in these circumstances. For more information, see the commentary on that paragraph.

Paragraph 18.4(6)(b) focuses on amounts deductible in respect of a payment in computing taxable income for foreign income tax purposes. If the payment arises under a hybrid mismatch arrangement and a taxpayer is a recipient of the payment, subsection 12.7(3) neutralizes a deduction/non-inclusion mismatch described under this paragraph by including an amount in the taxpayer's income.

A payment gives rise to a mismatch under paragraph 18.4(6)(b) if the amount determined for variable C (i.e., the foreign income tax deduction in respect of the payment) exceeds the amount determined for variable D (i.e., the taxable income in respect of the payment, for Canadian or foreign income tax purposes, to the extent it is not sheltered from tax by certain reliefs).

Variable C aggregates all amounts that – absent any "foreign expense restriction rule" (as defined in subsection 18.4(1)) – either would be deductible, or would reasonably be expected to be deductible, in respect of a payment in computing any entity's relevant foreign income or profits for a foreign taxation year (referred to as a "relevant foreign year"). For this purpose, "relevant foreign income or profits" is defined in subsection 18.4(1) and essentially refers to income in respect of which the entity is subject to an income or profits tax imposed by a foreign country.

An amount is included within variable C if it is taken into account as a deductible expense in calculating an entity's relevant foreign income or profits. For financial instruments, for example, this would include amounts deductible in respect of payments characterized as interest; issue discounts and redemption premiums; facilities and lending fees; and payments under derivative contracts.

Like paragraph 18.4(6)(a), paragraph (6)(b) identifies deduction/non-inclusion mismatches based on foreign tax outcomes that can reasonably be expected given the expected characterization and treatment of payments under the relevant foreign tax laws and in light of the terms or conditions of the arrangement, transaction or series of transactions at issue. Thus, an amount that may reasonably be expected to be deductible for foreign tax purposes is included under variable C.

Variable C tests whether there is a foreign income tax deduction available "in respect of" a payment and, in contrast to subsection 113(5), is not limited to foreign tax deductions by the payer of a payment (and entities with an equity interest in the payer or that include the payer's income in their income). For example, a deduction that is available to a transferor of a financial instrument under a sale and repurchase transaction in respect of a return paid to the transferee by the issuer of the instrument would be within scope. For more information, see the commentary on paragraph 18.4(12)(c).

Consistent with the BEPS Action 2 Report, variable C is calculated without regard to any "foreign expense restriction rule", with the result that a restriction of a foreign income tax

deduction under such a rule does not affect whether a payment gives rise to a mismatch and does not have any impact on the calculation of the mismatch amount under paragraph 18.4(7)(c). This ensures the hybrid mismatch rules apply with respect to "hybrid" arrangements that would generally be expected to result in mismatches in tax outcomes.

A foreign expense restriction rule is essentially a foreign tax rule that restricts the deductibility of expenses. This includes a rule that restricts deductions for interest or financing expenses based on a measure of excessive debt or excessive interest or financing expenses, relative to a given benchmark. For example, this includes thin capitalization rules that apply based on a ratio of debt to shareholder's equity or assets, and earnings-stripping rules that apply based on a ratio of interest to earnings. It also includes foreign tax rules that implement, or can reasonably be considered to be intended to implement, the Global Anti-Base Erosion Model Rules (Pillar Two), since the UTPR component of those rules may be implemented by way of a restriction of deductions for expenses. For further information, see the commentary on the definition "foreign expense restriction rule".

Variable D essentially measures the total taxable income inclusions, if any, in respect of the payment for the purposes of Canadian or foreign income tax. More specifically, it aggregates all amounts in respect of the payment that

- would be Canadian ordinary income of a taxpayer, determined without regard to the application of subsection 12.7(3) to avoid circularity (under subparagraph (i)); or
- can reasonably be expected to be, and actually are, foreign ordinary income of an entity (under subparagraph (ii)).

Variable D only includes Canadian ordinary income and foreign ordinary income for taxation years and foreign taxation years, respectively, that begin no more than 12 months after the end of the foreign taxation year in which the foreign income tax deduction arose.

In addition, under subparagraph (ii), foreign ordinary income of an entity is only included in variable D if the entity is a different entity from the entity that is entitled to a foreign tax deduction in respect of the payment. This may be particularly relevant in applying the hybrid transfer arrangement rule in subsection 18.4(12). For more information, see the commentary on paragraph (c) of that subsection.

Finally, as noted elsewhere in this commentary, one consequence of the broad "payment" definition in subsection 18.4(1) is that multiple payments may arise at different points in time in respect of the same payment obligation (e.g., when a contingent obligation to pay first arises and when the obligation to pay later crystallizes). Notwithstanding this breadth, it is expected that only one such payment would actually give rise to a deduction/non-inclusion mismatch. This is because, under paragraphs 18.4(6)(a) and (b), an amount must be deductible for Canadian or foreign income tax purposes in respect of a payment in order for the payment to give rise to a mismatch. If, for example, a foreign tax deduction for a foreign taxation year is available in respect of an amount that is not actually paid and the amount is actually paid in a subsequent foreign taxation year, two payments exist (i.e., one payment arising at the time of the foreign tax

deduction and another arising at the time of the actual payment), but the requirement in variable C would only be met in respect of the first payment.

Deduction/non-inclusion mismatch – application

ITA
18.4(7)

New subsection 18.4(7) is intended to essentially act as a "bridge" between subsection 18.4(6) and the provisions in subsections 18.4(11), (13) and (15), which, respectively, apply for hybrid financial instrument arrangements, hybrid transfer arrangements and substitute payment arrangements.

Subsections 18.4(6) and (7) can be understood as intermediate steps in determining whether the operative hybrid mismatch rules apply and, if so, the extent to which they do. Subsection 18.4(6) determines if a payment gives rise to a deduction/non-inclusion mismatch. Subsection 18.4(7) applies if a particular payment gives rise to a deduction/non-inclusion mismatch under subsection 18.4(6).

Paragraph 18.4(7)(a) is relevant if the deduction side of a deduction/non-inclusion mismatch arising from a payment is a Canadian income tax deduction. In that case, the amount determined for variable A under paragraph 18.4(6)(a) (i.e., the Canadian income tax deduction) is referred to as the "deduction component" of the mismatch.

The "deduction component" concept in paragraph 18.4(7)(a) is relevant for paragraphs 18.4(11)(b), (13)(b) and (15)(b), which, where applicable, result in a deduction component of a hybrid mismatch arrangement for the purpose of applying subsection 18.4(4). For example, if the payment arises under a hybrid financial instrument arrangement (as determined under subsection 18.4(10)), paragraph (11)(b) provides that the deduction component of the deduction/non-inclusion mismatch is the deduction component of the hybrid financial instrument arrangement. In that case, the condition in paragraph 18.4(3)(b) is met and subsection 18.4(4) restricts all or a portion of the deduction.

Paragraph 18.4(7)(b) is relevant if there is a foreign income tax deduction in respect of the payment. The foreign tax deduction element of a deduction/non-inclusion mismatch arising from the payment is the "foreign deduction component" of the mismatch. More specifically, the "foreign deduction component" of the deduction/non-inclusion mismatch is the amount determined for variable C under paragraph 18.4(6)(b) in respect of the payment.

The "foreign deduction component" in paragraph 18.4(7)(b) is relevant for paragraphs 18.4(11)(c), (13)(c) and (15)(c), which, where applicable, result in there being a foreign deduction component of a hybrid mismatch arrangement. This, in turn, results in the condition in paragraph 12.7(2)(b) being met, such that an amount is included in income under subsection 12.7(3).

Paragraph 18.4(7)(c) determines the amount of the deduction/non-inclusion mismatch arising from a payment based on the formula A – B.

If there is a deduction component of the deduction/non-inclusion mismatch, which will be true in the case of a mismatch involving a Canadian income tax deduction, the amount of the deduction/non-inclusion mismatch is determined under subparagraph (i) of variables A and B. In general terms, the result is that the amount of the deduction/non-inclusion mismatch is the amount by which the total Canadian income tax deductions for a particular taxation year in respect of the payment exceed the total of the "foreign ordinary income" and "Canadian ordinary income" (as those terms are defined in subsection 18.4(1)) in respect of the payment for foreign taxation years and taxation years, respectively, that begin no more than 12 months after the particular year.

If there is a foreign deduction component of the deduction/non-inclusion mismatch, the amount of the mismatch is calculated under subparagraph (ii) of variables A and B. In general terms, the result is that the amount of the deduction/non-inclusion mismatch is the amount by which the total of the amounts deductible in respect of a payment in computing "relevant foreign income or profits" (as defined in subsection 18.4(1)) for a particular foreign taxation year exceed the total of the Canadian ordinary income and foreign ordinary income in respect of the payment for taxation years and foreign taxation years, respectively, that begin no more than 12 months after the particular year.

Because the formula in paragraph 18.4(7)(c), in effect, incorporates the variables from subsection 18.4(6), the rules and assumptions that apply in determining whether a deduction/non-inclusion mismatch arises under that subsection also apply in determining the amount of the mismatch. For example, where an interest deduction is restricted under subsection 18(4) or 18.2(2), or an income tax deduction is restricted under a "foreign expense restriction rule" (as defined in subsection 18.4(1)), the restriction is disregarded in measuring the amount of the deduction/non-inclusion mismatch.

In determining the amount of the deduction/non-inclusion mismatch, clause (i)(A) of variable B provides a *de minimis* rule that effectively disregards foreign ordinary income and Canadian ordinary income in respect of a payment if the total of those amounts represents 10 per cent or less of the Canadian income tax deductions in respect of the payment. Clause (ii)(A) of variable B has the same effect if the total of Canadian ordinary income and foreign ordinary income in respect of a payment represents 10 per cent or less of the foreign income tax deductions in respect of the payment.

Determining the amount of the deduction/non-inclusion mismatch arising from a payment is an intermediate step in determining the "hybrid mismatch amount" (as defined in subsection 18.4(1)) in respect of the payment, which is the amount of the adjustment under subsection 12.7(3) or 18.4(4). Once the amount of the deduction/non-inclusion mismatch is determined, the hybrid mismatch amount is then determined under paragraph 18.4(11)(a), (13)(a) or (15)(a) (depending on the type of hybrid mismatch arrangement).

While the amount of the deduction/non-inclusion mismatch under paragraph 18.4(7)(c) provides the base for determining the hybrid mismatch amount, the hybrid mismatch amount can be less than the amount of the deduction/non-inclusion mismatch in certain cases. For more information, see the commentary on subsections 18.4(11), (13) and (15).

No double counting

ITA
18.4(8)

New subsection 18.4(8) is a rule against double counting, which applies where an amount has already been included in computing foreign ordinary income or Canadian ordinary income of an entity in respect of a payment. In that case, the amount cannot be included in computing foreign ordinary income or Canadian ordinary income of the same entity or any other entity in respect of the payment. Put differently, this rule clarifies that the same amount cannot be taken into consideration more than once in computing foreign ordinary income and Canadian ordinary income. The terms “foreign ordinary income” and “Canadian ordinary income” are defined in subsection 18.4(1).

This rule ensures, for example, that an amount included in foreign ordinary income or Canadian ordinary income of a particular entity is not also so included at the level of an investor, member or beneficiary of the particular entity.

This rule can apply, for example, where the same portion of a payment is included in the taxable income of more than one entity, or in a given entity’s taxable income under the income tax laws of more than one country. In these cases, the rule ensures that portion of the payment is only taken into consideration once in determining foreign ordinary income or Canadian ordinary income.

Notional interest expense – deemed payment

ITA
18.4(9)

New subsection 18.4(9) ensures that the rules for hybrid financial instrument arrangements, in subsections 18.4(10) and (11), apply where a foreign country allows an income tax deduction for a notional interest expense in respect of a debt and this results in a deduction/non-inclusion mismatch. A notional interest expense is one that does not have a corresponding legal obligation to pay interest in respect of a debt. Thus, subsection 18.4(9) can apply, for example, where a country allows a deduction in respect of a low- or non-interest bearing debt as if interest had been paid at a market rate. Because subsection 18.4(9) requires an interest deduction in respect of an instrument that is debt under Canadian law, it is not expected to apply to deductions with respect to equity (e.g., allowance for corporate equity regimes).

Subsection 18.4(9) reflects a departure from the recommendations in the BEPS Action 2 Report. The BEPS Action 2 Report recommends that the hybrid financial instrument rule not apply

where a country allows a deduction for deemed interest on a non-interest bearing debt, because there is no actual interest payment obligation under the financial instrument. From a policy perspective, however, it is arbitrary to distinguish between mismatches involving a deduction for a notional interest expense in respect of a debt, and those that involve a deduction for an actual interest expense in respect of a legal obligation to pay interest.

More specifically, subsection 18.4(9) applies if – on the assumption no "foreign expense restriction rules" (as defined in subsection 18.4(1)) applied – an amount would be deductible, or would reasonably be expected to be deductible, in respect of a notional interest expense on a debt in computing "relevant foreign income or profits" (as defined in subsection 18.4(1)). The reasons for disregarding the effect of any foreign expense restriction rules, and for testing whether an amount "can reasonably be expected to be" deductible for foreign income tax purposes, are the same as for the analogous test in subsection 18.4(6). For more information, see the commentary on that subsection.

Where these conditions are met, subsection 18.4(9) sets out several deeming rules. The deeming rules in paragraphs 18.4(9)(a) to (c) are principally relevant to the determination of whether there is a deduction/non-inclusion mismatch under subsection 18.4(6). They also deem a payment, which is a pre-requisite to the application of the operative rules in subsections 12.7(3) and 18.4(4). The overall effect is to deem a payment under the debt to the extent of the deductible amount. Paragraph (c) is intended to ensure that a mismatch is not considered to arise to the extent there is a corresponding inclusion in the creditor's taxable income in respect of notional interest income that is notionally accrued for the same period as the notional interest expense.

In addition, paragraph 18.4(9)(d) deems the payment to satisfy the causal condition in paragraph 18.4(10)(d), which may otherwise not be met in the case of such instruments because the mismatch results not from a difference in how two countries characterize or treat the instrument based on its terms or conditions, but rather, for example, from a difference in their respective transfer pricing rules.

Deduction/non-inclusion mismatches that arise from a deduction for notional interest expense are neutralized under subsection 12.7(3) to the extent of the portion of the notional interest expense that accrues on or after January 1, 2023. If a foreign taxation year begins before January 1, 2023, and ends after that date, it is intended that a payment deemed under paragraph 18.4(9)(a) to be made in the year be considered to have arisen on or after July 1, 2022. Thus, the payment is subject to subsection 12.7(3), except for any portion of the payment corresponding to a portion of a deduction that relates to a portion of a notional interest expense that is computed in respect of a period of time preceding January 1, 2023.

Example

Assumptions

- *A taxable Canadian corporation ("Canco") makes a non-interest bearing loan to a controlled foreign affiliate ("CFA").*
- *CFA uses the borrowed money to earn income from an active business.*

- *CFA is resident in a jurisdiction that, through the operation of its transfer pricing rules (or otherwise), allows CFA to deduct an amount of notional interest expense for tax purposes corresponding to the rate of interest that would be charged by an arm's length party.*
- *There is no corresponding income inclusion in Canada, as a result of the exceptions provided in subsections 17(8) (from the deemed interest imputation rule in subsection 17(1)) and 247(7) (from the application of the transfer pricing rules).*

Analysis

The conditions in subsection 18.4(10) are met, such that the hybrid financial instrument rule in subsection 18.4(11) applies.

The deduction in respect of a notional interest expense gives rise to a deduction/non-inclusion mismatch by operation of the deeming rules in subsection 18.4(9). Paragraph 18.4(9)(a) deems a payment equal to the deductible amount, and paragraph (b) deems the deductible amount to be in respect of the payment. Paragraph (c) does not apply in this case as Canco does not have an income inclusion in respect of the debt because of subsections 17(8) and 247(7). Thus, the deemed payment gives rise to a deduction/non-inclusion mismatch under paragraph 18.4(6)(b).

Paragraph 18.4(9)(d) deems the mismatch to meet the causal condition in paragraph 18.4(10)(d) (and the other conditions in subsection 18.4(10) are met), with the result that the deemed payment is considered to arise under a hybrid financial instrument arrangement and subsection 18.4(11) applies. Subsection 12.7(3) therefore applies to include an amount equal to the "hybrid mismatch amount" (in this case, equal to the deductible amount in respect of the notional interest expense on the debt) in respect of the deemed payment in computing Canco's income.

Hybrid financial instrument arrangement – conditions

ITA
18.4(10)

New subsection 18.4(10) sets out the conditions for determining if a payment arises under a hybrid financial instrument arrangement.

A hybrid financial instrument arrangement essentially is one where differences in the income tax treatment of payments under or in connection with a financial instrument under the tax laws of different countries give rise to a deduction/non-inclusion mismatch (as determined under subsection 18.4(6)).

Where all the conditions in subsection 18.4(10) are met, such that a payment is considered to arise under a hybrid financial instrument arrangement (and thus under a "hybrid mismatch arrangement", as defined in subsection 18.4(1)), the mismatch is neutralized under the operative hybrid mismatch rules. More specifically, if the payment is otherwise deductible for Canadian income tax purposes, subsection 18.4(4) restricts all or a portion of the deduction. If the payment

is deductible for foreign income tax purposes (including, based on the definition of "deductible" in subsection 18.4(1), any relief that is broadly equivalent to a deduction), subsection 12.7(3) includes an amount in a recipient taxpayer's income.

A payment is considered to arise under a hybrid financial instrument arrangement if four conditions are met.

The first condition, in paragraph 18.4(10)(a), requires that the payment arise under or in connection with a financial instrument. For these purposes, a payment arises under or in connection with a financial instrument if the terms or conditions of the financial instrument create the obligation to pay, credit or confer the payment, or the payment is consideration for a release from an obligation under the instrument.

Subsection 18.4(1) defines "payment" broadly to include amounts or benefits that will become payable in the future, and amounts that are capable of being paid (e.g., contingent payment obligations). Given this breadth, the accrual of a future payment obligation under a financial instrument, for example, would satisfy paragraph (a). In addition, subsection 18.4(1) defines a "financial instrument" broadly as a debt, equity interest (or other right that effectively replicates rights under an equity interest) or any other arrangement that gives rise to a "financing or equity return" (also defined in subsection 18.4(1)). For more information, see the commentary on the definitions of "payment", "financial instrument" and "equity or financing return".

If a transaction or arrangement meets the "financial instrument" definition, paragraph 18.4(10)(a) can be satisfied even if the country of residence of a non-resident counterparty under the instrument does not consider there to be a financial instrument. For example, if there is a payment by a purchaser on an asset transfer that is considered, from a Canadian income tax perspective, to include an equity or financing return (e.g., a portion of the purchase price is treated as an interest expense), the payment satisfies the condition in paragraph (a), notwithstanding that the counterparty country subsumes the payment in the purchase price.

Paragraph 18.4(10)(a) is not met if a payment is described in paragraphs 18.4(14)(a) to (d) of the substitute payment arrangement rule, which pertain to certain payments in respect of transfers of financial instruments, where the payment represents an underlying return on the transferred instrument. This exception ensures that such payments are dealt with under the substitute payment arrangement rule in subsection 18.4(14) or the hybrid transfer arrangement rule in subsection 18.4(12), and not under subsection 18.4(10).

In general terms, paragraph 18.4(10)(b) requires that either the payer and the recipient of the payment satisfy a relationship test, or the payment arises under a structured arrangement.

The relationship test under subparagraph 18.4(10)(b)(i) is satisfied if the payer and the recipient either do not deal at arm's length with one another, or are "specified entities" in respect of one another. The relationship test is intended to be generally consistent with the recommendations in the BEPS Action 2 Report, but with certain adaptations to rely on existing concepts in the Act. In particular, this test uses the existing "non-arm's length" concept in Canadian income tax to approximate the relationships reflected in the recommendations under Chapter 11 of the BEPS

Action 2 Report, which recommends that the hybrid financial instrument rule apply in respect of entities that are part of the same "control group" (defined by reference to effective control).

The "specified entities" concept is defined in subsection 18.4(1) and is met generally where either the payer or the recipient has a 25% equity interest in the other, or a third person has a 25% equity interest in both. This is consistent with the recommendation in the BEPS Action 2 Report to use a 25% equity threshold for the hybrid financial instrument arrangement rule. For more information, see the commentary on the definition of "specified entity" in subsection 18.4(1).

The term "structured arrangement", as referred to in subparagraph 18.4(10)(b)(ii), is defined in subsection 18.4(1) and essentially means an arrangement where the deduction/non-inclusion mismatch is priced into the terms or conditions of the arrangement, or that is otherwise designed to produce such a mismatch. For more information, see the commentary on that definition in subsection 18.4(1).

The third condition, in paragraph 18.4(10)(c), requires that the payment must give rise to a deduction/non-inclusion mismatch. For more information, see the commentary on subsection 18.4(6), which sets out the conditions for such a mismatch.

The final condition, in paragraph 18.4(10)(d), sets out a causal test to assess the "hybridity" of the mismatch. Under this test, a mismatch is considered hybrid if it arises because the terms of a financial instrument, or transactions that are related to the financial instrument, lead the instrument, or any of the related transactions, to be treated differently under the tax laws of different countries. The reference to "countries" excludes differences in tax treatment under the laws of sub-national governments (e.g., provincial or state tax laws).

The causal test involves a two-step analysis.

The first step asks if it can reasonably be considered that the deduction/non-inclusion mismatch arises, in whole or in part, because the tax laws of more than one country (including Canada) treat differently

- the financial instrument under which the payment arises; or
- one or more "transactions" (defined in subsection 18.4(1) to include an arrangement or event) that are part of a transaction or series of transactions that includes the payment or that relate to the financial instrument.

A transaction or series will be considered to "relate to" the financial instrument if it is legally, commercially or economically relevant to the financial instrument or the payment.

The causal test is met, for example, where a deduction/non-inclusion mismatch results from the fact that one country looks only at the terms and conditions of the financial instrument in characterizing it as a debt, while another country takes into consideration the terms or conditions of one or more transactions that relate to the financial instrument, or are part of the same series, in characterizing payments under the financial instrument as equity returns. The phrase "either

alone or together" ensures that the causal test is met regardless of whether the difference in tax treatment is due to a difference in how two countries view a single transaction, or a difference in how they view a set of multiple transactions taken together.

The second step in the causal test asks if it is reasonable to consider that the difference in tax treatment is "attributable to the terms" of the financial instrument or other relevant transactions. This focuses on whether the terms of the instrument or relevant transactions are essential to the difference in tax treatment. In applying this step, regard should be had to both express and implied terms of a financial instrument or a related transaction. An example of where this test could be met is where one country classifies an instrument as debt (and payments under the instrument as deductible interest) based on the instrument's terms, and another country classifies it as equity (and payments under the instrument as exempt dividends) based on the terms.

Consistent with the BEPS Action 2 Report, the causal test is not, however, limited to differences in classification of financial instruments. It can also be satisfied, for example, if the terms of a financial instrument are such that different principles for the computation of income or profit apply in respect of the same financial instrument under the tax laws of two different countries. This could occur, for example, if a financial instrument is viewed as a debt under the tax laws of both relevant countries but interest payments on the instrument are contingent, such that the laws of one country allow a payer to deduct the payments on an accrual basis but the laws of the other country allow a recipient to defer an income inclusion until actual payment. This difference in treatment is attributable to terms of the instrument, which provide for the contingent interest entitlement.

While the causal test is not satisfied in the case of a deduction/non-inclusion mismatch solely attributable to timing differences (e.g., where a payer's country of residence allows a deduction in respect of a payment on an accrual basis, but the recipient's residence country taxes on a cash basis in general, without regard to the terms of the particular instrument), it is met if a timing difference in the recognition of income and expenses between two countries results from the terms of an instrument. In this regard, the BEPS Action 2 Report includes examples where a timing difference is attributable to the terms of the financial instrument: example 1.21 (mismatch resulting from accrual of contingent interest liability) illustrates such a timing difference, and example 1.22 (no mismatch resulting from accrual of contingent liability) illustrates a timing difference that is not attributable to the terms.

Timing differences resulting from the status of a party to a transaction are not expected to meet the causal test. For example, if a party to the transaction is subject to mark-to-market taxation in respect of a transaction (e.g., a financial instrument) because it is a financial institution, a resulting timing difference in the recognition of income and expenses between two countries is not attributable to the terms or conditions of the transaction but rather to a party's status as a financial institution. This is true where the timing difference results from the fact the financial institution is subject to the mark-to-market taxation rules in the Act, notwithstanding that a taxpayer that is not a financial institution (i.e., a taxpayer of "ordinary status") can elect mark-to-market treatment under section 10.1 of the Act.

Consistent with the BEPS Action 2 Report, subsection 18.4(6) in effect provides a 12-month safe harbor, ensuring that a deduction/non-inclusion mismatch is not considered to arise in the first instance because of short-term timing differences between countries in the recognition of payments under a financial instrument. If a payment gives rise to Canadian ordinary income or foreign ordinary income outside this 12-month period, however, it will be considered to give rise to a deduction/non-inclusion mismatch. It is then necessary to apply the causal test to determine if the timing difference is attributable to the terms of the financial instrument or relevant transactions. Thus, the hybrid mismatch rules do not adopt the recommendation at paragraphs 56 to 60 of the BEPS Action 2 Report to provide relief where the tax administration is satisfied that the payment is expected to be included in income within a reasonable period of time. Instead, paragraph 20(1)(yy) allows a deduction where subsection 18.4(4) has previously applied to deny a deduction and the taxpayer subsequently demonstrates that an amount has been included in foreign ordinary income.

The causal test will not be met if a deduction/non-inclusion mismatch is solely attributable to differences in valuation, including foreign exchange exposure that is attributable to a fluctuation in the value of a currency.

The treatment of a financial instrument or related transaction may depend in part on the relationship between the issuer and the holder of the instrument or the period over which it is held (e.g., a participation exemption or comparable form of tax relief based on an equity interest threshold or minimum holding period). These surrounding factors do not limit the application of the causal test, which asks if it is reasonable to consider that the difference in tax treatment is attributable in whole or in part to the terms of the instrument or related transactions. As long as the terms of the instrument or related transactions play a role in the instrument being treated differently, the causal test is met. Thus, these surrounding circumstances are effectively treated as part of the terms of the instrument or related transaction.

Because the tax treatment of the financial instrument or related transactions must be linked to the terms, the causal test will not be met if a deduction/non-inclusion mismatch is solely attributable to the tax status of a recipient of payments under the instrument (e.g., a tax-exempt recipient). Such mismatches are attributable to how the law of the recipient’s country of residence treats the recipient generally for tax purposes rather than the terms of the financial instrument or relevant transactions.

The same is true for mismatches solely attributable to the context in which an instrument is held. Such a mismatch could arise where the instrument is held through a tax-exempt permanent establishment (where a mismatch is attributable to a branch exemption), in a country with a purely territorial taxation regime (where a mismatch is attributable to the nature or residence of a payer of the payment, in that the country exempts a recipient of the payment from tax on foreign-source income) or in a tax-exempt savings account (where any mismatch is attributable to the fact that the relevant tax laws do not generally subject the account to tax).

Consistent with the recommendations in the BEPS Action 2 Report, however, as long as the terms of a financial instrument or related transactions are sufficient to cause a deduction/non-inclusion mismatch, the mismatch will meet the causal test. In other words, if the mismatch

would have arisen from those terms, regardless of the status of the recipient of the payment or the context in which the instrument is held, then the causal test is satisfied. This principle is reflected in subparagraph 18.4(10)(d)(ii), which sets out a "multiple causation" rule that asks whether it is reasonable to consider that a deduction/non-inclusion mismatch would have arisen and been attributable to the terms of the instrument or related transactions if all other causes of the mismatch were disregarded. This test effectively adopts the "counterfactual test" recommended at paragraph 95 of the BEPS Action 2 Report.

Because the hybrid mismatch rules do not alter the tax status of the counterparties to a transaction, nor the context in which the instrument is held, the rules will not have a practical effect in all cases. For example, in the case of a payment to a tax-exempt recipient under a hybrid financial instrument arrangement, the approach to causation reflected in subparagraph 18.4(10)(d)(ii) can result in an income inclusion under subsection 12.7(3) that has no impact on the recipient's tax position if the recipient is a Canadian tax-exempt. If the payer under the instrument is a Canadian and the payee is a foreign tax-exempt entity, however, subsection 18.4(4) can apply to deny the payer a deduction in respect of the payment, despite the recipient being exempt from tax.

While the application of these rules will depend on the facts and circumstances of each case, the following example demonstrates the application of the conditions in 18.4(10) to an investment in a Canadian subsidiary by a foreign parent company.

Example

Assumptions

- Forco, a corporation resident in Country X, is the parent corporation of Canco, a corporation resident in Canada. Forco is the sole shareholder of Newco, an entity that is disregarded as a separate entity from its owner and is thus fiscally-transparent under Country X income tax law, but is treated as a non-resident corporation under Canadian income tax law.
- Forco makes an interest-bearing loan (the "Loan") with a principal amount of $100 million to Canco, which Canco must repay on a fixed maturity date.
- Canco is obligated under the Loan to make periodic cash payments of interest to Forco on fixed payment dates (each, an "Interest Payment Date").
- The following transactions are entered into concurrently with the Loan:
    - Canco and Newco enter into a forward subscription agreement (the "Forward Agreement") requiring Newco to subscribe for Canco shares on each Interest Payment Date.
    - Forco and Newco enter into a capital support agreement (the "Support Agreement") requiring Forco to contribute capital to Newco on each Interest Payment Date to allow Newco to satisfy its obligations under the Forward Agreement.
- Under the tax laws of Country X, it can reasonably be expected that:
    - The Forward Agreement is treated as being between Canco and Forco.

    - Because the obligations under the Loan and the Forward Agreement effectively offset one another from an economic perspective, these agreements are treated as though they were a single instrument in the nature of an integrated equity investment.
    - As a result, the interest payments on the Loan are treated as stock dividends, which are not included in computing Forco's income on which it is subject to tax in Country X.
- Canco takes the position in its income tax return that, under Canadian income tax law, the Loan is treated as a debt and the periodic interest payments are deductible under paragraph 20(1)(c).
- On December 31, 2022:
    - Forco contributes $5 million in cash to the capital of Newco in satisfaction of its obligation under the Support Agreement.
    - Newco uses the $5 million contributed by Forco to subscribe for shares of the capital stock of Canco in satisfaction of its obligation under the Forward Agreement.
    - Canco pays $5 million in cash (the "Payment") as interest under the Loan to Forco.

Analysis

The condition in paragraph 18.4(10)(a) is met because the Loan is a financial instrument and the Payment arises under the Loan since its terms provide for the periodic payments.

The condition in paragraph 18.10(b) is met because Canco, the payer, does not deal at arm's length with Forco, the recipient.

There are provisions in the Act (e.g., section 247) that apply in priority to the hybrid mismatch rules and which could deny Canco's deduction in respect of the Payment. The remainder of this analysis is based on the interpretation of Canadian income tax law reflected in Canco's filing position.

Based on Canco's filing position, the condition in paragraph 18.4(10)(c) is met because the Payment gives rise to a deduction/non-inclusion mismatch under paragraph 18.4(6)(a). Specifically, the $5 million that is deductible in respect of the Payment in computing Canco's income exceeds Forco's foreign ordinary income in respect of the Payment, which is nil since no amount in respect of the Payment is included in computing Forco's income that is subject to tax in Country X. The amount of the deduction/non-inclusion mismatch, as determined under paragraph 18.4(7)(c), is $5 million.

Any amount included, in respect of Canco's income, in the income of Forco or any other entity under a specified minimum tax regime in Country X does not result in foreign ordinary income in respect of the Payment. An income inclusion under such a regime would not be in respect of the Payment (since Canco is the payer, and not a recipient, of the Payment) and, in any event, is expressly excluded under variable A of the definition of "foreign ordinary income".

Based on Canco's filing position, the deduction/non-inclusion mismatch arising from the Payment meets the test in paragraph 18.4(10)(d). Canco's filing position is predicated on the Forward Agreement – which is part of a series of transactions that includes the Payment – and the Loan being treated differently under the tax laws of Canada and Country X. In particular, it assumes that Canada treats the Loan as a debt that is separate from the Forward Agreement and Country X treats these instruments as one integrated equity investment. All of the mismatch results from this difference, because the effect of Canadian tax law treating the Loan as a debt is that the Payment is characterized as deductible interest, while the effect of Country X tax law treating the Loan together with the Forward Agreement as an equity instrument is that Forco is treated as receiving a stock dividend that is not included in its income that is subject to tax in Country X.

This difference in tax treatment is attributable to the terms and conditions of the Loan and Forward Agreement. Canco's filing position assumes that the Loan is treated as a debt under Canadian tax law because the rights and obligations under the Loan are viewed in accordance with their legal substance and without regard to the terms of the Forward Agreement or any other transactions in the series. By contrast, the terms of the Loan, the Forward Agreement and other transactions in the series play an essential role in Country X characterizing the Loan, together with the Forward Agreement, as an integrated equity investment according to their economic substance.

Accordingly, the Payment arises under a hybrid financial instrument arrangement, and subsection 18.4(4) denies Canco a deduction in respect of the Payment since the hybrid mismatch amount in respect of the Payment, as determined under paragraph 18.4(11)(a), is $5 million. In addition, subsection 214(18) deems the Payment to be a dividend the purposes of Part XIII of the Act (withholding tax).

Hybrid financial instrument arrangement – amount

ITA
18.4(11)

New subsection 18.4(11) is relevant in determining the extent to which the operative hybrid mismatch rules restrict a deduction, or include an amount in income, in respect of a payment arising under a hybrid financial instrument arrangement. It also provides rules that act as a "bridge" between subsection 18.4(10) and the operative hybrid mismatch rules.

Paragraph 18.4(11)(a) determines the amount included in income under subsection 12.7(3), or the amount by which a deduction is restricted under subsection 18.4(4), in the case of a payment arising under a hybrid financial instrument arrangement. It ensures these results apply only to the extent the deduction/non-inclusion mismatch arising from the payment is "hybrid" in nature.

The starting point is to determine the amount of the deduction/non-inclusion mismatch that arises from the payment. Under paragraph 18.4(7)(c), this mismatch is essentially the amount by which the amounts deductible in respect of the payment for Canadian or foreign income tax purposes

exceed “Canadian ordinary income” and “foreign ordinary income” in respect of the payment (as defined in subsection 18.4(1)). For more information, see the commentary on subsection 18.4(7).

It is then necessary to determine the portion of the deduction/non-inclusion mismatch amount that can reasonably be considered to arise because of a difference in tax treatment described in paragraph 18.4(10)(d), or that would arise because of such a difference if all other reasons for the mismatch were disregarded. This portion is referred to as the “amount of the hybrid financial instrument mismatch” and, as a “hybrid mismatch amount” (as defined in subsection 18.4(1)), is the amount of the income inclusion under subsection 12.7(3), or the deduction restriction under 18.4(4), as the case may be. If all of the deduction/non-inclusion mismatch is attributable to the cause described in paragraph 18.4(10)(d), the entire amount of the mismatch is the amount of the hybrid financial instrument mismatch.

Paragraph 18.4(11)(b) links subsection 18.4(10) with the operative rule in subsection 18.4(4), ensuring that the operative rule will apply to restrict the amount deductible under Part I of the Act in respect of a payment arising under a hybrid financial instrument arrangement. This is achieved by labelling the amount that would otherwise be deductible under Part I in respect of the payment – which amount is referred to in paragraph 18.4(7)(a) as the “deduction component” of the deduction/non-inclusion mismatch – as the “deduction component of the hybrid financial instrument arrangement”. This allows the conditions for the application of subsection 18.4(4) to be satisfied, since that provision applies in respect of the deduction component of a “hybrid mismatch arrangement” (which is defined in subsection 18.4(1) to include a hybrid financial instrument arrangement).

Paragraph 18.4(11)(c) similarly links subsection 18.4(10) with the operative rule in subsection 12.7(3), by labelling any foreign income tax deduction in respect of a payment arising under a hybrid financial instrument arrangement as the “foreign deduction component” of the arrangement. This allows the condition in paragraph 12.7(2)(b) to be satisfied, resulting in an income inclusion under subsection 12.7(3) to the extent of the amount of the hybrid financial instrument mismatch.

Hybrid transfer arrangement – conditions

ITA
18.4(12)

New subsection 18.4(12) sets out the conditions for determining if a payment arises under a hybrid transfer arrangement.

A hybrid transfer arrangement is essentially a transaction or series of transactions involving a transfer of a financial instrument, where a deduction/non-inclusion mismatch (as determined under subsection 18.4(6)) typically results from different entities being treated as the owner of returns on the transferred instrument under the tax laws of different countries.

While hybrid transfer arrangements involve financial instruments, they differ from hybrid financial instrument arrangements in that the deduction/non-inclusion mismatches resulting from

hybrid transfer arrangements typically are not caused by differences in the characterization or treatment of financial instruments, which may be characterized and treated the same way under the tax laws of all relevant countries. Rather, the mismatch typically results from a difference, under the tax laws of two or more countries, in the treatment of the transfer of the financial instrument or the series of transactions that includes the transfer, or of certain payments connected with the transfer or series.

The BEPS Action 2 Report treats hybrid transfers as a category of hybrid financial instrument on the basis that hybrid transfers can be viewed, in substance, as financial instruments rather than asset transfers. A sale and repurchase (or "REPO") transaction, for example, can be viewed as a loan in substance. The approach under the hybrid mismatch rules in section 18.4 differs in form from the BEPS Action 2 Report in that, rather than subsume hybrid transfers into hybrid financial instruments, subsections 18.4(12) and (13) provide separate rules for hybrid transfer arrangements, including distinct causal (or "hybridity") tests.

Although subsection 18.4(12) applies to other types of transfer arrangements resulting in deduction/non-inclusion mismatches, it is particularly targeted at REPOs and securities lending transactions, where the transfer generally does not materially alter the transferor's economic exposure with respect to the transferred instrument.

A payment is considered to arise under a hybrid transfer arrangement if four conditions are met and the payment is not an exempt dealer compensation payment. For more information, see the commentary on the definition "exempt dealer compensation payment" in subsection 18.4(1).

The first condition, in paragraph 18.4(12)(a), requires that the payment arise under, or in connection with, either a transaction or series of transactions (referred to as a "transfer arrangement") that includes the transfer of a financial instrument, or the transferred instrument itself. The transfer can take any form, including a loan of a financial instrument.

A payment that compensates a transferor (or an entity that does not deal at arm's length with a transferor) for a return (e.g., a dividend) under a transferred instrument is considered to arise under or in connection with a transfer arrangement. The application of subsection 260(2) to a "securities lending arrangement" (within the meaning of subsection 260(1)) would not affect this result. While that subsection deems certain securities to not to be disposed of by the transferor, these financial instruments are nevertheless considered to be loaned or transferred under such arrangements, such that the compensation payment arises under or in connection with a transfer arrangement.

Consideration paid to acquire a transferred instrument is also considered to arise under or in connection with a transfer arrangement. Further, since "transfer arrangement" is broadly defined to encompass a series of transactions that includes a transfer of a financial instrument, consideration paid for the repurchase of a transferred instrument under a REPO, for example, also constitutes a payment under or in connection with a transfer arrangement.

For information on when a payment is considered to arise under or in connection with a transferred instrument, see the commentary on the definition of "payment" in subsection 18.4(1) and on subsection 18.4(10).

The second condition, in paragraph 18.4(12)(b), requires either that a relationship test be met or that there is a structured arrangement.

The relationship test is satisfied if either the payer and the recipient, or the transferor and transferee: (i) do not deal at arm's length with one another, or (ii) are "specified entities" in respect of one another. For further information, see the commentary on the definition of "specified entity" in subsection 18.4(1) and on paragraph 18.4(10)(b).

The relevant relationships are tested throughout the period beginning with the first transaction or event in the series of transactions that includes the transfer of the transferred instrument, and ending with the last such transaction or event. Depending on the facts and circumstances, the relevant period may begin, for example, at the time of the structuring of the transfer arrangement and may end at the time the payment arises or beyond.

The term "structured arrangement" is defined in subsection 18.4(1) and essentially means an arrangement where the deduction/non-inclusion mismatch is priced into the terms or conditions of the arrangement, or that is otherwise designed to produce such a mismatch. For more information, see the commentary on that definition in subsection 18.4(1).

Consistent with example 1.33 in the BEPS Action 2 Report, a hybrid transfer arrangement is unlikely to be a structured arrangement if the parties are left in the same after-tax position as if the transaction had not been entered into. In the context of a securities lending transaction, this may occur, for example, if the payer of a compensation payment in respect of an underlying return is taxable on the underlying return. As discussed below, however, the fact of the payer being taxable on the underlying return is not a relevant consideration in determining whether the hybrid transfer arrangement rule applies in the case of an arrangement between parties that satisfy a relationship test in subparagraph 18.4(12)(b)(i); in particular, that fact is not relevant in determining whether the arrangement gives rise to a deduction/non-inclusion mismatch.

The third condition, in paragraph 18.4(12)(c), requires that the payment give rise to a deduction/non-inclusion mismatch. This condition can be met even if the entity entitled to a deduction in respect of the payment is not the payer, since subsection 18.4(6) tests whether an amount would be deductible in respect of the payment, without regard to the identity of the deducting entity. This differs from subsection 113(5), which restricts a taxpayer's deduction in respect of a dividend received from a foreign affiliate only if it results in a foreign tax deduction in computing the affiliate's income or profits (or a foreign deduction to another entity because of a direct or indirect equity interest in the affiliate). This distinction is relevant, for example, in the case of a REPO, under which an amount in respect of a dividend payment on a transferred financial instrument may be deductible (as a financing expense) by the transferor rather than the issuer, with the result that the REPO may meet the condition in paragraph 18.4(12)(c) but not the requirements of subsection 113(5).

In determining whether a payment gives rise to a mismatch, not all amounts included, in respect of the payment, in income that is subject to foreign tax are taken into consideration. For example, in the context of a REPO, any amounts included in the foreign taxable income of a foreign transferor of a financial instrument, in respect of dividends received by the transferee on the instrument, are not relevant to the determination of the mismatch, since the transferor is not a recipient of the dividends and thus does not have "foreign ordinary income" (as defined in subsection 18.4(1)) in respect of the dividend payments. Moreover, the transferor under a REPO would generally be the entity entitled to a deduction in respect of the dividends, and under subparagraph (ii) of variable D of paragraph 18.4(6)(b), the entity entitled to a foreign income tax deduction in respect of the payment cannot have foreign ordinary income in respect of the payment.

Similarly, the determination of whether a mismatch arises from a payment by a transferee that compensates a transferor for an underlying return on a transferred instrument would not take into consideration any inclusion in the transferee's Canadian ordinary income or foreign ordinary income in respect of the underlying return. Such an inclusion is not in respect of the payment but rather in respect of the underlying return. This approach to the mismatch determination is consistent with the principle in the BEPS Action 2 Report that whether a payment gives rise to an inclusion in ordinary income should be determined without regard to whether the parties are taxable on the return on a transferred financial instrument, or whether funds obtained from the transfer have been invested in assets that generate a taxable return.

The fourth condition, in paragraph 18.4(12)(d), sets out three causal tests, each of which in effect assesses whether the deduction/non-inclusion mismatch results from the "hybridity" of the arrangement. It is met if any of the three causal tests is satisfied. To satisfy a particular causal test, it need only be "reasonable to consider" that all or part of the mismatch arises for a reason described in the particular test. It is intended that this determination be made based on how instruments and arrangements with terms and conditions similar to those of the transferred instrument and the transfer arrangement, respectively, and payments under such instruments and arrangements, would reasonably be expected to be treated under the relevant tax laws. This approach is similar to the determination, under subsection 18.4(6), of whether an amount in respect of a payment can reasonably be expected to be deductible for foreign income tax purposes or included in an entity's foreign ordinary income.

The parenthetical in the opening words of paragraph 18.4(12)(d) provides a "multiple causation" rule, the effect of which is that any causal test in the paragraph is met if it can reasonably be considered that all or part of the mismatch would satisfy the causal test if all other reasons for the mismatch were disregarded. For more information, see the commentary on paragraph 18.4(10)(d), which contains a similar rule.

The first causal test, in subparagraph 18.4(12)(d)(i), is aimed particularly at compensation payments under securities lending transactions. Generally under these arrangements, a transferee acquires a transferred financial instrument, and agrees to return it (or an identical property) at a later date and to compensate the transferor for underlying returns under the transferred instrument that arise over the course of the arrangement. These arrangements include, but are not limited to, "securities lending arrangements" within the meaning of subsection 260(1).

Subparagraph 18.4(12)(d)(i) is satisfied, in relation to a securities lending transaction, if a payment compensates for an underlying return under the transferred instrument and one country treats the compensation payment as a deductible expense but another country treats it as if it were the underlying return, with the result that a recipient of the compensation payment is effectively not taxable on the payment in the other country. A typical example is where a transferee makes a deductible compensation payment to a transferor for dividends received by the transferee on transferred shares, and the country where the transferor is resident exempts the compensation payment from tax as though it were a dividend.

To satisfy this causal test, it is sufficient that the tax laws of the other country treat the compensation payment as though it has the same character as, or represents, the underlying return; it is not necessary that the tax laws actually recharacterize the compensation payment or the transfer arrangement.

The second causal test, in clause 18.4(12)(d)(ii)(A), is met if the deduction/non-inclusion mismatch results because one country's tax laws treat one or more transactions in the transfer arrangement, either alone or together, as a borrowing or other indebtedness – or treat all or a portion of the payment as arising under or in connection with a borrowing or other indebtedness – and another country's tax laws do not treat those transactions or the payment, as the case may be, in that way. This test is aimed particularly at REPOs. Generally under these arrangements, a transferor sells a financial instrument to a transferee but concurrently agrees to repurchase it for a repurchase price that exceeds the original purchase price. Where the transferee is not required to compensate the transferor for returns (e.g., dividends) received by the transferee on the instrument, the repurchase price may be reduced by the amount of the returns retained by the transferee.

In the case of a REPO, the tax laws of the country in which the transferor is resident may treat the arrangement as a borrowing secured by the transferred instrument, in accordance with its "economic substance". Thus, under those tax laws, the transferor may be considered to beneficially own, for example, dividends received by the transferee on the transferred instrument and may be entitled to a financial expense deduction corresponding to the dividends. In contrast, the tax laws of the country where the transferee is resident may treat the transfer arrangement as an asset transfer, in accordance with its legal form, and the transferee as the beneficial owner of the transferred instrument and the dividends on that instrument. If the dividends received by the transferee are exempt from tax (or eligible for other tax relief), the arrangement may give rise to a deduction/non-inclusion mismatch that meets the second causal test, in clause 18.4(12)(d)(ii)(A).

The second causal test is not limited to payments under the transferred instrument. Payments that do not represent returns on the instrument, but are payments under the transfer arrangement itself, also stand to be tested to the extent they give rise to a deduction/non-inclusion mismatch. For example, in the case of a REPO, this could occur if the tax laws of one country allow the transferor a deduction to the extent the repurchase price exceeds the original purchase price, on the basis that the transfer arrangement is in substance a borrowing, and the tax laws of another

country do not view the transfer arrangement in this way and thus treat the transferee as having a capital gain on the sale of shares that is not fully taxable.

The final causal test, in clause 18.4(12)(d)(ii)(B), tests whether the deduction/non-inclusion mismatch arises because the tax laws of different countries take differing views as to who "derives" (i.e., beneficially owns) a payment arising under or in connection with the transfer arrangement or transferred instrument. This test is only met if the reason the countries treat different entities as deriving a given payment is due to a difference in how they treat one or more transactions included in the transfer arrangement. This ensures mismatches that are solely attributable to differences in how countries classify entities (i.e., "hybrid entities") are not addressed under the hybrid transfer arrangement rule.

The causal test in clause 18.4(12)(d)(ii)(B) is closely modelled on the causal test for hybrid transfers recommended in the BEPS Action 2 Report. It is a "residual" test that addresses arrangements that may not meet the requirements of the other two causal tests, which contain conditions that do not correspond to the causal test recommended in the BEPS Action 2 Report and are tailored to reflect the specific features of certain securities lending transactions and REPOs. Many arrangements that satisfy the first or second causal test would also be expected to satisfy this residual test.

Example

Assumptions

- Forco 1 is the sole shareholder of Forco 2. Forco 1 and Forco 2 are corporations that are resident for income tax purposes in Country X, a country with which Canada has a tax treaty, and controlled foreign affiliates of a corporation resident in Canada (Canco).
- Forco 1 and Canco enter into a series of transactions under which:
    - Forco 1 sells shares of Forco 2 to Canco for $100 million;
    - Forco 1 agrees to repurchase the shares of Forco 2 for $110 million one year after selling them to Canco (the Repurchase Date);
    - Canco will retain dividends paid on the shares of Forco 2 during the period when Canco holds the shares and is not obligated to compensate Forco 1 for these dividends; and
    - The repurchase price is reduced by the amount of any such dividends.
- Prior to the Repurchase Date, Forco 2 pays a $10 million dividend to Canco on the transferred shares.
- On the Repurchase Date, Forco 1 repurchases the transferred shares for $100 million (i.e., the repurchase price of $110 million minus the $10 million dividend received by Canco).
- Under the income tax laws of Country X:
    - The series of transactions is treated as a loan from Canco to Forco 1 that is secured by the transferred shares of Forco 2;
    - Forco 1 is considered to retain beneficial ownership of the transferred shares and the dividend;
    - Forco 1 is treated as having a $10 million deductible interest expense in respect of the dividend paid by Forco 2 to Canco.

- Although there are certain provisions and doctrines in Canadian income tax law that may result in Canco's tax treatment being otherwise, Canco takes the position in its income tax return that, under Canadian income tax law:
    - $10 million is included in Canco's income under subsection 90(1), in respect of the dividend; and
    - all $10 million of the dividend is prescribed to have been paid out of Forco 2's exempt surplus in respect of Canco, such that Canco may deduct $10 million under paragraph 113(1)(a) in computing its taxable income.

Analysis

All the conditions in subsection 18.4(12) are met, with the result that the dividend paid by Forco 2 to Canada is considered to arise under a hybrid transfer arrangement.

The condition in paragraph 18.4(12)(a) is met. There is a "transfer arrangement", being the series of transactions that includes the transfer of the shares of Forco 2 (which is a financial instrument) by Forco 1 to Canco. The dividend is a payment arising under the transferred instrument.

The condition in subparagraph 18.4(12)(b) is met because Forco1, the transferor, does not deal at arm's length with Canco, the transferee. (This condition is also met because Forco2, the dividend payer, does not deal at arm's length with Canco, the dividend recipient.)

The condition in paragraph 18.4(12)(c) is met because the dividend gives rise to a deduction/non-inclusion mismatch, as determined under subsection 18.4(6). Specifically, Forco 1 is entitled to a $10 million interest deduction in Country X because of the dividend, and Canco has no "Canadian ordinary income" (as defined in subsection 18.4(1)) in respect of the dividend because it files its tax return on the basis it is entitled to a deduction under paragraph 113(1)(a). Any amounts included in respect of the dividend in computing Forco 1's income that is subject to tax in Country X would not constitute "foreign ordinary income" because: (1) Forco 1 is not a recipient of the dividends; and (2) subparagraph (ii) of variable D of paragraph 18.4(6)(b) requires that the entity with foreign ordinary income must be different from the one that is entitled to a foreign income tax deduction in respect of the payment.

As determined under paragraph 18.4(7)(c), the amount of the deduction/non-inclusion mismatch is $10 million, being the amount by which Forco 1's $10 million deduction in Country X exceeds nil, which is the total Canadian ordinary income and foreign ordinary income in respect of the dividend.

The causal test in clause 18.4(12)(d)(ii)(A) is met because Country X tax law treats certain transactions, which are included in the series that is the transfer arrangement, together as a borrowing or other financing, while Canco files on the basis that Canadian tax law does not treat them as such. Alternately, the causal test is met because, by treating the dividend as giving rise to an interest expense, Country X law treats the dividend as though it arises under a borrowing or other indebtedness, while Canco files on the basis that Canadian tax law does not.

Accordingly, the dividend arises under a hybrid transfer arrangement, and thus under a hybrid mismatch arrangement for the purposes of sections 12.7 and 18.4. The $10 million income tax deduction in Country X is a "foreign deduction component" of the hybrid mismatch arrangement. Thus, the conditions in subsection 12.7(2) for the application of subsection 12.7(3) in respect of the dividend are met. Notably, subsection 113(5) does not apply to deny Canco's deduction under paragraph 113(1)(a), since Forco 1's deduction under Country X income tax law does not arise because Forco 1 has an equity interest in Forco 2, but rather because Country X treats Forco 1 as the beneficial owner of the dividends paid by Forco 2.

Consequently, subsection 12.7(3) includes $10 million in Canco's income. This amount is the hybrid mismatch amount in respect of the dividend, as determined under paragraph 18.4(13)(a), since the entire $10 million deduction/non-inclusion mismatch arises because Country X law treats the transfer arrangement as a borrowing or other indebtedness.

Hybrid transfer mismatch – amount

ITA
18.4(13)

New subsection 18.4(13) is relevant in determining the extent to which the operative hybrid mismatch rules restrict a deduction, or include an amount in income, in respect of a payment arising under a hybrid transfer arrangement. It also provides rules that act as a "bridge" between subsection 18.4(12) and the operative hybrid mismatch rules.

Subsection 18.4(13) performs an analogous function in the context of the rules on hybrid transfer arrangements to that performed by subsection 18.4(11) in the context of the rules on hybrid financial instrument arrangements, with paragraphs (a) to (c) of subsection 18.4(13) being analogous to the corresponding paragraphs in subsection 18.4(11). Accordingly, the commentary on subsection 18.4(11) applies equally with respect to subsection 18.4(13), with such modifications as the context requires (in particular, substituting references to the causal test in paragraph 18.4(12)(d) for references in that commentary to the causal test in paragraph 18.4(10)(d)).

Substitute payment arrangement – conditions

ITA
18.4(14)

New subsection 18.4(14) sets out the conditions to determine if a payment arises under a substitute payment arrangement.

The rules on substitute payment arrangements, in subsections 18.4(14) and (15), address certain arrangements that, absent those subsections, would undermine the integrity of the rules on hybrid financial instrument arrangements and hybrid transfer arrangements, or foreign hybrid mismatch rules. The deduction/non-inclusion mismatch arising from a payment under a substitute payment arrangement, however, need not necessarily be "hybrid" in nature (i.e., the mismatch need not be

attributable to a difference in how two countries treat the arrangement based on the terms and conditions of the arrangement or a financial instrument). In general terms, these arrangements involve a transfer of a financial instrument, where a payment made under, or in connection with, the transfer functions as a substitute for certain returns under the financial instrument.

Where a payment is considered to arise under a substitute payment arrangement (and thus under a "hybrid mismatch arrangement", as defined in subsection 18.4(1)), the mismatch otherwise resulting from the payment is neutralized under the operative hybrid mismatch rules. More specifically, if the payment is otherwise deductible for Canadian income tax purposes, subsection 18.4(4) restricts all or a portion of the deduction. If the payment is deductible for foreign income tax purposes, subsection 12.7(3) includes an amount in a recipient taxpayer's income.

A payment is considered to arise under a substitute payment arrangement if all the conditions in subsection 18.4(14) are met.

The first condition, in paragraph 18.4(14)(a), requires that the payment arise under or in connection with an arrangement under which a financial instrument is disposed of, loaned or otherwise transferred. The scope is sufficiently broad to include, for example, consideration paid or payable for the acquisition of the instrument, or a payment made by the transferee to the transferor as compensation for an underlying return under the transferred instrument. The terms "payment" and "financial instrument" are defined in subsection 18.4(1).

The second and third conditions, in paragraphs 18.4(14)(b) and (c), require that the transferee (or an entity non-arm's length with the transferee) and transferor (or an entity non-arm's length with the transferor) of the instrument be the payer and recipient of the payment, respectively. These conditions ensure that subsection 18.4(14) focusses on payments that are relatively closely connected with the transfer of the instrument.

The fourth condition, in paragraph 18.4(14)(d), essentially tests whether the payment is a substitute payment. It requires that all or a portion of the payment can reasonably be considered to represent or otherwise reflect, or be determined by reference to:

- a payment (referred to as an "underlying return") that arises under, or in connection with, the transferred instrument; or
- revenue, profit, cash flow, commodity price or a similar criterion.

This condition is generally met if either: (1) it is, as a matter of fact, reasonable to consider that this is the case; or (2) the tax laws of the country of the transferee or the transferor treat the payment in this manner.

A payment arises "under, or in connection with," the transferred instrument if the terms or conditions of the instrument create the obligation to pay, credit or confer the payment (e.g., a dividend on a share or an interest coupon on a debt), or if the payment is consideration for a release from an obligation under the instrument.

Subparagraph 18.4(14)(d)(ii) describes amounts that are economically equivalent to, or proxies for, an equity return in that they are determined by reference to revenue, profit, cash flow, commodity price or any other similar criterion. This would be relevant, for example, if a transferor disposes of shares of a corporation to a transferee, and the transferee has a contingent obligation to pay an additional amount of consideration based on the corporation's earnings. If the purchase price is adjusted accordingly, the additional consideration is described in subparagraph 18.4(14)(d)(ii), as it represents or otherwise reflects, or is determined by reference to, profit.

The fifth condition, in paragraph 18.4(14)(e), requires that either a relationship test be met or there is a structured arrangement.

The relationship test under subparagraph 18.4(14)(e)(i) is satisfied if the payer and the recipient of the substitute payment – or the transferor and transferee of the transferred instrument – either do not deal at arm's length with one another, or are "specified entities" in respect of one another. For further information, see the commentary on paragraph 18.4(10)(b) and the "specified entity" definition.

The term "structured arrangement", as referred to in subparagraph 18.4(14)(e)(ii), is defined in subsection 18.4(1) and essentially means an arrangement where the deduction/non-inclusion mismatch is priced into the terms or conditions of the arrangement, or that is otherwise designed to produce such a mismatch. For more information, see the commentary on that definition in subsection 18.4(1).

The sixth condition, in paragraph 18.4(14)(f), focusses on whether the substitute payment gives rise to a deduction/non-inclusion mismatch.

In determining if this condition is met, subparagraph 18.4(14)(f)(i) asks if the substitute payment would give rise to a deduction/non-inclusion mismatch if any Canadian ordinary income and any foreign ordinary income, in respect of the substitute payment, were limited to the portion of those amounts that can reasonably be considered to relate to the portion of the substitute payment that represents, or otherwise reflects, or is determined by reference to, an underlying return or a criterion in subparagraph 18.4(14)(d)(ii). This limitation ensures that the deduction/non-inclusion mismatch is determined only by reference to the portion of a payment that is a substitute payment.

For example, assume $10 of a $100 payment from a Canadian transferee to a non-resident transferor represents an underlying return, and the transferor has $50 of foreign ordinary income in respect of the payment. In this case, only $5 of the transferor's foreign ordinary income can reasonably be considered to relate to the portion of the payment that constitutes the substitute payment. As a result, the mismatch is measured on the basis the transferor has $5 of foreign ordinary income in respect of the payment.

The condition in paragraph 18.4(14)(f) can be met in certain circumstances where a substitute payment does not in fact give rise to a deduction/non-inclusion mismatch, but an amount is deductible to the transferee in respect of the underlying return on the transferred instrument. In

this regard, subparagraph 18.4(14)(f)(ii) sets out a hypothetical test, asking if the condition in subparagraph 18.4(14)(f)(i) would be met if an amount that is deductible in respect of the underlying return were instead deductible in respect of the substitute payment. These deductible amounts are, however, relevant only if they are deductible by the transferee because the underlying return accrues (or is considered to accrue) before the transfer of the financial instrument. This would be the case, for example, where a debt instrument bearing accrued interest is transferred, and the transferee is entitled to a deduction when the accrued interest is paid or payable to the transferee.

The seventh condition, in paragraph 18.4(14)(g), broadly describes the three scenarios in which a deduction/non-inclusion mismatch arising from a substitute payment would, in the absence of the rules on substitute payment arrangements, undermine the integrity of the hybrid mismatch rules or a foreign hybrid mismatch rule.

The first such scenario is covered by subparagraphs 18.4(14)(g)(i) and (ii), which, in general terms, target cases where a substitute payment is deductible by the transferee but the underlying return is not fully included in its Canadian ordinary income or foreign ordinary income (or would not be so included, were the transferee a recipient of the underlying return). This contrasts with the approach under the rule on hybrid transfer arrangements in subsection 18.4(12), which applies regardless of whether an underlying return is taxable.

More specifically, subparagraph 18.4(14)(g)(i) is relevant if the transferee (or an entity non-arm's length with the transferee) is a recipient of the underlying return or, if the substitute payment is determined by reference to any of the criteria in subparagraph 18.4(14)(d)(ii), a distribution under the transferred instrument. The condition in subparagraph 18.4(14)(g)(i) is met if the amount of the underlying return or the distribution, as the case may be, exceeds the total of the Canadian ordinary income and foreign ordinary income of the recipient that would reasonably be expected to arise – and actually does arise – from the underlying return or the distribution, respectively. For more information on the "reasonably be expected" test, see the commentary on subsection 18.4(6), which uses a similar concept.

If the condition in subparagraph 18.4(14)(g)(i) is not met (e.g., because neither the transferee, nor an entity non-arm's length with the transferee, is a recipient of the underlying return or distribution under the transferred instrument), subparagraph 18.4(14)(g)(ii) becomes relevant. It is met if the condition in subparagraph 18.4(14)(g)(i) would have been met had the transferee been a recipient of the underlying return or a distribution under the transferred instrument, as the case may be.

While the tests in subparagraphs 18.4(14)(g)(i) and (ii) focus on the transferee, those in subparagraph 18.4(14)(g)(iii) focus on the transferor. They essentially cover the two additional scenarios where substitute payment arrangements raise integrity concerns with respect to the hybrid mismatch rules.

Clause 18.4(14)(g)(iii)(A) addresses the scenario where, by transferring the financial instrument and receiving the substitute payment, the transferor obtains a more favourable income tax outcome than if it had retained the instrument and received the underlying return or, where

subparagraph 18.4(14)(d)(ii) applies, a distribution under the instrument. More specifically, this condition is met if the receipt of the underlying return or distribution, as the case may be, by the transferor would reasonably be expected to result in foreign ordinary income or Canadian ordinary income of the transferor.

Clauses 18.4(14)(g)(iii)(B) and (C) address the scenario where, absent the rules on substitute payment arrangements, the transfer of the financial instrument would effectively enable the avoidance of the hybrid mismatch rules or a foreign hybrid mismatch rule. The condition in clause 18.4(14)(g)(iii)(B) is met if the underlying return (or, where subparagraph 18.4(14)(d)(ii) applies, a distribution under the transferred instrument) would have arisen under a hybrid mismatch arrangement had the transferor been a recipient of the underlying return (or the distribution). The condition in clause 18.4(14)(g)(iii)(C) is met if a foreign hybrid mismatch rule would reasonably have been expected to apply in respect of the underlying return (or, where subparagraph 18.4(14)(d)(ii) applies, a distribution under the transferred instrument) had the transferor been a recipient of the underlying return (or the distribution). This test is met if a foreign hybrid mismatch rule would have restricted a foreign income tax deduction, included an amount in "relevant foreign income or profits" (as defined in subsection 18.4(1)) or restricted a participation exemption (or other tax relief) in respect of a dividend.

The final condition, in paragraph 18.4(14)(h), in general terms requires that some entity in respect of the arrangement is not resident in Canada. This is consistent with the hybrid financial instrument rule in subsection 18.4(10) and the hybrid transfer rule in subsection 18.4(12), which in effect only apply to cross-border arrangements because of the causal tests set out in those rules.

Substitute payment mismatch – amount

ITA
18.4(15)

New subsection 18.4(15) is relevant in determining the extent to which the operative hybrid mismatch rules restrict a deduction, or include an amount in income, in respect of a payment arising under a substitute payment arrangement. It also provides rules that act as a "bridge" between subsection 18.4(14) and the operative hybrid mismatch rules.

Paragraph 18.4(15)(a) determines the amount of the substitute payment mismatch, which is also a "hybrid mismatch amount" (as defined in subsection 18.4(1)). This is the amount that is included in income under subsection 12.7(3), or the amount by which a deduction is restricted under subsection 18.4(4), as the case may be, with respect to a payment arising under a substitute payment arrangement. The amount of the substitute payment mismatch is the lesser of:

- the amount of the deduction/non-inclusion mismatch arising from the payment; and
- the portion of the payment described in paragraph 18.4(14)(d). This refers to the portion (which can be the entire payment, depending on the facts) that can reasonably be considered to represent or otherwise reflect, or be determined by reference to, either an

underlying return on the transferred financial instrument or one of the criteria listed in subparagraph 18.4(14)(d)(ii), as the case may be.

For these purposes, the amount of the deduction/non-inclusion mismatch arising from the payment is determined under paragraph 18.4(7)(c), but is based on the assumptions in paragraph 18.4(14)(f). Thus, the same hypothetical tests that apply in determining under subparagraph 18.4(14)(f)(i) or (ii) if a deduction/non-inclusion mismatch arises from a payment also apply in determining the amount of the deduction/non-inclusion mismatch. For more information, see the commentary on paragraph 18.4(14)(f).

Paragraphs 18.4(15)(b) and (c) perform an analogous function in the context of the rules on substitute payment arrangements to that performed by paragraphs 18.4(11)(b) and (c), respectively, in relation to hybrid financial instrument arrangements. Accordingly, the commentary on paragraphs 18.4(11)(b) and (c) applies equally with respect to paragraphs 18.4(15)(b) and (c), with such modifications as the context requires.

Paragraph 18.4(15)(d) applies where subparagraph 18.4(14)(f)(ii) applies. That subparagraph generally applies where a substitute payment represents an underlying return under a financial instrument and an amount is deductible by the transferee in respect of the underlying return because the return accrues before the instrument is transferred.

Where applicable, paragraph 18.4(15)(d) deems, for the purposes of the hybrid mismatch rules in section 12.7 and subsections 18.4(3) and (4), the amount deductible by the transferee in respect of the underlying return to instead be deductible by the transferee in respect of the substitute payment. This is intended to ensure, for example, that subsection 18.4(4) can apply to restrict a Canadian-resident transferee’s deduction in respect of the underlying return, notwithstanding that the deduction is not actually in respect of the substitute payment itself.

Substituted instruments

ITA
18.4(16)

New subsection 18.4(16) ensures that taxpayers cannot avoid the hybrid mismatch rules by replacing one financial instrument with another. This rule does not contain an “avoidance purpose” test, but rather applies without regard to the reason for the substitution.

This rule ensures, for example, that the rules on hybrid transfer arrangements are not avoided by virtue of a different financial instrument being substituted for a transferred instrument at a time after the transfer and before any payments are made on or in respect of the instrument. In these circumstances, the substitution will not result in a failure to meet the causal test in paragraph 18.4(12)(d), since a payment made on, or as compensation for a return on, the substituted instrument will be considered to be made on, or as compensation for a return on, the transferred instrument.

It is intended that the provisions in subsection 248(5), which include a rule applicable in the case of a succession of substitutions of property, apply in connection with subsection 18.4(16).

Specified entity – deeming rules

ITA
18.4(17)

The deeming rules in new subsection 18.4(17) apply for the purposes of the definition "specified entity" in subsection 18.4(1).

Subject to paragraph 18.4(17)(b), paragraph 18.4(17)(a) deems certain rights, including contingent or future rights, to have been exercised by an entity (referred to as the "first entity") in relation to another entity when determining its equity interest owned, directly or indirectly, in the other entity.

In general terms, pursuant to the definition "specified entity", two entities will be treated as specified entities if one entity, directly or indirectly, has a 25% equity investment in the other entity, or a third entity, directly or indirectly, has a 25% equity investment in both. For the purpose of determining whether the 25% threshold has been met, by virtue of paragraph 18.4(17)(a), an entity is, in effect, deemed:

- To own any shares or control any voting rights that the entity has the right to acquire or control. Further, any shares that the entity has the right to require a corporation to redeem, acquire or cancel (other than shares held by the entity or non-arm's length persons) are considered to have been so redeemed, acquired or cancelled.
- To have exercised any rights to acquire beneficial interests in a trust. Further, any beneficial interests that the entity has the right to require a trust to redeem, acquire or terminate (other than those held by the entity or non-arm's length persons) are considered to have been so redeemed, acquired or terminated. Where an entity has a discretionary interest in a trust, subparagraph 18.4(17)(a)(ii) ensures that, in determining whether the 25% threshold has been met, the entity is considered to have the maximum possible interest it could have in the trust if the discretion were exercised.
- To own any similar interests or control any similar rights in respect of a partnership or any other entity that it has the right to acquire or control. Any interests that the entity has the right to require the partnership or other entity to redeem, acquire or terminate (other than those held by the entity or non-arm's length persons) are considered to have been so redeemed, acquired or terminated.

These deeming rules also apply to rights held by persons not dealing at arm's length with the entity.

Paragraph 18.4(17)(b) ensures that, notwithstanding paragraph 18.4(17)(a), two entities are not specified entities in respect of each other solely because a security interest is granted in respect of the shares of an entity in the ordinary course of a debt transaction.

Tiered partnerships

ITA
18.4(18)

New subsection 18.4(18) provides a "look-through" rule to deal with cases where a partnership (i.e., an upper-tier partnership) is a member of another partnership (i.e., a lower-tier partnership), for the purposes of determining if a person or partnership is a member of the other partnership and the extent of the person or partnership's rights to the income or capital of the other partnership.

This subsection is mainly relevant to calculating the Canadian ordinary income in respect of a payment (as defined in subsection 18.4(1)) of a taxpayer that is a lower-tier partnership. The amount included in the partnership's Canadian ordinary income is limited to the share that is allocable to Canadian resident members of the partnership and non-resident members who are taxable in Canada on their relevant income from the partnership. For example, where a non-resident person is a member of an upper-tier partnership that holds a direct or indirect interest in the lower-tier partnership, the non-resident's share of the lower-tier partnership's income (determined on a "look-through" basis) will not contribute to Canadian ordinary income of the lower-tier partnership if the non-resident member is not taxable in Canada on that income. Similarly, a reduction in computing the lower-tier partnership's Canadian ordinary income will occur if an amount is deductible under section 112 or 113 by a member of the upper-tier partnership in respect of the payment of which the lower-tier partnership is a recipient.

Multiple recipients

ITA
18.4(19)

New subsection 18.4(19) applies, for the purposes of sections section 12.7 and 18.4, if there would otherwise be multiple recipients of a particular payment and operates to, in effect, split the particular payment into separate payments, each corresponding to the portion of the particular payment that arises to a particular recipient. By deeming each such portion of the particular payment to be a separate payment arising to a particular recipient for the purposes of the hybrid mismatch rules, each particular recipient is treated as being a recipient of an amount equal to its actual share of the particular payment. This ensures, for example, that the particular recipient does not have an excessive income inclusion under subsection 12.7(3), and that the determination of any hybrid mismatch amount in respect of a separate payment is based on the actual tax treatment of the recipient's corresponding portion of the particular payment.

This subsection is relevant especially in the case of fiscally transparent entities. For example, assume a $100 payment is made to an entity (which includes an arrangement) that is disregarded as a separate entity from its two equal investors for Canadian income tax purposes. The $100 payment is deemed, for the purposes of the hybrid mismatch rules, to be two $50 payments, one to each investor. Thus, in determining whether either of the deemed $50 payments gives rise to a

deduction/non-inclusion mismatch, amounts of Canadian ordinary income and foreign ordinary income are determined separately in respect of each deemed payment, and amounts deductible for Canadian or foreign income tax purposes in respect of the $100 payment are apportioned pro rata to each deemed payment. Accordingly, if the $100 payment is fully deductible to the payer, $50 is considered to be deductible in respect of each of the deemed $50 payments. If, for example, the deemed payment to one investor gives rise to a deduction/non-inclusion mismatch that is within the scope of the hybrid mismatch rules, but the deemed payment to the other investor does not, the hybrid mismatch rules will apply to neutralize the mismatch only with respect to the deemed payment to the first investor.

Anti-avoidance

ITA
18.4(20)

New subsection 18.4(20) is an anti-avoidance rule that is intended to prevent the avoidance of the hybrid mismatch rules. In general terms, it applies where one of the main purposes of a transaction or series of transactions is to avoid the application of subsection 12.7(3), 18.4(4) or 113(5), or to limit the consequences of any of those provisions, and certain other conditions are met. These other conditions are intended to capture situations that, in substance, meet the essential characteristics of hybrid mismatch arrangements, notwithstanding that one or more of the precise technical requirements of the rules is not met. Where applicable, subsection 18.4(20) is intended to ensure that a transaction is subject to the same consequences as if the avoided hybrid mismatch rule had applied.

The avoidance test in paragraph 18.4(20)(a) recognizes that there may be multiple main purposes for a transaction or series of transactions. For example, where one of the main purposes of a transaction or series is to avoid subsection 12.7(3), 18.4(4) or 113(5), other main purposes of the transaction or series may include avoiding the application of a foreign hybrid mismatch rule or obtaining some other foreign tax benefit; making or restructuring a cross-border investment; or reducing overall financing costs. The existence of any other main purpose does not preclude a concurrent main purpose of avoiding one of the hybrid mismatch rules.

As noted, the other conditions in subsection 18.4(20) are intended to capture the essential characteristics of hybrid mismatch arrangements, informed by the BEPS Action 2 Report. The first of these other conditions is that a payment gives rise to a deduction/non-inclusion mismatch, or an outcome that is substantially similar to a deduction/non-inclusion mismatch. It is intended that subsection 18.4(20) can apply, for example, where a payment gives rise to a deduction/non-inclusion mismatch (as determined under subsection 18.4(6)), but the taxpayer avoids another technical requirement of the hybrid mismatch rules. In addition, the reference to a "substantially similar" outcome is intended to capture cases where the technical requirements for a deduction/non-inclusion mismatch under subsection 18.4(6) are not met, but a transaction or series nonetheless gives rise to an outcome that is, in substance, the type of mismatch that the hybrid mismatch rules are, in policy terms, intended to prevent.

As provided under subsection 18.4(2), the intended policy rationale and the scope of the targeted mismatches are to be interpreted consistently with the BEPS Action 2 Report. In general terms, the targeted mismatches occur where the total amount "deductible" (which includes the extended meaning of that term in subsection 18.4(1)) in respect of a payment under Canadian or foreign income tax law exceeds the total resulting Canadian and foreign taxable income that is not effectively sheltered from income or profits tax.

The other condition, in paragraph 18.4(20)(b), reflects that, consistent with the BEPS Action 2 Report, the hybrid mismatch rules are intended to address deduction/non-inclusion mismatches only where they are caused by certain factors. Paragraph 18.4(20)(b) describes the types of deduction/non-inclusion mismatches or other outcomes that are within the scope of subsection 18.4(20). More specifically:

- Subparagraph 18.4(20)(b)(i) is relevant mainly for mismatches involving dividend payments by non-resident entities that avoid the technical requirements of subsection 113(5).
- Subparagraph 18.4(20)(b)(ii) reflects the policy that the hybrid mismatch rules (other than subsection 113(5)) generally target mismatches that result from differences in the income tax treatment of arrangements under the laws of two or more countries that are grounded in the terms or conditions of the arrangement. Although this subparagraph uses language similar to the "causal test" in paragraph 18.4(10)(d) of the rule on hybrid financial instrument arrangements, it is intended to apply more broadly, including to arrangements that avoid the rule on hybrid transfer arrangements in subsection 18.4(12).
- Subparagraph 18.4(20)(b)(iii) ensures that if the terms or conditions of a transaction or series were sufficient to cause the mismatch, the requirements of paragraph 18.4(20)(b) are met, regardless of any other reasons for the mismatch. This principle is reflected in the causal tests throughout the hybrid mismatch rules.

Where all the conditions of application are met, subsection 18.4(20) provides that the Minister shall determine the tax consequences of the transaction or series in order to deny a tax benefit, but only to the extent necessary to eliminate any deduction/non-inclusion mismatch or substantially similar outcome. For these purposes, the terms "tax consequences" and "tax benefit" are defined in subsection 245(1). The intention is that the tax consequences of the transaction are, in effect, those that would have resulted had the avoided hybrid mismatch rule applied, since the general effect of subsections 12.7(3), 18.4(4) and 113(5) is to eliminate a mismatch. For example, if subsection 18.4(20) applies in respect of a payment by a resident of Canada to a non-resident that is deductible for Canadian income tax purposes, the tax benefit to be denied is the Canadian tax deduction, to the extent of the mismatch resulting from a factor set out in paragraph (b).

Filing requirement

ITA
18.4(21)

New subsection 18.4(21) requires taxpayers to file in their return of income for a taxation year a prescribed form containing prescribed information, if the primary operative rule in subsection 18.4(4) or the secondary operative rule in subsection 12.7(3) applies in respect of a payment in computing income for the year.

Clause 9

Adjustment for hybrid mismatch

ITA
20(1)(yy)

New paragraph 20(1)(yy) provides a deduction in computing a taxpayer's income for a taxation year from a business or property, generally where:

- Subsection 18.4(4) has applied to deny the taxpayer a deduction in respect of a payment for the year or a preceding taxation year, and
- The taxpayer demonstrates (by providing the relevant foreign tax returns and any other relevant supporting documentation to the Canada Revenue Agency) that an amount is foreign ordinary income of an entity in respect of the payment for a foreign taxation year that ends within 12 months of the end of the taxpayer's year for which the amount is deducted under paragraph 20(1)(yy). To prevent double counting, this amount of foreign ordinary income must not have already been taken into account in determining the deduction/non-inclusion mismatch, and thus the denial under subsection 18.4(4), in the first instance, nor in determining the amount of a previous deduction under paragraph 20(1)(yy).

The computation of the deductible amount, under subparagraph 20(1)(yy)(i), ensures that, where there are multiple applications of paragraph 20(1)(yy), the total amount deductible under this paragraph cannot exceed the amount of the deduction originally denied under subsection 18.4(4).

In addition, subparagraph 20(1)(yy)(ii), by deeming the deduction under paragraph 20(1)(yy) to be in respect of the payment, ensures the deduction takes the character of the payment. Thus, if the payment in question is treated as interest for Canadian income tax purposes, for example, an amount that is deductible in respect of the payment by virtue of paragraph 20(1)(yy) will still be subject to any other applicable restrictions in the Act, such as the thin capitalization rules and the excessive interest and financing expenses limitation in section 18.2.

There are several different circumstances where a deduction may be available under paragraph 20(1)(yy). For example, if a deduction/non-inclusion mismatch arises from a payment in the narrow circumstances where the hybrid mismatch rules apply in respect of timing differences (e.g., where an amount is deductible by a taxpayer in Canada when the payment accrues, but is not included in foreign ordinary income of a recipient until it is actually paid, and this difference in treatment is related to the terms and conditions of the arrangement), paragraph 20(1)(yy) may allow a deduction for an amount of foreign ordinary income arising in a later foreign tax year.

Deductions may also be available under paragraph 20(1)(yy) where, following a denial of a deduction in respect of a payment under subsection 18.4(4), a foreign tax authority is successful in reassessing a non-resident recipient of the payment to include an amount in its income subject to foreign income tax (although, if the taxation year for which the deduction was denied in the first instance remains open, alternatively, the taxpayer may be able to amend its return for that year and take the deduction on the basis that there was no deduction/non-inclusion mismatch in the first place and thus the hybrid mismatch rules did not apply).

Paragraph 20(1)(yy) applies in the context of the primary hybrid mismatch rule, in subsection 18.4(4), which denies a taxpayer a deduction in respect of a payment. There is no analogous rule applicable in the context of the secondary rule, in subsection 12.7(3), which includes an amount in income in respect of a payment arising under or in connection with a hybrid mismatch arrangement. Notably, however, where an amount is included in a taxpayer's income under subsection 12.7(3), for example in the case of a timing mismatch, subsections 12(3) and 248(28) should generally prevent the same amount from being included in income in respect of the same payment for a subsequent taxation year.

Clause 10

General rules

ITA
40(1)(a)(iii)

Subparagraph 40(1)(a)(iii) is amended to add a reference to new subsections (1.2) and (1.3) which extends the five-year period to 10 years for dispositions of shares that satisfy the conditions of subsections 84.1(2.31) or (2.32), and dispositions of shares of a qualifying business to an employee ownership trust pursuant to a qualifying business transfer, respectively. For more information, see the commentary to new subsections (1.2) and (1.3) of the Act.

Reserve - intergenerational business transfers

ITA
40(1.2)

As a general rule, where a taxpayer disposes of capital property in a taxation year, subparagraph 40(1)(a)(iii) provides that the gain otherwise determined may be reduced by a reasonable reserve in respect of proceeds of disposition that are not due to the taxpayer until after the end of the year. The taxpayer must include at least 1/5 of the gain in income each year over a maximum reserve period of five-years.

New subsection 40(1.2) provides an exception to the general rule provided under subparagraph 40(1)(a)(iii) to enable a taxpayer to claim a reserve over up to a ten-year period if the conditions in subsections 84.1(2.31) or (2.32) are satisfied in respect of the disposition.

These amendments come into force on January 1, 2024.

Reserve – dispositions to employee ownership trusts

ITA
40(1.3)

Where a taxpayer disposes of capital property in a taxation year, the gain otherwise determined may be reduced under subparagraph 40(1)(a)(iii) by a reasonable reserve in respect of proceeds of disposition that are not due to the taxpayer until after the end of the year. However, the gain from the disposition is fully recognized over the first five (or, in some cases, ten) taxation years of the taxpayer ending after the time of disposition.

New subsection (1.3) provides an extension of the application of subparagraph 40(1)(a)(iii) for dispositions of shares of a qualifying business to an employee ownership trust (EOT) pursuant to a qualifying business transfer. In computing the taxpayer's gain from the disposition of qualifying business shares to the EOT, the taxpayer may claim a reserve over up to ten years whereby a minimum of ten per cent of the gain is included in the taxpayer's income each year. The extension of the ten-year capital gains reserve to qualifying business transfers to EOTs is intended to facilitate the sale of businesses to EOTs.

For more information on the definitions "employee ownership trust", "qualifying business" and "qualifying business transfer", see the commentary to these definitions in subsection 248(1).

These amendments apply in respect of transactions that occur on or after January 1, 2024.

Clause 11

Adjustment to cost base

ITA
53(1)(e)(xiii)

Subparagraph 53(1)(e)(xiii) provides additions to the adjusted cost base of a taxpayer's partnership interest where investment tax credits have been recaptured (added to the taxpayer's tax otherwise payable) as required by subsection 127(30). Where an investment tax credit is recaptured, the adjusted cost base of a partnership interest is increased to reflect the amount recaptured.

Subparagraph 53(1)(e)(xiii) is amended to add a reference to new sections 127.44 and 127.45, consequential on the introduction of the CCUS tax credit and the clean technology investment tax credit.

This amendment applies to taxation years ending after 2021 with respect to the CCUS tax credit and after March 27, 2023 with respect to the clean technology investment tax credit.

Amounts to be deducted

ITA
53(2)(c)

Paragraph 53(2)(c) provides for certain amounts that must be deducted in computing the adjusted cost base to a taxpayer of a partnership interest. New subparagraph 53(2)(c)(vi.1) is added to the paragraph to require that a deduction be made for that part of a CCUS tax credit claimed by a taxpayer pursuant to subsection 127.44(2) which can reasonably be attributed to the taxpayer's share of a partnership's CCUS tax credit. New subparagraph 53(2)(c)(vi.2) is added to the paragraph to require that a deduction be made for that part of a clean technology investment tax credit claimed by a taxpayer pursuant to subsection 127.45(2) which can reasonably be attributed to the taxpayer's share of a partnership's clean technology investment tax credit.

This amendment applies to taxation years ending after 2021 with respect to the CCUS tax credit and after March 27, 2023 with respect to the clean technology investment tax credit.

Clause 12

Definitions

ITA
66(15)

"principal-business corporation"

Subsection 66(15) of the Act defines various terms that apply for the purposes of section 66, which includes rules applicable to the issuance of flow-through shares.

A "principal-business corporation" is defined in subsection 66(15) as a corporation whose principal business is any of, or a combination of, several activities specified in the definition.

Consequential to the expansion of eligibility for corporations involved in the exploration and development of lithium to issue flow-through shares and renounce certain Canadian exploration expenses and Canadian development expenses to investors, paragraphs (f.1) and (g) of the "principal-business corporation" definition are amended to add:

- the production and marketing of lithium to paragraph (f.1), and
- the manufacturing of products where the processing of lithium is involved to paragraph (g).

This amendment is deemed to have come into force on March 28, 2023.

Lithium brine well deemed mine

ITA
66(21)

Consequential to the expansion of eligibility for corporations involved in the exploration and development of lithium to issue flow-through shares and renounce certain Canadian exploration expenses (CEE) and Canadian development expenses (CDE), new subsection 66(21) is introduced as an interpretive rule that deems wells for the extraction of material from lithium brine deposits to be a mine for the purposes of paragraph (f) of the CEE definition in subsection 66.1(6) and paragraphs (c.2) and (d) of the CDE definition in subsection 66.2(5).

Paragraph 66(21)(a) provides that, for the purposes listed above, a mine includes a well for the extraction of materials from lithium brine deposits. Since injector or disposal wells will often be necessary adjuncts to such a well, this type of mine can also include injection wells or disposal wells that return processed brines to the aquifer (after lithium compounds have been extracted) and assist in maintaining reservoir pressure and brine production rates.

Paragraph (b) deems all lithium brine wells of a taxpayer to be one mine if the material extracted from each well is sent to the same processing facility.

Paragraph (c) deems all lithium brine wells of a taxpayer to be one mine if the Minister of National Revenue, in consultation with the Minister of Natural Resources, determines that the wells constitute one project. This paragraph allows for an evaluation of the mine based on different geological circumstances, especially where separate wells could be connected to multiple processing facilities.

New subsection 66(21) seeks to ensure that projects for the exploration and development of lithium from brines are treated similarly to traditional mines in a mineral resource (other than bituminous sands or oil shale deposits).

This amendment is deemed to have come into force on March 28, 2023.

Clause 13

Definitions

ITA
66.2(5)

“Canadian development expense”

Subsection 66.2(5) contains the definitions “accelerated Canadian development expense”, “Canadian development expense” (CDE), and “cumulative Canadian development expense”.

Consequential to the addition of lithium deposits (which includes lithium brine deposits) to the “mineral resource” definition in subsection 248(1), paragraph (c.2) of the CDE definition is amended to include expenses incurred in drilling a well for the extraction of lithium from brines as an example of an expense that may qualify as CDE.

Subparagraph (iii) is added to paragraph (d) of the CDE definition to include expenses incurred in drilling or completing a lithium well after the related “mine” comes into production.

For the purposes of paragraphs (c.2) and (d), a mine includes a well or a collection of wells for the extraction of material from a lithium brine deposit under new subsection 66(21).

Thus, for example, if a new well for the extraction of lithium from brines is drilled and that new well is part of a larger collection of wells that constitute a “mine” under subsection 66(21) that has already come into production, the expenses associated with drilling that new well would qualify as CDE under new subparagraph (d)(iii).

This amendment applies to expenses incurred on or after March 28, 2023.

Clause 14

Resource expenses of limited partner

ITA
66.8(1)(a)(ii)(B)(I)

Subsection 66.8(1) provides for the reduction of a taxpayer's share of a partnership's resource expenditures incurred in a fiscal period in certain cases where the taxpayer's share of such resource expenditures exceeds the taxpayer's “at-risk amount” at the end of the fiscal period in respect of the partnership. Subclause 66.8(1)(a)(ii)(B)(I) provides a further adjustment in respect of the amount required by subsection 127(8) in respect of the partnership to be added in computing the investment tax credit of the taxpayer in respect of the fiscal period. The result is that investment tax credits are subtracted from the “at-risk amount” in making the determination in subsection 66.8(1).

Subclause 66.8(1)(a)(ii)(B)(I) is amended to adjust for amounts required by subsections 127.44(11) and 127.45(8) in respect of the partnership to be added in computing the CCUS tax credit and the clean technology investment tax credits of the taxpayer in respect of the fiscal period.

This amendment applies to taxation years ending after 2021 with respect to the CCUS tax credit and after March 27, 2023 with respect to the clean technology investment tax credit.

Clause 15

Commercial Debt Obligation

ITA
80(1)

For a debt obligation to be a “commercial debt obligation” as defined in subsection 80(1), interest on the debt obligation must be deductible if the Act were read without reference to

certain subsections. Paragraph (b) of the definition “commercial debt obligation” is amended to add subsection 18.2(2) to the provisions that the Act is read without reference to when applying the definition of commercial debt obligation.

Clause 16

Loans

ITA
80.4(3)(c)

New paragraph 80.4(3)(c) provides an exception to the deemed interest benefit that an indebted shareholder would otherwise be deemed to realize in respect of any loan or debt, or any part thereof, under subsection 80.4(2). Specifically, this exception will apply for up to 15 years where an employee ownership trusts (EOT) borrows funds from a qualifying business for the purpose of purchasing the qualifying business pursuant to a qualifying business transfer. The loan must meet the conditions provided in new subsection 15(2.51) to be eligible for the new paragraph 80.4(3)(c) exception. (See the commentary to subsection 15(2.51) for more information.)

This amendment comes into force on January 1, 2024.

Clause 17

Non-arm’s length sale of shares

ITA
84.1(2)(e)

Section 84.1 is an anti-avoidance rule that prevents an individual from avoiding tax that would ordinarily arise on a taxable dividend by removing corporate surplus through a non-arm’s length transfer of shares.

In general terms, section 84.1 applies when a taxpayer resident in Canada that is not a corporation (i.e., an individual, trust or partnership) transfers shares (the “subject shares”) of a Canadian corporation (a “subject corporation”) to another corporation (the “purchaser corporation”) on a non-arm’s length basis for consideration that can be either a share of the capital stock of the purchaser corporation or non-share consideration (e.g., cash or a promissory note).

Paragraph 84.1(2)(e) is intended to accommodate certain intergenerational business transfers by deeming them to occur at arm’s length for purposes of section 84.1. Paragraph (e) requires that the subject shares (i.e., the shares being transferred by the individual taxpayer to the purchaser corporation) be either shares of the capital stock of a family farm or fishing corporation (FFFC shares) or qualified small business corporation (QSBC) shares. In general terms, these are the types of shares that may qualify for the lifetime capital gains exemption (LCGE) and each represents an interest in an underlying active business carried on in Canada. Paragraph 84.1(2)(e)

also requires that the purchaser corporation retain the subject shares for a period of 60 months. Additional rules regarding the application of paragraph (e) are provided in subsection 84.1(2.3).

While intended to accommodate intergenerational business transfers from parents to children or grandchildren who wish to continue to carry on the family business, the exception in paragraph (e) may unintentionally permit the distribution of corporate surplus in the form of capital gains without requiring that the transfer of a business takes place.

Consequently, paragraph 84.1(2)(e) is amended to:

- ensure that only genuine intergenerational business transfers from an owner-manager parent to an adult owner-manager child may benefit from the exception by adding conditions for paragraph (e) to apply in new subsections (2.31) and (2.32) (either of which a taxpayer may satisfy, and each of which include the current conditions that the subject shares be QSBC or FFFC shares, and that the purchaser corporation be controlled by one or more children or grandchildren of the taxpayer),
- repeal the 60-month holding period condition for the subject shares, and
- clarify that the deemed arm's length relationship between the taxpayer and the purchaser corporation applies at the time of the disposition of the subject shares notwithstanding any other paragraph in subsection 84.1(2); consequently, the application of paragraph (e) will override the deemed adjusted cost base and the other deemed non-arm's length relationship rules provided in subsection (2).

In support of paragraph (e), consequential amendments are made to replace subsection (2.3) with new rules applicable to the conditions in new subsections (2.31) and (2.32). Additionally, new subsection 40(1.2) provides up to a 10-year capital gains reserve for intergenerational business transfers that satisfy the conditions of subsection (2.31) or (2.32).

Paragraph (e) and subsections (2.3), (2.31), and (2.32) serve the dual purpose of:

- accommodating the genuine intergenerational transfer of an active business from an individual owner-manager to their adult owner-manager child or grandchild (including a niece or nephew and grandniece or nephew), and
- protecting the integrity of section 84.1 as an anti-avoidance rule that governs the taxation of corporate distributions.

For more information, see the commentary to new subsections (2.3), (2.31), and (2.32).

This amendment applies to dispositions of shares that occur on or after January 1, 2024.

Rules for subsections 84.1(2.31) and 84.1(2.32)

ITA
84.1(2.3)

Subsection 84.1(2.3) provides three additional conditions for the application of paragraph 84.1(2)(e). First, paragraph (a) provides certain consequences of the purchaser corporation disposing of the subject shares within 60 months. Second, paragraph (b) provides certain rules relating to the lifetime capital gains exemption in subsections 110.6(2) or (2.1) where the subject corporation has taxable capital employed in Canada of between $10 and $15 million. Third, paragraph (c) requires the taxpayer to provide the Minister of National Revenue with an independent assessment of the fair market value of the subject shares and an affidavit attesting to the disposal of the shares.

Consequential upon the introduction of new subsections (2.31) or (2.32) for the application of paragraph (2)(e), subsection (2.3) is replaced with new rules applicable for purposes of new subsections (2.31) and (2.32).

Extended definition of child

New paragraph 84.1(2.3)(a) provides an extended definition of "child" for the purposes of subsections 84.1(2.31) and (2.32).

For the purposes of the Act, subsection 252(1) provides an extended meaning of persons who are considered to be children of a taxpayer. Under subsection 252(1), a reference to a child of a taxpayer includes the spouse or common-law partner of a child of the taxpayer. However, if the taxpayer's child dies, the spouse or common-law partner of the child is no longer considered a child of the taxpayer.

Subsection 70(10) provides an extended meaning of the definition "child" for the purposes of the intergenerational rollover rules in section 70 and 73 (as well as other rules). The definition "child" of a taxpayer in subsection 70(10) also includes a person who was a child of the taxpayer immediately before the death of the spouse or common-law partner of the person. As a result of this extended definition, the death of a person's spouse or common-law partner will not cause the person to cease to be the child of the parent of their deceased spouse or common-law partner.

New paragraph 84.1(2.3)(a) adopts the meaning of "child" under subsection 70(10) for the purposes of the intergenerational business transfer rules under subsections 84.1(2.31) and (2.32) and extends it to also include a niece or nephew of the taxpayer or taxpayer's spouse or common-law partner, a spouse or common-law partner of the niece or nephew and children of the niece or nephew.

Control of partnerships

New paragraph 84.1(2.3)(b) is an interpretation rule that applies to determine whether a taxpayer controls a partnership (that is a relevant group entity) for the purposes of subparagraphs 84.1(2.31)(c)(iii) and (2.32)(c)(iii).

Paragraph (b) provides that, for the purposes described above, a partnership is deemed to be a corporation (the "deemed corporation") with a capital stock of a single class of shares and with a total of 100 issued and outstanding shares. Each member of the partnership is deemed to be a

shareholder of the deemed corporation and to own a number of shares based on the partner's proportionate interest in the partnership. More specifically, the number of shares deemed to be owned by each partner at any time is determined by reference to its "specified proportion" (as defined in subsection 248(1) of the Act) in respect of the partnership for the last fiscal period of the partnership ending before that time. Where this is not determinable (e.g., because no fiscal period of the partnership has ended since the partner became a member of the partnership), the number of shares deemed to be held by the partner is determined by reference to the relative fair market value of its interest in the partnership.

The deeming rules contained in paragraph (b) do not replace, but rather apply in addition to, all other rules of the Act that are relevant in determining control.

Direct or indirect ownership of shares and equity interests

New paragraph 84.1(2.3)(c) is an interpretation rule that applies to determine whether a taxpayer owns, directly or indirectly, equity (including shares) or debt of a subject corporation, purchaser corporation or relevant group entity for the purpose of subsections (2.31) and (2.32).

Paragraph (c) facilitates the determination of a taxpayer's indirect ownership interest by "looking-through" multi-tiered organizational structures. More specifically, paragraph (c) provides that the term "own, directly or indirectly" in respect of a property means (i) direct ownership of the property, and (ii) an ownership interest in the shares of a corporation, an interest in a partnership or an interest in a trust that has a direct or indirect interest, or for civil law a right, in the property.

However, for the purposes of paragraphs (2.31)(d) and (e) and (2.32)(d) and (e) (which require a taxpayer to transfer their equity interests in an underlying business), subparagraph (c)(ii) does not apply to look through an interest in debt and debt-like non-voting preferred shares of (A) the purchaser corporation, (B) the subject corporation, or (C) a relevant group entity (all as defined in subsections (2.31) and (2.32)). Consequently, if a taxpayer owned only non-voting preferred shares and debt of a purchaser corporation, subparagraph (c)(ii) would not apply to deem the taxpayer to own (indirectly) the common shares of the subject corporation held by the purchaser corporation.

For purposes of paragraph (2.32)(f), paragraph (c) facilitates the "look-through" of multi-tiered structures to determine the fair market value of a taxpayer's (direct or indirect) economic interest (including both debt and equity interests) in a purchaser corporation, subject corporation, and relevant group entity. However, for the purposes of paragraph (2.32)(f), there is no exception for debt or debt-like non-voting preferred shares.

Discretionary trusts

New paragraph 84.1(2.3)(d) is an anti-avoidance rule predicated on the general policy against the use of discretionary or similar interests to avoid certain tax consequences. More particularly, new paragraph (d) is intended to prevent taxpayers from using discretionary interests in trusts to avoid

the conditions provided in new subsections (2.31) and (2.32) (e.g., by taking the position that, due to the discretionary nature of the trust, a beneficiary does not own any property of the trust).

New paragraph (d) applies if the share of the accumulating income or capital of a beneficiary of the trust depends on the exercise by any person of, or the failure by any person to exercise, any discretionary power. New paragraph (d) effectively deems a beneficiary under a discretionary trust to hold or acquire, as the case may be, all of the property held or acquired by the trust. This result is achieved by deeming the beneficiary to have a 100% interest in the trust for the purposes of subsections (2.31) and (2.32).

Relief for arm's length share transfers

New paragraph 84.1(2.3)(e) provides relief, in certain circumstances, where a parent and child or children undertake an intergenerational business transfer pursuant to the conditions in new subsections (2.31) or (2.32) and the child or children subsequently disposes of, or causes the disposition of, all the shares in the capital stock of the purchaser corporation, the subject corporation, or all relevant group entities (as defined in subparagraphs (2.31)(c)(iii) and (2.32)(c)(iii), as applicable) to an arm's length person or group. In such a situation, the conditions under new paragraphs (2.31)(f) and (g) or (2.32)(g) and (h), as applicable, that the child or children would otherwise have had to satisfy are deemed to be met as of the time of the disposition provided that all equity interests in all relevant businesses (as defined in subparagraph (2.32)(c)(iii)) owned, directly or indirectly, by the child or children are included in the disposition.

A child could cause a disposition of subject shares by directing a purchaser corporation (which the child controls) to dispose of all of its shares of the subject corporation, for example.

Relief for share transfers between children

New paragraph 84.1(2.3)(f) provides relief, in certain circumstances, where a parent and child (or children) undertake an intergenerational business transfer pursuant to the conditions in new subsections (2.31) or (2.32) and the child (or any one or more of the children) subsequently dispose of, or cause the disposition of any of the shares of a purchaser corporation, subject corporation or relevant group entity to another child or group of children of the taxpayer (referred to as the "new child" or "new children"). In such scenario, the conditions in paragraphs (2.31)(f) and (g) or (2.32)(g) and (h) (applicable in respect of the child(ren)'s control of the purchaser corporation and carrying on and management of the underlying active business) are deemed (A) to be met as of the time of the disposition, and (B) to continue to apply to the new child (or new group of children) and any other member of the group of children that controls the purchaser corporation at the time of the disposition.

Relief for death or disability

New paragraph 84.1(2.3)(g) provides relief, in certain circumstances, where a parent and child undertake an intergenerational business transfer pursuant to the conditions in new subsections (2.31) or (2.32) and the child is unable to satisfy the control, service, management or continuing

active business conditions listed in new paragraphs 84.1(2.31)(f) and (g) or (2.32)(g) and (h), as applicable, because the child has died, or has, after the disposition of the subject shares, suffered a severe and prolonged physical or mental impairment. In such a situation, such conditions are deemed to be met from the time of the death or disability of the child or grandchild.

Relief for distribution of business assets to satisfy creditors

New paragraph 84.1(2.3)(h) provides relief, in certain circumstances, from the conditions in subparagraphs (2.31)(f)(ii) and (iii) and (2.31)(g)(i) or (2.32)(g)(ii) and (iii) and (2.32)(h)(i) (requiring at least one child to be actively engaged in a relevant business, each relevant business of a subject corporation and relevant group entity to continue to be carried on for a minimum time period, and for the taxpayer to take reasonable steps to transfer management of each relevant business to at least one child) if the business of the subject corporation or relevant group entity has ceased to be carried on due to the disposition of all of the assets that were used to carry on the business in order to satisfy debts owed to creditors of the corporation or of the entity.

Meaning of management

New paragraph 84.1(2.3)(i) provides an interpretation rule for the meaning of the word "management" in paragraphs (2.31)(g) and (2.32)(h) as referring to the direction or supervision of business activities but not including the provision of advice.

This amendment applies to dispositions of shares that occur on or after January 1, 2024.

Immediate Intergenerational Business Transfer

ITA
84.1(2.31)

New subsection 84.1(2.31) is intended to accommodate the intergenerational transfer of an active business from an individual owner-manager to their adult owner-manager child (within the meaning provided in paragraph 84.1(2.3)(a)) in a manner that protects the integrity of the anti-avoidance rule in subsection 84.1(1). It provides conditions for paragraph 84.1(2)(e) to apply to a disposition of subject shares by an individual taxpayer to a purchaser corporation controlled by the individual's child that would otherwise be subject to subsection (1). An individual taxpayer and their child may elect to satisfy the conditions of either subsection (2.31) or subsection (2.32) in order for the exception in paragraph (2)(e) to apply.

The conditions in subsection (2.31) are summarized and discussed in further detail below.

Parent has not previously sought exception to subsection 84.1(1) in respect of the same business

New paragraph 84.1(2.31)(a) is intended to ensure that a taxpayer's interest in a business is effectively transferred only once from a taxpayer to their child pursuant to the exception in paragraph 84.1(2)(e). This condition precludes the use of paragraph 84.1(2)(e) by a taxpayer to receive successive distributions of corporate surplus in the form of capital gains in respect of the

same business. New paragraph (a) does not apply to prior dispositions of shares that occurred before 2024 and relied on the exception in paragraph 84.1(2)(e).

Transferor cannot be a trust

New subparagraph 84.1(2.31)(b)(i) is intended to prevent abuse of paragraph (2)(e) and subsection (2.31) through the use of trusts. This provision requires that the taxpayer who transfers the subject shares be an individual (other than a trust). Trusts are excluded for greater certainty, and to prevent their use by individuals seeking to effectively multiply their lifetime capital gains exemption limit using accommodating beneficiaries.

Child or children must control purchaser corporation

New subparagraph 84.1(2.31)(b)(ii) is intended to ensure that the taxpayer's adult child or children control the purchaser corporation. This provision requires that, at the time the subject shares are disposed of by the taxpayer, the purchaser corporation is controlled by one or more children of the taxpayer, each of whom is 18 years of age or older. For this purpose and throughout subsection (2.31), the extended meaning of "child" in paragraph 84.1(2.3)(a) applies.

Subject shares must be qualified small business corporations shares or *shares of the capital stock of a family farm or fishing corporation*

New subparagraph 84.1(2.31)(b)(iii) is intended to ensure that the underlying business being transferred by the owner-manager parent is an active business carried on in Canada. This provision requires that the subject shares (i.e., the shares being transferred to the purchaser corporation) be either "qualified small business corporations shares" (QSBC shares) or "shares of the capital stock of a family farm or fishing corporation" (FFFC shares) (as defined in subsection 110.6(1) of the Act). In general terms, QSBC shares and FFFC shares represent shares of a corporation that, directly or indirectly, carries on an active business in Canada.

Parent must relinquish control

New paragraph 84.1(2.31)(c) is intended to ensure that the taxpayer (together with a spouse or common-law partner) relinquishes control of the interest in the underlying business being transferred to their child's purchaser corporation. This subparagraph requires that, at all times after the disposition of the subject shares, the taxpayer (together with a spouse or common-law partner) does not control, either in law or in fact, any of the subject corporation, the purchaser corporation, or any other person or partnership (referred to as a "relevant group entity") that carries on, at the disposition time, an active business (referred to as a "relevant business") that is relevant to the determination of whether subject shares are QSBC shares or FFFC shares.

Parent must transfer ownership of the business

New paragraphs 84.1(2.31)(d) and (e) are intended to ensure that the taxpayer (together with a spouse or common-law partner) transfers ownership of the underlying active business held through the subject shares to their child's purchaser corporation. Under these provisions, the

parents must immediately transfer at least a majority of the common shares of the subject corporation and any relevant group entity, and transfer the balance of common shares and equity interests within 36 months.

New subparagraphs (d)(i) and (ii) require that, at all times after the disposition time, the taxpayer (and a spouse of common-law partner of the taxpayer) must not own, directly or indirectly, 50% or more of any class of shares and equity interest, other than non-voting fixed value preferred shares (i.e., shares of a "specified class", as defined in subsection 256(1.1) of the Act) of the subject corporation and any relevant group entity.

New subparagraphs (e)(i) and (ii) require the taxpayer (together with a spouse or common-law partner) to dispose of the remaining balance of their shares (other than non-voting preferred shares) in the subject corporation and equity interests (other than non-voting preferred shares) in any relevant group entity within 36 months following the disposition time.

The taxpayer (and a spouse or common-law partner of the taxpayer) may continue to hold debt and debt-like preferred shares (i.e., non-voting fixed value preferred shares) in the subject corporation, the purchaser corporation and any relevant group entity for an indefinite period.

Child or children must continue to control purchaser corporation and carry on the business

New paragraph 84.1(2.31)(f) is intended to ensure that the taxpayer's child (or group of children) continues to control the purchaser corporation and carries on the acquired business. New paragraph (f) requires that, for a minimum period of 36 months after the disposition of the subject shares by the parent to the purchaser corporation:

- the child (or group of children) retains legal control of the purchaser corporation (and thus retains legal control of the acquired interest in the underlying active business),
- the child (or at least one member of such group of children) is actively engaged on a regular and continuous basis in the underlying active business (a child working at least an average of 20 hours per week during the portion of the year the active business operates is deemed to satisfy this condition per the reference to paragraph 120.4(1.1)(a)), and
- each underlying active business of the subject corporation and any relevant group entity continues to be carried on as an active business.

Relieving rules to the application of paragraph (f) are provided by new subparagraphs (2.3)(e)(i) where one or more of the children referred to in subparagraph (e)(i) disposes of, or causes the disposition of, all of the shares in the capital stock of the purchaser corporation, the subject corporation, or all relevant group entities, to an arm's length person or group of persons.

Similarly, where one or more children referred to in subparagraph (e)(i) disposes of, or causes the disposition of, any of the shares of the purchaser corporation, subject corporation or a relevant group entity to another child or group of children of the taxpayer, subparagraph (2.3)(f)(i) deems the conditions of paragraphs (2.31)(f) and (g) to be met as of the time of the disposition and to continue to apply to the new child or new group of children.

Lastly, where a child, or each child referred to in subparagraph (f)(ii), has (after the disposition of the subject shares) died or suffered one or more prolonged impairments in physical or mental functions relieving rules to the application of paragraph (f) are provided by new subparagraph (2.3)(g)(i).

With respect to the requirements that each active business of the subject corporation and any relevant group entity continue to be carried on as an active business and that the child (or at least one member of the group of children) be actively engaged in an active business carried on by the subject corporation or a relevant group entity, paragraph 84.1(2.3)(h) provides a relieving rule where the business ceases to be carried on due to the disposition of all of the assets of the business to satisfy debts owed to creditors of the corporation or entity.

Management of the business must be transferred to the child

New paragraph 84.1(2.31)(g) is intended to ensure that management of the underlying active business is transferred to the taxpayer's child (or at least one member of the group of children). Paragraph (g) requires that, within 36 months after the disposition time or such greater period of time as is reasonable in the circumstances, the taxpayer (and a spouse or common-law partner of the taxpayer):

- transfer to their child (or at least one member of the group of children) the management of each active business of the subject corporation and any relevant group entity, and
- permanently cease to manage such business.

New paragraph 84.1(2.3)(i) provides interpretive rules for the meaning of the word "management".

Joint election

New paragraph 84.1(2.31)(h) recognizes that the actions of the taxpayer's child could potentially cause the taxpayer to fail to satisfy the above conditions and to thus be reassessed under subsection (1). This paragraph requires that the taxpayer and the child (or each member of the group of children) jointly elect, in prescribed form, for subsection (2.31) to apply in respect of the disposition of the subject shares. The election must be filed with the Minister of National Revenue (i.e., the Canada Revenue Agency) on or before the taxpayer's filing-due date for the taxation year that includes the disposition time.

Pursuant to new subsection 160(1.5), any child who makes this joint election is, jointly and severally, or solidarily, liable for any amount payable by the taxpayer that is greater than it would have otherwise been had the share disposition satisfied the conditions in subsection 84.1(2.31). In recognition of the minimum 36 month period required to satisfy the above conditions, new subparagraph 152(4)(b.5)(i) provides the Minister with an additional three years after the normal reassessment period to assess the taxpayer where the conditions of subsection 84.1(2.31) are not met.

For more information, see the commentary on paragraph 84.1(2)(e), subsections 84.1(2.3) and (2.32), paragraphs 87(2)(j.6) and 152(4)(b.5) and subsection 160(1.5).

This amendment applies to dispositions of shares that occur on or after January 1, 2024.

Gradual Intergenerational Business Transfer

ITA
84.1(2.32)

New subsection 84.1(2.32) is intended to accommodate the gradual intergenerational transfer of an active business from an individual owner-manager to their adult owner-manager child (within the meaning provided in paragraph 84.1(2.3)(a)) in a manner that protects the integrity of subsection 84.1(1). New subsection (2.32) provides conditions for paragraph 84.1(2)(e) to apply to a disposition of subject shares by an individual taxpayer to a purchaser corporation controlled by the individual's child that would otherwise be subject to subsection (1). An individual taxpayer and their child may elect to satisfy the conditions of either new subsection (2.32) or new subsection (2.31) in order for the exception in paragraph (2)(e) to apply.

The conditions in new subsection (2.32) are summarized and discussed in further detail below.

Parent has not previously sought exception to subsection 84.1(1) in respect of the same business

New paragraph 84.1(2.32)(a) is intended to ensure that a taxpayer's interest in a business is effectively transferred only once from a taxpayer to their child pursuant to the exception in paragraph 84.1(2)(e). This condition precludes the use of paragraph 84.1(2)(e) by a taxpayer to receive successive distributions of corporate surplus in the form of capital gains in respect of the same business. New paragraph (a) does not apply to prior dispositions of shares that occurred before 2024 and relied on the exception in paragraph 84.1(2)(e).

Transferor cannot be a trust

New subparagraph 84.1(2.32)(b)(i) is intended to prevent abuse of paragraph (2)(e) and subsection (2.32) through the use of trusts. This provision requires that the taxpayer who transfers the subject shares be an individual (other than a trust). Trusts are excluded for greater certainty, and to prevent their use by individuals seeking to effectively multiply their lifetime capital gains exemption limit with accommodating beneficiaries.

Child or children must control purchaser corporation

New subparagraph 84.1(2.32)(b)(ii) is intended to ensure that the taxpayer's adult child or children control the purchaser corporation. This provision requires that, at the time the subject shares are disposed of by the taxpayer, the purchaser corporation is controlled by one or more children of the taxpayer, each of whom is 18 years of age or older. For this purpose and throughout subsection (2.32), the extended meaning of "child" in paragraph 84.1(2.3)(a) applies.

Subject shares must be qualified small business corporations shares or *shares of the capital stock of a family farm or fishing corporation*

New subparagraph 84.1(2.32)(b)(iii) is intended to ensure that the underlying business being transferred by the owner-manager parent is an active business carried on in Canada. This provision requires that the subject shares (i.e., the shares being transferred to the purchaser corporation) be either "qualified small business corporations shares" (QSBC shares) or "shares of the capital stock of a family farm or fishing corporation" (FFFC shares) (as defined in subsection 110.6(1) of the Act). In general terms, QSBC shares and FFFC shares represent shares of a corporation that, directly or indirectly, carries on an active business in Canada.

Parent must relinquish control

New paragraph 84.1(2.32)(c) is intended to ensure that the taxpayer (together with a spouse or common-law partner) relinquishes control of the interest in the underlying business being transferred to their child's purchaser corporation. This subparagraph requires that, at all times after the disposition of the subject shares, the taxpayer (together with a spouse or common-law partner) does not control, at law, any of the subject corporation, the purchaser corporation, or any other person or partnership (referred to as a "relevant group entity") that carries on, at the disposition time, an active business (referred to as a "relevant business") that is relevant to the determination of whether subject shares are QSBC shares or FFFC shares.

To provide greater certainty and administrative convenience, paragraph (c) does not require that a parent relinquish factual control of the subject corporation, purchaser corporation or any relevant group entity.

Parent must transfer ownership of the business

New paragraphs 84.1(2.32)(d), (e) and (f) are intended to ensure that the taxpayer (together with a spouse or common-law partner) commences, at the time of disposition of the subject shares, to transfer ownership of the underlying active business held through the subject shares to their child's purchaser corporation and relinquishes any majority ownership interest in the underlying active business within 10 years (referred to as the "final sale time"). These requirements are intended to ensure that both ownership and factual control of the entities that hold interests in the underlying active business are transferred from the taxpayer (and a spouse or common-law partner) to their child or children within 10 years of the disposition time.

New subparagraphs (d)(i) and (ii) require that, at all times after the disposition time, the taxpayer (and a spouse of common law partner of the taxpayer) must not own, directly or indirectly, 50% or more of any class of shares and equity interest, other than non-voting fixed value preferred shares (i.e., shares of a "specified class", as defined in subsection 256(1.1) of the Act) of the subject corporation and any relevant group entity.

New subparagraphs (e)(i) and (ii) require the taxpayer (together with a spouse or common-law partner) to dispose of the remaining balance of their shares (other than non-voting preferred

shares) in the subject corporation and equity interests (other than non-voting preferred shares) in any relevant group entity within 36 months following the disposition time.

The taxpayer (and a spouse or common law partner of the taxpayer) may continue to hold debt and debt-like preferred shares in the subject corporation, the purchaser corporation, and any relevant group entity for an indefinite period (subject to the restrictions on the fair market value of such economic interests provided in new subparagraphs (f)(i) and (ii)).

Where the subject shares are, at the disposition time, FFFC shares, subparagraph (f)(i) provides that, within 10 years after the disposition time, the taxpayer (and a spouse of common law partner of the taxpayer) must not own, directly or indirectly, more than 50% of the fair market value of all interests (including any debt or equity interest) that they held, directly or indirectly, in any of the subject corporation, the purchaser corporation and any relevant group entity immediately before the disposition time.

Where the subject shares are, at the disposition time, QSBC shares (other than shares also described in subparagraph (f)(i), i.e., other than shares that are also FFFC shares), subparagraph (f)(ii) provides that, within 10 years after the disposition time, the taxpayer (and a spouse of common law partner of the taxpayer) must not own, directly or indirectly, more than 30% of the fair market value of all interests (including any debt or equity interest) that they held, directly or indirectly, in any of the subject corporation, the purchaser corporation and any relevant group entity immediately before the disposition time.

Economic interests in a subject corporation, purchaser corporation, or a relevant group entity owned indirectly through a multi-tiered structure or a discretionary trust are subject to the indirect ownership interpretation rule provided in new paragraph (2.3)(c) and the deeming rule provided in new paragraph (2.3)(d). For more information, see the commentary to paragraphs (2.3)(c) and (d).

Child or children must continue to control the purchaser corporation and carry on the business

New paragraph 84.1(2.32)(g) is intended to ensure that the taxpayer's child (or group of children) continues to control the purchaser corporation and carries on the acquired business. New paragraph (g) requires that, from the time of disposition of the subject shares until the later of 60 months after the disposition time and the final sale time:

- the child (or group of children) retains legal control of the purchaser corporation (and thus retains legal control of the acquired interest in the underlying active business),
- the child (or at least one member of such group of children) is actively engaged on a regular and continuous basis in the underlying active business (a child working at least an average of 20 hours per week during the portion of the year the active business operates is deemed to satisfy this condition per the reference to paragraph 120.4(1.1)(a)), and
- each underlying active business of the subject corporation and any relevant group entity continues to be carried on as an active business.

Relieving rules to the application of paragraph (g) are provided by subparagraph (2.3)(e)(ii) where one or more of the children referred to in subparagraph (g)(i) disposes of, or causes the disposition of, all of the shares in the capital stock of the purchaser corporation, the subject corporation, or all relevant group entities, to an arm's length person or group of persons.

Similarly, where one or more children referred to in subparagraph (g)(i) disposes of, or causes the disposition of, shares of the purchaser corporation, subject corporation or a relevant group entity to another child or group of children of the taxpayer, subparagraph (2.3)(f)(ii) deems the conditions of paragraphs (2.32)(g) and (h) to be met as of the time of the disposition and to continue to apply to the new child or new group of children.

Lastly, where a child, or each child referred to in subparagraph (g)(ii), has (after the disposition of the subject shares) died or suffered one or more prolonged impairments in physical or mental functions relieving rules to the application of paragraph (g) are provided by new subparagraph (2.3)(g)(ii).

With respect to the requirements that the active business of the subject corporation and any relevant group entity continue to be carried on as an active business and that the child (or at least one member of the group of children) be actively engaged in an active business carried on by the subject corporation or a relevant group entity, paragraph 84.1(2.3)(h) provides a relieving rule for these conditions where the business ceases to be carried on due to the disposition of all of the assets of the business to satisfy debts owed to creditors of the corporation or entity.

Management of the business must be transferred to the child

New paragraph 84.1(2.32)(h) is intended to ensure that management of the underlying active business is transferred to the taxpayer's child (or at least one member of the group of children). Paragraph (h) requires that, within 60 months after the disposition time or such greater period of time as is reasonable in the circumstances, the taxpayer (and a spouse or common-law partner of the taxpayer):

- transfer to their child (or at least one member of the group of children) the management of each active business of the subject corporation and any relevant group entity, and
- permanently cease to manage such business.

New paragraph 84.1(2.3)(i) provides interpretive rules for the meaning of the word "management".

Joint election

New paragraph 84.1(2.32)(i) recognizes that the actions of the taxpayer's child could potentially cause the taxpayer to fail to satisfy the above conditions and to thus be reassessed under subsection (1). This new subparagraph requires that the taxpayer and the child (or each member of the group of children) jointly elect, in prescribed form, for subsection (2.32) to apply in respect of the disposition of the subject shares. The election must be filed with the Minister of

National Revenue (i.e., the Canada Revenue Agency) on or before the taxpayer's filing-due date for the taxation year that includes the disposition time.

Pursuant to new subsection 160(1.5), any child who makes this joint election is, jointly and severally, or solidarily, liable for any amount payable by the taxpayer that is greater than it would have otherwise been had the share disposition satisfied the conditions in subsection (2.32). In recognition of the minimum five to ten-year period required to satisfy the above conditions, new subparagraph 152(4)(b.5)(ii) provides the Minister with an additional ten years after the normal reassessment period to assess the taxpayer where the conditions of subsection 84.1(2.32) are not met.

For more information, see the commentary on paragraph 84.1(2)(e), subsections 84.1(2.3) and (2.31), paragraphs 87(2)(j.6) and 152(4)(b.5) and subsection 160(1.5).

This amendment applies to dispositions of shares that occur on or after January 1, 2024.

Clause 18

Continuing corporation

ITA
87(2)(j.6)

Paragraph 87(2)(j.6) provides continuity rules for the purposes of a number of provisions of the Act. Specifically, it provides, for certain enumerated purposes, the corporation formed as the result of an amalgamation is considered to be the same corporation as, and a continuation of, each predecessor corporation. Because of paragraph 88(1)(e.2), these continuity rules also apply in the context of a winding-up to which subsection 88(1) applies.

Paragraph 87(2)(j.6) is amended to add a reference to new subsections 84.1(2.31) and (2.32), which provide the intergenerational business transfer conditions for the application of the paragraph 84.1(2)(e) exception to the anti-avoidance rule in subsection 84.1(1).

This amendment is consequential on the amendments to paragraph 84.1(2)(e) and subsection 84.1(2.3) and upon the introduction of new subsections 84.1(2.31) and (2.32). This amendment ensures that an amalgamation (as defined in subsection 87(1)) of a subject corporation and a purchaser corporation (as defined in subsection 84.1(1)) and a winding-up under subsection 88(1) of a subject corporation into a purchaser corporation, are permitted under new subsections 84.1(2.31) and (2.32) which will continue to apply to the reorganized corporate group. For more information, see the commentary on subsections 84.1(2.31) and (2.32).

This amendment comes into force on January 1, 2024.

Certain investment tax credits

ITA

87(2)(qq.1)

Paragraph 87(2)(qq) treats the corporation formed on an amalgamation as the same corporation as, and a continuation of, each of its predecessors, for the purposes of computing the new corporation's investment tax credits.

New paragraph 87(2)(qq.1) is added to provide the same treatment for the purposes of new sections 127.44, 127.45, and Part XII.7, consequential on the introduction of the CCUS tax credit and the clean technology investment tax credit.

This amendment applies to taxation years ending after 2021 with respect to the CCUS tax credit and after March 27, 2023 with respect to the clean technology investment tax credit.

Non-capital losses, etc., of predecessor corporations

ITA
87(2.1)

Subsection 87(2.1) allows a corporation formed on an amalgamation of two or more other corporations (referred to as a "new corporation" and the "predecessor corporations", respectively) to deduct the unclaimed losses of its predecessor corporations, subject to the restrictions on the use of losses imposed by section 111 and subsection 149(10) of the Act.

Consequential on the introduction of new section 18.2 and new paragraph 111(1)(a.1), which are part of the new excessive interest and financing expenses limitation regime, paragraphs 87(2.1)(a) and (b) are amended to provide similar "continuity" treatment in respect of unused restricted interest and financing expense of each predecessor corporation. "Restricted interest and financing expense" is the amount of interest and financing expenses for which deductions were denied under subsection 18.2(2) (or amounts were included in income under paragraph 12(1)(l.2)) in prior years. For more information, see the commentary on paragraph 111(1)(a.1) and the definition "restricted interest and financing expense" in subsection 111(8).

Subsection 87(2.1) is also amended to add new paragraph 87(2.1)(a.1), which provides a similar continuity treatment in respect of the various amounts that are relevant in computing a taxpayer's cumulative unused excess capacity, which is defined in new subsection 18.2(1) and essentially reflects the three-year carry-forward of a taxpayer's excess capacity (as also defined in that subsection). This is intended to allow the cumulative unused excess capacity of the new corporation to be determined as though the new corporation were the same corporation as, and a continuation of, the predecessor corporations.

If new subsection 111(5.01) applies on a loss restriction event to restrict the cumulative unused excess capacity of a predecessor corporation, this restriction will also apply to the new corporation because subsection 111(5.01) provides that the restriction applies in respect of all taxpayers for all taxation years ending after the loss restriction event. For further information, see the commentary on that subsection.

Finally, paragraph 87(2.1)(d) is amended to ensure that the general rule that subsection 87(2.1) has no effect on the income of the new corporation does not prevent an amount in respect of interest and financing expenses from being deductible in a post-amalgamation year where the new corporation has cumulative unused excess capacity resulting from subparagraph 87(2.1)(a.1).

The amendments to paragraphs 87(2.1)(a) and (b) apply in respect of amalgamations that occur on or after October 1, 2023. New paragraph 87(2.1)(a.1) and amended paragraph 87(2.1)(d) apply in respect of amalgamations that occur in any taxation year.

Adjusted taxable income – non-capital losses of predecessor corporation

ITA
87(2.12)

New subsection 87(2.12) applies if a corporation is formed on an amalgamation of two or more other corporations (referred to as the "new corporation" and the "predecessor corporations", respectively). It is part of the new excessive interest and financing expenses limitation regime located mainly in sections 18.2 and 18.21.

Subsection 87(2.12) applies in determining an amount under paragraph (h) of variable B of the definition "adjusted taxable income" in subsection 18.2(1), which is an amount added in computing adjusted taxable income in respect of a non-capital loss of a predecessor corporation that is claimed by the new corporation in a post-amalgamation year. Such an amount is added to the extent that the predecessor corporation's loss is attributable to interest and financing expenses and certain other deductible amounts, net of interest and financing revenues and certain other amounts included in income. For more information, see the commentary on paragraph (h) of variable B of the definition "adjusted taxable income".

Where applicable, subsection 87(2.12) deems the new corporation to be the same corporation as, and a continuation of, a particular predecessor corporation for the purpose of computing the amount added to adjusted taxable income in respect of the amount deducted by the new corporation under paragraph 111(1)(a), if it may reasonably be considered that the deducted amount is in respect of all or a portion of a non-capital loss of the particular predecessor corporation. The intended effect is that the interest and financing expenses and interest and financing revenues of the particular predecessor corporation (as well as the other amounts of the particular predecessor corporation that are relevant in determining the amount to be added under paragraph (h) of variable B of the definition "adjusted taxable income" in respect of the loss) for the loss year of the particular predecessor corporation are considered those of the new corporation for the purpose of determining the amount added to the new corporation's adjusted taxable income in respect of the loss deducted by the new corporation. Notably, it is intended that all of those amounts of the particular predecessor corporation are considered amounts of the new corporation only for the purpose of determining the amount to be added to the new corporation's adjusted taxable income in respect of the loss in question, and not for the purpose of determining the amount to be added to the new corporation's adjusted taxable income in

respect of a loss of any other predecessor corporation that is deducted by the new corporation under paragraph 111(1)(a).

New subsection 87(2.12) applies in respect of amalgamations that occur in any taxation year.

Clause 19

Winding-up

ITA
88(1)(e.31)

Subsection 88(1)(e.3) allows the flow-through of existing investment tax credits to a parent corporation on a wind-up of the subsidiary. However, a parent corporation may also be subject to recapture or recovery of the new CCUS tax credit and clean technology investment tax credit.

New paragraph 88(1)(e.31) is added to ensure this result for the purposes of new sections 127.44, 127.45, and Part XII.7, consequential on the introduction of the CCUS tax credit and the clean technology investment tax credit.

This amendment applies to taxation years ending after 2021 with respect to the CCUS tax credit and after March 27, 2023 with respect to the clean technology investment tax credit.

Non-capital losses, etc., of subsidiary

ITA
88(1.1)

Subsection 88(1.1) allows a parent corporation under certain circumstances to carry forward the non-capital losses, restricted farm losses, farm losses and limited partnership losses of a subsidiary corporation that has been wound up.

Consequential on the introduction of new section 18.2 and new paragraph 111(1)(a.1), which are part of the new excessive interest and financing expenses limitation (EIFEL) regime, subsection 88(1.1) is amended in a number of respects to provide similar carry-forward treatment to a parent corporation in respect of the wound-up subsidiary's unused restricted interest and financing expense. A "restricted interest and financing expense" is the amount of the subsidiary's interest and financing expenses for which deductions were denied under new subsection 18.2(2), or amounts were included in income under paragraph 12(1)(l.2), in a prior taxation year. For more information, see the commentary on paragraph 111(1)(a.1) and the definition "restricted interest and financing expense" in subsection 111(8).

Subsection 88(1.1) is amended such that the carry-forward treatment in respect of the subsidiary's restricted interest and financing expense applies in respect of a parent corporation for the purposes of paragraph 111(1)(a.1), which is the provision that in certain circumstances allows such amounts to be deducted in computing a taxpayer's taxable income.

Consistent with the current approach to losses under subsection 88(1.1), the subsidiary's restricted interest and financing expense for a particular taxation year (referred to as the "subsidiary expense year") is allocated between a particular business carried on by the subsidiary (referred to as the "subsidiary's expense business"), to the extent it can reasonably be regarded as an expense or loss incurred in the course of carrying on the subsidiary's expense business, and any other source.

New paragraph 88(1.1)(d.2) deems the portion of the subsidiary's restricted interest and financing expense that is attributable to the subsidiary's expense business to be restricted interest and financing expense of the parent from carrying on the subsidiary's expense business for the parent's year in which the subsidiary's expense year ended. However, this deeming rule applies only to the extent that the conditions in paragraphs (a) and (b) of subsection 88(1.1) are met, which essentially require that the portion of a restricted interest and financing expense was not deducted by the subsidiary and would have been deductible to the subsidiary after the commencement of the winding-up. Consistent with the current treatment of losses under this subsection, the deemed restricted interest and financing expense is also deemed not to have been deductible by the parent for years beginning before the winding-up commenced.

New paragraph 88(1.1)(d.3) provides for similar treatment of the subsidiary's restricted interest and financing expense allocated to any other source.

Paragraph 88(1.1)(e) currently limits the use that can be made of the subsidiary corporation's non-capital losses and farm losses if either the parent or the subsidiary undergoes an acquisition of control. This paragraph is amended to ensure that this limitation applies similarly in respect of the subsidiary corporation's restricted interest and financing expenses.

Finally, paragraph 88(1.1)(f) currently allows the parent to elect to deem a loss of the subsidiary that would otherwise be a loss of the parent for a taxation year beginning after the commencement of the winding up to be a loss of the parent for the immediately preceding taxation year. New paragraph 88(1.1)(g) allows the parent to make a similar election if a portion of the subsidiary's restricted interest and financing expense would otherwise be the parent's restricted interest and financing expense for a taxation year beginning after the commencement of the winding up.

These amendments apply in respect of windings-up that begin on or after October 1, 2023.

Cumulative unused excess capacity of subsidiary

ITA
88(1.11)

New subsection 88(1.11) is part of the new excessive interest and financing expenses limitation regime located mainly in sections 18.2 and 18.21.

If a subsidiary corporation has been wound up in circumstances described in subsection 88(1.1), new subsection 88(1.11) applies for the purposes of determining the parent's cumulative unused excess capacity, which is defined in new subsection 18.2(1) and essentially reflects a three-year carry-forward of excess capacity (as also defined in that subsection).

This subsection is introduced to provide continuity treatment to the parent in respect of the subsidiary's cumulative unused excess capacity.

This is achieved by attributing to the parent the principal amounts that are relevant in determining the subsidiary's cumulative unused excess capacity. In particular, any absorbed capacity, excess capacity or transferred capacity (each as defined in subsection 18.2(1)) of the subsidiary for a taxation year is deemed to be absorbed capacity, excess capacity or transferred capacity, respectively, of the parent for its taxation year in which the subsidiary's year ends. By attributing to the parent not only the subsidiary's excess capacity, but also its absorbed capacity and transferred capacity, this rule, in effect, provides continuity in the parent only in respect of the subsidiary's excess capacity that is not "used" by the subsidiary before the winding-up.

Notably, if new subsection 111(5.01) applies on a loss restriction event to restrict the cumulative unused excess capacity of the subsidiary, that restriction will also apply to the parent because that subsection provides that the restriction applies in respect of all taxpayers for all taxation years ending after the loss restriction event. For further information, see the commentary on subsection 111(5.01).

New subsection 88(1.11) applies in respect of windings-up that begin in any taxation year.

Adjusted taxable income – non-capital losses of subsidiary

ITA
88(1.12)

New subsection 88(1.12) applies if a subsidiary corporation has been wound up in circumstances described in subsection 88(1.1) and paragraph 88(1.1)(c), (d) or (d.1) deems a portion of its non-capital loss to be a non-capital loss of a parent corporation. It is part of the new excessive interest and financing expenses limitation regime located mainly in sections 18.2 and 18.21.

Subsection 88(1.12) applies in determining an amount under paragraph (h) of variable B of the definition "adjusted taxable income" in subsection 18.2(1), which is an amount added in computing the adjusted taxable income of a parent corporation in respect of a portion of a non-capital loss of a subsidiary corporation that is deemed to be a non-capital loss of the parent corporation and subsequently deducted by the parent corporation under paragraph 111(1)(a). Such an amount is added to the extent that the portion of the subsidiary's loss is attributable to interest and financing expenses and certain other deductible amounts), net of interest and financial revenues and certain other amounts included in income. For more information, see the commentary on paragraph (h) of variable B of the definition "adjusted taxable income".

Where applicable, subsection 88(1.12) deems the amounts of the subsidiary referred to in variables W and X of the definition “adjusted taxable income”, for the subsidiary’s loss year, that relate to the particular source from which the portion of subsidiary’s loss that is deducted by the parent is derived, to be amounts of the parent relating to the particular source. In addition, it provides for similar continuity treatment to the extent that the parent itself is wound up and paragraph 88(1.1)(c), (d) or (d.1) applies to deem losses (or portions of losses) of the parent to be losses of another parent corporation.

It is intended that subsection 88(1.12) deems amounts of the subsidiary corporation to be amounts of the parent corporation only for the purpose of determining the amount to be added to the parent corporation’s adjusted taxable income in respect of the loss deducted by the parent corporation and corresponding to the portion of the loss of the subsidiary corporation, and not for the purpose of determining the amount to be added to the parent corporation’s adjusted taxable income in respect of a loss of any other subsidiary corporation that is deducted by the parent corporation under paragraph 111(1)(a). Further, in determining the amount to be added to the parent corporation’s adjusted taxable income in respect of the loss, it is intended that the amounts taken into account under variables W and X of the definition “adjusted taxable income” are exclusively the amounts of the subsidiary corporation that are deemed by subsection 88(1.12) to be amounts of the parent corporation, and not any amounts that were amounts of the parent corporation for the subsidiary corporation’s loss year in the absence of the winding-up of the subsidiary corporation.

New subsection 88(1.12) applies in respect of windings-up that begin in any taxation year.

Winding-up of Canadian corporation

ITA
88(2)(c)

Subsection 88(2) applies to a winding-up of a Canadian corporation to which subsection 88(1) does not apply. Paragraph 88(2)(c) provides that paragraph 12(1)(t), which generally requires investment tax credits claimed in a preceding taxation year to be included in computing a taxpayer's income to the extent that they have not been applied to reduce certain related expenditures or amounts, may also apply in respect of investment tax credits claimed by the corporation in the year in which all or substantially all of its property is distributed on a winding-up.

Paragraph 88(2)(c) is amended to reflect the introduction of the new CCUS tax credit and the clean technology investment tax credit, by adding references to new sections 127.44 and 127.45. References are also added to new subparagraphs 53(2)(c)(vi.1) and 53(2)(c)(vi.2), which apply cost base reductions to partners claiming the new credits.

This amendment applies to taxation years ending after 2021 with respect to the CCUS tax credit and after March 27, 2023 with respect to the clean technology investment tax credit.

Clause 20

Definitions

ITA
89(1)

"low rate income pool"

The definition "low rate income pool" (LRIP) in subsection 89(1) applies in respect of a corporation (referred to in the definition as a non-CCPC) that is neither a "Canadian-controlled private corporation" (as defined in subsection 125(7)) nor a "deposit insurance corporation" (as defined in subsection 89(15)). The LRIP definition is generally relevant for determining the extent to which the non-CCPC can pay eligible dividends in any given taxation year without making an "excessive eligible dividend designation" (as defined in subsection 89(1)).

The LRIP of a corporation at any time in a particular taxation year is the amount determined by reference to a formula: (A + B + C + D + E + F) – (G + H).

Variable D includes in a non-CCPC's LRIP the after-tax amount of its aggregate investment income for its preceding taxation year (assuming a notional tax rate of 20%). Only a non-CCPC that would, but for an election made under subsection 89(11) in respect of the definition "Canadian-controlled private corporation", have been a CCPC in its preceding taxation year is required to include an amount in respect of D.

Pursuant to an announcement in Budget 2022 that aims to align the taxation of investment income earned by CCPCs and substantive CCPCs, variable D is amended to also apply to a corporation that was a substantive CCPC at any time in its preceding taxation year.

Variable G reduces a non-CCPC's LRIP. Broadly put, variable G reduces the LRIP by taxable dividends (other than eligible dividends) paid by the non-CCPC in the particular taxation year but before the particular time. As with eligible dividends, taxable dividends paid by the non-CCPC that are capital gains dividends (within the meaning ascribed by subsection 130.1(4) or 131(1)) or that are deductible by the corporation under subsection 130.1(1) in computing its income for the particular taxation year or for its preceding taxation year do not reduce the non-CCPC's LRIP.

Variable G is amended to provide relief in certain circumstances where the interaction of variables D and G could create undue LRIP inclusions in a taxation year. This could occur where a CCPC that made an election under subsection 89(11) or a substantive CCPC earns aggregate investment income in a particular taxation year and distributes such investment income to its shareholders as a non-eligible dividend in the same taxation year. The mechanics of variables D and G could create an LRIP inclusion equal to 80% of the corporation's aggregate investment income in the subsequent taxation year notwithstanding that the after-tax aggregate investment income has already been distributed as a non-eligible dividend in the particular taxation year.

To address this issue, variable G is amended to permit LRIP to be reduced by taxable dividends (other than eligible dividends) paid by a non-CCPC in the particular taxation year but before the particular time as well as by dividends paid in the preceding taxation year where an amount is included in the non-CCPC's low-rate income pool under element D in the particular taxation year. To ensure the relief is targeted, and to prevent double counting of LRIP reductions, the total reduction in respect of dividends paid in the preceding taxation year is limited to the lesser of:

i. the amount included in the non-CCPC's low-rate income pool under element D in the particular taxation year, and
ii. the portion of the taxable dividend(s) paid in the previous year that has not reduced the non-CCPC's low rate income pool before the particular time.

In other words, the amendment to variable G aims to ensure that corporations can distribute their aggregate investment income in the taxation year in which it is earned without unduly affecting their LRIP balance.

Example

Facts

- Substantive CCPC has a residual LRIP balance of $300;
- Substantive CCPC earns $1,000 of aggregate investment income in Year 1; and
- Substantive CCPC pays an $800 non-eligible dividend to its shareholders in Year 1.

Tracking Substantive CCPC's LRIP under the previous rules

- Year 1
  - $300 LRIP inclusion at the beginning of Year 1 under variable A;
  - ($300) reduction upon payment of the $800 non-eligible dividend in Year 1 (note that, unlike GRIP, a corporation's LRIP cannot be negative per section 257).
- Year 2
  - $800 inclusion at the beginning of Year 2 under variable D (i.e. 80% of the substantive CCPC's aggregate investment income for its preceding taxation year).

Substantive CCPC's LRIP balance at the end of the series is $800 (the dividends paid in Year 1 cannot reduce LRIP in Year 2 under variable G).

Tracking Substantive CCPC's LRIP under the new rules

- Year 1
  - $300 inclusion at the beginning of Year 1 under variable A;
  - ($300) reduction upon payment of the $800 non-eligible dividend in Year 1 (note that, unlike GRIP, a corporation's LRIP cannot be negative per section 257).
- Year 2
  - $800 inclusion at the beginning of Year 2 under variable D (i.e. 80% of the

substantive CCPC's aggregate investment income for its preceding taxation year); and

- Variable G provides a reduction of ($500), i.e. the lesser of the amount included in the non-CCPC's LRIP under variable D in the year ($800) and the portion of the taxable dividend paid in the previous year that has not reduced the non-CCPC's LRIP before the particular time ($500).

Substantive CCPC's LRIP balance at the end of the series is $300.

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

For more information, see the commentary under the new definition of "substantive CCPC" in subsection 248(1).

Clause 21

Deemed year-end

ITA
91(1.2)

Subsection 91(1.2) is the operative provision of the “stub-period FAPI” rules. Its general effect is to ensure the appropriate amount of foreign accrual property income (FAPI) is included in a taxpayer’s income under subsection 91(1) where:

- the taxpayer is subject to an acquisition of control and the FAPI earned by a foreign affiliate of the taxpayer prior to the acquisition of control is not included in another taxpayer’s income because of the application of paragraph 95(2)(f.1); or
- the taxpayer’s interest in a foreign affiliate is reduced in certain circumstances.

Subsection 91(1.2) is amended to include a reference to new clause 95(2)(f.11)(ii)(D), to make the stub-period FAPI rules applicable for the purposes of applying the new excessive interest and financing expenses limitation (EIFEL) rules in respect of taxpayers with controlled foreign affiliates.

For more information, see the commentary on clause 95(2)(f.11)(ii)(D).

This amendment applies in respect of taxation years of foreign affiliates ending in taxation years of taxpayers beginning on or after October 1, 2023. However, it also applies in respect of a taxation year of a foreign affiliate that ends in an earlier taxation year of a taxpayer if any of the three immediately preceding taxation years of the taxpayer is shorter as a result of a transaction or event or series of transactions or events and it can reasonably be considered that one of the purposes of the transaction, event or series was to defer the application of the EIFEL regime.

Clause 22

Adjusted cost base of share of foreign affiliate

ITA
92(1)

Subsection 92(1) provides additions and deductions that apply in computing, at any time in a taxation year, the adjusted cost base (ACB) to a taxpayer resident in Canada of any share owned by the taxpayer of the capital stock of a foreign affiliate of the taxpayer.

Paragraph 92(1)(a) is amended consequential on the introduction of new clause 95(2)(f.11)(ii)(D), which applies the new excessive interest and financing expenses limitation (EIFEL) to the computation of the foreign accrual property income (FAPI) of a controlled foreign affiliate.

For more information, see the commentary on clause 95(2)(f.11)(ii)(D).

This amendment ensures that any ACB adjustments under subsection 92(1) are determined without regard to any denials of deductions under new subclause 95(2)(f.11)(ii)(D)(I) in respect of relevant affiliate interest and financing expenses of a controlled foreign affiliate, or income inclusions under new subclause 95(2)(f.11)(ii)(D)(II) in respect of such expenses of a partnership of which a controlled foreign affiliate is a member.

If clause 95(2)(f.11)(ii)(D) applies with the overall effect of reducing a foreign accrual property loss (FAPL), this can result in the amount included in the taxpayer's income under subsection 91(1) in a year when the FAPL is claimed being greater than it would have been in the absence of the application of that clause. In that case, the amendment to paragraph 92(1)(a) ensures that the ACB adjustment is determined based on the lesser amount that would have been included under subsection 91(1) if clause 95(2)(f.11)(ii)(D) had never applied.

This amendment applies in respect of taxation years of foreign affiliates ending in taxation years of taxpayers beginning on or after October 1, 2023. However, it also applies in respect of a taxation year of a foreign affiliate that ends in an earlier taxation year of a taxpayer if any of the three immediately preceding taxation years of the taxpayer is shorter as a result of a transaction or event or series of transactions or events and it can reasonably be considered that one of the purposes of the transaction, event or series was to defer the application of the EIFEL regime.

Clause 23

Deemed corporation

ITA
94.2(2)

Subsection 94.2(2) of the Act provides certain deeming rules that are relevant for the purposes of applying a number of provisions of the Act in respect of a trust that meets the conditions in subsection 94.2(1). Paragraph 94.2(2)(a) deems such a trust to be a non-resident corporation that is controlled by the beneficiary referred to in that subsection and, where applicable, by a taxpayer whose controlled foreign affiliate is such a beneficiary. Paragraph 94.2(2)(b) deems each beneficiary to own a proportion of the issued shares of each class that is commensurate with the fair market value of the beneficiary's beneficial interest in the corresponding class of interests in the trust.

Consequential on the introduction of new section 18.2, which is part of the new excessive interest and financing expenses limitation (EIFEL), subsection 94.2(2) is amended to provide that the deeming rules in that subsection also apply for the purposes of section 18.2 and the new definition "restricted interest and financing expense" in subsection 111(8).

This amendment applies in respect of taxation years beginning on or after October 1, 2023.

However, it also applies in respect of a taxation year that begins before and ends after that date if any of the three immediately preceding taxation years is shorter as a result of a transaction or event or series of transactions or events and it can reasonably be considered that one of the purposes of the transaction, event or series was to defer the application of the EIFEL regime.

Clause 24

Definitions

ITA
95(1)

"foreign accrual property income"

The definition "foreign accrual property income" (FAPI) in subsection 95(1) of the Act is relevant for the purpose of determining amounts that a taxpayer is to include under subsection 91(1), as income from a share of a controlled foreign affiliate, in computing its income for a particular taxation year. It is also relevant for the purposes of determining the taxable surpluses and deficits of a foreign affiliate of a taxpayer. Variables A to C of the formula in the FAPI definition contain the additions to FAPI and variables D to H contain the deductions from FAPI.

The FAPI definition is amended in two ways.

First, paragraph (b) of variable A of the definition excludes from the FAPI of a foreign affiliate of a taxpayer dividends received from another foreign affiliate of the taxpayer. Paragraph (b) is amended to align with the policy underlying new subsection 113(5), which implements Recommendation 2.1 of the BEPS Action 2 Report. Subsection 113(5) restricts a taxpayer's ability to deduct under section 113 certain amounts in respect of dividends received from a foreign affiliate out of the affiliate's exempt, hybrid, taxable and pre-acquisition surpluses,

generally to the extent the dividend is deductible for foreign income tax purposes. For more information, see the commentary on subsection 113(5).

The general effect of the amendment to paragraph (b) of variable A of the FAPI definition is that, if a foreign affiliate receives an inter-affiliate dividend that is deductible for foreign tax purposes, the dividend is included in the recipient affiliate's FAPI.

Second, variable H in the FAPI definition is relevant where a foreign affiliate of a taxpayer is a member of a partnership that receives a dividend from another foreign affiliate of the taxpayer, and ensures that the dividend is not included in the FAPI of the affiliate that is the partnership member. Variable H is amended to implement the same policy, and achieve a similar effect, to the amendment to paragraph (b) of variable A.

These amendments apply in respect of dividends received on or after July 1, 2024.

Determination of certain components of foreign accrual property income

ITA
95(2)(f.11)

Paragraph 95(2)(f.11) provides certain application rules for the purposes of the foreign affiliate income, gain and loss computation rules in paragraph 95(2)(f). Subparagraph 95(2)(f.11)(ii) applies in respect of income or loss from property, non-active businesses and non-qualifying businesses of a foreign affiliate of a taxpayer, as required to be computed under subparagraph 95(2)(f)(ii) in respect of the taxpayer.

Subparagraph 95(2)(f.11)(ii) is amended in several respects, consequential on the introduction of the hybrid mismatch rules in new sections 12.7 and 18.4, and the new excessive interest and financing expenses limitation (EIFEL) regime located mainly in sections 18.2 and 18.21.

First, clause 95(2)(f.11)(ii)(A) is amended to provide that the Act is to be read without reference to the primary operative rule of the hybrid mismatch rules, in new subsection 18.4(4), in determining the income or loss from property, non-active businesses and non-qualifying businesses of a foreign affiliate of a taxpayer, which are generally required by subparagraph 95(2)(f)(ii) to be computed on the basis the affiliate is resident in Canada. The effect is that the hybrid mismatch rules do not restrict deductions in determining those amounts.

Second, clause 95(2)(f.11)(ii)(A) is amended to provide that the Act is to be read without reference to the secondary operative rule of the hybrid mismatch rules, in new subsection 12.7(3), for payments arising before July 1, 2024. The effect is that, where applicable, the hybrid mismatch rules include amounts in the income or loss from property, non-active businesses and non-qualifying businesses of a foreign affiliate only in respect of payments arising on or after that date.

Third, clause 95(2)(f.11)(ii)(A) is amended to provide that the Act is to be read without reference to subsection 18.2(2) – the main operative rule in the EIFEL regime – in determining the income

or loss from property, non-active businesses and non-qualifying businesses of a foreign affiliate of a taxpayer. The effect of this amendment is that, in computing a foreign affiliate's foreign accrual property income (FAPI), there is no separate determination under subsection 18.2(2) of the proportion of the affiliate's interest and financing expenses that are "excessive" and the deductibility of which would thus be denied if that subsection applied in computing FAPI. Since no such proportion is separately determined in respect of the affiliate under subsection 18.2(2), paragraph 12(1)(l.2) also does not apply to include amounts in the affiliate's FAPI in respect of interest and financing expenses of a partnership of which it is member.

There is similarly no determination under the EIFEL rules of a foreign affiliate's "excess capacity" or "cumulative unused excess capacity", and no ability for a foreign affiliate to transfer or receive such amounts under subsection 18.2(4). Deduction capacity deriving from a controlled foreign affiliate's FAPI or relevant affiliate interest and financing revenues is instead reflected in the excess capacity or cumulative unused excess capacity of the taxpayer, to the extent of its specified participating percentage in respect of the affiliate.

Fourth, subparagraph 95(2)(f.11)(ii) is amended to introduce new clauses (D) and (E), which relate to the application of the EIFEL rules in determining a foreign affiliate's income or loss from property, non-active businesses and non-qualifying businesses.

While subsection 18.2(2) applies only in respect of a taxpayer and not a foreign affiliate of the taxpayer, new subclause 95(2)(f.11)(ii)(D)(I) provides that where a proportion of a taxpayer's interest and financing expenses for a taxation year (referred to as a "taxpayer year") are determined under subsection 18.2(2) to be excessive and thus subject to denial under that subsection, the same proportion of a controlled foreign affiliate's "relevant affiliate interest and financing expenses" (as defined in subsection 18.2(1)) is denied in computing the affiliate's FAPI for an affiliate taxation year ending in the taxpayer year. Similarly, subclause 95(2)(f.11)(ii)(D)(II) includes in computing a controlled foreign affiliate's FAPI an amount, in respect of interest and financing expenses of partnerships of which the affiliate is a member, that is also determined by reference to the proportion of the taxpayer's interest and financing expenses determined to be excessive under subsection 18.2(2).

Clause 95(2)(f.11)(ii)(D) applies only in respect of a foreign affiliate that is a controlled foreign affiliate of a taxpayer at the end of the affiliate taxation year. Thus, the EIFEL regime does not impact the computation of FAPI of foreign affiliates that are not controlled foreign affiliates. In addition, this clause does not apply in computing FAPI of a foreign affiliate in respect of a taxpayer that is an "excluded entity" (as defined in subsection 18.2(1)) for a taxation year in which the affiliate's taxation year ends.

New clause 95(2)(f.11)(ii)(E) provides an election to, in effect, forgo a foreign accrual property loss (FAPL) in order to avoid having to include expenses that gave rise to the FAPL in a taxpayer's interest and financing expenses. Because a foreign affiliate's FAPL can only be applied against its FAPI and not against the Canadian shareholder's own income, there are cases where a FAPL may never actually be used to reduce Canadian taxable income. Absent an election under this clause, however, interest and financing expenses underlying a FAPL are nonetheless included in a controlled foreign affiliate's relevant affiliate interest and financing

expenses, which are attributed to the Canadian shareholder and can negatively impact its ability to deduct its own interest and financing expenses.

Under this election, the Canadian shareholder elects in respect of one or more items of the affiliate's otherwise deductible interest and financing expenses, and can elect in respect of all or a portion (each referred to clause 95(2)(f.11)(ii)(E) as an "elected amount") of each such item. The elected amount is not deductible in computing its income or loss from property, a business other than an active business or a non-qualifying business. This non-deductibility has two effects:

- First, each elected amount is not included in the affiliate's relevant affiliate interest and financing expenses, which only include deductible amounts. Thus, the elected amounts are not included in the taxpayer's interest and financing expenses and will not impact the taxpayer's interest deduction capacity.
- Second, the affiliate's FAPL is reduced to the extent of the total of the elected amounts.

To ensure the elected amounts reflect only interest and financing expenses otherwise resulting in a FAPL, the total of the elected amounts in an affiliate taxation year is limited to the lesser of the FAPL and the affiliate's relevant affiliate interest and financing expenses for the affiliate taxation year (with each of those amounts being determined without regard to the election under clause 95(2)(f.11)(ii)(E)).

An election under clause 95(2)(f.11)(ii)(E) is made in respect of amounts that would, in the absence of clause 95(2)(f.11)(ii)(D) and new subsection 18.2(19), be included in relevant affiliate interest and financing expenses. As the effect of the election is to render the elected amount non-deductible, and thus to exclude it from the affiliate's relevant affiliate interest and financing expenses and therefore its relevant inter-affiliate interest (as defined in subsection 18.2(1), the election applies in priority to clause 95(2)(f.11)(ii)(D) and new subsection 18.2(19).

Fifth, subparagraph 95(2)(f.11)(ii) is amended to introduce new clause 95(2)(f.11)(ii)(F), which provides application rules for the purpose of applying the hybrid mismatch rule in subsection 12.7(3) in computing a foreign affiliate's FAPI.

Subclause 95(2)(f.11)(ii)(F)(II) excludes a payment received by a foreign affiliate from the application of subsection 12.7(3) to the extent that subparagraph 95(2)(a)(ii) treats the affiliate's income or loss derived from the payment as active business income. Conversely, if the affiliate receives a payment that does not meet the conditions for active business treatment in subparagraph 95(2)(a)(ii), the payment is potentially subject to subsection 12.7(3). This could occur, for example, in the case of a hybrid mismatch arrangement where the payer affiliate is different from the affiliate that has a deduction in respect of the payment in computing its earnings or loss from an active business.

Sub-subclause 95(2)(f.11)(ii)(F)(II)2 and subclause 95(2)(f.11)(ii)(F)(III) together exclude from the application of subsection 12.7(3) inter-affiliate debts (e.g., non-interest bearing loans) where subsection 18.4(9) deems a payment in respect of a foreign income tax deduction for notional interest expense on the debt and an actual interest payment on the debt would have been

recharacterized as active business income to the recipient foreign affiliate under subparagraph 95(2)(a)(ii).

New subclause 95(2)(f.11)(ii)(F)(IV) provides a modified reading of the definition "Canadian ordinary income" in subsection 18.4(1). It replaces references to sections 112 and 113 with references to paragraphs (b) and (c) of variable A and variable H of the definition "foreign accrual property income" in subsection 95(1). Those portions of the FAPI definition have effects, in computing FAPI, that are analogous to those of sections 112 and 113 in computing taxable income.

The broader context is that paragraph 95(2)(f) deems a foreign affiliate of a taxpayer to be a taxpayer resident in Canada for the purposes of determining its subparagraph 95(2)(f.11)(ii) amounts. Accordingly, the affiliate's Canadian ordinary income in respect of a payment is determined under paragraph (a) (as opposed to paragraph (c)) of the definition "Canadian ordinary income", such that it is never reduced to reflect the taxpayer's "aggregate participating percentage" (as defined in subsection 91(1.3)) in respect of the affiliate. In addition, subparagraph (a)(i) of the definition "Canadian ordinary income" and new subsection 18.4(8) prevent double counting.

The amendments to subparagraph 95(2)(f.11)(ii) that relate to the EIFEL regime apply in respect of taxation years of foreign affiliates ending in taxation years of taxpayers beginning on or after October 1, 2023. However, they also apply in respect of a taxation year of a foreign affiliate that ends in an earlier taxation year of a taxpayer if any of the three immediately preceding taxation years of the taxpayer is shorter as a result of a transaction or event or series of transactions or events and it can reasonably be considered that one of the purposes of the transaction, event or series was to defer the application of the EIFEL regime.

The amendment that excludes the application of subsection 18.4(4) of the hybrid mismatch rules in determining a foreign affiliate's income or loss from property, non-active businesses and non-qualifying businesses applies in respect of payments arising on or after July 1, 2022.

The amendments that make subsection 12.7(3) of the hybrid mismatch rules applicable in computing FAPI – subject to certain application rules for that purpose that are introduced by the amendments – apply only in respect of payments arising on or after July 1, 2024.

Clause 25

Limited partnership losses

ITA
96(2.1)(b)(ii)

Subsection 96(2.1) deals with the losses of limited partnerships. This subsection generally limits the deduction by a limited partner of losses to the extent of the limited partner's "at-risk amount" in respect of a partnership at the end of the fiscal period of the partnership ending in that year.

Subparagraph 96(2.1)(b)(ii) further limits the deduction of limited partner losses, beyond the "at-risk amount" limitation, by the amount of investment tax credits required to be added by subsection 127(8).

Subparagraph 96(2.1)(b)(ii) is amended to reduce limited partnership losses by the amount required to be added by new subsections 127.44(11) and 127.45(8), in respect of the new CCUS tax credit and the clean technology investment tax credit.

This amendment applies to taxation years ending after 2021 with respect to the CCUS tax credit and after March 27, 2023 with respect to the clean technology investment tax credit.

At-risk amount

ITA
96(2.2)

Subsection 96(2.2) defines the "at-risk amount" of a limited partner for the purposes of determining deductible losses and tax credits allocated to the partner.

Subsection 96(2.2) is amended to add references to new sections 127.44, 127.45, and 127.47, consequential to the introduction of the CCUS tax credit, the clean technology investment tax credit and the partnership rules related to clean economy investment tax credits.

This amendment applies to taxation years ending after 2021 with respect to the CCUS tax credit and the partnership rules related to clean economy investment tax credits, and after March 27, 2023 with respect to the clean technology investment tax credit.

Limited partner

ITA
96(2.4)

Subsection 96(2.4) provides an extended definition of "limited partner" for the purpose of applying the limited partnership at-risk rules in subsection 96(2.2).

Subsection 96(2.4) is amended to add references to new sections 127.44, 127.45, and 127.47, consequential to the introduction of the CCUS tax credit, the clean technology investment tax credit and the partnership rules related to clean economy investment tax credits.

This amendment applies to taxation years ending after 2021 with respect to the CCUS tax credit and the partnership rules related to clean economy investment tax credits, and after March 27, 2023 with respect to the clean technology investment tax credit.

Agreement or election of partnership members

ITA
96(3)

Subsection 96(3) provides rules that apply if a member of a partnership makes an election under certain provisions of the Act for a purpose that is relevant to the computation of the member's income from the partnership. In such a case, the election will be valid only if it is made on behalf of all the members of the partnership and the member has authority to act for the partnership.

Consequential on the introduction of the new excessive interest and financing expenses limitation (EIFEL) regime, subsection 96(3) is amended to add a reference to the definition "excluded interest" in new subsection 18.2(1). As a result, a member of a partnership that is a payee or payer of an amount of interest or a "lease financing amount" (as defined in subsection 18.2(1)) may make an election on behalf of all members of the partnership under paragraph (e) of that definition to treat that amount as excluded interest for purposes of the EIFEL regime (provided the other requirements of that definition are satisfied).

This amendment applies in respect of taxation years that begin on or after October 1, 2023.

Clause 26

Definitions

ITA
108(1)

"**trust**"

The definition "trust" excludes certain trusts from being treated as trusts for a number of specified purposes, including the application of the 21-year deemed disposition rule.

New paragraph (h) of the definition "trust" under subsection 108(1) is added to extend the above-described exclusions to employee ownership trusts (EOTs). Paragraph (a.1) of the definition "trust", which includes certain employment-related trusts, is also amended to exclude EOTs.

For more information on the definition "employee ownership trust", see the commentary to this definition in subsection 248(1).

This amendment comes into force on January 1, 2024.

Clause 27

Restricted interest and financing expenses

ITA
111(1)(a.1)

New paragraph 111(1)(a.1) permits taxpayers to deduct in computing taxable income for a taxation year such portion as they may claim of their restricted interest and financing expense for taxation years preceding the year, not exceeding the amount determined by the formula A + B included in the provision, as described below.

A taxpayer's "restricted interest and financing expense" for a taxation year is a new defined term in subsection 111(8). Generally, it represents the amount of the taxpayer's interest and financing expenses for the year for which deductions were denied – or that are were not included in calculating net taxable capital gains under paragraph 3(b) (and therefore did not reduce taxable capital gains included in income) – because of new subsection 18.2(2) (or in respect of which amounts were included in income under new paragraph 12(1)(l.2)). Paragraph 111(1)(a.1) applies regardless of whether the restricted interest and financing expense is in respect of a denied deduction in computing income or taxable income, or an allowable capital loss that is not included in the calculation of net taxable capital gains.

For more information, see the commentary on the new definition "restricted interest and financing expense" in subsection 111(8).

The amount a taxpayer may deduct under paragraph 111(1)(a.1) for a taxation year in respect of its restricted interest and financing expense for prior years is limited to the taxpayer's excess capacity for the year plus its total received capacity for the year (where both of those terms are as defined in new subsection 18.2(1)). For this purpose, the taxpayer's excess capacity is the amount it would be if no amount were deductible by the taxpayer under paragraph 111(1)(a.1). The effect, when taken together with the reduction to excess capacity under variable c in the definition of that term, is that a taxpayer's excess capacity for a taxation year is first applied to allow the taxpayer to deduct its unused restricted interest and financing expense from prior years, and the taxpayer can then elect to transfer any remaining excess capacity to other group members under subsection 18.2(4). For more information, see the commentary to the definition "excess capacity" in subsection 18.2(1) and to subsection 18.2(4).While, unlike certain losses to which subsection 111(1) applies, restricted interest and financing expense can only be carried forward to future taxation years, and not back to prior years, the rules, in effect, provide a three-year carry-forward of excess capacity, as reflected in the taxpayer's cumulative unused excess capacity (as defined in subsection 18.2(2)). This provides comparable results to a three-year carry-back of restricted interest and financing expense.

New paragraph 111(1)(a.1) applies in respect of taxation years beginning on or after October 1, 2023. However, it also applies in respect of a taxation year that begins before and ends after that date if any of the three immediately preceding taxation years is shorter as a result of a transaction or event or series of transactions or events and it can reasonably be considered that one of the purposes of the transaction, event or series was to defer the application of the EIFEL regime.

Limited partnership losses

ITA
111(1)(e)(ii)(A)

Paragraph 111(1)(e) contains rules for carryforwards of limited partnership losses. In general, limited partnership losses may not exceed a limited partner's at-risk amount, and amounts required by subsection 127(8) (investment tax credits of a partnership) to be included in computing the investment tax credit of the taxpayer for the taxation year.

Clause 111(1)(e)(ii)(A) is amended to add references to new subsections 127.44(11) and 127.45(8), consequential to the introduction of the CCUS tax credit and the clean technology investment tax credit. The effect of this amendment is to reduce losses available to a limited partner by the limited partner's share of a CCUS tax credit or clean technology investment tax credit.

This amendment applies to taxation years ending after 2021 with respect to the CCUS tax credit and after March 27, 2023 with respect to the clean technology investment tax credit.

Limitation on deductibility

ITA
111(3)

Subsection 111(3) of the Act sets out limitations on the amount that can be deducted or claimed under subsection 111(1) in respect of a non-capital loss, net capital loss, restricted farm loss, farm loss or limited partnership loss.

Subparagraph 111(3)(a)(i) reduces the amount that a taxpayer can deduct, in computing taxable income for a particular taxation year, in respect one of these losses for a taxation year by the total of amounts deducted in respect of the loss in preceding taxation years. Paragraph 111(3)(b) is an ordering rule that provides that no amount is deductible in respect of a non-capital loss, net capital loss, restricted farm loss, farm loss or limited partnership loss for a taxation year until a loss of the same type for a preceding taxation year has been deducted (i.e., losses of each type must be deducted in the order in which they arose).

Subparagraph 111(3)(a)(i) and paragraph (b) are amended consequential on the introduction of new paragraph 111(1)(a.1), which is part of the new excessive interest and financing expenses limitation regime whose core rules are in new sections 18.2 and 18.21. These amendments ensure that deductions under paragraph 111(1)(a.1) for restricted interest and financing expense are subject to limitations similar to those that already apply to losses.

The amendment to subparagraph 111(3)(a)(i) ensures that amounts deducted in respect of a restricted interest and financing expense in preceding taxation years under paragraph 111(1)(a.1), in computing taxable income or a non-capital loss, will reduce the amount deductible in respect of the restricted interest and financing expense in later taxation years. As a result of the amendment to the ordering rule in paragraph 111(3)(b), the same first-in, first-out rules that apply to losses will also apply to restricted interest and financing expense.

Paragraph 111(3)(a) is also amended to include new subparagraph (a)(iii), which is relevant where subsection 18.2(2) restricts a deduction under paragraph 111(1)(e) in respect of an amount claimed by a taxpayer in respect of a limited partnership loss. For more information, see the commentary on paragraph (i) of the definition "interest and financing expenses" in subsection 18.2(1).

New subparagraph (a)(iii) ensures that the portion of the claimed amount that is restricted under subsection 18.2(2) can only be applied in future taxation years as a restricted interest and financing expense and subject to the requirements of paragraph 111(1)(a.1).

These amendments apply in respect of taxation years beginning on or after October 1, 2023. However, it also applies in respect of a taxation year that begins before and ends after that date if any of the three immediately preceding taxation years is shorter as a result of a transaction or event or series of transactions or events and it can reasonably be considered that one of the purposes of the transaction, event or series was to defer the application of the EIFEL regime.

Loss restriction event – certain losses and expenses

ITA
111(5)(a)

Paragraph 111(5)(a) of the Act provides that, if a taxpayer is subject to a loss restriction event, the taxpayer's non-capital losses and farm losses for a taxation year ending before that event are deductible by it in computing its taxable income for later years only if certain conditions are met.

Consequential on the introduction of new paragraph 111(1)(a.1), which is part of the new excessive interest and financing expenses limitation (EIFEL) regime whose core rules are in new sections 18.2 and 18.21, paragraph 111(5)(a) is amended to restrict, in a manner similar to non-capital losses and farm losses, the deductibility of a taxpayer's restricted interest and financing expenses for taxation years ending before a loss restriction event. Such expenses will be deductible by the taxpayer in a taxation year ending after that event only to the extent they can reasonably be regarded as having been incurred in the course of carrying on a business, the taxpayer carries on that business in the later year and the conditions in subparagraphs 111(5)(a)(i) and (ii) are satisfied.

This amendment applies in respect of taxation years beginning on or after October 1, 2023. However, it also applies in respect of a taxation year that begins before and ends after that date if any of the three immediately preceding taxation years is shorter as a result of a transaction or event or series of transactions or events and it can reasonably be considered that one of the purposes of the transaction, event or series was to defer the application of the EIFEL regime.

Loss restriction event – cumulative unused excess capacity

ITA
111(5.01)

New subsection 111(5.01) of the Act is introduced in connection with the new excessive interest and financing expenses limitation (EIFEL) regime, the core rules of which are in new sections 18.2 and 18.21. This subsection is intended to ensure that, where a particular taxpayer is subject to a loss restriction event at any time, its excess capacity for taxation years ending before that time cannot be utilized by the particular taxpayer (or any other taxpayer) in a taxation year ending after that time.

To ensure this result, in general terms, certain pre-loss-restriction-event amounts are disregarded for taxation years ending after the loss restriction event. In particular, the cumulative unused excess capacity of any taxpayer for any taxation year ending after that time is determined without regard to the various amounts of the particular taxpayer for taxation years ending before that time that are otherwise relevant to the determination of cumulative unused excess capacity (specifically, the particular taxpayer's absorbed capacity, excess capacity and transferred capacity).

A taxpayer's "cumulative unused excess capacity" for a taxation year generally represents the unused portion of its excess capacity for the three immediately preceding years. It can be used by a taxpayer, in certain circumstances, to either deduct interest and financing expenses that would otherwise be denied under subsection 18.2(2), or to allow another member of the corporate group to do so by designating a portion of the cumulative unused excess capacity as "received capacity" of the other member in an election under subsection 18.2(4). Thus, the main effect of subsection 111(5.01) is to prevent the excess capacity of the particular taxpayer that was subject to the loss restriction event, for taxation years ending before that event, from being used for any of these purposes in taxation years ending after that event. For more information, see the commentary on the definition "cumulative unused excess capacity" in new subsection 18.2(1).

Notably, the restriction in subsection 111(5.01) applies in respect of "any taxpayer for any taxation year" that ends after the loss restriction event. Thus, for example, if the particular corporation that was subject to the loss restriction event subsequently amalgamates with another corporation, the restriction in subsection 111(5.01) will apply in determining the cumulative unused excess capacity of the new corporation resulting from the amalgamation, notwithstanding subsection 87(2.1).

New subsection 111(5.01) applies in respect of taxation years beginning on or after October 1, 2023. However, it also applies in respect of a taxation year that begins before and ends after that date if any of the three immediately preceding taxation years is shorter as a result of a transaction or event or series of transactions or events and it can reasonably be considered that one of the purposes of the transaction, event or series was to defer the application of the EIFEL regime.

Definitions

ITA
111(8)

Subsection 111(8) sets out the definitions that apply for the purpose of section 111. The amendments to this subsection apply in respect of taxation years beginning on or after

October 1, 2023. However, it also applies in respect of a taxation year that begins before and ends after that date if any of the three immediately preceding taxation years is shorter as a result of a transaction or event or series of transactions or events and it can reasonably be considered that one of the purposes of the transaction, event or series was to defer the application of the EIFEL regime.

“non-capital loss”

The definition “non-capital loss” determines a taxpayer’s non-capital loss for a taxation year using a formula. Variable E of this formula lists certain amounts to be included in a taxpayer’s non-capital loss.

Consequential on the introduction of new paragraph 111(1)(a.1), which is part of the new excessive interest and financing expenses limitation regime, variable E is amended to include, in determining a taxpayer’s non-capital loss for a taxation year, an amount deducted in the year under paragraph 111(1)(a.1), in respect of the taxpayer’s restricted interest and financing expense for a preceding taxation year.

“restricted interest and financing expense”

New definition “restricted interest and financing expense” is introduced in conjunction with the new excessive interest and financing expenses limitation in new section 18.2.

A taxpayer’s restricted interest and financing expense for a taxation year is, in general terms, the portion of its interest and financing expenses for the year (as defined in subsection 18.2(1)) for which a deduction is denied, or that are not included in calculating net taxable capital gains under paragraph 3(b) (and therefore do not reduce taxable capital gains included in income), by new subsection 18.2(2), or that results in an income inclusion under paragraph 12(1)(l.2) in respect of the taxpayer’s share of the interest and financing expenses of a partnership of which it is a member.

A taxpayer’s restricted interest and financing expense also includes its share of the portion of a controlled foreign affiliate’s relevant affiliate interest and financing expenses (as defined in subsection 18.2(1)) for which a deduction is denied by new clause 95(2)(f.11)(ii)(D) in computing foreign accrual property income (FAPI). It also includes the taxpayer’s share of a FAPI inclusion under that clause in respect of the affiliate’s share of the interest and financing expenses of a partnership of which it is a member. In both cases, the taxpayer’s share is determined by reference to its specified participating percentage (as defined in subsection 18.2(1)) in respect of the affiliate for the affiliate taxation year.

For more information, see the commentary on new clause 95(2)(f.11)(ii)(D) and the definition “specified participating percentage” in subsection 18.2(1).

The definition “restricted interest and financing expense” is most directly relevant to new paragraph 111(1)(a.1), which generally allows a taxpayer to carry forward its restricted interest and financing expense for a taxation year and deduct it in computing its taxable income for any

of its subsequent taxation years, to the extent of its excess capacity and received capacity for any of those years, subject to any applicable restrictions under subsection 111(3), paragraph 111(5)(a) and section 256.1.

For more information, see the commentary on paragraph 111(1)(a.1).

The amendments to section 111 apply in respect of taxation years beginning on or after October 1, 2023. However, it also applies in respect of a taxation year that begins before and ends after that date if any of the three immediately preceding taxation years is shorter as a result of a transaction or event or series of transactions or events and it can reasonably be considered that one of the purposes of the transaction, event or series was to defer the application of the EIFEL regime.

Exception

ITA
111(9)(a)

Subsection 111(9) restricts the loss carryovers that a taxpayer may claim for a year during which the taxpayer was not resident in Canada. The general purpose of the rule is to ensure that non-residents cannot apply, against Canadian-source income, losses from sources that are outside the Canadian tax system.

The preamble of this subsection is amended to add a reference to a taxpayer's restricted interest and financing expense for a taxation year. This amendment ensures that a taxpayer's restricted interest and financing expense for a year during which it is not resident in Canada is subject to the same restrictions that apply in respect of loss carryovers.

This amendment applies in respect of taxation years beginning on or after October 1, 2023. However, it also applies in respect of a taxation year that begins before and ends after that date if any of the three immediately preceding taxation years is shorter as a result of a transaction or event or series of transactions or events and it can reasonably be considered that one of the purposes of the transaction, event or series was to defer the application of the EIFEL regime.

Clause 28

Deduction of taxable dividends received by corporation resident in Canada

ITA
112

Dividends received by a corporation in a taxation year are generally required to be included in computing the taxable income of the corporation. However, subsections 112(1) and (2) generally permit the corporation to deduct the amount of any dividends received from certain Canadian resident corporations (the dividend received deduction). Consequently, the dividend received deduction exempts certain dividend income received by a corporation from tax.

The dividend received deduction, in part, integrates individual and corporate income taxation by allowing dividends to be paid through a chain of corporations without triggering an additional level of corporate income taxation. However, the dividend received deduction is not available in all circumstances. For example, the dividend received deduction may be denied where the dividend is received by certain taxpayers on certain types of shares (subsections 112(2.1), (2.2) and (2.4)), or where the dividend is received by a corporation that does not have a material risk of loss or opportunity for gain or profit in respect of the share (subsection 112(2.3)).

Section 112 is amended to add an additional exception to the availability of the dividend received deduction when the dividends are received by a financial institution on certain shares that are mark-to-market property (as defined in subsection 142.2(1)).

Sections 142.2 to 142.5 (the mark-to-market rules) address the income tax treatment of mark-to-market property held by a financial institution. Shares are generally mark-to-market property of a financial institution when the financial institution does not have a significant interest in the corporation that issued the shares (portfolio shares). This would generally be the case where the financial institution has less than 10 per cent of the votes or value of the corporation that issued the shares, and the financial institution and the corporation are not related. Under the mark-to-market rules, any realized or unrealized gains (profit) on shares that are mark-to-market property are included as income (and not as capital gains) when computing the financial institution's taxable income annually.

Financial institutions generally acquire and hold portfolio shares in the ordinary course of their business, with the income or profit from those shares supporting obligations arising in the ordinary course of their business. Although the mark-to-market rules address the gains (profit) arising from shares that are mark-to-market property, they do not specifically address dividends received on such shares. While any realized or unrealized gains (profit) on portfolio shares are included in computing the financial institution's taxable income annually, any dividends received on those same shares may be exempt from tax.

This additional exception to the availability of the dividend received deduction is intended to treat income or profit arising from shares that are mark-to-market property in a similar manner – as ordinary business income – whether that income or profit arises in the form of realized or unrealized gains on such shares, or in the form of dividends received on those shares. However, dividends received on certain preferred shares are excluded from this additional exception.

The additional exception applies notwithstanding the integration of any personal and corporate taxation that may otherwise result from the availability of the dividend received deduction to financial institutions in respect of dividends received on shares that are mark-to-market property. However, this exception does not override the integration of any personal and corporate taxation that may otherwise result from the availability of the dividend received deduction to financial institutions in respect of dividends received on any other shares (including, shares of subsidiary corporations).

Mark-to-market property

ITA
112(2.01)

New subsection 112(2.01) denies the dividend received deduction in respect of certain dividends received by financial institutions in a taxation year. This provision applies where the conditions in both paragraphs (a) and (b) are met.

Paragraph (a) applies if the corporation receiving the dividend in the year is a financial institution (as defined in subsection 142.2(1)) at any time in that year.

Paragraph (b) applies if the share on which the dividend is received satisfies the condition in either subparagraph (b)(i) or (ii).

Shares Held Directly

Subparagraph (b)(i) applies to dividends received on shares that are mark-to-market property (as defined in subsection 142.2(1)) of the financial institution. A share is mark-to-market property if it is held at any time in the taxation year by the financial institution and it is not excluded property (also as defined in subsection 142.2(1)). Generally, a share is mark-to-market property of a financial institution unless the financial institution is considered to have a significant interest (for the purposes of subsection 142.2(2)) in the corporation that issued the shares. A financial institution will generally not have a significant interest in a corporation if the financial institution holds shares that provide it with less than 10 per cent of the votes or value in the corporation that issued the share, and the financial institution and the corporation are not related.

Shares Held Indirectly

Subparagraph (b)(ii) applies to dividends received or deemed to be received on shares that would be mark-to-market property if the shares were held by the financial institution. Subparagraph (b)(ii) applies in circumstances where a dividend is received or deemed to have been received on a share that the financial institution does not hold directly. For example, a dividend paid on a share held by a trust in which a financial institution is a beneficiary may be deemed to be a dividend received by the financial institution because of a designation made under subsection 104(19). Alternatively, where a dividend is paid on a share that the financial institution transferred or loaned to another person under a securities lending arrangement (as defined in subsection 260(1)), any amount received as compensation for that dividend may be deemed to be received by the financial institution as a dividend on the share pursuant to subsection 260(5.1). In addition, the proportionate share of a dividend may be allocated to a financial institution that has an interest in a partnership that holds the share.

For purposes of subparagraphs (b)(i) and (ii), mark-to-market property includes shares that are deemed to be mark-to-market property under paragraph 112(2.02)(a) and excludes shares that are deemed not to be mark-to-market property under paragraph 112(2.02)(b).

Subsection 112(2.01) applies to dividends received after 2023.

Tracking property and preferred shares

ITA
112(2.02)

Subsection 112(2.02) applies for the purpose of paragraph 112(2.01)(b), which describes a condition to the application of new subsection 112(2.01) (for more information on paragraph 112(2.01)(b), see the commentary to new subsection 112(2.01)). Paragraph 112(2.02)(a) deems certain shares (i.e., tracking property) to be mark-to-market property and paragraph 112(2.02)(b) deems certain shares (i.e., taxable preferred shares) not to be mark-to-market property.

Tracking Property

Paragraph 112(2.02)(a) deems a share to be mark-to-market property if the share is a tracking property (as defined in subsection 142.2(1)). Tracking property is generally property whereby the value of the property (including where the property is a share) is determined primarily by reference to property that would be mark-to-market property if the property were owned directly by the financial institution.

While the definition of mark-to-market property in subsection 142.2(1) already incorporates tracking property, a share that is a tracking property may be an excluded property, and consequently not a mark-to-market property, if the financial institution has a significant interest (generally, 10 per cent or more of the votes and value) in the corporation that issued the share. This may allow financial institutions to avoid new subsection 112(2.01) by holding shares that are mark-to-market property indirectly through a corporation (other than another financial institution) in which the financial institution has a significant interest.

For example, a financial institution may hold shares of a mutual fund corporation (a mutual fund corporation is not a financial institution as that term is defined in subsection 142.2(1)) where the mutual fund corporation in turn holds shares that are mark-to-market property. Although the shares of the mutual fund corporation may be tracking property, the shares may also be excluded property if the financial institution has a significant interest in the mutual fund corporation.

Paragraph 112(2.02)(a) is intended to deem a share (other than a share of another financial institution) that is a tracking property to be a mark-to-market property for the purposes of new paragraph 112(2.01)(b), notwithstanding that the share may otherwise be excluded property. Subparagraphs 112(2.02)(a)(i) and (ii) provide that the deeming rule in paragraph 112(2.02)(a) applies to both a share that is a tracking property held directly by the financial institution and to a share that would be a tracking property if held directly by the financial institution. Subparagraph 112(2.02)(a)(ii) is intended to apply in circumstances similar to subparagraph 112(2.01)(b)(ii) where the share is held indirectly. For information on subparagraph 112(2.01)(b)(ii), see the commentary to new subsection 112(2.01).

Preferred Shares

Paragraph 112(2.02)(b) is intended to exclude dividends received on certain preferred shares from the scope of new section 112(2.01) by deeming a share to not be a mark-to-market property if the share is a taxable preferred share (as defined in subsection 248(1)). Consequently, subsection 112(2.01) will not apply to deny the dividend received deduction for a dividend received, or deemed to be received, by a financial institution on a taxable preferred share even if the share is a mark-to-market property of the financial institution or would be a mark-to-market property of the financial institution if held directly. The offering documents for most publicly issued preferred shares by taxable Canadian corporations generally disclose if the shares are taxable preferred shares.

However, this exclusion for taxable preferred shares does not apply where the share is also a tracking property of the financial institution or would be a tracking property if held directly. This is intended to exclude shares that may technically comply with the taxable preferred share definition but that in substance track the value of other mark-to-market property (including, for greater certainty, tracking the value of other taxable preferred shares that are not themselves tracking property). In addition, specific rules applicable to taxable preferred shares (Parts IV.1 and VI.1 of the Act) may also apply to any dividends paid or received with respect to shares that are taxable preferred shares.

Subsection 112(2.02) applies to dividends received after 2023.

Meaning of certain expressions

ITA
112(6)(c)

Subsection 112(6) defines certain terms used in section 112. Paragraph (c) of subsection 112(6) is amended to provide that the term “tracking property” has the same meaning as in subsection 142.2(1). The definition “tracking property” is relevant in determining whether a share is deemed to be mark-to-market property (or deemed not to be mark-to-market property) under new subsection 112(2.02).

This amendment applies to dividends received after 2023.

Clause 29

Definitions

ITA
113(3)

Subsection 113(3) of the Act defines various terms that apply for the purposes of section 113.

Subsection 113(3) is amended to add the definitions “deductible”, “entity”, “equity interest”, “foreign hybrid mismatch rule”, “foreign expense restriction rule”, “foreign taxation year” and

"relevant foreign income or profits", so that the definitions of these terms in subsection 18.4(1) apply for the purposes of section 113.

These amendments are consequent on the introduction of subsection 113(5), as the new definitions are relevant in applying that subsection.

Deduction restriction

ITA
113(5)

New subsection 113(5), in effect, restricts a taxpayer's ability to deduct under section 113 certain amounts in respect of dividends received by the taxpayer from a foreign affiliate out of the affiliate's exempt, hybrid, taxable and pre-acquisition surpluses, generally to the extent the dividend is deductible for foreign income tax purposes.

Subsection 113(5) implements Recommendation 2.1 of the BEPS Action 2 Report, which recommends that countries restrict dividend exemptions (or equivalent tax relief) for payments that are treated as deductible by the payer. Accordingly, pursuant to subsection 18.4(2), subsection 113(5) is to be interpreted consistently with that report (unless the context otherwise requires), as amended from time to time. For more information, see the commentary on subsection 18.4(2).

Where a deduction is provided under foreign income tax law in respect of a dividend paid by a foreign affiliate, this effectively results in the distributed income not being included in taxable income for foreign income tax purposes. Subsection 113(5) ensures that the income is not, in effect, also excluded from taxable income for Canadian income tax purposes.

More specifically, subsection 113(5) treats a dividend received by a Canadian-resident corporation from a foreign affiliate as not being a dividend so received for the purposes of section 113, to the extent an amount is deductible in respect of the dividend in computing income or profits of the affiliate (or certain other entities described in the commentary below) that are subject to foreign income tax. To the extent the dividend is deemed not to be a "dividend received", it will not meet the conditions for deductibility under subsection 113(1) or (2), and only the portion, if any, that is not so deemed will result in a deduction.

Given its purpose, subsection 113(5) is necessarily focussed on amounts that are considered to be dividends for the purposes of section 113. For these purposes, the question of whether an amount is a dividend is determined under Canadian income tax law (including subsection 90(2)) and not foreign income tax principles.

Subsection 113(5) applies only for the purposes of section 113 and, by extension, the provisions of the *Income Tax Regulations* (the "Regulations") that are relevant in applying that section. Accordingly, an amount that is deemed under subsection 113(5) to not be a "dividend received" for the purposes of section 113 is still considered to be an amount received as a dividend on a

share of the capital stock of a non-resident corporation for the purposes of section 90 and is therefore fully included in computing a taxpayer's income.

Where subsection 113(5) deems all or a portion of a dividend not to be a dividend received on a share of a foreign affiliate, that portion is still considered to be a dividend paid by the affiliate on its shares. This is relevant for certain provisions of the Regulations that apply for the purposes of section 113 (including section 5901, and the definitions of "exempt surplus" and "whole dividend" in subsection 5907(1)) and is intended to ensure that the payment of the dividend reduces the affiliate's applicable surplus balances, notwithstanding that subsection 113(5) restricts a deduction in respect of the dividend under section 113.

Under paragraph 113(5)(a), the portion of the dividend that is deemed not to be a "dividend received" is equal to the total of all amounts that are, or can reasonably be expected to be, deductible in computing:

- relevant foreign income or profits of
    - the affiliate, or
    - another entity because it has a direct or indirect equity interest in the affiliate; or
- income or profits of the affiliate that are taken into account in determining relevant foreign income or profits of another entity.

The term "relevant foreign income or profits" (defined in subsection 18.4(1)) essentially refers to income or profits in respect of which an entity is subject to tax imposed by a country other than Canada. Subsection 113(3) provides that the terms "entity" and "equity interest" also take on their definitions from subsection 18.4(1).

Consistent with the BEPS Action 2 Report, subsection 113(3) incorporates an extended definition of the term "deductible" from subsection 18.4(1), which essentially includes any relief that is broadly equivalent to a deduction.

Where a dividend is paid to multiple shareholders, only the portion of a deduction in respect of the dividend that relates to the amount of the dividend received by the taxpayer is included in calculating the amount deemed under subsection 113(5) to not be a dividend received by the taxpayer. For example, assume the taxpayer owns 25% of the common shares of the affiliate. If the affiliate pays a $100 dividend on its common shares and is entitled to deduct 50% of the dividend amount under the foreign tax law, assuming the foreign income tax deduction does not depend on the status or attributes of any shareholders, the amount calculated under paragraph (a) in respect of the taxpayer will be $12.50 (being 25% of the $50 deduction).

Subsection 113(5) restricts a deduction under section 113 if an amount is deductible, or can reasonably be expected to be deductible, in respect of the dividend for foreign income tax purposes. For further information on how this test is intended to be applied, see the commentary on subsection 18.4(6), which uses a similar test.

Unlike the hybrid mismatch rules in sections 12.7 and 18.4, subsection 113(5) requires the foreign tax deduction in respect of the dividend to be available in any of three specific scenarios set out in paragraph 113(5)(a).

The first scenario, in clause 113(5)(a)(i)(A), is where the dividend-paying affiliate is entitled to deduct an amount in respect of the dividend in computing income or profits in respect of which the affiliate is subject to foreign tax.

The second scenario, in clause 113(5)(a)(i)(B), is where the dividend gives rise to a deduction in computing income or profits of another entity (other than the corporation receiving the dividend) that are subject to foreign income tax, and the reason for the foreign deduction is that the other entity has a direct or indirect equity interest in the foreign affiliate that pays the dividend. This test would typically not be met where, for example, the other entity has transferred shares of the dividend-paying foreign affiliate subject to a sale and repurchase ("REPO") agreement, and the other entity is entitled to a foreign tax deduction because the foreign tax law treats the dividends as a deductible financing expense of the other entity. Such arrangements are generally within the scope of the hybrid transfer rule in subsection 18.4(12) and not the rule in subsection 113(5), and result in an income inclusion under subsection 12.7(3), since the reason for the foreign tax deduction in these cases is not because the other entity has an equity interest in the payer affiliate, but rather because the foreign tax law treats the other entity as a borrower under the arrangement. For further information, see the commentary on subsections 12.7(2) and (3) and 18.4(12).

The third scenario, in subparagraph 113(5)(a)(ii), is where an amount is deductible in computing income or profits of the foreign affiliate that pays the dividend, and the income or profits are taken into account in computing another entity's income or profits on which the other entity is subject to foreign income tax. This could occur, for example, if the affiliate is treated as fiscally transparent under the relevant foreign tax law, such that the affiliate's income or profits are allocated to another entity.

While subsection 113(5) is narrower than the hybrid mismatch rules in sections 12.7 and 18.4 in requiring the foreign tax deduction to arise in one of the three scenarios described above, it is broader than those rules in another respect: it is not limited to "hybrid mismatch arrangements" (as defined in subsection 18.4(1)). While subsection 113(5) can apply in respect of payments under those types of arrangements, its application does not turn on whether the mismatch – that is, the foreign tax deduction in respect of the dividend in combination with the deduction otherwise available under section 113 – is attributable to the "hybridity" of the financial instrument or arrangement under which the dividend is paid. Put differently, for subsection 113(5) to apply, the dividend need only be deductible by a relevant entity for foreign income tax purposes, without regard to the reason for the mismatch in treatment between the foreign and Canadian income tax laws (e.g., whether it is due to a difference in how a financial instrument or arrangement is treated for income tax purposes in Canada and a foreign country).

Paragraph 113(1)(b) ensures that subsection 113(5) applies in priority to a "foreign hybrid mismatch rule" (as defined in subsection 18.4(1)), by disregarding such rules. In effect, if a foreign country's hybrid mismatch rules apply to restrict a deduction to a foreign affiliate for a

dividend paid by the affiliate to a taxpayer, this restriction is disregarded (i.e., the amount is considered deductible) and thus subsection 113(5) applies. This approach is consistent with the BEPS Action 2 Report, which recommends that rules, such as subsection 113(5), implementing Recommendation 2.1 apply in priority to the "primary" hybrid mismatch rule of the dividend payer's country. Thus, in accordance with the BEPS Action 2 Report, the latter country should not apply its hybrid mismatch rules to deny a deduction in the first instance where a rule such as subsection 113(5) applies to deny relief to the dividend recipient.

Finally, paragraph 113(5)(b) also, in effect, requires that any foreign expense restriction rules be disregarded in determining whether a dividend paid by a foreign affiliate is deductible. As defined in subsection 18.4(1), "foreign expense restriction rule" refers to certain general interest deductibility restrictions under foreign tax law, as well as foreign tax rules that can reasonably be considered to be intended to implement the Global Anti-Base Erosion Model Rules (Pillar Two). For further information, see the commentary on subsection 18.4(6), which uses similar concepts.

Deduction for foreign taxes

ITA
113(6)

New subsection 113(6) provides a deduction for foreign withholding tax paid in respect of the portion of a dividend that new subsection 113(5) deems not to be a dividend received by a corporation resident in Canada on a share of the capital stock of a foreign affiliate because of a deduction in respect of the dividend in computing foreign income or profits. Thus, subsection 113(6) treats that portion of the dividend in a manner comparable to how paragraph 113(1)(c) treats the portion of a dividend received out of the taxable surplus of a foreign affiliate that is not deductible under paragraph 113(1)(b). This is intended to prevent double taxation.

Filing requirement

ITA
113(7)

New subsection 113(7) requires a taxpayer to file in its return of income for a taxation year a prescribed form containing prescribed information if new subsection 113(5) applies to deny, in whole or in part, the taxpayer a deduction under section 113 in respect of a dividend received by the taxpayer from a foreign affiliate out of the affiliate's exempt, hybrid, taxable or pre-acquisition surplus, because the dividend is deductible for foreign income tax purposes.

Clause 30

Definitions

ITA
122.8(1)

Section 122.8 provides the Climate Action Incentive (CAI) credit, which is a refundable tax credit for individuals in respect of certain amounts specified by the Minister of Finance for a province for a taxation year. The amount of any tax credit under this section is deemed to be a rebate in respect of charges levied under Part 1 of the Greenhouse Gas Pollution Pricing Act.

Subsection 122.8(1) defines a number of terms for the purposes of section 122.8, which contains the CAI credit.

New definition “relevant census” is added, consequential on the amendment of paragraph (a) of the description of E in the formula in subsection 122.8(4). This new definition is added to specifically reference the 2016 Census for the 2023 and 2024 taxation years when determining whether an individual lives outside a census metropolitan area for the purposes of CAI rural supplement eligibility. For taxation years other than 2023 and 2024, the last census published by Statistics Canada before the taxation year will be used to determine whether an individual lives outside a census metropolitan area for the purposes of determining eligibility for the CAI rural supplement.

New definition “relevant census” applies to the 2023 and subsequent taxation years.

Deemed payment on account of tax

ITA
122.8(4)

Subsection 122.8(4) provides for the calculation of the CAI credit. The amount of an individual's credit is determined by the formula in this subsection and is deemed to be a payment of tax by the individual at the end of a taxation year.

Paragraph (a) of the description of E of the formula in subsection 122.8(4) provides an increase in the amount of the CAI credit for individuals who live outside of a census metropolitan area if the eligible individual resides in a province for which there is a census metropolitan area. Paragraph (a) of the description of E is amended to provide that the amount of the CAI credit increase for these individuals is 20%.

Paragraph (a) of the description of E of the formula is also amended to reference the new definition, “relevant census”, for the purpose of determining whether an eligible individual lives outside a census metropolitan area within a relevant province.

These amendments apply to the 2023 and subsequent taxation years.

Clause 31

Refundable tax on investment income

ITA
123.3

Section 123.3 imposes an additional amount of tax (the "additional tax") under Part I of the Act on investment income of a Canadian-controlled private corporation (CCPC). A corporation that is a CCPC throughout a taxation year must add to its tax otherwise payable under Part I for that year an amount that is equal to 10 2/3% of the lesser of two amounts. The first amount is the corporation's "aggregate investment income" for the year as defined in subsection 129(4) and the second is the corporation's taxable income for the year less any amount in respect of which the corporation claimed the "small business deduction" under subsection 125(1).

Pursuant to the Budget 2022 announcement to align the taxation of investment income earned by CCPCs and substantive CCPCs, section 123.3 is amended to extend the application of the additional tax to the investment income of a corporation that is a substantive CCPC at any time in a taxation year. Since a substantive CCPC is not eligible for the "small business deduction" under subsection 125(1), the additional tax will apply to the lesser of the substantive CCPC's "aggregate investment income" and its taxable income for the year.

This amendment applies to taxation years that end on or after April 7, 2022.

The objective of the additional tax is to reduce tax deferral opportunities that individuals earning investment income directly might otherwise obtain by earning such income through a CCPC or substantive CCPC.

The additional tax imposed under section 123.3 is reflected in a CCPC or substantive CCPC's "non-eligible refundable dividend tax on hand" under subsection 129(4). It is accordingly refundable under subsection 129(1) to the corporation when it pays certain taxable dividends. For more information, see the commentary under subsections 129(1) and (4) and under the new definition of "substantive CCPC" in subsection 248(1).

Clause 32

Corporate tax reductions – Definitions

ITA
123.4(1)

"full rate taxable income"

Section 123.4 contains rules that allow a corporation to reduce its tax otherwise payable under Part I of the Act by a percentage of its "full rate taxable income" --- a term that is separately defined in the section for Canadian-controlled private corporations (CCPCs) and for other corporations. The full rate taxable income of a corporation for a taxation year is, in general terms, that part of the corporation's taxable income for the year that is not exempt from tax and has not benefited from, or been subject to, any of the various special effective tax rates provided under the Act. This amount is determined differently depending on the status of the corporation.

Pursuant to an announcement in Budget 2022 that aims to align the taxation of investment income earned by CCPCs and substantive CCPCs, paragraph (b) of the definition of full rate taxable income is amended to include corporations that were substantive CCPCs at any time in a taxation year. This ensures that the aggregate investment income of a substantive CCPC does not benefit from the general rate reduction in subsection 123.4(2).

This amendment applies to taxation years that end on or after April 7, 2022.

For more information, see the commentary on the definition of "substantive CCPC" in subsection 248(1).

Clause 33

Zero-emission technology manufacturing

ITA
125.2(2)

Subsection 125.2(2) of the Act provides the formula for determining the amount of a corporation’s zero-emission technology manufacturing deduction, which provides a tax rate reduction applicable to zero-emission technology manufacturing profits (as defined in subsection 125.2(1) of the Act) for taxation years that begin after 2021 and before 2032.

Subsection 125.2(2) is amended to extend the availability of the tax rate reduction so that it is applicable to zero-emission technology manufacturing profits for taxation years that begin after 2021 and before 2035.

Specifically, variables A and C are modified such that the full tax rate reduction applies for taxation years that begin after 2021 and before 2032. The amount of the rate reduction is gradually phased-out for taxation years that begin after 2031.

Clause 34

Investment tax credit of limited partner

ITA
127(8.1)

Subsection 127(8.1) restricts the amount of investment tax credits (ITCs) that may be allocated by a partnership to a limited partner under subsection 127(8). In general terms, a limited partner can be allocated the limited partner's share of ITCs only to the extent the allocation is not constrained by the limited partner's expenditure base and at-risk amount in respect of the partnership.

Paragraph 127(8.1)(b) is amended to adjust the at-risk amount used for the purposes of subsection 127(8.1) for amounts required by a “clean economy allocation provision” (defined in

new subsection 127.47(1)) to be added in computing a "clean economy tax credit" (also defined in new subsection 127.47(1) and currently consisting of the CCUS and clean technology investment tax credits) of the taxpayer in respect of the fiscal period.

In effect, the at-risk amount used to determine the ITCs that can be allocated to a taxpayer who is a limited partner under subsection 127(8) is reduced by the amount of any clean economy tax credit allocated to the taxpayer by the partnership.

This amendment comes into force on January 1, 2022.

Definitions

ITA
127(9)

"government assistance"

The definition of "government assistance" in subsection 127(9) is amended to exclude the CCUS tax credit in section 127.44 and the clean technology investment tax credit in section 127.45. This amendment is intended to ensure that the investment tax credits under section 127 (such as the Atlantic Investment Tax Credit) and the clean technology investment tax credit itself are not reduced where the clean technology investment tax credit is available. In the case of the CCUS tax credit, which is not reduced by government assistance, its exclusion from the definition of "government assistance" facilitates the operation of new partnership rules for clean economy tax credits in section 127.47.

This amendment applies to taxation years ending after 2021 with respect to the CCUS tax credit and after March 27, 2023 with respect to the clean technology investment tax credit.

"non-government assistance"

The definition "non-government assistance" in subsection 127(9) is relevant for the purposes of the scientific research and experimental development rules and various investment tax credit provisions, including the new investment tax credits in sections 127.44 and 127.45.

The definition is amended to clarify that amounts received directly from a government, municipality or other public authority are not considered non-government assistance.

This amendment comes into force on Royal Assent.

Clause 35

Carbon Capture, Utilization and Storage Tax Credit

ITA
127.44

New section 127.44 provides an investment tax credit for certain expenditures incurred in respect of carbon capture, utilization and storage (CCUS) projects. It is deemed to have come into force on January 1, 2022, and will generally apply to qualifying expenditures incurred on or after that date and before 2041.

Definitions

ITA
127.44(1)

New subsection 127.44(1) provides various definitions relevant for the purpose of determining the CCUS investment tax credit (the CCUS tax credit) of a taxpayer. The definitions also apply for the purposes of new Part XII.7.

The definitions in this subsection are deemed to have come into force on January 1, 2022.

“captured carbon”

“Captured carbon” means captured carbon dioxide that would otherwise be released into the atmosphere, or that is captured directly from the ambient air.

“CCUS process”

“CCUS process” provides a definition of what is meant by the process of carbon capture, utilization and storage for the purposes of CCUS tax credits. To be a CCUS process, the process must include capturing carbon, as described in paragraph (a) of the definition, and storing or using the captured carbon. Note that captured carbon is itself a defined term.

“CCUS project”

A CCUS project is defined as a project that supports a CCUS process by capturing (as described in paragraph (a) of the definition), transporting, storing or using captured carbon.

“CCUS tax credit”

The definition “CCUS tax credit” creates a cross-reference to subsection 127.44(2), which in turn refers to a portion of the cumulative CCUS development tax credit (described in subsection 127.44(4)) and the CCUS refurbishment tax credit (described in subsection 127.44(5)).

“dedicated geological storage”

In general terms, “dedicated geological storage” means a geological formation capable of permanently storing captured carbon in a “designated jurisdiction”. The geological storage must also be authorized and regulated under the laws of the designated jurisdiction. However,

dedicated geological storage does not include a geological formation where captured carbon is used for enhanced oil recovery.

“designated jurisdiction”

“Designated jurisdiction” means each of Alberta, British Columbia and Saskatchewan, as well as any other jurisdiction in Canada or the United States that the Minister of the Environment designates as described in new subsection (13). For more information, see the commentary on new subsections (13) and (14).

“dual-use equipment”

A portion of expenditures for “dual-use equipment” may qualify for CCUS tax credits under certain circumstances. To be included as dual use equipment, equipment must be described in any of paragraphs (a) to (d) of the definition. In addition, in the case of property acquired before the first day of commercial operations of the CCUS project, the equipment must be verified by the Minister of Natural Resources as being dual-use equipment.

Property included in paragraph (a) of the definition does not include property that is used for natural gas processing or acid gas injection. Paragraph (a) of the definition “dual-use equipment” has four subparagraphs:

- subparagraph (i) describes energy generation equipment;
- subparagraph (ii) describes water supply equipment;
- subparagraph (iii) describes electrical transmission equipment; and
- subparagraph (iv) describes energy distribution equipment.

Energy generation equipment (described in subparagraph (a)(i) of the definition) is equipment that is part of a CCUS project of a taxpayer and that generates electrical energy, heat energy or a combination of electrical or heat energy, if more than 50% of either the electrical energy or heat energy (not a combination of electrical or heat energy) that is expected to be produced over the total CCUS project review period, based on the most recent project plan, is expected to directly support a qualified CCUS project or hydrogen production from electrolysis or natural gas. However, the energy generation equipment cannot use fossil fuels and emit carbon dioxide that is not subject to capture by a qualified CCUS project. In addition, if the energy generation equipment is used for hydrogen production from electrolysis or natural gas any emissions produced, if not recaptured, must be abated by a qualified CCUS project. For greater certainty, energy generation equipment does not include equipment that supports the qualified CCUS project indirectly by way of an electrical utility grid.

Water supply equipment (described in subparagraph (a)(ii)) is equipment that delivers, collects, recovers, treats or recirculates water, or a combination of any of those activities and that supports a qualified CCUS project of a taxpayer,

Electrical transmission equipment (described in subparagraph (a)(iii)) is transmission equipment that directly transmits electrical energy generated by an energy generation equipment (as

described in subparagraph (a)(i)) to a qualified CCUS project, if more than 50% of the electrical energy to be transmitted by the equipment over the total CCUS project review period, based on the most recent project plan, is expected to support the qualified CCUS project or hydrogen production from electrolysis or natural gas. In addition, any emissions produced by the electrical transmission equipment must be abated by a qualified CCUS project.

Energy distribution equipment described in subparagraph (a)(iv) is equipment that is part of a CCUS project of a taxpayer that distributes electrical or heat energy.

Paragraph (b) of the definition describes integrated ancillary equipment. The integrated ancillary equipment must be physically and functionally integrated with the energy generation equipment, water supply equipment, electrical transmission equipment or energy distribution equipment. The integrated ancillary equipment must be ancillary equipment that is used solely to support the energy generation equipment, water supply equipment, electrical transmission equipment or energy distribution equipment and in performing its functional duties within a CCUS process as part of a supporting subsystem. The supporting subsystems are the electrical system, fuel supply system, liquid delivery and distribution system, a cooling system, process material storage and handling and distribution system, process venting system, process waste management system, or utility air or nitrogen distribution system. However, for greater certainty the integrated ancillary equipment does not include construction equipment, all or part of any furniture, office equipment or vehicles.

Paragraph (c) has three subparagraphs.

Subparagraph (c)(i) describes control, monitoring and safety system equipment. The control, monitoring and safety system equipment is equipment that is used as part of a control, monitoring or safety system solely to support the energy generation equipment, water supply equipment, electrical transmission equipment, energy distribution equipment or integrated ancillary equipment.

Subparagraph (c)(ii) describes a building or any other structure that is used for the installation or operation of the energy generation equipment, water supply equipment, electrical transmission equipment, energy distribution equipment, integrated ancillary equipment, or control, monitoring and safety system equipment. All or substantially all of the building or structure must be used for this purpose. All or substantially all generally means more than 90% in this context.

Subparagraph (c)(iii) describes a conversion property. The conversion property is property that is used solely to convert another property that would not otherwise be described in paragraph (a) or (b) or subparagraphs (i) and (ii) of the definition if the conversion causes the other property to satisfy the description in the paragraphs (a) or (b) or subparagraphs (i) or (ii)

Paragraph (d) of the definition includes property that is used solely to refurbish property described in paragraphs (a) or (b) or subparagraphs (c)(i) or (ii) of the definition and that is part of the CCUS project of the taxpayer.

A portion of the cost of equipment that meets the requirements of the definition “dual use equipment” is included in variable A in the formula used in the definition “qualified carbon capture expenditure”.

“eligible use”

An “eligible use” in the context of carbon capture, utilization and storage means storing captured carbon dioxide in dedicated geological storage or using the captured carbon dioxide for producing concrete using a qualified concrete storage process. For more information, see the commentary on the definitions to “dedicated geological storage” and “qualified concrete storage process” in subsection 127.44(1).

“first day of commercial operations”

The “first day of commercial operations” is the day that is 120 days after the day on which captured carbon dioxide is first delivered – on an ongoing operational basis – to a carbon transportation, carbon storage or carbon use system for the purpose of storage or use. The words “ongoing operational basis” are intended to clarify that incidental delivery of captured carbon as part of start-up testing does not constitute “commercial operations”. Similarly, the phrase “120 days after” provides some buffer in relation to expenditures that may straddle the start-up of operations. This term is relevant for establishing the beginning of the first project period, and for determining whether a CCUS development tax credit (new subsection 127.44(4)) or a CCUS refurbishment tax credit (new subsection 127.44(5)) is applicable.

“ineligible use”

An “ineligible use” in the context of carbon capture, utilization and storage means the emission of captured carbon dioxide into the atmosphere (subject to an exception for emissions for the purposes of system integrity or safety and a *de minimis* tolerance), the use of captured carbon dioxide for enhanced oil recovery or the use of captured carbon dioxide for any other purpose that is not an eligible use (as defined above).

“non-government assistance”

“Non-government assistance” has the same meaning as in subsection 127(9) of the Act. For further information, see the notes for that subsection.

“preliminary CCUS work activity”

Expenditures in respect of a “preliminary CCUS work activity” cannot be included as qualified CCUS expenditures because of new subparagraph 127.44(9)(b)(iii).

A preliminary CCUS work activity is an activity that is preliminary to the acquisition, construction, fabrication or installation by or on behalf of a taxpayer of property described in Class 57 or 58 in respect of the taxpayer’s CCUS project. Generally, a preliminary CCUS work activity includes (but is not limited to) the following activities:

- obtaining permits or regulatory approvals,
- performing front-end design or engineering work, including front-end engineering design studies (or equivalent studies as determined by the Minister of Natural Resources),
- conducting feasibility studies or pre-feasibility studies (or equivalent studies as determined by the Minister of Natural Resources), but excluding detailed design or engineering work in relation to Class 57 or 58 property,
- conducting environmental assessments, or
- clearing or excavating land.

Because "preliminary work activity" operates with subparagraph 127.44(9)(b)(iii) to exclude amounts from being qualified CCUS expenditures, the portion of paragraph (b) of the definition that excludes "detailed design or engineering work in relation to Class 57 or 58 property" signifies that expenditures on such work are not affected by subparagraph 127.44(9)(b)(iii) and may potentially qualify as qualified CCUS expenditures.

"projected eligible use percentage"

"Projected eligible use percentage" is determined for a specific length of time – usually for each project period (these are generally five calendar years each, with minor differences for the first project period due to various potential start-up dates during a calendar year). Projected eligible use percentage is determined from the project plan as the quotient obtained from the division of projected eligible use during the relevant period with, in general terms, projected total use (i.e., ineligible use + eligible use) during the same period, expressed as a percentage.

A project that plans only eligible use (for example, permanent storage in dedicated geological storage) for the entire approximately 20-year period following the first day of commercial operations (the "total CCUS project review period" – see commentary to that new definition below) would have projected eligible use of 100% for each project period. A project that plans to use 20% of its captured carbon in enhanced oil recovery (and 80% in an eligible use) for the first and second project periods, but plans to use all of the captured carbon in the third and fourth periods for producing concrete using a qualified concrete storage process, would have a projected eligible use percentage of 80% for those first two periods and 100% for the third and fourth project periods.

This new definition is used in the new definitions "qualified carbon capture expenditure" and "qualified carbon transportation expenditure" as well as in the recovery tax provisions in new Part XII.7. In new Part XII.7, there is a companion definition "actual eligible use percentage" which is important for the calculation of the recovery tax. For more information, see the commentary on that new Part.

"project plan"

A "project plan" is a plan for a CCUS project that reflects a front-end engineering design study (or an equivalent study as determined by the Minister of Natural Resources) for the project and describes the quantity of captured carbon that the CCUS project is expected to support for

storage, in each calendar year over the life of the project, in eligible use and ineligible use. In addition, the plan must contain information required as specified in guidelines published by the Minister of Natural Resources and be filed with the Minister of Natural Resources, in the form and manner determined by the Minister of Natural Resources.

An important aspect of the project plan for tax credit calculation purposes is the projected eligible use in each of four "project periods". Eligible use, as a ratio of ineligible use plus eligible use, creates the "projected eligible use percentage" described below.

"qualified carbon capture expenditure"

The definition "qualified carbon capture expenditure" is relevant to determining the amount of the taxpayer's CCUS development tax credit under new subsection (4) and CCUS refurbishment tax credit under new subsection (5). In general terms, it represents a portion of the taxpayer's capital expenditures incurred in the year to acquire property that is used for the capture aspect of a CCUS project (in contrast to property used in other parts of a CCUS project, such as for transportation, storage or use). The portion of capture expenditures that qualifies is determined based on the proportion of captured carbon that the CCUS project is expected to support for storage or use in eligible uses compared to ineligible uses.

The formula relies on the definition "projected eligible use percentage". The formula also accommodates the addition of some expenditures on project "refurbishment" as qualified carbon capture expenditures after the first day of commercial operations of the project.

As noted above, the portion of expenditures that qualify is based on the projected proportion of eligible use of captured carbon compared to ineligible use. More specifically, a "qualified carbon capture expenditure" is the portion of an expenditure incurred in the year by the taxpayer to acquire a property in respect of a qualified CCUS project, determined by the formula

$$A \times (B + C + D + E) \times F$$

Variable A represents the capital cost to the taxpayer of the property acquired by the taxpayer in the year that is property described in paragraph (a) of Class 57 in Schedule II to the Regulations, or paragraph (d), (e), (f) or (g) of Class 57 in relation to equipment described in paragraph (a) of Class 57. Property described in these paragraphs is the type of property that is used for, or related to, the capture aspect of a CCUS project. To be included in variable A, the Minister of Natural Resources must verify that the relevant property is described in one of the paragraphs referred to in the previous two sentences

Variable A also includes a portion of the capital cost of "dual-use equipment". In addition, in the case of dual-use equipment acquired before the first day of commercial operations of the CCUS project, the equipment must be verified by the Minister of Natural Resources as being dual-use equipment. The included portion is the proportion of output from the dual-use equipment that is expected to be used in a CCUS project is of total output over the period of the project's "total CCUS project review period". For more information, see the commentary on the definitions "dual-use equipment" and "total CCUS project review period".

Specifically, if the dual-use equipment is energy generation equipment, as described in subparagraph (a)(i) of the definition "dual-use equipment" the proportion of the capital cost of dual-use equipment that is to be included in Variable A is the proportion that the amount of energy expected to be produced for use in a qualified CCUS project over the project's total CCUS project review period is of the total amount of energy expected to be produced by the equipment in that period based on the project's most recent project plan. For this purpose, the energy produced and consumed by the equipment in the process of producing energy is not taken into account.

In the case of water supply equipment, as described in subparagraph (a)(ii) of the definition "dual-use equipment", the proportion of the capital cost of dual-use equipment that is to be included in Variable A is the proportion that the mass of water expected to be returned from a qualified CCUS project over the project's total CCUS project review period is of the total mass of water expected to be returned to the equipment in that period, based on the project's most recent project plan.

The proportion of the cost of dual-use equipment that is electrical transmission equipment (as described in subparagraph (a)(iii) of the definition of dual-use equipment) or energy distribution equipment (as described in subparagraph (a)(iv)) of the definition dual-use equipment) and that is to be included in Variable A is determined in a similar manner as is the case for the energy generation equipment as explained above.

However, the energy distribution equipment could also include equipment that expands the capacity of the existing energy distribution equipment. In the case of the equipment that expands the capacity of the existing energy distribution equipment, the portion of the cost of such equipment that is included in Variable A is, based on the project's most recent project plan, the proportion of the amount of electrical or heat energy expected to be distributed by the new and existing equipment for use in a qualified CCUS project over the total CCUS project review period is of the total amount of electrical or heat energy expected to be distributed by the new and existing equipment in that period.

Property located outside of Canada is excluded, such that expenditures for property outside of Canada do not qualify for the CCUS tax credit (the same restriction exists for the other categories of qualified CCUS expenditures).

For CCUS expenditures before the first day of commercial operations of the relevant CCUS project, variables B, C, D and E are the projected eligible use percentages for each of the four project periods, respectively. For expenditures after the first day of commercial operations, the projected eligible use percentage for a particular period only applies if the expenditure is before or during the period. Hence variables B, C and D can be nil depending on the timing of the expenditure.

Variable F is a factor that adjusts the result, depending on how many "projected eligible use percentages" were used in the "(B + C + D + E)" portion of the formula. In the basic situation of expenditures (for example, $10 million of such expenditures) before the first day of commercial

operations for a qualified CCUS project that projects 100% eligible use for all project periods, all of the variables after A result in “1” as a multiplier:

$10 million x (100% + 100% + 100% + 100%) x 0.25 = $10 million x 100% = $10 million.

Expenditures for property used in other parts of a CCUS project may be qualified carbon transportation expenditures, qualified carbon storage expenditures or qualified carbon use expenditures. The definition “qualified carbon transportation expenditure” is very similar to the definition “qualified carbon capture expenditure”, except that the property included in variable A of each definition references different paragraphs in Class 57, thus covering different types of property.

The definitions “qualified carbon use expenditure” and “qualified carbon storage expenditure” are also similar, except that

- there is no calculation based on projected eligible use over the project periods required, and
- the property covered by each of those definitions must be used solely to support the storage or use of captured carbon to produce concrete using a qualified concrete storage process (in the case of a qualified carbon use expenditure) or to support storage in dedicated geological storage (in the case of a qualified carbon storage expenditure).

The classification of expenditures between the different categories is relevant to determining the rate of the CCUS tax credit. Pursuant to the definition “specified percentage” in subsection (1), qualified carbon capture expenditures benefit from a higher rate relative to other types of expenditures.

New subsection (9) contains additional rules for calculating the amount of a taxpayer’s qualified carbon capture expenditures. Pursuant to that subsection, certain amounts are excluded from, or may reduce, the taxpayer’s qualified CCUS expenditures. See the commentary related to subsection (9) for more discussion.

“qualified carbon storage expenditure”

The definition “qualified carbon storage expenditure” is relevant to determining the amount of the taxpayer’s CCUS development tax credit under new subsection (4) and CCUS refurbishment tax credit under new subsection (5). In general terms, it represents a portion of the taxpayer’s capital expenditures related to property used for the storage of captured carbon (being property described in paragraph (c) of Class 57 in Schedule II to the Regulations, or paragraph (d), (e), (f) or (g) of Class 57 in relation to equipment described in paragraph (c) of Class 57). As with the other categories of qualified expenditures, expenditures must be verified by the Minister of Natural Resources as being in respect of property described in those paragraphs. The property must also be situated in Canada.

In addition, expenditures will only qualify if they are expenditures to acquire property that is expected to support storage of captured carbon solely in a manner described in paragraph (a) of

the definition of “eligible use” in subsection (1). That means the property must be expected to be used to support the storage of captured carbon in dedicated geological storage. Unlike with other types of qualified expenditures for capture and transportation, there is no ability to prorate the expenditure to the extent that it relates in part to an eligible use and in part to an ineligible use.

“qualified carbon transportation expenditure”

The definition “qualified carbon transportation expenditure” is relevant to determining the amount of the taxpayer’s CCUS development tax credit under new subsection (4) and CCUS refurbishment tax credit under new subsection (5). In general terms, it represents a portion of the taxpayer’s capital expenditures related to property used for the transportation of captured carbon (being property described in paragraph (b) of Class 57 in Schedule II to the Regulations, or paragraph (d), (e), (f) or (g) of Class 57 in relation to equipment described in paragraph (b) of Class 57). The portion of transportation expenditures that qualify is determined using the “projected eligible use percentage” for each project period in the total CCUS project review period (based on the project’s most recent project plan filed with the Minister of Natural Resources before the time the expenditure is incurred).

The definition “qualified carbon transportation expenditure” is essentially the same as the definition “qualified carbon capture expenditure”, except for the type of property that falls within variable A of the formula in each definition. See the commentary on the definition of “qualified carbon capture expenditure” for more detail.

“qualified carbon use expenditure”

The definition “qualified carbon use expenditure” is relevant to determining the amount of the taxpayer’s CCUS development tax credit under new subsection (4) and CCUS refurbishment tax credit under new subsection (5). In general terms, it represents the taxpayer’s capital expenditures related to property that is part of the “use” phase of a CCUS process (being property listed in Class 58 in Schedule II to the Regulations). Qualified carbon use expenditures must be verified by the Minister of Natural Resources as being in respect of property described in Class 58 in the case of property that is acquired before the first day of commercial operations of the relevant qualified CCUS project. The property must also be situated in Canada.

Expenditures will qualify only if they are expenditures to acquire property that is expected to support storage or use of captured carbon solely in a manner described in paragraph (b) of the definition of “eligible use” in subsection (1). That means the property must be expected to be used to support the storage or use of captured carbon to produce concrete using a qualified concrete storage process. Unlike with other types of qualified expenditures for capture and transportation, there is no ability to prorate the expenditure to the extent that it relates in part to an eligible use and in part to an ineligible use.

“qualified CCUS expenditure”

A “qualified CCUS expenditure” is any expenditure that is a qualified carbon capture expenditure, qualified carbon transportation expenditure, qualified carbon storage expenditure or qualified carbon use expenditure. See the commentary to those definitions for more detail.

“qualified CCUS project”

A “qualified CCUS project” means a CCUS project of a taxpayer that meets the following four conditions.

First, the project is expected to support the capture of carbon dioxide in Canada for a period at least equal to the “total CCUS project review period” for the project.

Second, an initial project evaluation has been issued by the Minister of Natural Resources, in the form and manner determined by the Minister of Natural Resources, in respect of the project.

Third, based on the project’s most recently filed project plan, in each of the project’s first 20 years of operation, the proportion of the quantity of captured carbon the project is expected to support for storage or use in eligible use equals or exceeds 10% of the quantity of captured carbon the project is expected to support for storage or use in both eligible use and ineligible use during the year.

Fourth, if the project is operated to service a facility that existed on April 7, 2022, it cannot be undertaken for the purpose of complying with emission standards that apply, or will apply, under the *Reduction of Carbon Dioxide Emissions from Coal-fired Generation of Electricity Regulations.*

As noted above, in order to qualify, a CCUS project must be expected to support the capture of carbon dioxide in Canada. It may do this by incorporating one or more parts of a CCUS process. The following are examples of projects that would generally be expected to satisfy this condition if undertaken in Canada:

- capturing carbon dioxide from a single site and transporting it up to the point where it connects to a transportation hub;
- transporting carbon captured from multiple sites (i.e., a transportation hub);
- storing or using captured carbon;
- capturing carbon dioxide from a single site, transporting the captured carbon and storing or using the captured carbon; and
- transporting and storing or using carbon captured from multiple sites (i.e., a transportation and storage hub).

“qualified concrete storage process”

A “qualified concrete storage process” is a process by which at least 60% of the carbon dioxide that is injected into concrete is expected to be mineralized and permanently stored in the concrete. This expected outcome must be verified by a professional or organization that meets the accreditation requirements of paragraph (a) of the definition and the third-party inspection

body requirements of its paragraph (b). This definition is relevant to the definition “eligible use”. Pursuant to paragraph (b) of that definition, captured carbon is considered to have been used in an eligible use if it is used for producing concrete using a qualified concrete storage process.

“qualifying taxpayer”

A “qualifying taxpayer” is a taxable Canadian corporation. “Taxable Canadian corporation” is defined in subsection 89(1) of the Act.

“specified percentage”

The definition “specified percentage” is the tax credit rate used to determine the amount of a taxpayer’s CCUS development tax credit and the taxpayer’s CCUS refurbishment tax credit under new subsections (4) and (5).

The specified percentage is different depending on the type of qualified CCUS expenditure. For a qualified carbon capture expenditure, the rate also varies based on whether or not the carbon is captured directly from the ambient air.

For expenses incurred after 2021 and before 2031, the rate for a qualified carbon capture expenditure is 60% if incurred to capture carbon directly from ambient air or 50% in any other case. Both rates drop by half for expenditures incurred after 2030 and before 2041.

For all other types of qualified CCUS expenditures (being qualified carbon transportation expenditures, qualified carbon storage expenditures and qualified carbon use expenditures) the rate is 37 ½% (for expenditures incurred after 2021 and before 2031) or 18 ¾% (for expenditures incurred after 2030 and before 2041).

Note that, in respect of specified property prepared or installed on or after the day on which the notice of Ways and Means motion in respect of these rules is tabled in the House of Commons, these credit rates are available for taxpayers that meet the labour requirements in new section 127.46. For taxpayers that do not elect to meet the labour requirements, each tax credit rate is reduced by ten percentage points. For more information, see the commentary on new section 127.46.

For all expenditures made after 2040 the rate is zero.

“total CCUS project review period”

“Total CCUS project review period” is a new definition of the time from the first day of commercial operations until the last day of the “fourth project period”. This is the approximately 20-year period during which a taxpayer could be required to pay CCUS recovery tax under Part XII.7.

Deemed payment of Part I tax

ITA
127.44(2)

New subsection 127.44(2) of the Act creates a deeming rule that deems a qualifying taxpayer to have paid an amount on account of its tax payable under Part I of the Act. This is the mechanism that creates the refundable tax credit. The amount is equal the total of the amounts in paragraphs (a) and (b). The deeming rule is conditional on filing a prescribed form with the taxpayer's return of income for the relevant taxation year. This approach to the legislative creation of a refundable tax credit is similar to that taken in section 125.4 (Canadian Film or Video Production Tax Credit), section 125.5 (Film or Video Production Services Tax Credit) and section 125.6 (Labour Credit for Journalism Organizations).

Paragraph (a) describes the taxpayer's cumulative CCUS development tax credit for the year minus the taxpayer's cumulative CCUS development tax credit for the preceding year. Paragraph (b) is the taxpayer's CCUS refurbishment tax credit for the year. A taxpayer's cumulative CCUS development tax credit for the year is determined under new subsection (4) and its CCUS refurbishment tax credit for the year is determined under subsection (5). For more information, see the commentary on those provisions below.

Deemed deduction

ITA
127.44(3)

New subsection 127.44(3) of the Act deems the amount that is deemed to have been paid on account of tax payable under new subsection (2) to have been deducted from the taxpayer's tax otherwise payable under Part I. This deeming rule applies for purposes of paragraph 12(1)(t), subsection 13(7.1), variable I of the definition "undepreciated capital cost" in subsection 13(21), subsection 53(2), new section 127.45 and new Part XII.7 of the Act. It causes these rules to operate in the same manner whether the CCUS credit is received as a refund or deducted against tax otherwise payable.

Cumulative CCUS development tax credit

ITA
127.44(4)

Under subsection 127.44(2), the amount by which a taxpayer's "cumulative CCUS development tax credit" for a taxation year exceeds its "cumulative CCUS development tax credit" for the preceding taxation year is, in effect, its refundable CCUS development tax credit for the year. New subsection (4) effectively defines the amount of a taxpayer's cumulative CCUS development tax credit. A taxpayer's cumulative CCUS development tax credit is the specified percentage of each type of qualified CCUS expenditure (being qualified carbon capture expenditures, qualified carbon transportation expenditures, qualified carbon storage expenditures, and qualified carbon use expenditures) incurred by the taxpayer in a taxation year and before the first day of commercial operations of the relevant qualified CCUS project. In

paragraph (4)(b), it also includes amounts required to be added in computing the taxpayer's CCUS development tax credit because of subsection 127.44(11) (the basic partnership allocation rule for CCUS tax credits). The cumulative aspect in respect of CCUS development tax credits is mainly relevant for the purpose of new Part XII.7. In particular, new subsection 211.92(2) can apply to trigger the application of a recovery tax in certain circumstances related to comparative "cumulative CCUS development tax credit" amounts year-over-year.

For more detail, see the commentary for the definitions "specified percentage", "qualified carbon capture expenditure", "qualified carbon transportation expenditure", "qualified carbon storage expenditure", and "qualified carbon use expenditure" in new subsection 127.44(1) as well as the commentary on new subsection 211.92(2).

CCUS refurbishment tax credit

ITA
127.44(5)

New subsection (5) effectively defines the amount of a taxpayer's CCUS refurbishment tax credit that can be claimed under subsection (2). As with CCUS development tax credits, a taxpayer's CCUS refurbishment tax credit is the specified percentage of each type of qualified CCUS expenditure (being qualified carbon capture expenditures, qualified carbon transportation expenditures, qualified carbon storage expenditures and qualified carbon use expenditures). The difference is that refurbishment credits relate to expenditures after the first day of commercial operations of the relevant qualified CCUS project. In paragraph (5)(b), the provision also includes amounts required to be added in computing the taxpayer's CCUS refurbishment tax credit because of subsection 127.44(11) (the basic partnership allocation rule for CCUS tax credits). Expenditures on refurbishment of a qualified CCUS project are subject to a limit, under new subparagraph (8)(b)(v), of 10% of total qualified CCUS expenditures incurred before the first day of commercial operations of the qualified CCUS project.

For more detail, see the commentary for the definitions "specified percentage", "qualified carbon capture expenditure", "qualified carbon transportation expenditure", "qualified carbon storage expenditure" and "qualified carbon use expenditure" in new subsection 127.44(1).

Change to project or eligible use

ITA
127.44(6)

New subsection 127.44(6) of the Act applies before the first day of commercial operations of a CCUS project. It requires a taxpayer to file a revised project plan for a qualified CCUS project of the taxpayer with the Minister of Natural Resources, in the form and manner determined by the Minister of Natural Resources, if the Minister of Natural Resources determines that there has been a material change to the project and requests the taxpayer to file a revised project plan for the project. A revised project plan is also required to be filed if there has been a reduction (as compared to the most recent project plan for the project) of more than five percentage points in

the quantity of captured carbon that the project is expected to support for storage or use in eligible use during any five-year period over the life of the project.

Revised project evaluation

ITA
127.44(7)

Under new subsection 127.44(7), if a taxpayer has filed a revised project plan in accordance with subsection 127.44(6) the Minister of Natural Resources is required to issue a revised project evaluation will all due dispatch.

Qualified CCUS project determination

ITA
127.44(8)

New subsection 127.44(8) of the Act provides that, for the purpose of the definition of "qualified CCUS project" in subsection (1), the Minister of National Revenue may, in consultation with the Minister of Natural Resources, determine whether one or more CCUS projects of a taxpayer is one project or multiple projects. This could be relevant, for example, to determining what portion of a taxpayer's expenditures are qualified carbon capture expenditures, qualified carbon transportation expenditures, or qualified carbon use expenditures, because each of those definitions takes into account the proportion of captured carbon that a particular qualified CCUS project will support for use in eligible uses compared to ineligible uses. This proportion could change depending on what is determined to be part of a particular qualified CCUS project. It is also relevant in determining the "first day of commercial operations" of a qualified CCUS project, which is the dividing line between CCUS development tax credits and CCUS refurbishment tax credits. Under subparagraph 127.44(9)(b)(v), in general terms, refurbishment expenditures that qualify for CCUS tax credits are restricted to 10% of development expenditures (that is, expenditures incurred before the first day of commercial operations of a project).

New subsection (8) also stipulates, in its paragraph (d), the power of the Minister of Natural Resources to request necessary documentation and the ability of the Minister to refuse to verify expenditures or a approve project if insufficient documentation is provided to the Minister.

Special rules – adjustments

ITA
127.44(9)

New subsection 127.44(9) of the Act contains several special rules that apply for the purposes of the CCUS tax rules.

ITA

127.44(9)(a)

New paragraph 127.44(9)(a) requires two adjustments to the cost of a taxpayer's Class 57 or 58 property. First, the cost of the taxpayer's Class 57 or 58 property shall be determined without reference to subsections 13(7.1) and (7.4) (allowing CCUS tax credits to be disregarded in determining the cost of property in these two classes). Second, the cost of such property is required to be reduced by the amount of any non-government assistance that, at the time of the filing of the taxpayer's return of income under this Part for the taxation year, the taxpayer has received, is entitled to receive or can reasonably be expected to receive in respect of the property.

ITA
127.44(9)(b)

Paragraph (b) causes certain expenditures to be excluded from a taxpayer's qualified CCUS expenditures. In particular, the following amounts must be excluded when calculating a taxpayer's qualified CCUS expenditure:

- any amount incurred by the taxpayer before 2022 or after 2040;
- any amount in respect of any expenditure incurred to acquire property
    - that was previously used by any person or partnership,
    - for which a CCUS tax credit was previously claimed, or
    - for which a clean technology credit or a section 127 investment tax credit is claimed;
- any amount in respect of an expenditure incurred for a "preliminary CCUS work activity" (defined in new subsection 127.44(1));
- an amount that has been added to the cost of property because of section 21; and
- an expenditure on "refurbishment" (i.e., incurred on or after the first day of commercial operations of a particular qualified CCUS project) to the extent that it exceeds 10% of the taxpayer's qualified CCUS expenditures incurred before the first day of commercial operations of the project.

Due to the breadth of the term "in respect of" used in subparagraph (b)(ii), an exception is introduced in clause (b)(ii)(B) to allow expenditures in relation to repair or replacement of property for which a CCUS tax credit was previously claimed.

ITA
127.44(9)(c)

In general terms, the CCUS rules support CCUS projects in Canada. However, taxpayers may acquire property outside of Canada to include in their CCUS projects. Because the available for use rules do not apply in relation to CCUS projects, new subsection 127.44(9)(c) provides a special rule for property being imported into Canada.

This rule generally deems the related expenditure to have been incurred, and the property acquired, at the time that it is brought into Canada. Because the rule is turned off for the purposes of subparagraph (9)(b)(i), it cannot be used to move the time of acquisition of property that was

factually acquired outside Canada before 2022 to after the effective date of the CCUS regime. Similarly, this rule is subject to new subsection 127.44(11), which delays the date on which unpaid expenditures are considered to have been incurred until the date they were paid.

ITA
127.44(9)(d)

New subparagraph 127.44(9)(d) incorporates certain rules from section 127 (investment tax credits) with minor modifications to adapt them for the purposes of the CCUS rules. The effect of subsections 127(11.6) to (11.8), as adapted for CCUS purposes, is to restrict amounts recognized as costs in non-arm's length situations. For more information, see the commentary to existing subsections 127(11.6) to (11.8).

ITA
127.44(9)(e)

New paragraph 127.44(9)(e) is a special rule to deal with circumstances where an expenditure is incurred in relation to a property before the property is acquired. This could happen, for example, if there is a delay in delivery of purchased property. If these two events happen in different taxation years, paragraph 127.44(9)(e) deems both the incurring of the expenditure and the acquisition of the property to happen in the later of the two taxation years. In this regard, subsection 127.44(12) could apply to deem an expenditure to be incurred when it is paid (i.e. later than when it was factually incurred). That deeming rule is not overridden here, meaning that subsection (12) should be applied in the first place, to determine when an affected expenditure (involving unpaid amounts) is initially deemed to have been incurred (when paid). That expenditure could then be further delayed under paragraph 127.44(9)(e) if the property is not acquired until a subsequent year.

ITA
127.44(9)(f)

New paragraph 127.44(9)(f) provides that, in determining whether a process is a CCUS process (as defined in subsection 127.44(1)), whether a property is "dual-use equipment" or is described in Class 57 or 58 of Schedule II to the Regulations, the technical guide published by the Department of Natural Resources applies conclusively with respect to engineering and scientific matters. This rule is similar to the existing rule in subsection 13(18.1) which applies in relation to determinations related to Classes 43.1 and 43.2.

ITA
127.44(9)(g)

Paragraph 127.44(9)(g) is an enforcement mechanism for the requirement to file a revised project plan under subsection 127.44(6). Until the revised project plan is filed, the taxpayer's projected eligible use percentage is deemed to be nil. Once the revised project plan is filed, the rule ceases to apply and is deemed never to have applied.

Repayment of assistance

ITA
127.44(10)

New subsection 127.44(10) of the Act applies if a taxpayer repaid (or has not received and can no longer reasonably be expected to receive) in a particular taxation year, an amount of non-government assistance that was applied to reduce the amount of a qualified CCUS expenditure (the "reduced expenditure") under one of paragraphs (a) to (d) (the "relevant paragraph") of that definition for a preceding taxation year. The amount of the reduced expenditure is added to the amount otherwise determined to be the taxpayer's qualified CCUS expenditure (under the relevant paragraph of that definition) for the particular year.

Partnerships and limited partners

ITA
127.44(11)

The CCUS rules are intended to apply to partnerships and their partners in a generally similar manner to other investment tax credits under section 127, while maintaining the exclusion of tax-exempt entities from eligibility for CCUS tax credits. New subsection 127.44(11) of the Act applies if a qualifying taxpayer in a particular taxation year is a member of a partnership, and a CCUS tax credit would be determined in respect of the partnership for its taxation year that ends in the particular taxation year if the partnership were a taxable Canadian corporation (and its fiscal period were its taxation year). New subsection (11) provides a rule, similar to existing subsection 127(8), that effectively flows the portion of a CCUS tax credit that can reasonably be considered to be a member's share of the credit to the member.

New subsection (11) states that it is subject to section 127.47. New section 127.47 provides a number of rules relevant to the allocation of certain tax credits by partnerships to their members. For more information, refer to the commentary on that new section.

Unpaid amounts

ITA
127.44(12)

New subsection 127.44(12) of the Act provides that if an expenditure that is unpaid on the day that is 180 days after the end of the taxation year of a taxpayer in which the expenditure is incurred, for the purposes of section 127.44, the expenditure is deemed to have been incurred at the time it is paid.

Designated jurisdictions

ITA
127.44(13) and (14)

In order for captured carbon (carbon dioxide) to be stored in accordance with the requirements of the CCUS rules, it must be stored in "dedicated geological storage" as defined in subsection 127.44(1). Among other things, dedicated geological storage must be in a "designated jurisdiction", which is also defined in subsection 127.44(1). A designated jurisdiction means any of Alberta, British Columbia or Saskatchewan, plus any jurisdiction in Canada or the United States for which a designation by the Minister of the Environment is in effect. New subsection 127.44(13) provides the authority and mechanism for the Minister of the Environment (i.e., the Minister responsible for Environment and Climate Change Canada) to designate a jurisdiction for this purpose. It also deems the existing designated jurisdictions to have been designated in this same manner.

New subsection 127.44(14) provides the Minister with the authority to revoke a designation of a jurisdiction, in circumstances where the regulatory regime or the enforcement of that regime has ceased to be adequate to ensure permanent storage of captured carbon.

Purpose

ITA
127.44(15)

New subsection 127.44(15) specifies that the purpose of new section 127.44 and new Part XII.7 of the Act is to encourage and support the investment of capital in the development and operation of carbon capture, transportation, utilization and storage capacity in Canada.

Tax shelter investments

ITA
127.44(16)

New subsection 127.44(16) prevents CCUS tax credits from being available in respect of CCUS projects if a property used in the project is a tax shelter investment (for the purpose of section 143.2).

This rule is similar to existing subsection 125.4(4), which applies in relation to Canadian Film or Video Production Tax Credits.

Late filings

ITA
127.44(17)

New subsection 127.44(17) is an administrative rule for the purpose of ensuring efficient administration of the CCUS tax credits by the Minister of National Revenue.

The rule permits the Minister to accept the late-filing by a qualifying taxpayer of the prescribed form referred to in subsection (2) only until one year after the filing-due date referred to in subsection (2). No overpayment by the taxpayer is deemed to arise under that subsection until the form has been filed with the Minister.

Clause 36

Clean Technology Investment Tax Credit

ITA
127.45

New section 127.45 provides a fully refundable investment tax credit for acquisitions of certain clean technology capital property. The credit applies to clean technology property that is both acquired and becomes available for use on or after March 28, 2023.

Definitions

ITA
127.45(1)

Subsection (1) contains definitions that apply in new section 127.45.

"clean technology investment tax credit"

The definition of "clean technology investment tax credit" contains two elements. The first element includes the specified percentage of the capital cost to the taxpayer of clean technology property acquired by the taxpayer in the year. The second element applies where the taxpayer is a member of a partnership that acquired clean technology property, and includes amounts required by subsection (8) to be added in computing the taxpayer's clean technology investment tax credit at the end of the year. This definition is relevant to computing the amount of a taxpayer's credit that may be claimed under subsection 127.45(2).

"clean technology property"

The definition of "clean technology property" is added to describe the property for which the clean technology investment tax credit may be available. The definition contains four general requirements, which are set out in paragraphs (a) to (d).

Paragraph (a) requires that the property be situated in Canada and is intended for use exclusively in Canada. Paragraph (a) also ensures that certain wind and water energy properties (more fully described in subparagraphs (d)(v) and (d)(xiv) of Class 43.1 in Schedule II to *the Income Tax Regulations*) are included if they are installed in Canada's exclusive economic zone. Parallel language has been added to subparagraph (e)(i) of Class 43.1 in respect of such properties. In order to qualify for the clean technology investment tax credit, these wind and water energy

properties would also have to meet the requirement in subparagraph (d)(i) of the definition of "clean technology property".

Paragraph (b) requires that the property has not previously been acquired for use or lease before it was acquired by the taxpayer. This ensures that the credit is only available for new equipment.

Paragraph (c) requires that if the property is leased by the taxpayer to another person, that person must be a qualifying taxpayer. Alternatively, it also permits the property to be leased to a partnership all the members of which are taxable Canadian corporations. Paragraph (c) also requires that the property be leased in the ordinary course of carrying on a business in Canada by the taxpayer whose principal business is one of the specified activities, or any combination thereof.

Paragraph (d) requires that the property be described in one of subparagraphs (i) to (vii), which describe specific types of equipment. These subparagraphs set out certain property described in Classes 43.1, 43.2 and 56 of Schedule II to the *Income Tax Regulations*, with certain qualifications and exceptions. In general terms, qualifying equipment falls under the following categories:

- Equipment used to generate electricity from solar, wind and water energy
- Stationary electricity storage equipment that does not use any fossil fuel in operation
    - This exclusion is not intended to apply to the electricity used to charge an electricity storage system, but rather to the direct use of fossil fuels by such a system.
- Active solar heating equipment, air-source heat pumps and ground-source heat pumps
- Non-road zero-emission vehicles and related charging and refueling equipment
- Equipment used exclusively to generate electrical or heat energy from geothermal energy, unless it is part of a system that will co-produce oil, gas or other fossil fuels for sale
    - Equipment that uses any fossil fuel to generate electricity and/or heat energy would be ineligible for the credit.
- Concentrated solar energy equipment
- Small modular nuclear reactors

"concentrated solar energy equipment"

The definition of "concentrated solar energy equipment" captures certain equipment used all or substantially all to generate heat or electricity exclusively from concentrated sunlight. Such equipment is then incorporated into the definition of "clean technology property" in subparagraph (d)(vi) of that definition. Concentrated solar energy equipment does not include "excluded equipment".

"excluded equipment"

The definition of "excluded equipment" carves out certain types of property that are not intended to qualify as concentrated solar energy equipment.

“government assistance” and “non-government assistance”

For the purposes of section 127.45, the terms “government assistance” and “non-government assistance” have the meanings assigned by subsection 127(9). As is the case for existing investment tax credits in section 127, the capital cost of property that is eligible for the clean technology investment tax credit is reduced by the amount of any government assistance or non-government assistance pursuant to paragraph 127.45(5)(b). Those amounts could become eligible for the clean technology investment tax credit if they are subsequently repaid, pursuant to subsection 127.45(7).

“non-clean technology use”

The definition of “non-clean technology use” describes one of the circumstances where a previously-eligible clean technology property could become subject to the recapture rules in subsections 127.45(11) to (18). It does so by applying a point-in-time test: if, after its acquisition by the taxpayer, the property no longer meets the criteria for being a clean technology property (other than the requirement that it was not previously used), it will be treated as having been converted to a non-clean technology use.

For example:

- Equipment described in subparagraph (d)(i) of the definition of “clean technology property” could be subject to recapture if it is no longer used to generate solar, wind or water energy (e.g., the equipment is disassembled).
- A property that was originally eligible under subparagraph (d)(v) of the definition of “clean technology property” as equipment used exclusively for the purpose of generating electrical energy from geothermal energy might later be used in connection with a system that co-produces a fossil fuel for sale. This would be a non-clean technology use that could trigger recapture.
- Electrical generating equipment that was originally a component of a small modular nuclear reactor could be repurposed to a non-clean technology use such as production of energy from natural gas. In that case, it would no longer be used “all or substantially all to generate electrical energy or heat energy from nuclear fission” and could trigger recapture.

“qualifying taxpayer”

The definition of “qualifying taxpayer” ensures that only taxable Canadian corporations, together with mutual fund trusts that are real estate investment trusts, are eligible for the clean technology investment tax credit. Qualifying taxpayers that are members of a partnership that acquires clean technology property may also be eligible for the credit.

“small modular nuclear reactor”

The definition of "small modular nuclear reactor" describes a category of equipment that qualifies as clean technology property. It describes certain equipment that is used all or substantially all to generate heat or electricity from nuclear fission. Since the clean technology investment tax credit is intended to be limited to small reactors, the definition establishes caps on the gross rated generating capacity of the related system, consisting of 300 megawatts electric and 1,000 megawatts thermal. In addition, the equipment must be part of a system comprised of modules that are factory-assembled and transported pre-built to the installation site. Certain ancillary equipment (including nuclear fission fuel and equipment and materials for nuclear waste disposal and disposal sites) are ineligible.

"specified percentage"

The definition of "specified percentage" sets out the rates for determining the amount of the clean technology investment tax credit.

Under paragraph (a), the rate is nil for property that is acquired before March 28, 2023. Paragraph (a) applies without reference to subsection 127.45(4), which otherwise deems property not to have been acquired until it is available for use. Accordingly, property that is acquired before March 28, 2023, but becomes available for use on or after that day, is ineligible for the clean technology investment tax credit.

Under paragraph (b), the rate is 30 per cent for property acquired on or after March 28, 2023 and before 2034.

Under paragraph (c), the rate is 15 per cent for property acquired in 2034. Subsection 127.45(4) would deem property that was acquired in 2033 or earlier, but became available for use in 2034, to be acquired in 2034 so that it would be subject to the 15 per-cent rate.

Under paragraph (d), the rate is nil for property acquired after 2034. Subsection 127.45(4) would deem property that was acquired in 2034 or earlier, but became available for use in 2035, to be acquired in 2035 so that it would be subject to the nil rate.

However, the above-noted rates could be reduced by ten percentage points if the claimant does not elect to meet the labour requirements set out in new section 127.46. See the explanatory notes to that section for more information.

Refundable Clean Technology Investment Tax Credit

ITA
127.45(2)

Subsection 127.45(2) deems the amount of the clean technology investment tax credit to have been paid on account of tax payable by a qualifying taxpayer for the year, where the taxpayer has filed with its return of income for the year a prescribed form containing prescribed information. The deemed payment will effectively reduce the taxpayer's tax payable for the year, if any, and

result in a refund to the extent the clean technology investment tax credit exceeds its tax payable for the year.

Time limit for application

ITA
127.45(3)

Subsection 127.45(3) places a time limit on filing the form necessary to be eligible for the clean technology investment tax credit. The prescribed form claiming the clean technology investment tax credit must be filed on or before the day that is one year after the taxpayer's filing-due date for the year. A consequential change to subsection 220(2.2) removes the Minister's discretion to waive this requirement.

Time of acquisition

ITA
127.45(4)

Subsection 127.45(4) deems clean technology property not to have been acquired until it has become available for use by a taxpayer. Accordingly, the clean technology investment tax credit cannot be claimed before the year the property is available for use, even if expenditures to acquire the property are incurred in an earlier year. This could also impact the specified percentage applicable during the phase-out period. See the explanatory notes to the definition of "specified percentage" in subsection 127.45(1) for more information.

Special rules – adjustments

ITA
127.45(5)

Subsection (5) sets out a number of restrictions on clean technology investment tax credit claims.

Under paragraph (a), the clean technology investment tax credit is not available for any property for which a clean technology investment tax credit was previously claimed by any person, or for which a CCUS tax credit in section 127.44was deducted. In addition, amounts added to the cost of property by virtue of section 21 may not form part of the capital cost of a clean technology property for clean technology investment tax credit purposes.

Under paragraph (b), the capital cost of clean technology property is reduced by amounts of "government assistance" and "non-government assistance" (as those terms are defined in subsection 127(9)) in respect of the property. Amounts that are repaid or are no longer expected to be received may be eligible for the clean technology investment tax credit under subsection (7).

Under paragraph (c), adjustments in subsections 127(11.6) to 127(11.8) may apply to the cost of property transferred between non-arm's length parties for investment tax credit purposes. Those rules are imported for the purpose of the clean technology investment tax credit, subject to certain necessary adjustments.

Deemed deduction

ITA
127.45(6)

Subsection 127.45(6) ensures that any amount deemed to have been paid on account of tax payable under subsection 127.45(2) is also deemed to have been deducted from the taxpayer's tax otherwise payable under Part I. This deeming rule applies for the purpose of various provisions of the Act. It causes these rules to operate in the same manner whether the clean technology investment tax credit is received as a refund or is actually deducted against tax otherwise payable.

Repayment of assistance

ITA
127.45(7)

The capital cost of clean technology property may be reduced under paragraph 127.45(5)(b) by the amount of "government assistance" and "non-government assistance" that is received, is receivable or is reasonably expected to be received, in respect of the property. If such assistance is subsequently repaid or can no longer reasonably be expected to be received, those amounts may once again be eligible for the clean technology investment tax credit because of subsection 127.45(7).

Partnerships

ITA
127.45(8)

Subsection 127.45(8) applies if a taxpayer in a particular taxation year is a member of a partnership, and a clean technology investment tax credit would be determined in respect of the partnership if it were a taxable Canadian corporation. The clean technology investment tax credit rules are generally intended to apply to partnerships and their partners that are qualifying taxpayers in a manner similar to the partnership rules for the investment tax credits under section 127. However, some important modifications to the partnership rules are made for the clean economy investment tax credits described in new section 127.47, to which subsection 127.45(8) is subject. See the explanatory notes to section 127.47 for more information.

Unpaid amounts

ITA

127.45(9)

Subsection 127.45(9) ensures that if any part of the capital cost of a taxpayer's clean technology property is unpaid on the day that is 180 days after the end of the taxation year of a taxpayer in which the clean technology property was acquired, that part of the cost is added to the capital cost of the clean technology property at the time it is paid for the purpose of section 127.45.

Tax shelter investment

ITA
127.45(10)

Subsection 127.45(10) provides that the clean technology investment tax credit is unavailable if a clean technology property (or an interest in a person or partnership with a direct or indirect interest in such property) is a tax shelter investment under section 143.2.

Recapture – conditions for application

ITA
127.45(11)

Subsection 127.45(11) sets out three conditions for when recapture of all or part of the clean technology investment tax credit applies.

Paragraph (a) requires that the taxpayer have acquired a clean technology property in the particular year or in any of the preceding ten calendar years. This means that the recapture rules could apply based on actions that occur during the ten calendar years after a property is acquired.

Paragraph (b) requires that the taxpayer became entitled to a clean technology investment tax credit in respect of all or a portion of the capital cost of that property.

Paragraph (c) requires that the property be converted to a non-clean technology use, be exported from Canada or be disposed of. Paragraph (c) does not apply if the property was previously converted to a non-clean technology use or exported from Canada, which ensures that recapture is not triggered twice for the same property. In cases where the property has been disposed of without having previously been converted to a non-clean technology use or exported from Canada, recapture may be deferred in some cases by virtue of subsections 127.45(13) and (14).

Recapture of credit

ITA
127.45(12)

Where recapture applies in respect of a clean technology property, it is effectively calculated based on the proportion of the value of the property that has been utilized by the taxpayer prior to its conversion to a non-clean technology use, its export or its disposition. For example, if a clean

technology property is sold to an arm's length party for 80% of the of the original capital cost of the property to the taxpayer, 80% of the clean technology investment tax credit associated with that property will be recaptured. Similarly, if a clean technology property is converted to a non-clean technology use at a time when its fair market value is 50% of its original capital cost, 50% of the clean technology investment tax credit associated with that property will be recaptured. Recapture of the clean technology investment tax credit will in no case exceed the clean technology investment tax credit associated with the particular property.

Where a clean technology property is disposed of to a person that deals at arm's length with the taxpayer, variable B of the formula in subsection 127.45(12) will be the proceeds of disposition of the particular property. In the other cases (being the disposition to a non-arm's length party, conversion to a non-clean technology use or export), variable B of the formula in subsection 127.45(12) will be the fair market value of the particular property.

There is an exception to the recapture rules if the property is disposed of to certain related persons, in which case recapture may be deferred pursuant to subsections 127.45(13) and (14).

Certain non-arm's length transfers — recapture deferred

ITA
127.45(13) and (14)

Subsection 127.45(13) sets out the conditions for the deferral of recapture under subsection 127.45(14).

Under subsection 127.45(13), recapture of the clean technology investment tax credit will be deferred where clean technology property is disposed of by a taxable Canadian corporation to a related taxable Canadian corporation in circumstances where the property would be clean technology property to the purchaser (but for the requirement that the property not have been previously used under paragraph (b) of the definition of clean technology property). This relieving provision is intended to facilitate bona fide transfers of clean technology property within corporate groups. It is similar to subsection 127(33), which provides for deferral of the recapture of certain other investment tax credits where property is transferred to a non-arm's length party.

Subsection 127.45(14) provides for the deferred recapture. It generally causes the transferee to be treated as if it had claimed credits of the transferor in respect of the property, ensuring that the transferee is subject to recapture if it changes the use of the property to a non-clean technology use, or disposes of or exports the property. To achieve this result, subsection 127.45(14) makes subsection 127(34) applicable, with such modifications as the circumstances require. See the explanatory notes to subsections 127(33) and (34) for more information.

Recapture event reporting requirement

ITA
127.45(15)

Where a recapture event described in subsection 127.45(11) occurs, or a deferral of recapture occurs because a taxable Canadian corporation transferred clean technology property to a related taxable Canadian corporation under subsection 127.45(13), the taxpayer is required to notify the Minister in prescribed form and manner on or before the taxpayer's filing-due date for that year. Consequential amendments to subsections 152(4) and (4.01) will extend the assessment period in respect of clean technology investment tax credit recapture assessments where the notification has not been filed in prescribed form and manner.

Recapture of credit – partnerships

ITA
127.45(16) and (17)

Subsection 127.45(16) sets out the conditions for the recapture of a clean technology investment tax credit received through a partnership. These conditions are substantially similar to the recapture conditions that would apply to a qualifying taxpayer who acquired a clean technology property directly.

Under paragraph (a), the partnership must have acquired a clean technology property in the fiscal period or in any of the ten preceding calendar years.

Under paragraph (b), the cost, or a portion of the cost, of the clean technology property must have been included in computing the clean technology investment tax credit of a member of the partnership (i.e., the partnership computed a clean technology investment tax credit, which is attributable to the property, and allocated that credit to its members under subsection (8)). Under paragraph (c), in the fiscal period, the partnership must have converted the property (or another property that incorporates the property) to a non-clean technology use, exported it from Canada or disposed of it, in each case without having previously exported it or converted it to a non-clean technology use.

In these circumstances, subsection 127.45(17) provides for an addition to tax in respect of a recaptured clean technology investment tax credit for a member of a partnership during its fiscal period where all the conditions in paragraphs (a) to (c) of subsection (16) are met.

The recaptured amount is the taxpayer's share of the lesser of (a) the amount that can reasonably be considered to have been included in respect of the property in computing the partnership's credit amount that was available for allocation under subsection (8), and (b) the percentage of the partnership's credit amount in respect of the property, applied to either the proceeds of disposition of the property (if the property is disposed of to an arm's length person) or the fair market value of the property at the time the property is converted to a non-clean technology use, exported, or disposed of (in any other case).

Information return – partnerships

ITA

127.45(18)

Where a recapture event described in subsection 127.45(16) that gives rise to recapture under subsection 127.45(17) occurs, the partnership is required to notify the Minister in prescribed form and manner on or before the day when a return is required by section 229 of the *Income Tax Regulations* to be filed in respect of the period. Consequential amendments to subsections 152(4) and (4.01) will extend the period during which an assessment may be made in respect of the recapture of the clean technology investment tax credit where the notification has not been filed in prescribed form and manner.

Clean technology investment tax credit – purpose

ITA
127.45(19)

Subsection (19) is an interpretative provision that describes the intended purpose of the clean technology investment tax credit: to encourage the investment of capital in the adoption and operation of clean technology property in Canada.

Authority of the Minister of Natural Resources

ITA
127.45(20)

Subsection 127.45(20) gives the Department of Natural Resources the authority to publish technical guidance that will apply conclusively with respect to engineering and scientific matters, for the purpose of determining whether a property is a clean technology property. The Department of Natural Resources already publishes such a technical guide for property in Classes 43.1 and 43.2 of Schedule II to the *Income Tax Regulations*.

Clause 37

Labour Requirements Related to Certain Investment Tax Credits

ITA
127.46

New section 127.46 introduces labour requirements that apply in relation to the new investment tax credits for carbon capture utilization and storage (CCUS) and clean technology. Future investment tax credits may also be subject to these requirements. The labour requirements apply for taxpayers that claim the higher rate for these investment tax credits. Taxpayers that do not elect to meet the labour requirements can claim investment tax credits at a rate reduced by ten percentage points.

There are two main aspects to the labour requirements: the prevailing wage requirements and the apprenticeship requirements. In general terms, among other conditions,

- the prevailing wage requirements (subsection 127.46(3)) are met by paying "covered workers" either in accordance with the terms of an "eligible collective agreement" or at a level at least equivalent to the value of compensation (including benefits) provided to similar workers under such an agreement; and
- the apprenticeship requirements (subsection (5)) are met by ensuring that at least 10% of the labour performed by workers in the Red Seal trades is performed by registered apprentices.

The basic structure of section 127.46 is as follows:

1. Subsection 127.46(1) contains the relevant definitions.
2. Subsection 127.46(2) requires an election regarding labour requirements to be made to by a taxpayer that claims certain tax credits at the "regular tax credit rate" (as defined in subsection 127.46(1)).
3. Subsection 127.46(3) sets out the prevailing wage requirements and subsection 127.46(4) provides a related indexation rule.
4. Subsection 127.46(5) sets out the apprenticeship requirements.
5. Subsections 127.46(6) to (9) specify consequences for failing to meet the labour requirements. Subsection (10) provides an exception where subsection (9) does not apply.
6. Subsections (11) and (12) set out the corrective measures (top-up payments to covered workers) that apply, in addition to the tax under subsection 127.46(6), for circumstances where some covered workers are not paid at the prevailing wage within the time specified (unless subsection (9) applies). Subsection (14) specifies the tax treatment of top-up payments.
7. Subsection (15) provides an exception where section 127.46 does not apply.
8. Subsection (16) provides a method of satisfying the apprenticeship requirements in paragraphs (5)(a) and (b).
9. Subsection (17) provides rules for incentive claimants that are partnerships.

The new rules apply in respect of specified property (as defined in subsection 127.46(1)) prepared or installed on or after the day on which the notice of a Ways and Means motion in respect of this section is tabled in the House of Commons.

More detail regarding these new rules is set out below.

Definitions

ITA
127.46(1)

New subsection 127.46(1) provides definitions that apply for the purposes of the section.

"apprenticeship requirements"

This term creates a cross-reference to new subsection (5), which contains the requirements.

“benefits”

This term is defined to mean vacation, pension, health and welfare benefits required to be provided by employers to or for employees under an eligible collective agreement.

“covered worker”

The labour requirements apply in relation to “covered workers”. Covered workers are those workers who are engaged in the preparation or installation of specified property at a “designated work site” and whose work is primarily manual or physical in nature. The term includes workers who are employees of an “incentive claimant” (a taxpayer claiming an investment tax credit) as well as employees of any other person or partnership (contractors or subcontractors) who are engaged in the preparation or installation of the investment tax credit property.

Paragraph (c) of the definition specifically excludes workers who are administrative, clerical or executive employees, or who are business visitors to Canada under section 187 of the *Immigration and Refugees Protection Regulations*.

“designated work site”

A designated work site is a site where “specified property” of an incentive claimant is located.

“eligible collective agreement”

An eligible collective agreement for Quebec means a collective agreement negotiated in accordance with applicable provincial law or a prescribed agreement. At this time, no agreements are prescribed. For other provinces and territories, it means either

- the most recent multi-employer collective bargaining agreement negotiated with a trade union affiliated with Canada’s Building Trades Union that may reasonably be considered the industry standard for a given trade, in a region or province, or
- a project labour agreement that
    - is negotiated with a trade union;
    - is in accordance with provincial law,
    - covers the work associated with the investments eligible for the specified tax credits and
    - provides for wages and benefits for covered workers in a given trade that are at least equal to the regular wages and benefits provided for covered workers in an agreement described in the previous bullet.

  For this purpose, wages means the base wage that applies without taking into account overtime or other special circumstances.

Note that under subsection 35(1) of the *Interpretation Act* the term “province” includes each of Canada’s territories.

Additional types of agreements could be prescribed by regulation.

“incentive claimant”

This term means a person that plans to claim or has claimed a specified tax credit for a taxation year. It also includes a partnership if at least one member of the partnership plans to claim or has claimed a specified tax credit for a taxation year.

“installation taxation year”

This term generally means a taxation year during which preparation or installation of specified property takes place. It is relevant because labour that is undertaken in a different year from the year in which the related tax credit is claimed must still meet the labour requirements. This situation could occur in multi-year projects (where the labour may occur in a taxation year before the credit is claimed), or in situations where the CCUS tax credit is available in an earlier year because the available for use rules do not apply to it (i.e., the credit may be claimed in a taxation year before the labour occurs).

There may be multiple installation taxation years in respect of the same credit, and the labour requirements would need to be met in respect of all those years.

“prevailing wage requirements”

This term creates a cross-reference to new subsection (3), which contains the requirements.

“Red Seal trade”

This term has essentially its ordinary meaning of a Red Seal trade for a province or territory under the Red Seal Program, but also includes an equivalent provincially registered trade for those provinces that do not use the Red Seal Program for a particular trade.

“Red Seal worker”

This term means a covered worker whose duties are, or are equivalent to, those duties normally performed by workers in a Red Seal trade.

“reduced tax credit rate”

This term means the regular tax credit rate minus ten percentage points.

“regular tax credit rate”

This term means the “specified percentage” as defined in subsections 127.44(1) and 127.45(1), as the case may be, and is the tax credit rate available for taxpayers who meet the labour requirements.

“specified property”

This term means property all or a portion of the cost of which qualifies for a specified tax credit. The labour requirements relate to the preparation or installation of specified property.

“specified tax credit”

Under these legislative proposals, this term means a CCUS tax credit under section 127.44 or a clean technology investment tax credit under section 127.45.

Reduced or regular rate

ITA
127.46(2)

New subsection 127.46(2) specifies that, in order qualify for the “regular tax credit rate”, an incentive claimant must elect in prescribed form and manner to meet the labour requirements. An incentive claimant that does not elect under subsection (2) is limited to claiming the CCUS tax credit and clean technology investment tax credit at the “reduced tax credit rate”, which is ten percentage points less than the rate that would otherwise be available in respect of those credits under section 127.44 or 127.45, as applicable.

Where an incentive claimant elects to meet the labour requirements but fails to do so, the incentive claimant generally maintains its entitlement to the credit at the regular tax credit rate but will be required to take corrective measures or pay related penalties. An incentive claimant loses its entitlement to a credit at the regular tax credit rate if it fails to meet the labour requirements knowingly or in circumstances amounting to gross negligence. Subsections 127.46(6) and (7) specify the ordinary consequences of failing to meet the prevailing wage and apprenticeship requirements, respectively, in the absence of intentional conduct or gross negligence. Subsection (9) sets out the consequences of intentional conduct or gross negligence.

Prevailing wage requirements

ITA
127.46(3)

New subsection 127.46(3) sets out the prevailing wage requirements.

Paragraph (a) provides that the prevailing wage requirements could be prescribed by regulation. Initially there will be no requirements prescribed by regulation. Where no regulations have been prescribed for a particular circumstance, the prevailing wage requirements in paragraph (b) apply.

There are three elements to the prevailing wage requirements in paragraph (b).

First, the required level of compensation for covered workers at the designated work site, in respect of their work on the preparation or installation of specified property, is described in subparagraph 127.46(3)(b)(i). The compensation must either be paid in accordance with an eligible collective agreement, or in an amount at least equal to the amount of wages and benefits specified in the eligible agreement that most closely aligns to the worker's experience level, tasks and location.

The second requirement in subparagraph 127.46(3)(b)(ii) is that the incentive claimant must attest in prescribed form and manner that it has met the prevailing wage requirements for its own employees at the designated work site. It must also attest that it has taken reasonable steps to ensure that covered workers employed by others at the designated work site are so compensated.

The final requirement stipulates the means of informing covered workers about the prevailing wage requirements in place at the designated work site. This should help ensure that covered workers, including workers who are not employed directly by the incentive claimant, are aware that they should expect to be paid prevailing wages.

Indexation of prevailing wages

ITA
127.46(4)

New subsection 127.46(4) requires that prevailing wages be indexed for inflation in cases where the relevant eligible collective agreement referred to in subparagraph (3)(b)(i) has expired. For this purpose, the average Consumer Price Index should be applied as set out in section 117.1 (the rule that applies for indexation of the personal income tax brackets) for each calendar year that begins after the expiration of the eligible collective agreement.

Apprenticeship requirements

ITA
127.46(5)

New subsection 127.46(5) sets out the apprenticeship requirements. There are two basic elements to the apprenticeship requirements. The first, in paragraph (a), is that incentive claimants must make reasonable efforts to ensure that apprentices registered in a Red Seal trade work at least 10% of the total hours that are worked during an installation taxation year by Red Seal workers at a designated work site of the incentive claimant on the preparation or installation of specified property. However, this requirement is subject to paragraph (b) which overrides paragraph (a) if the basic requirement cannot be met because of conflicting requirements of an applicable law or collective agreement. In that case, the incentive claimant must make reasonable efforts to come as close as possible to meeting the paragraph (a) requirement, without breaking the other applicable rules.

The second requirement is that the incentive claimant attest in prescribed form and manner that it has met the apprenticeship requirements in respect of covered workers at the designated work site.

An incentive claimant may be deemed to have satisfied the apprenticeship requirements if they meet the conditions in subsection (16). See the commentary accompanying that subsection.

Addition to tax — wage requirement

ITA
127.46(6)

If an incentive claimant has claimed the regular rate tax credit rate but has failed to meet the prevailing wage requirements, then the incentive claimant is liable to pay a special tax equal to $20 per day for each covered worker paid at less than the prevailing wage. This tax applies except in situations of intentional conduct or gross negligence, in which case the consequences in subsection (9) apply.

Addition to tax — apprenticeship requirement

ITA
127.46(7)

In general terms, if an incentive claimant has claimed the regular rate tax credit rate but has not achieved the 10% apprenticeship labour hours requirement in subsection 127.46(5), subject to the modification of that 10% rule in paragraph 127.46(5)(b)), then the incentive claimant is liable to pay a special tax equal to $50 multiplied by the difference between the number of hours that were required to have been performed by apprentices and the number of hours of labour that were either actually performed by apprentices, or in respect of which reasonable efforts were made to employ the required number of apprentices.

In this regard, new subsection (16) creates a deeming rule that outlines a way for an incentive claimant to establish that it has made reasonable efforts. See the commentary below on that provision.

This tax also does not apply in situations of intentional conduct or gross negligence, in which case the consequences in subsection (9) apply.

Indexation

ITA
127.46(8)

New subsection 127.46(8) provides an indexation rule for the dollar amounts in subsections (6) and (7), similar to the rule in new subsection 127.46(4) that applies in relation to expired eligible collective agreements.

Gross negligence

ITA
127.46(9)

Subsection 127.46(9) applies in circumstances of intentional conduct or gross negligence in relation to the labour requirements. In these circumstances, there are two consequences. First, the incentive claimant is disentitled to the regular tax credit rate that was claimed, and is entitled only to the reduced tax credit rate. Second, the incentive claimant must pay a penalty equal to 50% of the difference between the amount of the specified tax credit that the incentive claimant claimed, and the amount that the incentive claimant would have been entitled to claim at the reduced rate credit rate. The gross negligence penalty applies across taxation years so that, if the preparation and installation labour in relation to property that qualified for an investment tax credit occurs in a different year from the year for which the credit is claimed, the tax credit rate is reduced in the year for which the credit is claimed.

CCUS refurbishment credit

ITA
127.46(10)

Subsection (10) specifies that new subsection (9) does not apply in respect of CCUS refurbishment tax credits (those credits are described in new subsection 127.44(5)).

Corrective measures — prevailing wage requirement

ITA
127.46(11) to (13)

Unless subsection (9) applies, in cases where the CRA determines that an incentive claimant did not meet the prevailing wage requirements for a designated work site for a taxation year, the incentive claimant may cause each covered worker to be paid the "top-up" amount determined under new subsection (12). In general terms, the "top-up" amount is the difference between the prevailing wages that were required to have been paid to the covered worker for a taxation year and the amount that the covered worker was actually paid for the year.

The incentive claimant is liable to a penalty under subsection (13) for each covered worker that is not paid the top-up amount. The penalty is payable to the Receiver General and is equal to 120% of the top-up amount determined by the formula in subsection (12), in respect of each worker that was not paid the top-up amount.

Tax treatment of top-up amount

ITA
127.46(14)

Subsection 127.46(14) specifies the tax treatment of top-up amounts paid to covered workers under subsection (11). In particular, such a payment is deemed to be salary and wages of the worker for the year in which it is received. For the payor, the amount of the payment is deductible for income tax purposes in the year it is paid, but it does not qualify for any specified tax credit.

Exception

ITA
127.46(15)

Subsection (15) specifies that the labour requirements do not apply to a specified tax credit claimed for the acquisition of off-road zero emission vehicles or to the acquisition and installation of low carbon heat equipment.

Deemed reasonable efforts

ITA
127.46(16)

New subsection (16) provides a deeming rule related to the apprenticeship requirements. Without narrowing the general meaning of "reasonable efforts", an incentive claimant is deemed to have satisfied the requirements of paragraph (5)(a) or (b), as the case may be, in relation to apprenticeship labour hours, regardless of the number of apprenticeship hours actually worked at the designated work site, if the incentive claimant takes the steps described in paragraphs (a) and (b) and attests to those actions in accordance with paragraph (c). Since these steps are meant to be illustrative of a means of meeting the reasonable efforts tests in the apprenticeship requirements, variations on these actions to better reflect specific circumstances (such as shorter time periods for equipment installation) may also be considered reasonable efforts.

To rely on the deeming rule, paragraph (a) provides that a series of actions must be taken at least every four months (i.e., in respect of the installation year):

1. Subparagraph (a)(i) requires the incentive claimant to post an advertisement seeking the needed apprentices to satisfy the apprentice hours of labour requirement (from paragraphs (5)(a) or (b)). The advertisement has to include a commitment to facilitate the participation of apprentices in a Red Seal trade program (or, because of the expanded definition "Red Seal trade", in a program for an equivalent provincially registered trade). The advertisement must be open and accessible on the Job Bank website and on at least two other websites. The advertisement must be either continuously open throughout the year, or be open for at least 30 days each time it is posted. To the extent that contractors and subcontractors are involved in work at the designated work site, apprenticeship opportunities with those other employers would need to be included in the advertisement to satisfy the condition in this paragraph.

2. Subparagraph (a)(ii) provides that the incentive claimant must communicate with a trade union (as described in the provision), as well as a secondary school or post-secondary educational institution, for the purposes of facilitating the hiring of apprentice positions.

3. Subparagraph (a)(iii) requires that the incentive claimant receive confirmation in writing that as many apprentices as were available have been provided as candidates for work at the designated work site. However, this requirement is in effect waived if the trade union fails to respond within five days of a request.

Other conditions

In addition to the requirements of paragraph (a), paragraph (b) requires that the incentive claimant review and duly consider all applications received in response to the advertisement, or, if the applications are for employment at the designated work site with someone other than the incentive claimant, that the incentive claimant take reasonable steps to ensure that such review and consideration takes place.

Paragraph (c) describes the required attestation in relation to the requirements in paragraph (b).

Partnerships

ITA
127.46(17)

New subsection (17) provides rules for situations where an incentive claimant is a partnership. In that case, in accordance with paragraph (17)(a), any member of the partnership may elect to pay any tax or penalty arising under subsections (6), (7), (9) or (13). If that election is not made, then under paragraph (17)(b), the tax or penalty is to be apportioned among members and is payable by each member accordingly. To the extent that the tax is neither paid because of an election under paragraph (a) nor payable by the members of the partnership in accordance with paragraph (b), each member of the partnership is jointly and severally or for civil law, solidarily, liable for the relevant tax or penalty.

Clause 38

Clean economy ITCs – partnership rules

ITA
127.47

New section 127.47 provides rules that apply to partnerships for the purposes of the new investment tax credits for carbon capture, utilization and storage (CCUS tax credit) and clean technology (clean technology investment tax credit). It is also intended to apply for purposes of the new clean hydrogen, clean technology manufacturing and clean electricity investment tax credits, as announced in Budget 2023, once those provisions are enacted. Collectively, the

investment tax credits that are affected by section 127.47 are referred to in these notes as the "clean economy tax credits".

New section 127.47 comes into force on January 1, 2022 in respect of the CCUS tax credit, after March 27, 2023 in respect of the clean technology investment tax credit and, in respect of section 127.46, on or after the day on which the notice of a Ways and Means motion in respect of this section is tabled in the House of Commons.

Definitions

ITA
127.47(1)

"at-risk amount"

For the purposes of new section 127.47, "at-risk amount" has the meaning assigned by subsection 96(2.2).

Under new subsection 127.47(3), the total clean economy tax credit amount that may be allocated to a limited partner by a partnership is restricted to the partner's at-risk amount in respect of the partnership.

"clean economy allocation provision"

For the purposes of new section 127.47, "clean economy allocation provision" means any of subsections 127.44(11) (the partnership allocation provision for the CCUS tax credit) and 127.45(8) (the partnership allocation provision under the clean technology investment tax credit).

"clean economy expenditure"

A "clean economy expenditure" means a qualified CCUS expenditure, as defined in and determined under section 127.44, and the capital cost of a clean technology property, as defined in and determined under section 127.45.

This definition serves to consolidate expenditures that qualify for the new clean economy tax credits. Under new subsection 127.47(5), government or non-government assistance received by a partner of a partnership in respect of a clean economy expenditure of the partnership is deemed to have been received by the partnership.

"clean economy provision"

A "clean economy provision" means any of sections 127.44, 127.45, 127.46 and 127.47 and Part XII.7.

This definition allows the tiered partnership rule in new subsection 127.47(7) to apply for the purposes of all clean economy provisions.

“clean economy tax credit”

A “clean economy tax credit” means any of a CCUS tax credit, as defined in subsection 127.44(1), and a clean technology investment tax credit, as defined in subsection 127.45(1).

This definition serves to consolidate the new clean economy tax credits for the purposes of limiting the total clean economy tax credit amount based on reasonableness under new subsection 127.47(2) and, for limited partners, based on the partner’s at-risk amount under new subsection 127.47(3). It is also relevant for the purpose of apportioning any aggregate credit amounts back to each clean economy tax credit under new subsection 127.47(4).

“limited partner”

For the purposes of section 127.47, “limited partner” has the meaning assigned by subsection 96(2.4), read without reference to the words “if the member’s partnership interest is not an exempt interest (within the meaning assigned by subsection (2.5)) at that time and”. The deleted words refer to a legacy provision.

Credits in unreasonable proportions

ITA
127.47(2)

New subsection 127.47(2) ensures that the allocation of a clean economy tax credit among partners is reasonable in the circumstances, notwithstanding any agreement providing otherwise. Relevant factors in the determination of a reasonable allocation include the capital invested and work performed by members of the partnership.

Limited partners

ITA
127.47(3)

New subsection 127.47(3) restricts the total amount of clean economy tax credits that may be allocated by a partnership at the end of its fiscal period to a limited partner, notwithstanding any allocation otherwise made under a clean economy allocation provision or under subsection 127.47(2).

In general terms, a partnership may allocate to a limited partner a share of clean economy tax credits (based on investments made by the partnership) only to the extent that the allocation does not exceed the limited partner's at-risk amount in respect of the partnership at the end of the partnership’s fiscal period.

Apportionment rule

ITA
127.47(4)

New subsection 127.47(4) provides that the amount required by any clean economy allocation provision to be added in computing a particular clean economy tax credit of a taxpayer in respect of a partnership for the taxation year in which the partnership's fiscal period ends is deemed to be the portion of the amount otherwise determined under this section in respect of the taxpayer that is reasonably attributable to each particular clean economy tax credit.

This provision apportions the total clean economy tax credit of a taxpayer who receives an allocation from a partnership that was limited by any provision in section 127.47. The portion of the total allocated to each clean economy tax credit should be the amount that is reasonably attributable to the clean economy tax credit.

Example:

A limited partnership incurs $15,000 in clean economy expenditures: $10,000 in qualified CCUS expenditures (in respect of equipment for capturing carbon from ambient air) and $5,000 for the capital cost of clean technology property. The total clean economy tax credits that may be allocated to the partners is ($10,000 × 60%) + ($5,000 × 30%) = $7,500.

If a limited partner has an at-risk amount of $3,000, then the maximum credit that may be allocated to it under subsection 127.47(3) is $3,000. If the full $3,000 can be reasonably allocated to the limited partner, then subsection 127.47(4) requires that this $3,000 total credit be reasonably apportioned to each clean economy tax credit.

An example of a reasonable attribution would be to apply the proportion that the particular qualifying expenditure is of the total qualifying expenditures. In this example, $10,000 / $15,000 = 2/3 of the partnership's clean economy expenditures relate to CCUS, while $5,000 / $15,000 = 1/3 relate to clean technology property. As a result, $3,000 × 2/3 = $2,000 could be added to the limited partner's CCUS tax credit, and $3,000 × 1/3 = $1,000 could be added to its clean technology investment tax credit.

Another example may be to apportion based on the credit amounts, where $6,000 CCUS tax credits / $7,500 total credits = 80% is apportioned to CCUS, and $1,500 clean technology investment tax credits / $7,500 total credits = 20% is apportioned to clean technology. The corresponding credit amounts for the limited partner could then be $3,000 × 80% = $2,400 CCUS tax credits and $3,000 × 20% = $600 clean technology investment tax credits.

Assistance received by member of partnership

ITA
127.47(5)

New subsection 127.47(5) provides for a reduction of a partnership's clean economy expenditures (on which a partnership may calculate a clean economy tax credit) where a member

of the partnership has received, is entitled to receive, or can reasonably be expected to receive, government assistance or non-government assistance in respect of the expenditure.

This provision essentially mirrors paragraph 127(11.1)(d) and applies to the new clean economy tax credits.

Credit received by member of partnership

ITA
127.47(6)

New subsection 127.47(6) ensures that the amount of any clean economy tax credit allocated to a member of a partnership reduces the capital cost of the related depreciable property (that is owned by the partnership) under subsection 13(7.1) as assistance from government.

This provision essentially mirrors subsection 127(12) and applies to the new clean economy tax credits.

Tiered partnerships

ITA
127.47(7)

New subsection 127.47(7) provides a "look-through" rule for the situation where a partnership (i.e., an upper-tier partnership) is a member of another partnership (i.e., a lower-tier partnership). Under this rule, a person or partnership that is a member of an upper-tier partnership is deemed to be a member of the lower-tier partnership.

This rule applies for the purposes of each clean economy provision (defined in subsection 127.47(1)), including for determining the amount of a clean economy tax credit earned by a lower-tier partnership (i.e., the clean economy expenditure is incurred by the lower-tier partnership) to be allocated to the members of the upper-tier partnership. It would also apply for the purposes of determining the amount of any addition to tax payable of taxpayers who are members of an upper-tier partnership from the recovery or recapture of clean economy tax credits that were allocated through a lower-tier partnership.

Example – Allocation of Clean Economy Tax Credits

Partnership 1, a limited partnership, has two partners: Partner A and Partner B. Partner A is a limited partner and Partner B is the general partner. Each of Partner A and Partner B contributes $1,000 to Partnership 1 and Partnership 1 borrows $8,000 from the bank.

Partnership 2 is also a limited partnership and has three partners: Partnership 1, Partner C and Partner D. Partnership 1 contributes $10,000 to Partnership 2 and is a limited partner in Partnership 2. Partner C contributes $8,000 to Partnership 2 and is also a limited partner in

Partnership 2. Partner D contributes $2,000 to Partnership 2 and acts as the general partner of Partnership 2. Partnership 2 borrows $10,000 from the bank.

Partners A, B, C and D are all taxable Canadian corporations.

Partnership 2 incurs clean economy expenditures of $30,000: $20,000 in qualified CCUS expenditures and $10,000 as the capital cost of clean technology property, and the expenditures are eligible for these credits at the highest available rates (60% for the CCUS tax credit and 30% for the clean technology investment tax credit).

Therefore, Partnership 2 has ($20,000 × 60%) + ($10,000 × 30%) = $15,000 of total credits for potential allocation to its partners.

Under new subsection 127.47(7), Partners A and B are deemed to be members of Partnership 2 for the purposes of allocating the $15,000 total available credits.

In accordance with subsections 127.44(11) and 127.45(8), as well as subsections 127.47(2) to (4), an example of a reasonable allocation of the credits would be as follows.

On the basis of capital invested in Partnership 2 by its three partners ($20,000), and assuming all other factors were equal among the partners of Partnership 2:

- Partnership 1, which contributed $10,000 (50%) of the total $20,000, could receive 50% of the total credits, $15,000 × 50% = $7,500.
- Partner C, which contributed $8,000, could receive 40% of the total credits ($15,000 × 40% = $6,000).
- Partner D, which contributed $2,000, could receive 10% of the total credits ($15,000 × 10% = $1,500).

Since Partnership 1 is comprised of Partners A and B, and Partners A and B are deemed to be partners of Partnership 2 under subsection 127.47(7), each could reasonably receive 50% of the amount allocated to Partnership 1 (based on each partner's contribution), which would be $3,750 each.

However, under subsection 127.47(3), the amount of credit that can be allocated to limited partners cannot exceed the partner's at-risk amount.

Partner A's at-risk amount in respect of Partnership 1 is $1,000, so Partner A's total clean economy tax credit allocation is limited to $1,000.

Next, applying subsection 127.47(4), each partner could reasonably have 80% of their allocated credit amount attributable to CCUS ($12,000 CCUS tax credits ÷ $15,000 total clean economy tax credits = 80%) and 20% attributable to clean technology ($3,000 clean technology investment tax credits ÷ $15,000 total clean economy tax credits = 20%).

Partner A's amount to be added in computing its CCUS tax credit under subsection 127.44(11) could therefore be $800 (80% of $1,000) and its clean technology investment tax credit under subsection 127.45(8) could be $200 (20% of $1,000).

Partner B, who is not a limited partner, would be allocated $3,000 for the CCUS tax credit (80% of $3,750) and $750 for the clean technology investment tax credit (20% of $3,750).

As for Partner C, since it is also a limited partner, its total clean economy tax credit also cannot exceed its at-risk amount. However, because its at-risk amount ($8,000) exceeds its allocated tax credit amount ($6,000), Partner C can be allocated the full tax credit amount, which would consist of $4,800 in CCUS tax credits (80% of $6,000) and $1,200 in clean technology investment tax credits (20% of $6,000).

Partner D, as general partner of Partnership 2, could be allocated the full $1,500 that was available. This would consist of $1,200 in CCUS tax credits (80% of $1,500) and $300 in clean technology investment tax credits (20% of $1,500).

Clause 39

Where individual bankrupt

ITA
128(2)

Subsection 128(2) contains a number of special rules that apply in cases of personal bankruptcy. In particular, paragraph 128(2)(d) divides the calendar year in which an individual becomes bankrupt into two taxation years. The first taxation year runs from January 1 to the day before bankruptcy and the second taxation year begins on the day of bankruptcy and runs to December 31.

New subparagraph 128(2)(d.3)(i) provides that where a bankrupt individual has a taxation year that is not a calendar year, the definitions in subsection 146.6(1) and the definition "excess FHSA amount" in subsection 207.01(1) are to be read as though references to "taxation year" are instead references to "calendar year". This amendment ensures that the definitions "annual FHSA limit" and "FHSA carryforward" in subsection 146.6(1) function as intended (i.e., a taxpayer does not attain additional amounts of "annual FHSA limit" or "FHSA carryforward" than they would otherwise be entitled to had they not become bankrupt). Correspondingly, the definition of "excess FHSA amount" in 207.01(1) is effectively made to refer to the amount of an individual's FHSA carryforward for a *calendar year* (rather than *taxation year*).

Similarly, new subparagraph 128(2)(d.3)(ii) provides that where a bankrupt individual has a taxation year that is not a calendar year, references to a taxpayer's annual FHSA limit in the description of A of the formula in paragraph 146.6(5)(a) are read in respect of a calendar year (instead of a taxation year, as would otherwise be the case due to the preamble of subsection 146.6(5)). This amendment ensures that 146.6(5) functions as intended (i.e., a taxpayer is not

able to deduct more than they would have otherwise been entitled to had they not become bankrupt).

These amendments come into force on April 1, 2023.

Clause 40

Dividend refund to private corporation

ITA
129(1)(b)

Section 129 allows a private corporation that pays a taxable dividend to obtain a partial refund of the taxes it has paid on its investment income (or a full refund in the case of Part IV tax paid on certain taxable dividends received). The dividend refund system is intended to integrate corporate and shareholder taxation by providing comparable tax results for Canadians who invest through private holding companies and those who invest directly.

Subsection 129(1) defines the term "dividend refund" for the purposes of the Act and provides the specific computational and administrative rules for the issuance by the Minister of National Revenue of a dividend refund for a taxation year where the corporation has filed its tax return within 3 years from the end of the taxation year.

Paragraph 129(1)(a) provides that the amount of a corporation's dividend refund for a taxation year may be refunded by the Minister of National Revenue without application, upon mailing the corporation's notice of assessment for the year.

Paragraph 129(1)(b) requires the Minister of National Revenue to make the dividend refund after mailing the notice of assessment if the corporation has made an application for the refund within the period within which the Minister of National Revenue would be allowed under subsection 152(4) to assess tax payable under Part I by the corporation for the year if that subsection were read without reference to paragraph 152(4)(a).

Paragraph 129(1)(b) is amended as a consequence of the introduction of new subsection 152(4.31). New subsection 152(4.31) extends the period within which the Minister may assess or reassess the tax, interest or penalties payable under Part IV of the Act by a taxpayer (the dividend recipient) in respect of a taxable dividend received where:

i. the dividend recipient receives a taxable dividend in a taxation year from a corporation (the dividend payer); and
ii. the dividend payer, as a result of having paid the dividend, is entitled to a dividend refund.

Where these conditions are met, the period within which the Minister may assess or reassess the tax, interest or penalties payable under Part IV of the Act by the dividend recipient in respect of

the taxable dividend received is extended by one year after the expiration of the normal reassessment period. (See commentary on new subsection 152(4.31) for more information.)

Paragraph 129(1)(b) is amended to ensure that the period within which a dividend refund may be issued to the dividend recipient is not shorter than the period described in new subsection 152(4.31), where that subsection applies. This ensures that the dividend recipient is entitled to receive a dividend refund if it has in turn paid a dividend to its shareholder during the extended period described in new subsection 152(4.31).

This amendment applies to taxation years that end on or after April 7, 2022.

For more information, see the commentary on the definition of "substantive CCPC" in subsection 248(1).

Definitions

ITA
129(4)

"eligible portion"

As a consequence of the Budget 2022 announcement to align the taxation of investment income earned by CCPCs and substantive CCPCs, the definition "eligible portion" is amended to ensure that the portion of a corporation's taxable capital gains or allowable capital losses for a taxation year that accrued while the property, or a property for which it was substituted, was property of a corporation that is a substantive CCPC is included in the "eligible portion" of the corporation's taxable capital gains or allowable capital losses and thus, included in the computation of its "aggregate investment income".

This amendment applies to taxation years that end on or after April 7, 2022.

For more information, see the commentary on the definition of "aggregate investment income" in subsection 129(4) and on the definition of "substantive CCPC" in subsection 248(1).

"non-eligible refundable dividend tax on hand"

A corporation's "non-eligible refundable dividend tax on hand" (NERDTOH) tracks:

- the refundable Part I tax in respect of the investment income of a Canadian-controlled private corporation (paragraph (a)); and
- the Part IV tax paid by a corporation in respect of dividends other than those described under ERDTOH (paragraph (b)).

A corporation's NERDTOH will be reduced by dividend refunds for a preceding taxation year in respect of its NERDTOH. Such dividend refunds can only arise upon the payment by the

corporation of non-eligible dividends. For additional information on the dividend refund mechanism, see the comments under subsection 129(1).

Paragraph (a) of the NERDTOH definition is amended to also apply to corporations that are substantive CCPCs at any time in a taxation year. This amendment is consequential to the amendments to section 123.3 and the definition of "full rate taxable income" in subsection 123.4(1) that subject the "aggregate investment income" of a substantive CCPC to a higher rate of corporate tax. This amendment aims to ensure that the appropriate proportion of a substantive CCPC's "aggregate investment income" is included in its NERDTOH, which in turn allows the corporation to receive a dividend refund when non-eligible dividends are paid to its shareholders.

This amendment applies to taxation years that end on or after April 7, 2022.

For more information on the treatment of investment income earned by substantive CCPCs, see the commentary on the definition of "substantive CCPC" in subsection 248(1).

Clause 41

Eligible trust

ITA
135.2(4)

Subsection 135.2(4) contains rules that relate to an eligible trust (i.e., a type of trust that, among other conditions, was established in connection with the Canadian Wheat Board continuance application) and its beneficiaries.

Paragraphs 135.2(4)(f) and (g) recognize that it is not intended that a beneficial interest (i.e., an eligible unit) in, debt issued by, or any other security of the eligible trust become property of certain tax-exempt arrangements. Consistent with this, special taxes will apply to the extent that such a property is held by a DPSP, RDSP, RESP, RRIF, RRSP or TFSA. An additional tax is imposed under section 207.05 on the holder of a TFSA that acquires such a property.

These paragraphs are amended to include trusts governed by an FHSA.

This amendment comes into force on August 4, 2023.

Clause 42

Definitions

ITA
137(6)

“**credit union**”

Section 137 provides rules that apply to credit unions. The definition “credit union” in subsection 137(6) is used for purposes of the Act, as well as other federal legislation, including the definition of “credit union” in subsection 123(1) of the *Excise Tax Act*.

The definition “credit union” in subsection 137(6) includes three alternative requirements for a corporation, association or federation incorporated or organized as a credit union or cooperative credit society to qualify as a credit union. Paragraph (a), the first of the alternatives, currently requires a revenue test to be satisfied.

Paragraph (a) is amended to replace the revenue test with a requirement that the corporation, association or federation must be (i) a “federal credit union” within the meaning assigned by section 2 of the *Bank Act*, or (ii) a provider of financial services that is organized on cooperative principles and incorporated by or under a law of a province.

These changes are intended to generally align the definition of a credit union with the relevant provincial or federal requirements.

A federal credit union is defined in subsection 248(1) by reference to the meaning assigned by section 2 of the *Bank Act*. A federal credit union must be a bank that is organized and carries on business on a cooperative basis (within the meaning assigned by section 12.1 of the *Bank Act*).

A corporation, association or federation incorporated or organized as a credit union or cooperative credit society that is not a federal credit union must be organized on cooperative principles, incorporated by or under provincial legislation and provide financial services.

Subparagraph (b)(i) of the definition “credit union” in subsection 137(6) is also amended to correspondingly replace a reference to the revenue test with the requirement described above.

These amendments come into force on January 1, 2016.

“member”

Among the definitions set out in subsection 137(6) is “member”, meaning essentially a member of record who is entitled to the services of the credit union. The definition treats an RRSP, RRIF, RESP and TFSA as a member, provided that the annuitant, holder or subscriber under the plan is a person who meets the existing definition of “member”.

This definition is amended to add FHSAs to the types of registered plans treated as members (provided that the holder under the plan is an individual that is a member).

This amendment comes into force on April 1, 2023.

Clause 43

Definitions

ITA
146.01(1)

“excluded premium”

Subsection 146.01(1) sets out definitions which apply for the purposes of the Home Buyers' Plan (HBP). An “excluded premium” is a specified type of RRSP contribution that does not qualify as a repayment of an amount withdrawn under the HBP.

The definition of “excluded premium” is amended so that amounts transferred directly from an FHSA to an RRSP are included within the definition. This amendment ensures that amounts held in an FHSA cannot be used to make HBP repayments (e.g., contributions to an FHSA, which would generally be deductible, cannot be transferred to an RRSP as a repayment of an HBP balance).

This amendment comes into force on the day on which the notice of Ways and Means motion in respect of this definition is tabled in the House of Commons.

Clause 44

Definitions

ITA
146.02(1)

“excluded premium”

Subsection 146.02(1) sets out definitions which apply for the purposes of the Lifelong Learning Plan (LLP). An “excluded premium” is a specified type of RRSP contribution that does not qualify as a repayment of an amount withdrawn under the LLP.

The definition of “excluded premium” is amended so that amounts transferred directly from an FHSA to an RRSP are included within the definition. This amendment ensures that amounts held in an FHSA cannot be used to make LLP repayments (e.g., contributions to an FHSA, which would generally be deductible, cannot be transferred to an RRSP as a repayment of an LLP balance).

This amendment comes into force on the day on which the notice of Ways and Means motion in respect of this definition is tabled in the House of Commons.

Clause 45

Definitions

ITA
146.4(1)

“qualifying person”

Subsection 146.4(1) defines “qualifying person” in relation to a beneficiary of a disability savings plan.

Paragraph (c) is relevant for the purposes of allowing a disability savings plan to be established by a qualifying family member, who at the time the plan is established, is a qualifying person in relation to the plan’s beneficiary.

Paragraph (c) is amended so that it applies for the purposes of new paragraph 146.4(4)(b.1). Upon the death of a plan holder who was a qualifying family member, another qualifying family member may acquire rights as a successor of a holder of a disability savings plan of a beneficiary if, at the time the rights are acquired, that successor is a qualifying person in relation to the beneficiary.

For further information, please refer to the commentary on new paragraph 146.4(4)(b.1).

Beneficiary replacing holder

ITA
146.4(1.5)

Subsection 146.4(1.5) sets out the circumstances in which a holder of a disability savings plan who is a “qualifying person” under paragraph (c) of that definition (referred to below as the “existing holder”) ceases to be the holder of the plan.

This subsection applies if the beneficiary of the plan is determined to be contractually competent by a competent tribunal or other authority under the laws of a province, or if in the issuer’s opinion, after reasonable inquiry, the beneficiary’s contractual competence to enter into a disability savings plan is no longer in doubt. If the beneficiary notifies the issuer that the beneficiary chooses to become the holder of the plan, the existing holder of the plan ceases to be the holder and the beneficiary becomes the new holder of the plan.

Subsection 146.4(1.5) is amended, consequential on the introduction of paragraph 146.4(4)(b.1). For the purposes of subsection (1.5), the existing holder of the plan includes a qualifying person who was a successor holder of the plan because of paragraph 146.4(4)(b.1).

Entity replacing holder

ITA
146.4(1.6)

Subsection 146.4(1.6) sets out the circumstances in which a holder of a disability savings plan who is a “qualifying person” because of paragraph (c) of that definition (referred to below as the “existing holder”) ceases to be the holder of the plan.

If an entity described in subparagraph (a)(ii) or (iii) of the definition “qualifying person” in subsection 146.4(1) is legally authorized to act on behalf of the beneficiary of the plan (notably, a guardian, tutor, curator or other individual, or public department, agency or institution), then the entity must notify the issuer of its appointment, the existing holder of the plan ceases to be the holder and the entity becomes the new holder of the plan.

Subsection 146.4(1.6) is amended, consequential on the introduction of paragraph 146.4(4)(b.1). For the purposes of subsection (1.6), the existing holder of the plan includes a qualifying person who was a successor holder of the plan because of paragraph 146.4(4)(b.1).

Rules applicable in case of dispute

ITA
146.4(1.7)

Subsection 146.4(1.7) applies to a disability savings plan entered into between an issuer and a qualifying family member who is a “qualifying person” in relation to the beneficiary of the plan because of paragraph (c) of that definition if a dispute arises because of the issuer’s acceptance of the qualifying family member as holder of the plan.

Subsection 146.4(1.7) is amended, consequential on the introduction of paragraph 146.4(4)(b.1). As a result, this subsection also applies to a qualifying family member who is a qualifying person in relation to the beneficiary of the plan who became a successor holder of the plan because of paragraph 146.4(4)(b.1).

Plan conditions

ITA
146.4(4)

Subsection 146.4(4) sets out registration conditions applicable to registered disability savings plans.

Subparagraph 146.4(4)(b)(iv) is amended, consequential on the introduction of paragraph 146.4(4)(b.1).

New paragraph 146.4(4)(b.1) is introduced in order to allow a qualifying family member who is a qualifying person in relation to the beneficiary to become a successor holder of the plan in each case where a qualifying family member who is the existing holder of the plan passes away.

Paragraph 146.4(4)(b.1) only applies in circumstances where after the death of the qualifying family member plan holder, there are no qualifying family members that remain as plan holders. For example, if two legal parents are both plan holders because of paragraph (c) of the definition of “qualifying person”, paragraph 146.4(4)(b.1) will not apply upon the death of one legal parent, as there is still one plan holder that remains. If there are no remaining plan holders, only one

qualifying family member at a time can acquire the rights as a successor of the holder of the plan. If this successor holder also passes away, another qualifying family member who is a qualifying person in relation to the beneficiary can become a successor holder.

Paragraph 146.4(4)(b.1) will apply until the end of 2026. As a consequence, a qualifying family member who is a qualifying person in relation to the beneficiary will not have a right after 2026 to succeed an existing qualifying family member plan holder. However, an individual who becomes a successor holder of a disability savings plan by virtue of this measure will generally be able to remain the holder of the plan after 2026.

The French version of paragraphs (f) and (g) in subsection 146.4(4) are amended to better align the French and the English versions of these paragraphs.

Obligations of issuer

ITA
146.4(13)

Subsection 146.4(13) imposes obligations on the issuer of a registered disability savings plan.

Paragraph 146.4(13)(c) is amended, consequential on the introduction of paragraph 146.4(4)(b.1), to add a reference to a qualifying family member who was a successor holder of the plan because of paragraph 146.4(4)(b.1).

Issuer's liability

ITA
146.4(14)

Subsection 146.4(14) limits the issuer's liability with respect to the issuer's decision to enter into a disability savings plan with a qualifying family member who is a "qualifying person" in relation to the beneficiary because of paragraph (c) of that definition, if after reasonable inquiry, the issuer is of the opinion that the contractual competence of the beneficiary to enter into a plan is in doubt.

Subsection 146.4(14) is amended, consequential on the introduction of paragraph 146.4(4)(b.1), to add a reference to a qualifying family member who was a successor holder of the plan because of paragraph 146.4(4)(b.1).

Amendments to section 146.4 of the Act come into force on royal assent.

Clause 46

Definitions

ITA

146.6(1)

“survivor”

Subsection 146.6(1) defines an individual to be a “survivor” if that individual was, immediately before a qualifying individual's death, a spouse or common-law partner of that qualifying individual. An individual who is the holder of an FHSA may provide for a survivor to become the holder of the FHSA upon the individual's death. For more information about successor holders, see subsection 146.6(13).

It is not intended that a decedent must be a qualifying individual at the time of death for their spouse or common-law partner to be a survivor. The definition “survivor” is therefore amended to replace references to a “qualifying individual” (the decedent) with references to “holder”.

This amendment comes into force on April 1, 2023.

“beneficiary”

The definition “beneficiary” refers to any individual (including an estate) or a qualified donee (e.g., a registered charity) who will receive the proceeds of an FHSA after the death of the holder.

The French version of the definition is amended to correct typographical errors.

This amendment comes into force on April 1, 2023.

“annual FHSA limit”

The definition “annual FHSA limit” is used in the determination of the amount an individual may deduct, in respect of contributions to an FHSA, in computing the individual's income for a particular taxation year under subsection 146.6(5). The annual FHSA limit for a particular taxation year is the lesser of paragraphs (a), (b) and (c) of the definition.

The amount determined for paragraph (b) operates by way of a formula. In particular, paragraph (b) works to establish the maximum amount of contributions that could be deductible in a given year, which would typically be $8,000 plus any “FHSA carryforward”. However, this amount may be reduced where amounts have been transferred into the FHSA from an RRSP (less amounts transferred back to an RRSP at any time as a designated amount to correct an excess FHSA amount).

The description of E of the formula in paragraph (b) of the definition “annual FHSA limit” is revised to be the taxpayer’s “net RRSP-to-FHSA transfer amount” at the end of the taxation year. As a result, the formula in paragraph (b) no longer includes a separate variable for the total of all amounts transferred back to an RRSP at any time as a designated amount to correct an excess FHSA amount. This will ensure the formulas described in paragraph (b) of the definition “annual FHSA limit” function as intended.

For additional information, see the commentary below for “net RRSP-to-FHSA transfer amount”.

This amendment comes into force on April 1, 2023.

“FHSA carryforward”

The definition “FHSA carryforward” measures the amount of unused FHSA deduction limit for FHSA contributions (and transfers from an RRSP) that an individual may carryforward from any particular year to use in future years.

The formula in this definition is amended to ensure that contributions made to an FHSA after the first qualifying withdrawal, but before the end of the year, are appropriately taken into account in the determination of a taxpayer’s “FHSA carryforward” amount. Specifically, the description of B is amended to add reference to amounts contributed after the taxpayer’s first qualifying withdrawal in the same year as that withdrawal (i.e., contributions made in the time period after the first qualifying withdrawal to the end of that taxation year). In the absence of this amendment, some taxpayers would be able to contribute to an FHSA in the year of the first qualifying withdrawal without reducing their “FHSA carryforward” amount. While contributions following a qualifying withdrawal do not give rise to an income tax deduction, they should be counted for the purpose of applying the 1%-per-month tax on over-contributions.

This amendment comes into force on April 1, 2023.

“net RRSP-to-FHSA transfer amount”

Subsection 146.6(1) is amended to add the definition “net RRSP-to-FHSA transfer amount”. A holder’s net RRSP-to-FHSA transfer amount at a given time is the total of all amounts transferred from an RRSP to an FHSA of the holder under paragraph 146(16)(a.2) at or before that time less the total of all designated amounts in respect of a transfer (i.e., amounts designated under paragraph (a) of the definition “designated amount” in subsection 207.01(1)) at or before that time.

The “net RRSP-to-FHSA transfer amount” definition is used in the amendment to the definition “annual FHSA limit”, the amendment to paragraph 146.6(5)(b) and the amendment to the definition “excess FHSA amount” in subsection 207.01(1).

This amendment comes into force on April 1, 2023.

Amount credited to a deposit

ITA
146.6(3.1)

New subsection 146.6(3.1) provides that, in the case of an FHSA that is a deposit, the mere crediting of interest (or the addition of other income) in respect of the deposit does not constitute the receipt of that interest or other income by the FHSA holder (or any other person). Consequently, the holder is not required to include that amount in income.

In conjunction with this amendment, subsection 12(11) of the Act is amended to provide that an FHSA is listed as an investment contract. For more information, see the commentary for the amendment to the definition "investment contract" in subsection 12(11).

This amendment comes into force on April 1, 2023.

FHSA deduction

ITA
146.6(5)(b)

Subsection 146.6(5) provides that an individual may deduct in computing their income for a taxation year an amount not exceeding the lesser of two amounts. The first amount, calculated in paragraph 146.6(5)(a) is the individual's total undeducted "annual FHSA limit" for the year and all preceding taxation years. The second amount, determined under paragraph 146.6(5)(b) is the lifetime limit of $40,000 (reduced by amounts transferred from an RRSP to an FHSA).

Subparagraph 146.6(5)(b)(ii) is amended to refer to the taxpayer's "net RRSP-to-FHSA transfer amount" as at the end of the taxation year. This amendment ensures that amounts transferred in the year or a preceding year are appropriately reduced by amounts designated under paragraph (a) of the definition designated amount in subsection 207.01(1). In cases where an individual has carried forward FHSA deductions and later has an excess FHSA amount caused by a transfer from an RRSP, this amendment ensures that designated amounts returned to an RRSP will allow the individual to deduct previously undeducted contributions.

Example

Jimmy contributes $8,000 to an FHSA in 2023 and contributes another $8,000 in 2024. Jimmy is able to deduct $8,000 from his income in each of those years, but instead decides to carry forward these deductions to a later year. In other words, Jimmy may deduct $16,000 from income in a future taxation year.

Suppose Jimmy transfers $30,000 from his RRSP to his FHSA on January 1, 2025 (as a result, Jimmy will have an excess FHSA amount of $22,000 afterward, which will be subject to a 1%-per-month tax). Paragraph 146.6(5)(b) reduces the amount Jimmy can deduct from $16,000 to $10,000 ($40,000 – 0 – $30,000 = $10,000). The amendment will allow Jimmy to designate $6,000 to reduce his excess and restore his carried forward deduction to $16,000.

This amendment comes into force on April 1, 2023.

Transfer of amounts

ITA
146.6(7)(c)

Subsection 146.6(7) provides conditions relating to the transfer of an amount from an FHSA to certain other registered vehicles. If those conditions are satisfied, subsection 146.6(8) allows the transfer to be made on a tax-free basis.

Variables A and B of the formula in paragraph 146.6(7)(c) are amended to clarify that, in cases where an FHSA may have no holder because of the previous holder's death, the calculations are to be made in respect of the last (i.e., most recent) holder. Furthermore, variable B of the formula in paragraph 146.6(7)(c) is amended to clarify that it is to be determined immediately before the particular time (instead of *at* the particular time).

These amendments come into force on April 1, 2023.

Successor holder

ITA
146.6(13)

Subsection 146.6(13) of the Act permits the holder's survivor (i.e., the surviving spouse or common-law partner), if they are designated as a successor holder and are a qualifying individual (as defined in subsection 146.6(1)), to choose to keep the deceased holder's FHSA or to transfer the FHSA's assets to an RRSP or RRIF by the end of the year following death. If the survivor chooses to keep the deceased holder's FHSA, the survivor is deemed to enter into a new qualifying arrangement in respect of the FHSA immediately after the time of death.

If the survivor is not a qualifying individual, then paragraph 146.6(13)(b) prohibits the survivor from becoming a successor holder, and the survivor must either transfer the FHSA property (to an RRSP or RRIF of the survivor) or receive a taxable distribution from the deceased holder's FHSA.

Paragraphs (a) and (b) are amended to clarify that the determination of whether the survivor is a qualifying individual takes place immediately after the time of death of the FHSA holder.

Paragraph (a) is also amended to ensure that a survivor that contributes or transfers an amount into an inherited FHSA, or makes a qualifying withdrawal from that FHSA, between the deceased holder's time of death and the end of the calendar year following the death will be deemed to have entered into a new arrangement immediately after the death of their spouse. That is, by making a contribution or transfer to an inherited FHSA, or a qualifying withdrawal from an inherited FHSA, a survivor (that is a qualifying individual) cannot later avail themselves of paragraph (a) (to avoid being deemed to have opened an FHSA) by closing the account before the end of the year following the year in which their spouse died.

Paragraph (b) is also amended to allow a survivor that is not a qualifying individual immediately after the deceased holder's death to transfer the balance of the decedent's FHSA to an FHSA they opened in the past (i.e., opened at a time the survivor was a qualifying individual).

These amendments come into force on April 1, 2023.

Deemed transfer or distribution

ITA
146.6(15)

Subsection 146.6(15) of the Act deals with situations in which an amount paid from a deceased holder's FHSA to the holder's estate would have been eligible for a tax-free transfer under subsection 146.6(7) to a survivor (spouse or common-law partner), or would have been taxable to a beneficiary if the amount had been paid directly to the beneficiary from the FHSA, to the extent that the recipient has a beneficial interest under the deceased holder's estate.

Paragraph 146.6(15)(a) allows the legal representative of a deceased holder's estate and the survivor to jointly designate (via a prescribed form) to have the FHSA proceeds that were paid to the estate treated as having been transferred from the FHSA of the deceased holder to an FHSA, RRSP or RRIF of the survivor.

Subparagraph 146.6(15)(a)(ii), which suggests that this deemed transfer must meet the conditions in subsections 146.6(7) to (10), is effectively repealed. The transfer rules of 146.6(7) to (10) would already apply, as appropriate, to the deemed transfer, thereby rendering the subparagraph unnecessary.

This amendment comes into force on April 1, 2023.

Rules applicable on FHSA cessation

ITA
146.6(17)

Subsection 146.6(17) of the Act outlines the consequences of an arrangement ceasing to be an FHSA.

Subsection 146.6(17) is amended in two ways. First, existing paragraphs (a) to (c) are amended. Paragraph (a) is amended to include a reference to new subsection 146.6(3.1). This amendment clarifies that if an arrangement ceases to be an FHSA, neither subsection 146.6(3) nor 146.6(3.1) will apply to exempt the trust, deposit or contract (as the case may be) from tax under Part I of the Act. Paragraph (b), which relates to the case where the last holder of an FHSA is alive, is amended to deem the fair market value of the FHSA to be received by the holder upon cessation for the purpose of 146.6(6). Similarly, paragraph (c), which relates to the case where the last holder of an FHSA is deceased, is amended to deem the fair market value of the FHSA to be distributed to a beneficiary (or proportionally in the case of multiple beneficiaries) upon

cessation for the purpose of 146.6(14). The amendments to paragraphs (b) and (c) clarify that the time at which the fair market value of an FHSA is to be determined and deemed to be received or distributed is the time of cessation. The amendments also remove the income-inclusion provisions of paragraphs (b) and (c), with the amended paragraphs instead referring to existing income-inclusion provisions of 146.6(6) or 146.6(14), as appropriate.

Second, new paragraphs 146.6(17)(d) and (e) are added. Paragraph (d) treats a trust as having disposed of each of its properties immediately before the time that the arrangement ceases to be an FHSA, and as having reacquired each of those properties at the particular time. It also deems the proceeds of disposition, and the cost of acquisition, for each such property to be the property's fair market value immediately before the particular time. Subparagraphs 146.6(17)(d)(iii) and (iv) deem the trust's current taxation year to have ended immediately before the particular time and for a new taxation year to have commenced at the particular time.

New subparagraph 146.6(17)(e)(i) treats the holder of a non-trusteed FHSA as having disposed of the deposit or contract, as the case may be, at the time immediately before it ceases to be an FHSA for proceeds of disposition equal to the fair market value of the deposit at that time. Under subparagraph (ii), if the arrangement is an annuity contract, the contract is deemed to be a separate contract that was issued at the time the arrangement ceased to be an FHSA, and as not having been issued or effected as an FHSA. Under subparagraph (iii), each person with an interest in the deposit or contract, as the case may be, at the time it ceases to be an FHSA is treated as having acquired that interest at that time at a cost equal to its fair market value at that time.

These amendments come into force on April 1, 2023.

Clause 47

Assessment

ITA
152(1)(b)

Section 152 contains rules relating to assessments and reassessments of tax, interest and penalties payable by a taxpayer. Subsection 152(1) lists certain refunds and deemed payments on account of tax that are to be determined in the course of assessment of tax.

Consequential on the introduction of new refundable CCUS tax credit under section 127.44 and the clean technology investment tax credit under section 127.45, paragraph 152(1)(b) is amended to add references to new subsections 127.44(2) and 127.45(2). Subsection 127.44(2) deems an amount equal to the CCUS tax credit to have been paid on account of tax payable by a qualifying taxpayer.

Subsection 127.45(2) deems an amount equal to the clean technology investment tax credit to have been paid on account of tax payable by a qualifying taxpayer.

This amendment applies to taxation years ending after 2021 with respect to the CCUS tax credit and after March 27, 2023 with respect to the clean technology investment tax credit.

Definition of "normal reassessment period"

ITA
152(3.1)

Subsection 152(3.1) defines the expression "normal reassessment period" for the purposes of various provisions in section 152. The subsection is amended to add a reference to new subsection 152(4.31) in respect of assessments or reassessments of taxpayers for taxation years that end on or after April 7, 2022.

For more information, see the commentary on new subsection 152(4.31).

Assessment and Reassessment

ITA
152(4)(b)(viii)

Subsection 152(4) of the Act generally provides that the Minister of National Revenue may at any time assess tax and other amounts payable by a taxpayer for a taxation year, but may not assess after the normal reassessment period for the year.

Paragraph (4)(b) is amended by adding subparagraph (viii), which allows the Minister to assess within an additional three-year period, if the assessment is made as a consequence of the application of the general anti-avoidance rule in section 245.

The extended assessment period is intended to provide the Minister with additional time to detect and analyze transactions potentially subject to the general anti-avoidance rule (GAAR). As such, an exclusion to the extended period applies where the transaction had been disclosed by the taxpayer to the Minister in accordance with section 237.3 or 237.4, which contain the disclosure rules for reportable transactions and notifiable transactions respectively.

This amendment applies to transactions that occur on or after January 1, 2024.

ITA
152(4)(b.8)

Subsection 152(4) of the Act generally provides that the Minister of National Revenue may, at any time, assess tax and other amounts payable by a taxpayer for a taxation year, but may not assess after the normal reassessment period for the year. Exceptions to this general rule are described in paragraphs 152(4)(a) to (d) and include exceptions where a taxpayer fails to provide to the Minister certain information required under the Act.

New subsection 18.2(18) requires taxpayers to file in their return of income for the year a prescribed form containing prescribed information with respect to the deductibility of their interest and financing expenses.

Paragraph 152(4) of the Act is amended to add new paragraph 152(4)(b.8), which permits the Minister to reassess taxpayers who fail to file the prescribed form as required by subsection 18.2(18), or who file the prescribed form without including all of the information required by the form, outside of the normal reassessment period. When this paragraph applies, the Minister may reassess the taxpayer within four years (in the case of a corporation) or three years (in the case of a trust) from the date on which the taxpayer files the form and information required by subsection 18.2(18), in effect, delaying the commencement of the normal reassessment period until the required information is provided. The Minister's ability to reassess under this paragraph is limited to reassessments related to the application of the EIFEL rules.

ITA
152(4)(b.9)

Subsection 152(4) generally provides that the Minister of National Revenue may at any time assess tax and other amounts payable by a taxpayer for a taxation year, but may not assess after the normal reassessment period for the year. An individual taxpayer's normal reassessment period for a year is generally three years from the date of the initial notice of assessment.

New paragraph 152(4)(b.9) is introduced to allow the Minister of National Revenue to reassess a taxpayer who does not satisfy the intergenerational business transfer conditions listed in new subsections 84.1(2.31) or (2.32), as applicable, for the exception in paragraph 84.1(2)(e) to apply to the anti-avoidance rule in subsection 84.1(1).

Specifically, new subparagraph 152(4)(b.9)(i) provides an additional three year reassessment period after the end of the normal reassessment period for the taxpayer in respect of the taxation year in which an election was filed under paragraph 84.1(2.31)(h). Because the conditions in subsection 84.1(2.31) cannot be satisfied until a minimum period of 36 months has passed, an extended reassessment period is required to afford the Minister of National Revenue the ability to verify compliance.

Similarly, new subparagraph 152(4)(b.9)(ii) provides an additional ten year reassessment period after the end of the normal reassessment period for the taxpayer in respect of the taxation year in which an election was filed under paragraph 84.1(2.32)(i). Because the conditions in subsection 84.1(2.32) cannot be satisfied until a minimum period of up to ten years has passed, an extended reassessment period is required to afford the Minister of National Revenue the ability to verify compliance.

For more information, see the commentary on subsections 84.1(2.31) and (2.32).

This amendment comes into force on January 1, 2024.

ITA

152(4)(b.10)

New subsections 127.45(15) and (18) require taxpayers and partnerships that trigger recapture events described in subsections 127.45(11) to (14), or (16) and (17), including a tax-deferred transfer of clean technology property from a taxable Canadian corporation to a related taxable Canadian corporation under subsection 127.45(13), to notify the Minister in prescribed form and manner. Notice must be filed by a taxpayer, for a recapture event that occurred in the year, on or before the taxpayer's filing-due date for the year. Notice must be filed by a partnership, for a recapture event that occurred during its fiscal period, on or before the day when a return is required by section 229 of the *Income Tax Regulations* to be filed in respect of the period.

Subsection 152(4) is amended to add new paragraph 152(4)(b.10), which allows the Minister to reassess a taxpayer outside the normal reassessment period when either the taxpayer has failed to notify the Minister in prescribed form and manner, or a partnership of which the taxpayer is a member has failed to notify the Minister in prescribed form and manner, of a recapture event described in subsections 127.45(11) to (14), or (16) and (17). When this paragraph applies, the Minister may reassess the taxpayer within four years (in the case of a mutual fund trust or a corporation other than a Canadian-controlled private corporation) or three years (in any other case) from the date the form is filed. The Minister's ability to reassess under this paragraph is limited to reassessments related to the application of the clean technology investment tax credit recapture rules.

This amendment comes into force on Royal Assent.

Extended period of assessment

ITA
152(4.01)(b)(xi)

Subsection 152(4.01) limits the matters in respect of which the Minister of National Revenue can reassess when a reassessment to which paragraph 152(4)(a), (b), (b.1) or (c) applies is made beyond the normal reassessment period for a taxpayer in respect of a taxation year.

Consequential on the addition of subparagraph 152(4)(b)(viii), subparagraph (4.01)(b)(xi) is added with a to reference that subparagraph. As such, a reassessment for a taxation year, made by the Minister after the normal reassessment period as a result of subparagraph (4.01)(b)(xi), is limited to the assessment of the GAAR.

This amendment applies to transactions that occur on or after January 1, 2024.

ITA
152(4.01)(b)(xii)

Subsection 152(4.01) limits the matters in respect of which the Minister can reassess when a reassessment to which paragraph 152(4)(a), (b), (b.1) or (b.5) to (c) applies is made beyond the normal reassessment period for a taxpayer in respect of a taxation year.

Consequential on the addition of paragraph 152(4)(b.10), subparagraph 152(4.01)(b)(xii) is added with a reference to that paragraph. As such, a reassessment for a taxation year, made by the Minister after the normal reassessment period as a result of paragraph 152(4)(b.10), is limited to the recapture of the clean technology investment tax credit.

This amendment comes into force on Royal Assent.

Consequential assessment of Part IV tax

ITA
152(4.31)

New subsection 152(4.31) aims to correct an administrative issue that can arise in multi-tiered structures involving corporations with mismatched year-ends or different normal reassessment periods (see commentary on subsection 152(3.1)).

For example, where a non-Canadian-controlled private corporation (non-CCPC) (which has a normal reassessment period of four years under paragraph 152(3.1)(a)) pays a taxable dividend to a Canadian-controlled private corporation ("CCPC") (which has a normal reassessment period of three years under paragraph 152(3.1)(b)), a situation can arise where the Minister, upon reassessing the non-CCPC, is obligated to issue a dividend refund to the non-CCPC in respect of the dividend paid to the CCPC. However, the Minister may be precluded from reassessing tax payable under Part IV of the Act by the CCPC with respect to the taxable dividend received due to the prior expiration of the CCPC's normal reassessment period. This timing mismatch results in a windfall for taxpayers who receive the dividend refund while also avoiding Part IV tax, thus permitting a permanent tax deferral advantage. The same result can arise where both corporations are either CCPCs or non-CCPCs, provided the corporations have different year-ends or different normal reassessment periods.

New subsection 152(4.31) addresses this issue by extending the period within which the Minister may assess or reassess the tax, interest or penalties payable under Part IV of the Act by a taxpayer (the dividend recipient) in respect of a taxable dividend received where:

i. the dividend recipient receives a taxable dividend in a taxation year from a corporation (the dividend payer); and
ii. the dividend payer, as a result of having paid the dividend, is entitled to a dividend refund (see commentary on subsection 129(1)).

Where these conditions are met, the period within which the Minister may assess or reassess the tax, interest or penalties payable under Part IV of the Act by the dividend recipient in respect of the taxable dividend received is extended by one year after the expiration of the normal reassessment period.

A consequential amendment is made to paragraph 129(1)(b) to ensure that the period within which a dividend refund may be issued to the dividend recipient is not shorter than the period

described in new subsection 152(4.31), where that subsection applies. This ensures that the dividend recipient is entitled to receive a dividend refund if it has in turn paid a dividend to its shareholder during the extended period described in new subsection 152(4.31) (see commentary on subsection 129(1)).

New subsection 152(4.31) applies in respect of assessments or reassessments of taxpayers for taxation years that end on or after April 7, 2022.

Clause 48

Withholding

ITA
153(1)

Subsection 153(1) requires the withholding of tax from certain payments described in paragraphs 153(1)(a) to (v). The person making the payment is required to remit the amount withheld to the Receiver General on behalf of the payee. Paragraph (v) of subsection 153(1) requires the withholding of tax on payments out of or under an FHSA (if the amount must be included in computing a taxpayer's income) or out of an arrangement that ceased to be an FHSA.

Paragraph 153(1)(v) is amended to not require withholding on payments out of an arrangement that ceased to be an FHSA, by removing subparagraph (ii). Note that subsection 146.6(17) will still deem the fair market value of an FHSA upon cessation to be received or distributed, as the case may be, to one or more taxpayers for inclusion in their income for the year in which the cessation occurs. For more information on the rules that apply to FHSAs upon cessation, see the commentary on subsection 146.6(17).

This amendment comes into force on April 1, 2023.

Clause 49

Reduced instalments

ITA
157(3)(e)

Section 157 requires a corporation to pay instalments of its total tax payable under Parts I, VI, VI.1 and XIII.1 of the Act. Paragraph 157(3)(e) allows a corporation to reduce its monthly installments by certain refundable amounts under the Act.

Paragraph 157(3)(e) is amended to add references to new subsections 127.44(2) and 127.45(2), consequential on the introduction of the CCUS tax credit and the clean technology investment tax credit.

This amendment applies to taxation years ending after 2021 with respect to the CCUS tax credit and after March 27, 2023 with respect to the clean technology investment tax credit.

Amount of payment — three-month period

ITA
157(3.1)(c)

Subsection 157(1.1) allows small Canadian-controlled private corporations that meet certain conditions to pay their annual tax liability by quarterly instalments instead of monthly.

Subsection 157(3.1) allows these corporations to reduce each quarterly instalment by 1/4 of the amount of certain tax refunds. Paragraphs 157(3.1)(b) and (c) list these tax refunds.

Paragraph 157(3.1)(c) is amended to add references to new subsections 127.44(2) and 127.45(2), consequential on the introduction of the CCUS tax credit and the clean technology investment tax credit.

This amendment applies to taxation years ending after 2021 with respect to the CCUS tax credit and after March 27, 2023 with respect to the clean technology investment tax credit.

Clause 50

Joint liability – intergenerational business transfer

ITA
160(1.5)

New subsection 160(1.5) is added consequential on the introduction of the joint elections provided by new paragraphs 84.1(2.31)(h) and 84.1(2.32)(i), as applicable, to satisfy the intergenerational business transfer conditions listed in new subsections 84.1(2.31) or (2.32) for the exception in paragraph 84.1(2)(e) to apply to the anti-avoidance rule in subsection 84.1(1).

New paragraphs 84.1(2.31)(h) and 84.1(2.32)(i) require an individual taxpayer who wishes to undertake a share sale to a purchaser corporation controlled by their adult child or children (as defined in paragraph 84.1(2.3)(a)) that will be excluded from the anti-avoidance rule in subsection 84.1(1), to jointly elect, in prescribed form, with the taxpayer's child (or each member of a group of children) for subsection 84.1(2.31) or (2.32) to apply in respect of the share disposition.

The joint election, and the joint and several liability imposed by this new subsection, recognize that the actions of the taxpayer's child or children could potentially cause the parent to fail the conditions listed in subsection 84.1(2.31) or (2.32), as applicable. For example, where the child ceases to work in the business within the time required by subparagraph 84.1(2.31)(f)(ii) or paragraph 84.1(2.32)(g)(ii), as applicable (and without any of the relieving exceptions in subsection 84.1(2.3) applying), the conditions of subsections 84.1(2.31) or (2.32) would not be

satisfied for paragraph 84.1(2)(e) to apply, and the parent would be subject to assessment or reassessment pursuant to subsection 84.1(1).

Consequently, any child who jointly elects under paragraph 84.1(2.31)(h) or (2.32)(i) for subsection 84.1(2.31) or (2.32) to apply to a share disposition is, jointly and severally, or solidarily, liable for tax payable by the parent under Part I of the Act, to the extent that the tax payable by the parent is greater than it would have been had the share disposition satisfied the conditions in subsection 84.1(2.31) or (2.32), as applicable.

For more information, see the commentary on paragraph 84.1(2)(e) and subsections 84.1(2.31) and (2.32).

This amendment comes into force on January 1, 2024.

Clause 51

Joint and several liability—FHSA

ITA
160.2(2.3)

Subsection 160.2(2.3) provides that a taxpayer who receives benefits out of another person's FHSA is jointly and severally liable for the portion of that other person's tax that is attributable to those benefits.

Subsection 160.2(2.3) is repealed. Note that Section 160 contains rules regarding the joint and several liability of a taxpayer for the income tax liability of another person who, when not dealing at arm's length with the taxpayer, transferred property to the taxpayer for consideration less than its fair market value.

This amendment comes into force on April 1, 2023.

Clause 52

False statements or omissions

ITA
163(2)(d.1)

Subsection 163(2) imposes a penalty where a taxpayer knowingly, or in circumstances amounting to gross negligence, participates in or makes a false statement or omission for the purposes of the Act. New paragraph 163(2)(d.1) is added to apply where false information is provided in respect of an amount claimed under new subsection 127.44(2) (the CCUS tax credit) or 127.45(2) (the clean technology investment tax credit).

Clause 53

New Part II.2 of the Act imposes a tax on the net value of equity repurchases by certain publicly listed entities (covered entities). Each covered entity must add to its tax otherwise payable for a year under Part II.2 an amount equal to 2% of the covered entity's net value of equity repurchases during the year. Although not an income tax, Part II.2 tax is included in the Act for administrative convenience given the use of the Act's existing definitions and administrative provisions to determine the amount of Part II.2 tax payable.

New sections 183.3 and 183.4 apply to transactions that occur after 2023.

Definitions

ITA
183.3(1)

New subsection 183.3(1) contains definitions that apply for the purposes of Part II.2.

"covered entity"

The term "covered entity" specifies the entities subject to Part II.2 tax. A covered entity for a taxation year means an entity that, at any time in the taxation year, has its issued and outstanding equity listed on a designated stock exchange (as defined in subsection 248(1)) and is a

- Canadian-resident corporation (other than a mutual fund corporation),
- real estate investment trust (as defined in subsection 122.1(1)),
- specified investment flow-through trust (SIFT trust), as defined in subsection 122.1(1) (or would be a SIFT trust if its assets were situated in Canada, other than a mutual fund trust with a class of units in continuous distribution), or
- SIFT partnership, as defined in subsection 197(1) (or would be a SIFT partnership if its assets were situated in Canada).

"equity"

"Equity" of an entity is defined to be a share of the capital stock of a corporation, an income or capital interest in a trust, or an interest of a member of a partnership, as the case may be.

Transactions with respect to the equity of a covered entity determine the amount of Part II.2 tax payable.

"qualifying issuance"

Generally speaking, a "qualifying issuance" is an issuance of equity that is netted against any equity repurchases, and therefore acts to reduce (or eliminate) the amount of Part II.2 tax payable by a covered entity. A "qualifying issuance" of equity by a covered entity is included in paragraph (a) of variable C of the "netting rule" calculation in subsection 183.3(2), which

determines the amount of Part II.2 tax payable for the year. Inclusion in variable C decreases the net amount to which Part II.2 tax applies. A qualifying issuance means any portion of an issuance of equity that is described in paragraphs (a) to (c) of the definition.

Paragraph (a) of the definition describes an issuance of equity that is made in exchange for cash, a security the terms of which confer on the holder the right to make the exchange (for example, a bond, debenture, note or other security (other than equity) of the covered entity), or any combination thereof. For example, paragraph (a) includes equity issued pursuant to the conversion of a convertible debenture, warrant or subscription receipt that was issued by the covered entity for cash.

Paragraph (b) describes an issuance of equity to an employee of the covered entity (or an entity related to the covered entity) in the course of the employee's employment.

Paragraph (c) describes an issuance of equity to a person or partnership, who deals at arm's length and is not affiliated with the covered entity, in exchange for property used in the covered entity's active business.

Example – Convertible debt of the issuer

A public corporation (Pubco) issues a debt instrument in exchange for cash. Pursuant to the terms of the debt, it can be converted at the option of the holder into common shares of Pubco that have a fair market value equal to the principal amount of the debt. The individual exercises the right to convert the debt to equity and disposes of the debt to Pubco for no consideration other than for issued shares of Pubco.

Since the issuance of Pubco shares is in exchange for a convertible debt of Pubco, which provided the terms for the exchange and was issued for cash, the full amount of the issuance is a qualifying issuance pursuant to subparagraph (a)(ii) of that definition and thus is included in variable C of subsection 183.3(2).

"reorganization transaction"

Equity that is repurchased, acquired or cancelled through a "reorganization transaction" is generally excluded from Part II.2 tax. For certain "reorganization transactions" that include the issuance of a non-equity consideration, Part II.2 tax is reduced based on the proportion of equity consideration.

A redemption, acquisition or cancellation of equity in a "reorganization transaction" is excluded from variable A of the netting rule in subsection 183.3(2) which calculates Part II.2 tax payable. The types of redemption, acquisition or cancellation transactions considered to occur in a "reorganization transaction" are listed in paragraphs (a) to (h) of the definition.

Paragraph (a) of the definition describes a range of transactions where there is an exchange of equity by a holder for consideration that includes equity (that is not substantive debt) of certain entities. Those entities are:

(i) the covered entity,
(ii) an entity that is related to the covered entity immediately before the exchange and that is itself a covered entity immediately after the exchange, and
(iii) another covered entity that controls the covered entity (or an amalgamated successor entity of the first covered entity) immediately after the exchange.

If substantive debt or consideration other than equity described in this paragraph ("non-equity consideration") is received by an equity holder on an exchange, the fair market value of the non-equity consideration is included in variable B of the netting rule. See the commentary on variable B in subsection 183.3(2) for more information.

Example – Section 86 share-for-share exchange

A public corporation (Pubco) wishes to reorganize its share capital to exchange all of its Class A shares, held by its shareholders, for new Class B shares. The Class A and Class B shares are both ordinary common shares (meaning they are not "substantive debt"). The shareholders of Pubco transfer, on a tax-deferred basis under section 86, their Class A shares for new Class B shares.

Subparagraph (a)(i) of the "reorganization transaction" definition is met because the exchange is for consideration that includes newly issued Class B shares of Pubco (equity of the covered entity). Consequently, the redemption, acquisition or cancellation of Pubco's Class A shares that occurs on the share-for-share exchange is a reorganization transaction that is excluded from variable A of the formula in subsection 183.3(2).

Furthermore, the issuance of Pubco's new Class B shares is not a qualifying issuance and is therefore excluded from variable C of the formula in subsection 183.3(2).

Example – Section 86 spin-off

A public corporation (Pubco) wishes to divest a particular business (Target Assets) by distributing the Target Assets to its shareholders. Pubco incorporates Spinco and transfers, on a tax-deferred basis under section 85, the Target Assets to Spinco. The shareholders of Pubco exchange all their Pubco shares, on a tax-deferred basis under section 86, for a new class of Pubco common shares and all the Spinco shares owned by Pubco. Immediately after the exchange, the Spinco shares are listed on a designated stock exchange.

Paragraph (a) of the definition "reorganization transaction" is met because the exchange is for:

(i) the new class of Pubco common shares (equity of the covered entity), and

(ii) common shares of Spinco, an entity that is related to Pubco immediately before the exchange and that is a covered entity immediately after the exchange (thus, the distribution of the shares of Spinco satisfies the subparagraph (a)(ii) requirement of the "reorganization transaction" definition).

Consequently, the redemption, acquisition or cancellation of Pubco's shares would be a reorganization transaction that is excluded from variable A of the formula in subsection 183.3(2).

Furthermore, the issuance of Pubco's new shares is not a qualifying issuance and is therefore excluded from variable C of the formula in subsection 183.3(2).

Example – Triangular amalgamation

A public corporation (Acquiror) wishes to acquire a second public corporation (Target). First, Acquiror incorporates Subco. Subco and Target then amalgamate to form Amalco pursuant to a triangular amalgamation undertaken in accordance with subsection 87(9). Consequently, on the amalgamation the shareholders of Target exchange all their Target shares for newly issued common shares of Acquiror.

Pursuant to subparagraph (a)(iii) of the definition "reorganization transaction", because the consideration for the cancellation of Target shares include equity (Acquiror shares) of another covered entity that, immediately after the exchange, controls an amalgamated successor entity of Target, the redemption, acquisition or cancellation of Target's equity that occurs on its acquisition would be excluded from variable A of the formula in subsection 183.3(2).

Furthermore, the issuance of Acquiror's shares is not a qualifying issuance and is therefore excluded from variable C of the formula in subsection 183.3(2).

Paragraph (b) describes an amalgamation of the covered entity with one or more other predecessor corporations to which subsection 87(1) applies. As part of the amalgamation, an equity holder must receive equity (that is not substantive debt) of the amalgamated corporation. If substantive debt or consideration other than equity described in this paragraph ("non-equity consideration") is received by an equity holder, the fair market value of the non-equity consideration is included in variable B of the formula in subsection 183.3(2). See the commentary on variable B in subsection 183.3(2) for more information.

Paragraph (c) describes a wind-up of the covered entity during which all or substantially all the property owned by the covered entity is distributed to the equity holders of the covered entity.

Paragraph (d) describes a divisive reorganization to which paragraph 55(3)(a) or (b) applies.

Paragraph (e) describes a qualifying disposition (as defined in subsection 107.4(1)) that occurs when a disposition of property to a trust does not result in any change in the beneficial ownership of the property and that otherwise meets the conditions set out in that section.

Paragraph (f) describes a qualifying exchange (as defined in subsection 132.2(1)) that occurs as part of a merger of two mutual fund trusts or a mutual fund corporation and a mutual fund trust.

Paragraph (g) describes a redemption, acquisition or cancellation of equity by the covered entity at the demand of the equity holder in accordance with the conditions under paragraph 108(2)(a),

for an amount that does not exceed the fair market value of the equity at the time of the redemption, acquisition or cancellation.

Paragraph (h) describes a redemption, acquisition or cancellation of equity by the covered entity pursuant to the exercise of a statutory right of dissent by the equity holder.

"specified affiliate"

The "specified affiliate" definition is relevant to determining whether certain equity transactions of an affiliate of a covered entity cause the covered entity to be subject to Part II.2 tax pursuant to subsection 183.3(2) and the anti-avoidance rule in subsection 183.3(5). An entity is a "specified affiliate" of a covered entity if, at that time, one of the following conditions is satisfied:

- If the affiliate is a corporation, the covered entity controls the affiliate or has a direct or indirect interest in more than 50% of the fair market value of the corporation's equity.
- If the affiliate is a trust, the covered entity is a majority-interest beneficiary (as defined in subsection 251.1(3)) of the trust or has a direct or indirect interest in more than 50% of the fair market value of the trust's equity.
- If the affiliate is a partnership, the covered entity is a majority-interest partner (as defined in subsection 248(1)) of the partnership or has a direct or indirect interest in more than 50% of the fair market value of the partnership's equity.

See the commentary on subsection 183.3(5) for more information regarding specified affiliates.

"substantive debt"

"Substantive debt" of a covered entity is equity that possesses debt-like characteristics. As such, substantive debt is effectively treated as debt, rather than equity, for purposes of Part II.2. Consequently, substantive debt redeemed, acquired or cancelled is excluded from variables A and B of the netting rule in subsection 183.3(2). Substantive debt issued by a covered entity is also excluded from variable C of the netting rule. Equity must possess the following attributes to qualify as substantive debt.

Non-convertible or exchangeable

Subparagraphs (a)(i) and (ii) of the substantive debt definition require that the equity cannot be convertible or exchangeable, other than for other substantive debt of the covered entity or a bond, debenture or note of the covered entity where the fair market value does not exceed the fixed redemption entitlement under paragraph (d) (see discussion below). This is intended to accommodate convertible equity only if it is convertible into debt or a debt-like instrument. Subparagraph (a)(iii) also allows for equity that would be issued only after the occurrence of a trigger event pursuant to a non-viability contingent capital provision to satisfy regulatory capital requirements applicable to the covered entity. Such exceptional circumstances apply to the regulation of banks and other financial institutions under the capital adequacy requirement guidelines issued by the Office of the Superintendent of Financial Institutions.

Non-voting

Paragraph (b) of the substantive debt definition requires that the equity must be non-voting in respect of the election of the board of directors, the trustees or the general partner (as applicable) of the covered entity, except in the event of a failure or default under the terms or conditions of the equity. This exception recognizes that instruments that are generally non-voting may provide for voting rights in exceptional situations involving defaults.

Fixed dividend or distribution entitlement

Paragraph (c) of the substantive debt definition requires the equity to have a fixed dividend or distribution entitlement. This includes equity that has a dividend or distribution rate that fluctuates periodically based on a market interest rate plus a fixed amount (for example, floating rate preferred shares with a dividend entitlement that is determined by reference to a Government of Canada Treasury Bill yield rate plus a fixed amount), provided the dividend or distribution rate is based on the fair market value of the consideration for which the equity was issued.

Fixed redemption entitlement

Paragraph (d) of the substantive debt definition requires that the entitlement to the equity holder on the redemption, cancellation or acquisition of the equity cannot exceed the total of:

(i) the fair market value of the consideration for which the equity was issued,
(ii) any unpaid distributions or dividends on the equity,
(iii) any premium that is payable to the holder solely due to the early redemption, cancellation or acquisition of the equity, and
(iv) any other amount in respect of an amount described in subparagraphs (i) to (iii) that increases the equity holder's entitlement due to a fluctuation in a currency other than Canadian currency relative to the Canadian currency.

In other words, the equity must have a fixed redemption entitlement.

Tax payable

ITA
183.3(2)

New subsection 183.3(2) provides that a person or partnership that is a covered entity for a taxation year is liable to pay tax under Part II.2. The amount of Part II.2 tax payable is determined by the formula 0.02 x (A + B – C) (also referred to as the "netting rule").

Variable A – Redemptions, acquisitions or cancellations

Variable A of the netting rule is the total fair market value (FMV) (at the time of the redemption, acquisition or cancellation) of equity (other than substantive debt) that is redeemed, acquired or cancelled in the taxation year by the covered entity, subject to two exceptions.

First, paragraph (a) excludes from variable A the redemption, acquisition or cancellation of equity that occurs in a reorganization transaction (as defined in subsection 183.3(1)) (see the commentary on that definition). Certain reorganization transactions are instead taken into account under variable B, discussed below.

Second, paragraph (b) excludes equity that has previously been deemed to be acquired under the rule in subsection 183.3(5) and included in this variable. This deals with situations where equity of a covered entity was previously acquired by a specified affiliate of the covered entity and was treated, due to subsection 183.3(5), as if it had been acquired directly by the covered entity for the purpose of calculating the covered entity's Part II.2 tax liability. In those circumstances, this exception ensures that a subsequent acquisition by the covered entity of that equity from its specified affiliate will not trigger a second tax liability. See the discussion under subsection 183.3(5) for more detail.

Variable B – Non-equity consideration

Variable B of the netting rule is generally relevant in reorganizations that include the issuance of ordinary common share as well as other consideration. This rule effectively operates to prorate the tax based on the amount of non-equity consideration issued in relevant reorganization transactions.

Paragraph (a) of variable B applies where the redemption, acquisition or cancellation of a covered entity's equity (other than substantive debt) occurs pursuant to paragraph (a) or (b) of the "reorganization transaction" definition and, as consideration, the equity holder receives substantive debt or other consideration that is not equity described in those paragraphs ("non-equity consideration").

In those cases, the amount included in variable B is determined by the formula D – E, where

- D is the total FMV (at the time of the redemption, acquisition or cancellation) of the covered entity's equity (other than substantive debt) that is redeemed, acquired or cancelled pursuant to the reorganization transaction, and
- E is the total FMV (at the time of the redemption, acquisition or cancellation) of the equity consideration described in paragraphs (a) or (b) of the "reorganization transaction" definition received by the equity holders pursuant to the reorganization transaction. This means equity (other than substantive debt) of one of the entities listed in subparagraphs (a)(i) to (iii) of the "reorganization transaction" definition or of the new corporation referred to in paragraph (b) of that definition.

This formula operates to include, in the netting rule, the value of non-equity consideration received by equity holders on a reorganization transaction described in paragraph (a) or (b) of the definition.

Paragraph (b) applies to any transaction not described in paragraph (a). It provides that the amount included in variable B is nil. Accordingly, variable B will be nil (and therefore effectively not relevant) for any transaction that is not described in paragraph (a) or (b) of the "reorganization transaction" definition or in which no non-equity consideration is received.

Example – Share-for-share exchange with non-equity consideration

A public corporation (Pubco) wishes to reorganize its share capital (and in the process distribute cash proceeds received from a recent asset sale) by exchanging all its Class A shares, held by its shareholders, for new Class B shares and cash consideration. The shareholders of Pubco transfer, in aggregate, $1 million of their Class A shares for $700,000 of new Class B shares and $300,000 cash.

Subparagraph (a)(i) of the "reorganization transaction" definition is met because the exchange is for consideration that includes newly issued Class B shares of Pubco (equity of the covered entity). Consequently, the redemption, acquisition or cancellation of Pubco's Class A shares is a reorganization transaction that is excluded from variable A of the formula in subsection 183.3(2).

However, since the redemption, acquisition or cancellation of the covered entity's equity occurs pursuant to paragraph (a) of the "reorganization transaction" definition and cash (non-equity consideration) is received by an equity holder, $300,000 ($1 million – $700,000) (i.e. the FMV of non-equity consideration) is included in variable B of the formula in subsection 183.3(2).

Furthermore, the issuance of Pubco's new Class B shares is not a qualifying issuance and is therefore excluded from variable C of the formula in subsection 183.3(2).

Pursuant to the de minimis exception in subsection 183.3(4), if the amount determined for variable A and B is less than $1 million, Part II.2 tax is not payable for the taxation year (regardless of any variable C amount).

Variable C – Issuances

Variable C of the netting rule includes the total FMV (at the time of the issuance or disposition, as applicable) of equity (other than substantive debt) that is, in the taxation year, issued or acquired in one of two circumstances.

First, paragraph (a) of variable C includes equity issued by the covered entity in a "qualifying issuance" (as defined in subsection 183.3(1)). Equity issued by a covered entity in a situation that is not a "qualifying issuance" does not get taken into account in the netting rule.
Second, paragraph (b) applies to equity disposed of by a specified affiliate of the covered entity (except a disposition to the covered entity or another specified affiliate of the covered entity), if that equity was previously deemed to be acquired under the rule in subsection 183.3(5) and included in variable A. See the discussion under subsection 183.3(5) for more detail.

Example – Stock consolidation (reverse split)

A public corporation (Pubco) has 10 million shares outstanding with an FMV of $10 per share. Pubco undertakes a stock consolidation (reverse split). After the stock consolidation, Pubco has 5 million shares outstanding with an FMV of $20 per share.

Stock consolidations (and similarly, stock splits) are not considered to result in an issuance or a redemption, acquisition or cancellation of shares under Part II.2 and are therefore not included in the "netting rule" in subsection 183.3(2).

Example – The "netting rule"

During the year, a public corporation (Pubco) acquires 1,000 of its shares outstanding with an FMV of $10 million and subsequently issues 100 new shares with an FMV of $1 million in consideration for cash. None of Pubco's shares acquired or issued are considered substantive debt.

Pubco's acquisition of $10 million of its shares does not satisfy any of the transactions described in the definition of "reorganization transaction" in subsection 183.3(1) and is therefore included in variable A of the netting rule.

The consideration for Pubco's issuance of shares is $1 million of cash and thus, the issuance is a qualifying issuance pursuant to subparagraph (a)(i) of that definition in subsection 183.3(1). The issuance of shares is included in variable C of the netting rule.

Pubco's Part II.2 tax payable for the taxation year is $180,000, determined by the formula 0.02 x (A + B – C), or 0.02 x ($10 million + 0 – $1 million).

Tax payable – anti-avoidance

ITA
183.3(3)

New subsection 183.3(3) is an anti-avoidance rule. If it is reasonable to consider that the primary purpose of a transaction or series of transactions by a covered entity is to cause a decrease in the formula under subsection 183.3(2) (either by decreasing variable A or B, or increasing variable C), the equity is deemed by new subsection 183.3(3) to be a redemption, acquisition or cancellation of equity included in variable A or B or an issuance of equity included in variable C of the formula (as the case may be).

***De minimis* rule**

ITA
183.3(4)

New subsection 183.3(4) provides that if the total amount determined for variables A and B in subsection 183.3(2) for a taxation year is less than $1 million, Part II.2 tax is not payable for the

covered entity's taxation year. If a covered entity's taxation year is a short year (i.e., less than 365 days), the $1 million amount is reduced to the proportion of the amount that the number of days in the short year is of 365.

Similar transactions

ITA
183.3(5)

New subsection 183.3(5) is an anti-avoidance rule that deems equity to be acquired by a covered entity if a specified affiliate (defined in new subsection 183.3(1)) of the covered entity acquires equity of the covered entity.

If such a deemed acquisition of equity is included in variable A of the netting rule in subsection 183.3(2), a subsequent acquisition (or deemed acquisition) of that equity by the covered entity will not be included again due to the exception in paragraph (b) of variable A in subsection 183.3(2) (inclusion in variable A would increase the net amount to which Part II.2 tax applies). This exception ensures that an acquisition of equity by an affiliated group of entities is not included in the netting rule formula (and thus subject to tax) more than once.

Further, if the deemed acquisition of equity is included in variable A of the netting rule, a subsequent disposition of the equity will be included in variable C of the netting rule (inclusion in variable C would decrease the net amount to which Part II.2 tax applies). This rule does not apply where the disposition is made to the covered entity or another specified affiliate of the covered entity. This exception ensures that a disposition of equity by an affiliated group of entities is not included in the netting rule formula (reducing the Part II.2 tax base) more than once.

Example – Specified affiliate

A public corporation (Pubco) wholly owns another corporation (Subco). Subco purchases $10 million of Pubco's shares on the open market. Later that same year, Subco disposes of its $3 million of Pubco shares to Pubco and the remaining $7 million on the open market.

Since Subco is a corporation that is controlled and wholly owned by Pubco, Subco is a "specified affiliate" of Pubco per paragraph (a) of the definition in subsection 183.3(1).

Subsection 183.3(5) deems Pubco to acquire the $10 million of Pubco shares which is included in variable A of the "netting rule" in subsection 183.3(2).

Subco's disposition of the $3 million of Pubco shares to Pubco is excluded from variable A of the netting rule (pursuant to the exception in paragraph (b)) because the shares had previously been deemed to be acquired by Pubco pursuant to subsection 183.3(5) and included in variable A of the netting rule. The $7 million disposition on the open market is not included under variable A since it is not a disposition to Pubco.

Since the $3 million disposition of Subco's shares of Pubco is made to Pubco (the covered entity), this amount is not included in variable C of the netting rule. However, the $7 million disposition of Subco's shares of Pubco on the open market is not made to the covered entity or another specified affiliate of the covered entity and thus, is included in variable C of the netting rule pursuant to paragraph (b).

Pubco's Part II.2 tax payable for the taxation year is $60,000, determined by the formula 0.02 x (A + B – C), or 0.02 x ($10 million + 0 – $7 million).

Exceptions to the anti-avoidance rule are provided for registered securities dealers acquiring equity (in the capacity of an agent) and disposing of the equity within a reasonable period of time in the ordinary course of their business, trusts that are employee benefit plans and trusts that are governed by an employees profit sharing plan or deferred profit sharing plan.

Similar transactions – anti-avoidance

ITA
183.3(6)

New subsection 183.3(6) is an anti-avoidance rule to address transactions or series of transactions entered into by a person or partnership where one of their main purposes is to acquire equity of a covered entity to avoid Part II.2 tax otherwise payable. If this subsection applies, the person or partnership is deemed to be a specified affiliate of the covered entity.

Return

ITA
183.4(1)

New subsection 183.4(1) requires a covered entity that redeems, acquires or cancels equity in a taxation year to file with the Minister of National Revenue a return for the year under Part II.2 in prescribed form. The filing deadline for a Part II.2 return is as follows:

(a) if the covered entity is a corporation, the return must be filed on or before the day it is required to file its return of income under Part I for the year;
(b) if the covered entity is a trust, the trustee of the trust must file the return within 90 days from the end of the taxation year; and
(c) if the covered entity is a partnership, a member of the partnership that has authority to act for the partnership must file the return before the earlier of 5 months after the end of the taxation year and March 31 immediately following the calendar year in which the taxation year ended.

Payment

ITA
183.4(2)

New subsection 183.4(2) provides that a covered entity that is liable to pay tax under this Part for a taxation year shall pay to the Receiver General its tax payable under Part II.2 for the taxation year by the following date:

(a) if the covered entity is a corporation or trust, the tax must be paid on or before its balance-due day for the taxation year; and
(b) if the covered entity is a partnership, the tax must be paid on or before the day on which the partnership is required to file a return for the year under paragraph 183.4(1)(c).

Provisions applicable to Part

ITA
183.4(3)

New subsection 183.4(3) provides that certain provisions of Part I of the Act relating to assessments, payments, appeals and other procedural and administrative matters are applicable to Part II.2 with such modifications as the circumstances require.

Clause 54

Undeducted RRSP premiums

ITA
204.2(1.2)

Subsection 204.2(1.2) provides rules for determining the amount of an individual's "undeducted RRSP premiums" at any time. This amount is used to calculate the individual's cumulative excess amount (subject to a monthly tax) in respect of RRSPs under subsection 204.2(1.1).

Subparagraph (a)(iii) of variable I of the formula in subsection 204.2(1.2) is amended to add transfers from an FHSA to an RRSP to the list of transfers that are not considered for purposes of the Part X.1 tax to be premiums paid to an RRSP.

This amendment comes into force on April 1, 2023.

Clause 55

Definitions

ITA
207.01(1)

Part XI.01 of the Act contains anti-avoidance rules applicable to certain registered plans to help ensure that they do not provide excessive tax advantages unrelated to their respective basic

objectives, and that they do not hold investments that are prohibited investments or that are not qualified investments for the particular plan.

Subsection 207.01(1) contains definitions that apply in Part XI.01 and in Part XLIX of the Income Tax Regulations. The definitions “excess FHSA amount”, “designated amount” and “swap transaction” are amended as follows.

“excess FHSA amount”

The definition "excess FHSA amount" is used for the special tax imposed under section 207.021 on excess FHSA contributions. The amount of the tax under section 207.021 is determined on the basis of an individual's highest "excess FHSA amount" in a particular month.

The amendment replaces the existing “excess FHSA amount” definition. New paragraph (a) determines an individual’s excess FHSA amount by examining a taxpayer’s FHSA activity on a year-by-year basis. New paragraph (b) of the definition “excess FHSA amount” provides the Minister of National Revenue the discretion to reduce the amount determined in paragraph (a) in appropriate circumstances.

Specifically, paragraph (a) is the amount determined by the formula A + B + C – D – E – F. The formula starts with Variable A, which is the individual’s excess FHSA amount as at the end of the previous year. In the first year an individual has an FHSA, variable A is set to zero by application of its subparagraph (i).

Variables B and C represent amounts that could increase an individual’s excess FHSA amount. Specifically, variables B and C are the contributions and transfers, respectively, that have been made to an individual’s FHSA in the taxation year (at or before the particular time).

Variables D, E and F represent amounts that reduce an individual’s excess FHSA amount. Specifically, variable D is the lesser of (i) the amount of the FHSA carryforward plus $8,000 and (ii), an amount determined by the subformula $40,000 – G. For the purpose of subparagraph (i), the FHSA carryforward is to be determined under the assumption that the amount of any taxable withdrawal is considered, to the extent that it could have been so designated, as a designated amount. Subparagraph (i) of Variable D can at most be $16,000 (a full $8,000 FHSA carryforward amount plus $8,000).

The subformula in subparagraph (ii) of variable D will reduce the amount determined in the previous subparagraph as a taxpayer approaches the $40,000 lifetime limit on deductible contributions. In principle, variable G should simply be the amount of deductible contributions made before the start of the current taxation year.

However, since transfers generally reduce the amount of deductible contributions available to a taxpayer, variable G is calculated under the assumption (see clauses (A) and (B) of variable G) that transfers could have given rise to a deduction if they were instead directly contributed. Since designated amounts under paragraph (a) of the definition “designated amount” in subsection 207.01(1) can reinstate the amount a taxpayer is able to deduct, variable G will implicitly be

based on an individual's "net RRSP-to-FHSA transfer amount" (refer to the explanatory note for this definition in subsection 146.6(1)). Ultimately, variable G is the total of all amounts in respect of preceding taxation years that were deducted, could have been deducted, or would have been deductible if any increase in an individual's "net RRSP-to-FHSA transfer amount" in a given year had instead been directly contributed in that year.

The operation of variable D in paragraph (a) of the definition "excess FHSA amount" is shown through several examples below. In these examples, assume that the "excess FHSA amount" is calculated after any transactions are made in a given year.

Example 1

Janice contributes $40,000 to an FHSA on April 1, 2023 (as a result, Janice will have an excess FHSA amount of $32,000 throughout the remainder of 2023, which will be subject to a 1%-per-month tax). Presuming Janice takes no further action, her excess FHSA amount would be determined as follows:

	A	**B**	**C**	**D**	**E**	**F**	**Excess FHSA Amount**
2023	0	40,000	0	8,000	0	0	32,000
2024	32,000	0	0	8,000	0	0	24,000
2025	24,000	0	0	8,000	0	0	16,000
2026	16,000	0	0	8,000	0	0	8,000
2027	8,000	0	0	8,000	0	0	0
2028	0	0	0	0	0	0	0

Note:

- In 2023, D is 8,000, since the lesser of (i) 8,000 and (ii) 40,000 is 8,000.
  - ↳ Subparagraph (i) of D is 0 + 8,000, Subparagraph (ii) of D is 40,000 – 0 = 40,000.
- In 2024, D is 8,000, since the lesser of (i) 8,000 and (ii) 32,000 is 8,000.
  - ↳ Subparagraph (i) of D is 0 + 8,000, Subparagraph (ii) of D is 40,000 – 8,000 = 32,000.
- In 2025, D is 8,000, since the lesser of (i) 8,000 and (ii) 24,000 is 8,000.
  - ↳ Subparagraph (i) of D is 0 + 8,000, Subparagraph (ii) of D is 40,000 – 16,000 = 24,000.
- In 2026, D is 8,000, since the lesser of (i) 8,000 and (ii) 16,000 is 8,000.
  - ↳ Subparagraph (i) of D is 0 + 8,000, Subparagraph (ii) of D is 40,000 – 24,000 = 16,000.
- In 2027, D is 8,000, since the lesser of (i) 8,000 and (ii) 8,000 is 8,000.

- ↳ Subparagraph (i) of D is 0 + 8,000, Subparagraph (ii) of D is 40,000 – 32,000 = 8,000.
- In 2028, D is 0, since the lesser of (i) 8,000 and (ii) 0 is 0.
  - ↳ Subparagraph (i) of D is 0 + 8,000, Subparagraph (ii) of D is 40,000 – 40,000 = 0.

Example 2

Instead, suppose Janice transfers $40,000 from her RRSP to an FHSA on April 1, 2023. Her resulting excess FHSA amounts would be the same.

	A	**B**	**C**	**D**	**E**	**F**	**Excess FHSA Amount**
2023	0	0	40,000	8,000	0	0	32,000
2024	32,000	0	0	8,000	0	0	24,000
2025	24,000	0	0	8,000	0	0	16,000
2026	16,000	0	0	8,000	0	0	8,000
2027	8,000	0	0	8,000	0	0	0
2028	0	0	0	0	0	0	0

Note:

- In 2023, D is 8,000, since the lesser of (i) 8,000 and (ii) 40,000 is 8,000.
  - ↳ Subparagraph (i) of D is 0 + 8,000, Subparagraph (ii) of D is 40,000 – 0 = 40,000.
- In 2024, D is 8,000, since the lesser of (i) 8,000 and (ii) 32,000 is 8,000.
  - ↳ Subparagraph (i) of D is 0 + 8,000, Subparagraph (ii) of D is 40,000 – 8,000 = 32,000.
- In 2025, D is 8,000, since the lesser of (i) 8,000 and (ii) 24,000 is 8,000.
  - ↳ Subparagraph (i) of D is 0 + 8,000, Subparagraph (ii) of D is 40,000 – 16,000 = 24,000.
- In 2026, D is 8,000, since the lesser of (i) 8,000 and (ii) 16,000 is 8,000.
  - ↳ Subparagraph (i) of D is 0 + 8,000, Subparagraph (ii) of D is 40,000 – 24,000 = 16,000.
- In 2027, D is 8,000, since the lesser of (i) 8,000 and (ii) 8,000 is 8,000.
  - ↳ Subparagraph (i) of D is 0 + 8,000, Subparagraph (ii) of D is 40,000 – 32,000 = 8,000.
- In 2028, D is 0, since the lesser of (i) 8,000 and (ii) 0 is 0.
  - ↳ Subparagraph (i) of D is 0 + 8,000, Subparagraph (ii) of D is 40,000 – 40,000 = 0.

Example 3

Instead, suppose on April 1, 2023 Janice contributes $18,000 to an FHSA and transfers $24,000 from her RRSP to an FHSA. Her resulting excess FHSA amounts would be the following:

	A	B	C	D	E	F	Excess FHSA Amount
2023	0	18,000	24,000	8,000	0	0	34,000
2024	34,000	0	0	8,000	0	0	26,000
2025	26,000	0	0	8,000	0	0	18,000
2026	18,000	0	0	8,000	0	0	10,000
2027	10,000	0	0	8,000	0	0	2,000
2028	2,000	0	0	0	0	0	2,000

Note:

- In 2023, D is 8,000, since the lesser of (i) 8,000 and (ii) 40,000 is 8,000.
  - ↳ Subparagraph (i) of D is 0 + 8,000, Subparagraph (ii) of D is 40,000 – 0 = 40,000.
- In 2024, D is 8,000, since the lesser of (i) 8,000 and (ii) 32,000 is 8,000.
  - ↳ Subparagraph (i) of D is 0 + 8,000, Subparagraph (ii) of D is 40,000 – 8,000 = 32,000.
- In 2025, D is 8,000, since the lesser of (i) 8,000 and (ii) 24,000 is 8,000.
  - ↳ Subparagraph (i) of D is 0 + 8,000, Subparagraph (ii) of D is 40,000 – 16,000 = 24,000.
- In 2026, D is 8,000, since the lesser of (i) 8,000 and (ii) 16,000 is 8,000.
  - ↳ Subparagraph (i) of D is 0 + 8,000, Subparagraph (ii) of D is 40,000 – 24,000 = 16,000.
- In 2027, D is 8,000, since the lesser of (i) 8,000 and (ii) 8,000 is 8,000.
  - ↳ Subparagraph (i) of D is 0 + 8,000, Subparagraph (ii) of D is 40,000 – 32,000 = 8,000.
- In 2028, D is 0, since the lesser of (i) 8,000 and (ii) 0 is 0.
  - ↳ Subparagraph (i) of D is 0 + 8,000, Subparagraph (ii) of D is 40,000 – 40,000 = 0.

Example 4

Instead, suppose Janice contributes $8,000 to an FHSA on April 1, 2023 and transfers $16,000 from her RRSP to an FHSA at the beginning of 2024. Her resulting excess FHSA amounts would be the following:

	A	B	C	D	E	F	Excess FHSA Amount
2023	0	8,000	0	8,000	0	0	0

2024	0	0	16,000	8,000	0	0	8,000
2025	8,000	0	0	8,000	0	0	0
2026	0	0	0	8,000	0	0	0
2027	0	0	0	16,000	0	0	0
2028	0	0	0	16,000	0	0	0

Note:

- In 2023, D is 8,000, since the lesser of (i) 8,000 and (ii) 40,000 is 8,000.
  - ↳ Subparagraph (i) of D is 0 + 8,000, Paragraph (ii) of D is 40,000 – 0 = 40,000.
- In 2024, D is 8,000, since the lesser of (i) 8,000 and (ii) 32,000 is 8,000.
  - ↳ Subparagraph (i) of D is 0 + 8,000, Subparagraph (ii) of D is 40,000 – 8,000 = 32,000.
- In 2025, D is 8,000, since the lesser of (i) 8,000 and (ii) 24,000 is 8,000.
  - ↳ Subparagraph (i) of D is 0 + 8,000, Subparagraph (ii) of D is 40,000 – 16,000 = 24,000.
- In 2026, D is 8,000, since the lesser of (i) 8,000 and (ii) 16,000 is 8,000.
  - ↳ Subparagraph (i) of D is 0 + 8,000, Subparagraph (ii) of D is 40,000 – 24,000 = 16,000.
- In 2027, D is 16,000, since the lesser of (i) 16,000 and (ii) 16,000 is 16,000.
  - ↳ Subparagraph (i) of D is 8,000 + 8,000, Subparagraph (ii) of D is 40,000 – 24,000 = 16,000.
- In 2028, D is 16,000, since the lesser of (i) 16,000 and (ii) 16,000 is 16,000.
  - ↳ Subparagraph (i) of D is 8,000 + 8,000, Subparagraph (ii) of D is 40,000 – 24,000 = 16,000.

Variable E reflects the total of the individual's "designated amounts" made in the taxation year before the particular time or amounts to be included in the taxpayer's income for the taxation year before the particular time. Designated amounts allow an individual to correct an excess FHSA contribution by essentially reversing a transfer from an RRSP or a direct contribution.

Finally, variable F represents the total of amounts to be included in the taxpayer's income in previous taxation years that did not reduce the taxpayer's "excess FHSA amount" in a prior taxation year, either through variable E or through F itself. For instance, if a non-qualifying (taxable) withdrawal exceeds the amount of the taxpayer's "excess FHSA amount" determined immediately prior to the withdrawal, the taxpayer's "excess FHSA amount" will be zero immediately following the withdrawal by virtue of variable E (as this formula may not produce a negative result due to the application of section 257 of the *Income Tax Act*). The portion of the amount of the non-qualifying withdrawal that did not reduce the taxpayer's "excess FHSA amount" in the year of the taxable withdrawal could then be used to reduce the taxpayer's "excess FHSA amount" in a subsequent year via variable F. Once a reduction in the taxpayer's "excess FHSA amount" has been effected through variable F, that amount can no longer be used to reduce a taxpayer's "excess FHSA amount" though variable F in the future.

Taken together, variables E and F effectively ensure that amounts withdrawn and subject to tax can later be recontributed to an FHSA without attracting the 1%-per-month tax on overcontributions.

The operation of variables E and F in paragraph (a) of the definition “excess FHSA amount” is shown through several examples below. In these examples, assume that the “excess FHSA amount” is calculated after any transactions are made in a given year.

Example 5

Janice contributes $8,000 to an FHSA on April 1, 2023, another $8,000 on January 1, 2024, and makes a non-qualifying (taxable) withdrawal of $10,000 later in 2024. Janice then contributes $10,000 each year from 2025 to 2027 and a final contribution of $4,000 in 2028. Presuming Janice takes no further action, her excess FHSA amount would be determined as follows:

	A	**B**	**C**	**D**	**E**	**F**	**Excess FHSA Amount**
2023	0	8,000	0	8,000	0	0	0
2024	0	8,000	0	8,000	10,000	0	0
2025	0	10,000	0	8,000	0	10,000	0
2026	0	10,000	0	8,000	0	8,000	0
2027	0	10,000	0	8,000	0	6,000	0
2028	0	4,000	0	0	0	4,000	0

Example 6

As in example 5, suppose Janice contributes $8,000 to an FHSA on April 1, 2023, another $8,000 on January 1, 2024, and makes a non-qualifying (taxable) withdrawal of $10,000 later in 2024. Unlike example 5, however, suppose Janice then contributes $18,000 in each of 2025 and 2026. Presuming Janice takes no further action, her excess FHSA amount would be determined as follows:

	A	B	C	D	E	F	Excess FHSA Amount
2023	0	8,000	0	8,000	0	0	0
2024	0	8,000	0	8,000	10,000	0	0
2025	0	18,000	0	8,000	0	10,000	0
2026	0	18,000	0	8,000	0	0	10,000

As noted above, new paragraph (b) of the definition “excess FHSA amount” provides the Minister of National Revenue the discretion to reduce the amount determined in paragraph (a) in appropriate circumstances. Such circumstances could include situations of financial hardship. For example, if the value of a taxpayer’s FHSA portfolio has decreased substantially and the taxpayer has exhausted all corrective remedies available to them (e.g., designated amounts, non-qualifying withdrawals), paragraph (b) would provide the Minister the discretion to reduce any remaining excess FHSA amount that would otherwise be determined by paragraph (a).

“designated amount”

The definition “designated amount” is used in the formula in the definition “excess FHSA amount” to reduce an individual's excess FHSA amount. A “designated amount” provides an individual the ability to correct an overcontribution to an FHSA; either by returning an amount to an RRSP or reversing a direct contribution through a tax-free withdrawal.

Paragraph (a) of the definition “designated amount” is amended to ensure the language “to an FHSA under which the individual is the holder” correctly appears after the reference to paragraph 146(16)(a.2), instead of after the reference to subparagraph 146.6(7)(b)(ii).

This amendment comes into force on April 1, 2023.

“swap transaction”

A "swap transaction" is generally a transfer of property between a controlling individual of a registered plan (or a person with whom the controlling individual does not deal at arm's length) and a registered plan of the individual, with certain exceptions.

Consequential on amendments to include FHSAs among the registered plans that are subject to taxes under Part XI.01, the exceptions in paragraph (d) were expanded. Subparagraph (d)(i) was amended to define “swap transaction” as excluding transfers between two plans of the controlling individual where each of the plans involved are RRSPs, RRIFs, or FHSAs. This amendment came into force on April 1, 2023 (Bill C-32, Royal Assent on December 15, 2022).

The definition “swap transaction” is amended to clarify the intention behind the original amendment. Specifically, these amendments clarify that the definition “swap transaction” excludes transfers between FHSAs, non-taxable transfers from an FHSA to an RRSP or RRIF (in accordance with subsection 146.6(8)) and non-taxable transfers from an RRSP to an FHSA (in accordance with paragraph 146(16)(a.2)).

The amendment to paragraph (b) of the definition “swap transaction” comes into force on April 1, 2023. Amendments to paragraph (d) of the definition “swap transaction” come into force on August 4, 2023.

Clause 56

Definitions

ITA
207.5(1)

“refundable tax”

The “refundable tax” of a retirement compensation arrangement at the end of a taxation year is defined as:

- 50% of all contributions made under the arrangement before that time (paragraph (a)), plus
- 50% of the amount by which the total income or capital gains of the arrangement exceeds its losses for the year or any preceding taxation year (paragraph (b)), minus
- 50% of all benefits paid under the arrangement (other than those benefits paid as part of a series of contributions and refunds) for the year or any preceding taxation year (paragraph (c)).

Paragraph (a) of the definition “refundable tax” is amended to include a reference to the new definition “excluded contribution”. Any amount that is determined to be an “excluded contribution” made after March 28, 2023 shall not be included in the amount of contributions in paragraph (a) and is therefore excluded for the purposes of determining the arrangement’s “refundable tax”.

“excluded contribution”

The new definition “excluded contribution” in subsection 207.5(1) refers to an amount paid under a “specified arrangement”, also defined in this subsection, to obtain or renew a letter of credit or surety bond issued by a financial institution for the purposes of securing retirement benefits under the arrangement.

The “excluded contribution” definition is only relevant for the purposes of the “refundable tax” definition. An “excluded contribution” is still considered to be a contribution to a “retirement compensation arrangement” for the purposes of that definition in subsection 248(1).

“specified arrangement”

The new definition “specified arrangement” in subsection 207.5(1) refers to a retirement compensation arrangement that has a primary purpose of providing annual or more frequent retirement benefit payments and that meets one of the following conditions:

- it provides benefits that are supplemental to the benefits provided under a registered pension plan, a registered retirement savings plan, a deferred profit sharing plan, a pooled registered pension plan, or any combination of these plans, or
- it substantially complies with the criteria to be registered as a registered pension plan (except for, most notably, the maximum benefit limits prescribed in the Regulations).

These amendments are deemed to have come into force on March 28, 2023.

Clause 57

Specified refundable tax

ITA
207.71

As of March 28, 2023, amounts defined as an “excluded contribution” (in subsection 207.5(1)) are no longer subject to the refundable tax in section 207.7.

New section 207.71 provides for a refund mechanism of a retirement compensation arrangement’s refundable tax that was paid with respect to excluded contributions made prior to March 28, 2023, provided certain conditions are met. Amounts would generally be refunded at a rate of 50% of the retirement benefits paid after 2023 directly by an eligible employer to beneficiaries whose retirement benefits were secured under a specified arrangement with a letter of credit or surety bond issued by a financial institution.

New section 207.71 applies to the 2024 and subsequent taxation years.

Definitions

ITA
207.71(1)

New subsection 207.71(1) sets out definitions that apply for the purposes of the new refund mechanism in cases where a “specified arrangement” was secured (before March 28, 2023) by a letter of credit or surety bond.

“eligible employer”

The definition “eligible employer” refers to an employer that paid an “excluded contribution” under a “specified arrangement” before March 28, 2023. It also includes an employer whose predecessor employer (e.g., predecessor employer’s business was acquired by the employer) paid an amount that is an “excluded contribution”. See the additional commentary for the definitions added to subsection 207.5(1).

Only eligible employers will be allowed to file an election under subsection (2) for the purposes of obtaining a refund for refundable tax that was paid in respect of excluded contributions.

“specified refundable tax”

The definition of “specified refundable tax” is the maximum total amount of refundable tax that can be refunded with respect to a “specified arrangement” (as defined in subsection 207.5(1)) for any given year, determined by the formula A – B.

Variable A is the total amount of refundable tax that was paid solely with respect to fees incurred prior to March 28, 2023 for obtaining or renewing a letter of credit or surety bond for the purposes of securing future retirement benefit payments under a retirement compensation arrangement. The amount for variable A is the amount that was elected under subsection (2) and should remain fixed for each year that the specified refundable tax is determined.

Variable B is the total amount of all refunds determined under subsection (3) for each preceding taxation year. The amount for variable B increases each year as the eligible employer claims refunds.

The amount of specified refundable tax is determined at the end of the taxation year and is relevant for the purposes of determining the amount of the refund that can be claimed under subsection (3) for any given year.

Election

ITA
207.71(2)

New subsection 207.71(2) contains three conditions that, when satisfied, allow the eligible employer to claim a refund of refundable tax under subsection 207.71(3).

The first condition (paragraph 207.71(2)(a)) is met if an eligible employer, or the custodian of a specified arrangement, paid a refundable tax with respect to an “excluded contribution” made before March 28, 2023.

The second condition (paragraph 207.71(2)(b)) requires that the eligible employer file an election with the Minister of National Revenue, in prescribed form and manner, identifying the retirement compensation arrangement as a “specified arrangement”.

Lastly, paragraph 207.71(2)(c) requires that, as part of the election, the employer must identify the total amount of refundable tax that was paid solely with respect to excluded contributions. This amount corresponds to variable A in the definition of "specified refundable tax".

For additional information, see the commentary on the new definitions "excluded contribution" and "specified arrangement" in subsection 207.5(1) and the definition "specified refundable tax" in subsection 207.71(1).

Amount of refund

ITA
207.71(3)

New subsection 207.71(3) applies where an "eligible employer" (as defined in subsection (1)) has filed an election with the Minister of National Revenue under subsection (2).

Under this subsection, an eligible employer, or the custodian of the arrangement, as requested upon filing a return for a taxation year, can claim a refund equal to 50% of all retirement benefits paid in the year directly by the eligible employer for the benefit of beneficiaries whose retirement benefits were secured under a "specified arrangement" (as defined in subsection 207.5(1)) with a letter of credit or surety bond. The amount claimed in a taxation year cannot exceed the arrangement's "specified refundable tax" balance (as defined in subsection 207.71(1)) at the end of the taxation year.

Refundable tax definition

ITA
207.71(4)

New subsection 207.71(4) provides that where an eligible employer claims a refund of refundable tax under subsection (3) with respect to a specified arrangement, the arrangement's "refundable tax" balance (as defined in subsection 207.5(1)) must be reduced by the amount of the refund claimed for the year.

Clause 58

ITA
PART XII.7

New Part XII.7 of the Act introduces special taxes as well as reporting rules in relation to CCUS tax credits. Section 211.92 contains rules for recovery taxes that apply, in general terms, to certain CCUS tax credits for CCUS projects that do not meet their "projected eligible use percentage" (as defined in new subsection 127.44(1)) for the project. The potential application of these recovery taxes is only in relation to CCUS tax credits for "qualified carbon capture expenditures" and "qualified carbon transportation expenditures" (as defined in subsection

127.44(1)). Section 211.92 also includes “recapture” taxes – broadly similar to the existing recapture rules under section 127 – that apply in certain circumstances where CCUS property is disposed of or exported.

New Part XII.7 also contains reporting requirements in new section 211.93: climate risk disclosure and knowledge sharing rules as well as an annual reporting rule to aid in administration of new section 211.92. Finally, sections 211.94 and 211.95 adopt various provisions of the Act for the purposes of Part XII.7 and provide an extended record retention period in relation to the CCUS rules in s. 127.44 and in Part XII.7.

As with the basic CCUS tax credit provisions in new section 127.44, these rules apply as of January 1, 2022.

ITA
211.92

New section 211.92 implements the recovery tax (i.e., repayment of tax credit), as well as related provisions.

ITA
211.92(1)

Definitions

New subsection 211.92(1) provides various definitions relevant for the purpose of determining the CCUS tax credit recovery tax liability of a taxpayer and for the reporting requirements in new section 211.93. These definitions apply for the purposes of Part XII.7 as well as section 127.44, which contains the main portion of the CCUS tax credit rules.

“actual eligible use percentage”

This is the companion definition to “projected eligible use percentage” in new subsection 127.44(1). In general terms, to qualify for tax credit support, the proponents of a CCUS project must (among other things) project their eligible use percentage in their project plan before commencing operations. The recovery tax calculations in new subsections 211.92(4) and (5) compare projected eligible use percentage to actual eligible use percentage at the end of each of four “project periods”. If actual eligible use percentage is more than five percentage points lower than projected eligible use percentage in a given period, then a recovery tax is payable to recoup the excess tax credits claimed based on what has turned out to be an over-projection of eligible use. For more information, see the commentary to new subsections 211.92(4) and (5).

“exempt corporation”

Generally, subsection 211.93(1) requires a taxpayer to make a climate risk disclosure report available to the public in a prescribed manner as stipulated in subsection 211.93(2). However, an exempt corporation is not required to produce an annual climate risk disclosure report.

An “exempt corporation” is one that is not involved in a large project. More specifically, an exempt corporation is one that does not have an ownership interest, whether directly or indirectly, in a qualified CCUS project that or is expected to incur qualified expenditures, based on the most recent project evaluation issued by the Minister of Natural Resources for the project, of $20 million or more.

“first project period”

A taxpayer could be liable to pay a recovery tax at the end of each of four “project periods”. Each project period is five calendar years, except that the first project period has special rules to account for project start-up dates that are off-calendar. For projects that have their “first day of commercial operations” (or their expected first day of commercial operations, if they have not yet started up) before October 1st, the end of the first project period is on December 31st of the fourth calendar year after the first “stub year”.

For those projects, the first project period will be three to nine months shorter than five years, depending on their first day of commercial operations. For projects that have their “first day of commercial operations” (or their expected first day of commercial operations, if they have not yet started up) after September 30th, the stub period is added on to the following five calendar years, resulting in a first project period of up to five years and three months in length. Each of the subsequent project periods is five calendar years commencing immediately following the end of the previous project period.

“first recovery taxation year”

The “first recovery taxation year” for a CCUS project is the year that includes the last day of the first project period of a qualified CCUS project. Similarly, each of the second, third and fourth recovery taxation years is the year that includes the last day of the corresponding project period.

“fourth project period”

The “fourth project period” in respect of a CCUS project is the period of five calendar years following the end of the third project period. Refer to the commentary above on the definition of “first project period” for more details.

“fourth recovery taxation year”

The “fourth recovery taxation year” in respect of a qualified CCUS project is the year that includes the last day of the fourth project period.

“knowledge sharing CCUS project”

A “knowledge sharing CCUS project” is a qualified CCUS project that is either

- expected to incur qualified CCUS expenditures of $250 million or more over the life of the project based on the most recent initial project evaluation issued by the Minister of Natural Resources for the project, or
- has incurred $250 million or more of qualified CCUS expenditures before the first day of commercial operations of a CCUS project.

“knowledge sharing report”

A “knowledge sharing report” in respect of a CCUS project means each of an annual operations knowledge sharing report and the construction and completion knowledge sharing report.

All knowledge sharing reports must include the information described by the Minister of Natural Resources in the *CCUS-ITC Technical Guidance Document* as published by the Minister of Natural Resources and amended from time to time, in the form annexed to the CCUS-ITC Technical Guidance Document.

“knowledge sharing taxpayer”

A “knowledge sharing taxpayer” means a taxpayer that claimed a CCUS tax credit (under section 127.44 from its tax otherwise payable under Part I) for a taxation year ending before the first day of commercial operations of a knowledge sharing CCUS project.

“project period”

A “project period” is any of the first to fourth project periods of a qualified CCUS project.

“project start-up day”

The “project start-up day” is the day that is 120 days before the first day of commercial operations for a CCUS project. This date is relevant for determining reporting requirements in relation to knowledge sharing.

“recovery taxation year”

A “recovery taxation year” is any of the first to fourth recovery taxation years of a qualified CCUS project.

“relevant project period”

A “relevant project period”, in respect of each recovery taxation year, is the related project period, e.g., in case of the first recovery taxation year, since the first project period is the related project period, it is the relevant project period for the first recovery taxation year.

“reporting-due day”

The definition “reporting-due day” establishes the reporting-due day for the construction and completion knowledge sharing report and the annual operations knowledge sharing reports.

The reporting-due day for the construction and completion knowledge sharing report, which is a one-time report, is the last day of the sixth month beginning after the project start-up day of the knowledge sharing CCUS project.

In the case of annual operations knowledge sharing reports, the definition establishes the reporting-due day for each of the five annual reports.

In this regard, the definition provides for two possibilities for the reporting-due day for the first annual operations knowledge sharing report, as follows:

- if the project start-up day is before October 1st in a calendar year, the reporting-due day is the June 30th of the following calendar year, or
- if the project start-up day is after September 30th in a calendar year, the reporting-due day is June 30th of the second calendar year after the calendar year which includes the project start-up day.

For each of the second through the fifth annual operations knowledge sharing reports, the reporting due-day is each June 30th of each of the first four calendar years immediately following the reporting-due day for the first annual operations knowledge sharing report.

“reporting period”

The definition “reporting period” is relevant for both the construction and completion knowledge sharing report and the annual operations knowledge sharing reports.

In the case of the construction and completion knowledge sharing report, the reporting period begins on the day an expenditure for the qualified CCUS project is first incurred and ends on the project start-up day of the knowledge sharing CCUS project.

In the case of each annual operations knowledge sharing report, the reporting period begins on the project start-up day of the knowledge sharing CCUS project and ends on the last day of the calendar year ending immediately before the reporting-due day for that report (or for each of the annual operations knowledge sharing reports).

“reporting taxation year”

Generally, a “reporting taxation year” is a taxation year in which a CCUS tax credit is first claimed as well as each subsequent taxation year until the end of the twenty-year period which begins after the year that includes the first day of commercial operations of an eligible CCUS project.

“**second project period”**

The “second project period” in respect of a CCUS project means the five calendar years following the end of the first project period. Refer to the commentary above on the definition of “first project period” for more details.

“second recovery taxation year”

The “second recovery taxation year” in respect of a qualified CCUS project is the year that includes the last day of the second project period.

“**third project period”**

The “third project period” in respect of a CCUS project means the five calendar years following the end of the second project period. Refer to the commentary above on the definition of “first project period” for more details.

“third recovery taxation year”

The “third recovery taxation year” in respect of a qualified CCUS project is the year that includes the last day of the third project period.

Recovery of development tax credit

ITA
211.92(2)

New subsection 211.92(2) requires a taxpayer to pay a tax under Part XII.7 in certain circumstances related to the period before project start-up. The tax is payable for a particular taxation year that includes the first day of commercial operations of a CCUS project, or for any preceding year. The amount of the tax is the amount, if any, by which the taxpayer’s cumulative CCUS development tax credit for the immediately preceding taxation year exceeds its cumulative CCUS development tax credit for the particular taxation year. This situation could occur if the taxpayer’s “projected eligible use percentage” is reduced before operations begin.

Example

During year one of a CCUS project, a taxpayer’s projected eligible use percentage for all years of the CCUS project is 100% and qualified carbon capture expenditures are calculated on that basis. Over years one and two, there are $20 million of qualified expenditures based on the 100% projected eligible use percentage. In year three, the taxpayer’s plans change and only 40% of the captured carbon is expected to be used in an eligible use during all project periods; consequently, the taxpayer’s new projected eligible use percentage is 40%. The taxpayer has $1 million of new expenditures in year three.

Assuming the applicable specified percentage (the tax credit rate) is 50%, at the end of year two, the taxpayer’s cumulative CCUS development tax credit under subsection 127.44(4) is $20

million x 100% x 50% = $10 million. However, in year three, the taxpayer's new CCUS development credit for that year will be $1 million x 40% x 50% = $200,000.

In addition, in applying subsection 127.44(5) at the end of year three, based on the revised projected eligible use percentage, the taxpayer's qualified expenditures for the earlier years are reduced retrospectively. The qualified expenditures in the first two years, instead of being $20 million, are now $20 million x 40% = $8 million for a revised cumulative CCUS development tax credit at the end of year three of $4 million plus $200,000. Since the taxpayer received tax credits reflecting a higher eligible use than is now planned, the difference between the year two cumulative CCUS development tax credit of $10 million and the year three cumulative CCUS development tax credit of $4.2 million is $5.8 million. This amount is repayable as recovery tax to recover CCUS tax credits that were based on an over-projection of eligible use.

Acceleration of recovery tax

ITA
211.92(3)

New subsection 211.92(3) applies to trigger recovery tax if the actual eligible use percentage of a CCUS project falls below 10% during any year during the project's total CCUS project review period. This could occur if a CCUS project switched to enhanced oil recovery as its use of captured carbon. Note that subsection (3) does not apply if subsections 211.92(6) and (7), or 211.92(8), apply. For more information, see the notes to those new subsections.

In the case of qualified carbon capture expenditures and qualified carbon transportation expenditures (as defined in subsection 127.44(1)), the qualifying portion of expenditures is determined by multiplying the expenditure (as described in variable A) by the projected eligible use percentage under section 127.44 for each project period (and then using variable F in those definitions to arrive at the overall qualifying portion). "Projected eligible use percentage" is determined from the project plan as, in general terms, the quotient obtained from the division of projected eligible use during the relevant period by the projected total use (i.e., ineligible use plus eligible use) during the same period, expressed as a percentage. For more information, see the commentary to its definition in new subsection 127.44(1). Under the definition "qualified CCUS project", a qualified CCUS project in effect must plan to operate for at least 20 years to be eligible for the CCUS tax credit. The projected eligible use percentage is required to be greater than or equal to 10% in every year for the project to be eligible for the CCUS tax credit.

If the actual eligible use percentage falls below 10% during any of the periods described in subparagraph (c)(i) or (ii) of the definition "qualified CCUS project" in subsection 127.44(1), which are generally calendar years, then paragraph (a) of subsection 211.92(3) deems the actual eligible use percentage for the relevant project period to which the period relates, and for each subsequent project period, to be nil. Paragraph (b) further deems the relevant project period for the particular recovery taxation year to include all subsequent project periods, accelerating the application of the recovery tax.

As a result, any CCUS tax credits that are recoverable for that period, or any subsequent recovery period become payable by the taxpayer under Part XII.7 for the particular recovery

taxation year. Essentially, unless subsection 211.92(3) is inapplicable due to subsections 211.92(6) and (7), or 211.92(8), if a taxpayer's actual eligible use percentage is below 10% for any year (or for the slightly longer period described in subparagraph (c)(i) of the definition "qualified CCUS project" in subsection 127.44(1)), up to the total amount of the taxpayer's CCUS tax credits may become repayable as recovery tax under this subsection. However, if the situation of actual eligible use of under 10% for a year occurs in the second, third or fourth project period, then the CCUS tax credits allocated to prior periods are preserved.

Paragraph 211.92(3)(c) ensures that the taxpayer will not be subject to any further recovery of amounts under Part XII.7 in respect of the CCUS project.

Development credits recovery amount

ITA
211.92(4)

New subsection 211.92(4) is the recovery tax rule that can apply if there is ineligible use of captured carbon in relation to a CCUS project. It applies to recover a portion of CCUS development tax credits if

- the difference between the actual eligible use percentage for a particular recovery taxation year in respect of a relevant project period is more than the permissible de minimis tolerance of five percentage points, and
- subsection (3) does not apply (subsection (3) specifies that subsections (4) and (5) do not apply if subsection (3) applies).

Where subsection 211.92(4) applies, a taxpayer is required to add an amount to the tax otherwise payable under this Part for the recovery taxation year that relates to the relevant project period. Unless subsection 211.92(9) has previously applied, the amount to be added is the difference between the amount of the taxpayer's cumulative CCUS development tax credit (under subsection 127.44(4)) for the taxation year that included the first day of commercial operations (i.e., based on the projected eligible use from the project plan), and the amount that would have been the taxpayer's cumulative CCUS development tax credit for that taxation year if the projected eligible use percentage for the relevant project period were equal to its actual eligible use percentage.

Subsection 211.92(4) therefore requires a re-calculation of the taxpayer's CCUS development tax credit entitlements using the actual eligible use percentage for the relevant project period instead of the projected eligible use percentage for that period. All other aspects of the calculation stay the same.

Example

A taxpayer has $15 million of carbon capture expenditures before the first day of commercial operations of a qualified CCUS project. In its project plan, the taxpayer projected eligible use at 100% in each project period. Consequently, assuming the taxpayer's expenditures are described

in variable A of the definition “qualified carbon capture expenditure”, variables B through E of that definition are each 100%. The bracketed portion of the formula yields 400%, while variable F is 0.25, so the taxpayer’s qualified carbon capture expenditure is $15 million x 400% x 0.25 = $15 million. Assume that the applicable specified percentage is 50%, resulting in refundable CCUS development tax credits of $7.5 million and that there are no other qualified CCUS expenditures.

At the end of the first project period, the taxpayer’s actual eligible use percentage is 100%. Therefore, no recovery tax is payable. However, at the end of the second project period – reflecting the taxpayer’s new use of some of the captured carbon in enhanced oil recovery – the taxpayer’s actual eligible use percentage is only 60%. Subsection 211.92(3) does not apply, because the actual eligible use percentage is above 10%. However, subsection 211.92(4) applies, because the actual eligible use percentage for the second project period is more than five percentage points lower than the projected eligible use percentage for the second project period. In applying the formula in subsection 211.92(4) to this example, variable A is $7.5 million, the original amount of the taxpayer’s cumulative CCUS development tax credits under subsection 127.44(4). Variable B is the same as variable A, except that instead of using the projected eligible use for the second project period (which is the relevant project period for the second recovery taxation year) the taxpayer must use the actual eligible use percentage for that period, or 60%.

This re-application of the definition “qualified carbon capture expenditure”, but with the reduced use percentage for the second project period yields:

$15 million x (100% + 60% + 100% + 100%) x 0.25 = $13.5 million.

The difference between A and B is $1.5 million, which must be paid as recovery tax under subsection 211.92(4). The qualified carbon capture expenditure definition in subsection 127.44(1) effectively allocates the taxpayer’s expenditures across the four project periods. Each recovery taxation year requires looking back at the previous project period to measure the difference between the projected eligible use percentage and the actual eligible use percentage for that period. Since the $3.75 million of the taxpayer’s expenditures that were notionally allocated to the second project period supported 40% ineligible use, the recovery tax, as noted above, is $1.5 million, reflecting the government’s intention to provide support only to eligible use. Variable C reduces the amount payable under subsection 211.92(4) by any amount previously paid by the taxpayer under subsection (9) in respect of the project. In this example, variable C is zero.

No additional recovery tax will be payable until the third recovery taxation year, unless the taxpayer’s actual eligible use percentage falls below 10%, which would cause subsection 211.92(3) to apply.

Refurbishment credits recovery amount

ITA
211.92(5)

New subsection 211.92(5) provides a rule for the recovery of the CCUS refurbishment tax credit under certain circumstances. It is similar to the rule in subsection 211.92(4) described above.

As is the case for subsection (4), subsection (5) applies in respect of the recovery of CCUS refurbishment tax credits if subsection (3) does not apply and if the difference between the actual eligible use percentage for a particular recovery taxation year and the projected eligible use percentage in respect of a relevant project period is more than the permissible *de minimis* tolerance of five percentage points. If this is the case, a taxpayer is required to add an amount to the tax otherwise payable under Part XII.7 for the particular recovery taxation year in respect of the relevant project period. Unless subsection 211.92(10) has previously applied, the amount to be added is the difference between the taxpayer's CCUS refurbishment tax credit under subsection 127.44(5) for the year or a previous taxation year, and the amount that would have been the taxpayer's CCUS refurbishment tax credit for the year or a previous taxation year if the projected eligible use percentage for the relevant project period were equal to its actual eligible use percentage. This amount is reduced under variable C by any amount previously paid by the taxpayer under subsection 211.92(10). As with CCUS development tax credits, the recovery of CCUS refurbishment tax credits is only relevant in relation to tax credits for "qualified carbon capture expenditures" and "qualified carbon transportation expenditures".

Extraordinary eligible use reduction

ITA
211.92(6)

Subsection 211.92(6) sets out the conditions when new subsection (7) applies. Subsection (7) provides for a safe harbour rule under which a taxpayer is not required to pay a recovery tax under subsections (3) to (5).

Subsection (6) has three paragraphs, one for each of the three conditions for the application of subsection (7). First, the condition in paragraph (a) is that the taxpayer's actual eligible use percentage for a qualified CCUS project during a project period is significantly reduced due to extraordinary circumstances. The extraordinary circumstances must have resulted due to *bona fide* reasons outside the taxpayer's control and outside the control of each person or partnership that does not deal at arm's length with the taxpayer.

Second, paragraph (b) requires that the taxpayer request in writing, on or before the taxpayer's filing-due date for the year, that the Minister consider the potential application of subsections (6) and (7).

Third, paragraph (c) requires that the Minister of National Revenue be satisfied that the taxpayer has taken all reasonable steps to attempt to rectify the extraordinary circumstances, and that it is appropriate, having regard to all the circumstances, to apply subsections (6) and (7).

Effect of extraordinary circumstances

ITA
211.92(7)

New subsection (7) applies if the conditions set out in subsection (6) have been met. There could be one of two consequences of the application of the new subsection (7), depending on how long the extraordinary circumstances last.

First, paragraph (a) provides that no amount is payable under subsections (3) to (5) for a taxation year if subsection (6) applies and if the qualified CCUS project's operations are affected by extraordinary circumstances for all or substantially all of the project period (i.e., the project period referred to in subsection (6)).

Second, paragraph (b) provides that, if paragraph (a) does not apply, but subsection (6) applies, then the portion of the project period during which the project's operations are affected by the extraordinary circumstances is disregarded for the purpose of calculating the actual eligible use percentage for that project period.

Shutdown

ITA
211.92(8)

New subsection 211.92(8) provides for a safe harbour rule in circumstances when a taxpayer's qualified CCUS project is shut down. It is similar to subsections (6) and (7), except that no ministerial determination is required. The new subsection has two paragraphs that set out one of two consequences that apply if the qualified CCUS project is shut down, depending on how long the period of shutdown lasts.

Paragraph (a) provides that no amount is payable by the taxpayer under subsections (3) to (5) for a recovery taxation year in respect of the CCUS project if the project is inoperative during all or substantially all of the relevant project period. In this context, "inoperative" and "shut down" are intended to mean the same thing.

Paragraph (b) applies if paragraph (a) does not apply and the qualified CCUS project of the taxpayer was shut down for a portion of the project period. If paragraph (b) applies, then for the purposes of determining a taxpayer's liability for tax under Part XII.7 for a recovery taxation year, the portion of the relevant project period during which the project is inoperative is to be disregarded for the purpose of calculating the actual eligible use percentage for the project period.

Development property disposition

ITA
211.92(9)

New subsection 211.92(9) provides that all or a portion of a CCUS development tax credit in respect of a particular property is either denied, or recaptured through the imposition of a tax under certain circumstances. In general terms, the rule applies if a taxpayer disposes of a property or exports it from Canada during a particular taxation year and the taxpayer obtained, or would otherwise have obtained, a CCUS tax credit in respect of the property. Subsection 211.92(10) provides a similar rule in the case of disposition or export of a property that resulted in a CCUS refurbishment tax credit. Subsections (9) and (10) do not apply to disposition of a property if the election for certain asset sales in subsection (11) applies.

Paragraph (a) applies if the time of disposition or export of the property is before the total CCUS project review period. "Total CCUS project review period" is defined in subsection 127.44(1) and it begins on the first day of commercial operations of a qualified CCUS project. If that timing condition is met, paragraph (a) provides that an expenditure in respect of the disposed property is deemed not to be a qualified CCUS expenditure for the purpose of determining the taxpayer's cumulative CCUS development tax credit for the particular year and any subsequent taxation years. This effectively disentitles the taxpayer to a CCUS tax credit and eliminates the need to perform the recapture tax calculation. If the disposition or export is in the same year as the expenditure is incurred, no CCUS tax credit is available. If the disposition or export is later, but before the first day of commercial operations, then the taxpayer's cumulative CCUS development tax credit (under subsection 127.44(4)) will be reduced, triggering tax, or reducing credit entitlement, under subsection 211.92(2).

Paragraph (b) applies if the export or disposition is during the total CCUS project review period. If paragraph (b) is applicable, a taxpayer is required to add to the tax otherwise payable under Part XII.7 for the year the amount determined by the formula

$$A \times B \times C \div D - E$$

Variable A in the formula is the relevant qualified CCUS expenditure in respect of the property as determined for the taxation year that included the first day of commercial operations of the CCUS project. The stipulation that that taxation year be used allows any changes to the projected eligible use percentage before start-up (which can result in changes to CCUS tax credit entitlement, or in the application of subsection 211.92(2) as described above) to be taken into account.

Variable B is the appropriate specified percentage applicable to the qualified CCUS expenditure. The A x B portion of the formula is therefore generally equal to the taxpayer's CCUS tax credit in respect of the property.

Variable C is the lesser of the capital cost of the property and either

- the proceeds of disposition of the property, if the property was disposed of to an arm's length person, or
- in any other case, the fair market value of the property at the time of its disposition or export.

Variable D is the taxpayer's capital cost of the property at the time of its acquisition.

Variable E, which reduces the total amount payable under subsection (9), is the amount of any recovery tax previously paid by the taxpayer in respect of the particular property.

Example – Interaction of subsections 211.92(4) and 211.92(9)

Step 1 - Application of subsection 211.92(4)

Assume a taxpayer incurred $25 million on qualified carbon capture expenditures before the first day of commercial operations, projecting eligible use at 100% throughout the project, generating tax credits of $12.5 million (i.e., the specified percentage is 50%).

For the first project period, the actual eligible use percentage turns out to be 75%. Therefore, the recovery tax in subsection 211.92(4) applies. As noted in the notes to that subsection above, A is the taxpayer's CCUS tax credits obtained, or in this case, $12.5 million. As also noted above, variable B must be determined by re-calculating "qualified carbon capture expenditure" but using the actual eligible use percentage for the first project period, keeping everything else the same:

$25 million x (75% + 100% + 100% + 100%) x 0.25 = $23,437,500.

This is then multiplied by the applicable specified percentage, 50%, yielding $11,718,750, the amount of tax credits that the taxpayer "ought to have" received based on their actual eligible use percentage. This is variable B. The difference between what the taxpayer in fact received and the revised number based on their actual eligible use, A – B, is $12,500,000 – $11,718,750 = $781,250.

This is the amount of recovery tax payable for the first recovery taxation year. Note that this tax amount is subject to interest from the time of the balance-due day for the year the credit arose due to the application of new section 211.94.

Step 2 – Application of subsection 211.92(9)

Assume that, in year two of the second recovery period, the same taxpayer from step 1 above sells an asset that benefited from CCUS tax credits (for qualified carbon capture expenditures) to an arm's length party for $3 million. Its cost on acquisition, before the first day of commercial operations, was $5 million. Subsection 221.92(9) will generally apply to this situation, which is described in the opening portion of paragraph 211.92(9)(b): the time of disposition is during the total project review period. Therefore, the formula in paragraph (b) must be applied to determine the amount of "recapture" tax.

Variable A is the qualified CCUS expenditure in respect of the property, as determined for the first day of commercial operations; in this case, that amount is $5 million. Variable B is the appropriate specified percentage, or 50%. Variable C is $3 million, the property's proceeds of disposition to an arm's length person and variable D is the capital cost of the property, $5 million. The first portion of the formula is therefore $5 million x 50% x $3 million ÷ $5

million = $1.5 million. This is the amount that would be payable as recapture tax, except that variable E applies to reduce that amount.

The taxpayer has already paid recovery tax of $781,250 in relation to their original expenditures of $25 million. The asset that was sold represented $5 million out of $25 million or 20% of those expenditures. It is reasonable to consider that $781,250 x 20% or $156,250 has already been paid as recovery tax in respect of the property. Therefore, the amount repayable under subsection 211.92(9) is

$5 million x 50% x $3 million ÷ $5 million - $156,250 = $1,343,750.

Refurbishment property disposition

ITA
211.92(10)

New subsection 211.92(10) is very similar to subsection 211.92(9), but it applies to recapture all or a portion of the CCUS refurbishment tax credit under certain circumstances. In particular, the recapture applies if the taxpayer disposes of a property, or exports it from Canada, during a particular taxation year, and the expenditure incurred for the property resulted in the determination of a CCUS refurbishment tax credit for the taxpayer for a previous taxation year. Since refurbishment tax credits relate to expenditures that are incurred on or after the first day of commercial operations of a CCUS project, there is no need for a rule similar to paragraph 211.92(9)(a).

Election - CCUS project sale

ITA
211.92(11)

New subsection 211.92(11) provides an election to avoid the outcomes in subsections 211.92(9) and (10) if certain conditions are met. The election may be available where a qualifying taxpayer (referred to as the vendor in this subsection) disposes of all or substantially all of its properties that are part of a qualified CCUS project of the corporation (the CCUS project properties) to a taxable Canadian corporation (referred to as the purchaser in this subsection). Instead of applying subsections (9) and (10), the purchaser can assume the relevant tax history of the vendor so that Part XII.7 taxes can apply appropriately at a later time if necessary.

If the vendor and the purchaser elect to have the rules in subsection (11) apply, subsections (9) and (10) do not apply to the vendor in respect of the dispositions of any of the CCUS project properties, and instead the four rules set out in each of the paragraphs (a) to (d) of subsection (11) apply to the purchaser.

Paragraph (a) sets out that the purchaser is deemed to have made the qualifying CCUS expenditures that were incurred by the vendor at the same time as were incurred by the vendor.

Paragraph (b) provides that provisions of the ITA that applied to the vendor in respect of the CCUS project properties that are relevant to the application of the ITA in respect of the CCUS project properties are deemed to have applied to the purchaser. In particular, the purchaser is deemed to have claimed the CCUS tax credits determined under section 127.44 that were deducted by the vendor against its taxes payable in respect of the expenditures incurred for the CCUS project properties before the disposition of the CCUS project properties by the vendor.

Paragraph (c) deems any project plans that were prepared or filed by the vendor in respect of the CCUS project properties to have been filed by the purchaser.

Paragraph (d) ensures that the purchaser is or will be liable for amounts in respect of the CCUS project properties for which the vendor would be liable under Part XII.7 regarding actions, transactions or events that occur after the dispositions of the CCUS project properties, as if the vendor had undertaken them or otherwise participated in them.

Partnerships

ITA
211.92(12) to (15)

Subsections 211.92(12) to (15) provide rules that allocate tax obligations under Part XII.7 in the context of partnerships.

ITA
211.92(12)

When a member of a partnership has claimed CCUS credits in respect of a project allocated to it by the partnership applying subsection 127.44(11), subsection (12) provides, in general terms, that amounts under Part XII.7 are to be determined in respect of the partnership as if it were a taxable Canadian corporation (with a taxation year rather than a fiscal period) and as if the deemed corporation had claimed all the CCUS tax credits that were claimed by any member of the partnership.

ITA
211.92(13)

Subsection 211.92(13) requires that the amount of tax determined in respect of the partnership be allocated to the partnership members and added to their tax payable. All members of the partnership, regardless of when they acquired their partnership interest, would generally be expected to be liable to pay a share of any tax payable under Part XII.7 because of this rule. Subsection 211.92(13) is subject to an elective provision in subsection 211.92(14).

ITA
211.92(14)

Subsection 211.92(14) enables a taxable Canadian corporation that is a member of a partnership at the end of the partnership's fiscal period to elect to pay the entire amount determined in respect of the partnership under subsection (12).

ITA
211.92(15)

Subsection 211.92(15) creates joint and several liability (or, for civil law, solidary liability) for partnership members for any tax determined because of subsection (12) in respect of the partnership, except to the extent that the tax has been paid by a taxable Canadian corporation that elected under subsection 211.92(14), or has been allocated to a member of the partnership and added to their tax payable under subsection (13).

CCUS Reporting Requirements

ITA
211.93

New section 211.93 of the Act contains the knowledge sharing and climate risk disclosure requirements associated with the CCUS tax credit.

CCUS projects with eligible expenses of $250 million or more over the life of the project are required to contribute to public knowledge sharing in Canada. Taxpayers are required to make available for public dissemination certain knowledge sharing reports. The reports are required following the commissioning of the CCUS facility and for each of the five following years.

Details surrounding the content requirements of the knowledge sharing report were developed in consultation with, and will be monitored by, the Department of Natural Resources Canada.

The penalty for not producing a knowledge sharing report in respect of the commissioning of the CCUS facility or the five subsequent annual reports is $2 million for each report not produced by the deadline.

Similarly, certain corporations are required to produce an annual climate risk disclosure report beginning in respect of the tax year in which an ITC is first claimed through the first 20 years of operations of the eligible CCUS project. Corporations are exempt from this requirement if they are "exempt corporations" that do not have a large CCUS project. Reports are due nine months after the taxpayer's tax year-end and are required to be made public by the taxpayer by publishing them on their website.

If a taxpayer fails to meet the climate risk disclosure requirement in respect of any year, the taxpayer is required to pay a penalty equal to the lesser of 4 per cent of the cumulative CCUS tax credits that have been claimed by the taxpayer at that time or $1 million. This penalty is applied in respect of each year that this obligation is not met, up to the end of the first 20 years of operations.

Consistent with the coming into force of other CCUS tax credit provisions of the Act, section 211.93 applies as of January 1, 2022.

Reporting requirements

ITA
211.93(1)

Subsection 211.93(1) requires a knowledge sharing taxpayer to submit, by the applicable deadline, knowledge sharing reports to the Minister of Natural Resources and to make climate risk disclosure reports available to the public. A "knowledge sharing taxpayer" is defined in subsection 211.92(1).

Paragraph 211.93(1)(a) concerns "knowledge sharing reports". It requires that a knowledge sharing taxpayer submit a knowledge sharing report to the Minister of Natural Resources for each reporting period, on or before the reporting-due day.

Paragraph 211.93(1)(b) concerns "climate risk disclosures". It requires that certain knowledge sharing taxpayers (a corporation, other than an exempt corporation (as defined in subsection 211.92(1)) make available to the public for each reporting taxation year a climate risk disclosure report, on or before the reporting-due day. A climate risk disclosure report must detail the four criteria set out by the Task Force on Climate-Related Financial Disclosures: governance, strategy, risk management, and metrics and targets. The report also needs to set out how corporate governance, strategies, policies and practices contribute to achieving Canada's commitments under the Paris Agreement and goal of net-zero by 2050.

"Reporting-due day" for the reports is defined in subsection 211.92(1). The climate risk disclosure report is to be made available to the public in a prescribed manner. (Subsection 211.93(2) provides that a climate risk disclosure report is deemed to have been made public in a prescribed manner if it includes its date of publication and is published on the taxpayer's website for at least three years after the reporting-due day.)

Subparagraph 211.93(1)(b)(i) and (ii) set out the information that is required to be included in the climate risk disclosure report. Subparagraph 211.93(1)(b)(i) requires that a climate risk disclosure report should describe the climate-related risk and opportunities for the corporation based on the following thematic areas:

- the corporation's governance measures around climate-related risks and opportunities,
- the actual and potential impacts of climate-related risks and opportunities on the corporation's businesses, strategy, and financial planning where such information is material,
- the processes used by the corporation to identify, assess, and manage climate related risks, and
- the metrics and targets used by the corporation to assess and manage relevant climate-related risks and opportunities.

Subparagraph 211.93(1)(b)(ii) requires that the climate risk disclosure report explain how the corporation's governance, strategies, policies and practices that contribute to achieving Canada's commitments under the Paris Agreement made on December 12, 2015, and goal of net-zero emissions by 2050.

Publication

ITA
211.93(2)

Subsection 211.93(2) provides that, for the purpose of paragraph 211.93(1)(b), a climate risk disclosure report is deemed to have been made publicly available in a prescribed manner if the report includes the publication date and is made available on the corporation's website (or the website of a related person to the corporation) for a period of at least three years after the reporting-due day (as that day is defined in subsection 211.92(1)).

Shared filing

ITA
211.93(3)

Subsection 211.93(3) is a relieving rule that applies when more than one person may be required, by subsection 211.93(1), to submit a knowledge sharing report in respect of the same CCUS knowledge sharing project. Subsection 211.93(3) deems that a report filed by one person with full and accurate disclosure in respect of a CCUS knowledge sharing project is deemed to have been filed by each person to whom subsection (1) applies in respect of the report.

Penalty - non-compliance with reporting requirements

ITA
211.93(4)

A knowledge sharing taxpayer is required to submit to the Minster of Natural Resources the construction and completion knowledge sharing report and five annual operations knowledge sharing reports. The reports are required for each relevant reporting period and are due on or before reporting-due day for each report.

Subsection 211.93(4) provides for a penalty of $2 million for failure to submit the construction and completion knowledge sharing report, or an annual operations knowledge sharing report, to the Minster of Natural Resources on or before the reporting-due day for the report. The $2 million penalty, if applicable, is payable the day after the reporting-due day for the report.

Failure to disclose

ITA
211.93(5)

Subsection 211.93(5) sets out a penalty that a taxpayer must pay if it fails to make a climate risk disclosure report publicly available as required by subsection 211.93(2). The penalty is calculated as the amount which is the lesser of

- 4% of the total CCUS tax credits claimed by the taxpayer for each taxation year that ended before the reporting-due day for the reporting taxation year (for which the climate risk disclosure report is required to be made publicly available); and
- $1 million.

Report disclosure

ITA
211.93(6)

Subsection 211.93(6) requires the Department of Natural Resources to publish each knowledge sharing report that had been submitted to the Minister of Natural Resources by a knowledge sharing taxpayer. The report is required to be published on a website maintained by the Government of Canada, as soon as practicable after the knowledge sharing taxpayer has submitted the report.

Eligible use reporting

ITA
211.93(7)

Subsection 211.93(7) provides a requirement for a taxpayer to file a report in prescribed form, along with each return of income for taxation years of the taxpayer that include any part of the relevant project period (as defined in subsection 211.92(1)) of a CCUS project.

The report is required if the CCUS project was commissioned in a prior taxation year and a tax credit under section 127.44 was claimed in respect of the CCUS project by a taxpayer for a taxation year.

The annual report must include the actual amount of carbon captured, during the calendar year ending in the taxation year, for storage or use in eligible use; and the aggregate quantity of captured carbon during that calendar year that supported storage or use in both eligible use and ineligible use.

If the taxpayer fails to file the annual report, the actual eligible use percentage (as defined in subsection 211.92(1)) for the relevant project period is deemed to be nil.

Administration

ITA
211.94

New section 211.94 provides that certain provisions of Part I relating to assessments, payments, appeals and various other procedural and administrative matters are also applicable to Part XII.7.

In particular, subsection 150(2) and (3), sections 152, 158, 159 and 161 to 167, and Division J of Part I apply to Part XII.7, with such modifications as the circumstances require.

In addition, when applying subsection 161(1) of Part I to an amount of tax payable under section 211.92 in Part XII.7, the balance-due day of a taxpayer in respect of a recovery taxation year is deemed to be the balance-due day of the taxation year for the related CCUS tax credit under subsection 127.44(2). This has the effect of creating a potential liability for interest from the taxation year for which the tax credit was originally claimed.

Records and books

ITA
211.95

New section 211.95 of the Act extends, for certain taxpayers, the time period for maintaining adequate books and records for examination by the Minster of National Revenue from six years to 26 years.

Section 230 of the Act requires that taxpayers maintain adequate books and records to enable the Minister of National Revenue to determine the taxes payable under the Act or amounts that should have been deducted, withheld or collected under the Act.

Taxpayers that claim CCUS tax credits against their tax otherwise payable are subject to recovery of the tax credits for up to 20 years. Paragraph 230(4)(b) of the Act generally requires taxpayers to maintain their books and records for a period of six years. Consequential on the introduction of new refundable CCUS tax credit under section 127.44 and Part XII.7, new section 211.95 is introduced.

The new section requires a taxpayer to maintain records and books of account as are necessary to verify information regarding CCUS tax credits of the taxpayer under section 127.44 or amounts payable by the taxpayer under Part XII.7, in respect of a qualified CCUS project, until the later of the period referred to in paragraph 230(4)(b), (which is generally six years); and 26 years from the end of the taxpayer's last taxation year for which an amount was deemed to have been paid under subsection 127.44(2) by reason of its paragraph (a).

Clause 59

Deemed interest payments

ITA
214(17)

Subsection 214(17) provides rules that apply for the purposes of subsection 214(16), which generally treats interest that is not deductible because of the thin capitalization rules as a deemed dividend for the purposes of Part XIII of the Act.

In particular, paragraph 214(17)(a) deems interest (other than compound interest) that is payable in respect of a corporation's taxation year to have been paid at the end of that year and not at any other time (i.e., not to have been paid or credited when it is actually paid or credited). Paragraph 214(17)(b) ensures that the deemed dividend under subsection 214(16) cannot be avoided by transferring a debt obligation in the circumstances described in either subsection 214(6) or (7).

Consequent on the introduction of new subsection 214(18), subsection 214(17) is amended to extend its application to cases where subsection 214(18) applies to treat interest that is not deductible because of the hybrid mismatch rule in subsection 18.4(4) as a deemed dividend for the purposes of Part XIII of the Act. For more information, see the commentary on subsection 214(18).

This amendment applies in respect of payments arising on or after July 1, 2022.

Hybrid mismatch arrangements – deemed dividend

ITA
214(18)

New subsection 214(18) deems interest paid or credited by a corporation resident in Canada, that is not deductible because of the hybrid mismatch rule in subsection 18.4(4), to be a dividend and not interest for the purposes of Part XIII of the Act. This rule is analogous to paragraph 214(16)(a) in the thin capitalization context.

This rule, in effect, aligns the treatment of these interest payments for the purposes of withholding tax under Part XIII with the tax treatment for the purposes of Part I and under the relevant foreign tax law, and prevents taxpayers from using hybrid mismatch arrangements as equity substitutes to inappropriately avoid dividend withholding tax.

This amendment applies in respect of payments arising on or after July 1, 2022.

Clause 60

Section 216 Filers

ITA
216(1)(e)

Subsection 216(1) of the Act allows non-resident taxpayers who receive payments on account of rent on real or immovable property in Canada or a timber royalty to elect to pay tax under Part I rather than paying Part XIII tax on the payments. Paragraph 216(1)(a) requires the non-resident

to calculate Part I tax as though it was a person resident in Canada and not exempt from tax under section 149.

Subsection 216(1) of the Act is amended to add paragraph (e), which provides that the calculation of Part I tax under subsection 216(1) is made without applying the definitions "eligible group entity", "excluded entity", and "fixed-interest commercial trust", and without applying section 18.21. As a result, non-resident taxpayers who file returns under subsection 216(1) cannot be excluded entities, eligible group entities or fixed-interest commercial trusts as defined in subsection 18.2(1) and are not eligible to apply the group ratio rule in section 18.21.

Non-resident taxpayers who file returns under subsection 216(1) continue to be subject to the rules in paragraphs 216(1)(a) to (d) in applying the EIFEL rules. In particular, paragraph 216(1)(c) prevents such taxpayers from deducting restricted interest and financing expenses under paragraph 111(1) (a.1).

Clause 61

Exception

ITA
220(2.2)

Subsection 220(2.2) provides that the Minister's discretion to waive a requirement to file a prescribed form, receipt or other document, or to provide prescribed information, does not extend to such items filed on or after the day specified for the purposes of subsection 37(11) or paragraph (m) of the definition of "investment tax credit" in subsection 127(9).

Subsection 220(2.2) is amended to extend the restriction on Ministerial discretion to waive filing requirements by adding references to new subsections 127.44(17) and 127.45(3), consequential on the introduction of the CCUS tax credit and the clean technology investment tax credit.

This amendment applies to taxation years ending after 2021 with respect to the CCUS tax credit and after March 27, 2023 with respect to the clean technology investment tax credit.

Clause 62

Collection-commencement days

ITA
225.1(1.1)

Section 225.1 generally prevents the Minister of National Revenue from commencing collection activities for amounts assessed under the Act during specified time periods. However, the Minister may commence collection activities on the day after the expiry of the specified time period, known as the collection-commencement day.

In addition to providing for a rule of general application in paragraph (c) to describe the collection-commencement day in respect of an amount assessed under the Act, paragraphs (a) and (b) of subsection 225(1.1) also describe the collection-commencement day in the case of specific amounts that become payable by charities under certain circumstances.

Consequential on the introduction of new refundable CCUS tax credit under section 127.44 and Part XII.7, subsection 225.1(1.1) is amended by introducing new paragraph (b.1). Taxpayers that claim CCUS tax credits against their otherwise tax payable under section 127.44 may be subject to recovery of the tax credits for up to twenty years under section 211.92 in Part XII.7 of the Act. New paragraph 225.1(1.1)(b) provides that taxpayers will generally have up to five years to pay any recovery amounts that become payable subsections 211.92(2) to (5).

Subparagraph (i) of the new paragraph states that the Minister may only start collection action for one-fifth of the recovery amounts one year after the day on which the notice of assessment is mailed. Subparagraphs (ii) to (v) further allow the Minster to start collection action in respect of an additional one-fifth of the recovery amount in each of the following four years.

Clause 63

Hybrid mismatch adjustment

ITA
227(6.3)

A payment arising under, or in connection with, a hybrid mismatch arrangement may not be deductible because of subsection 18.4(4). Where that payment was made to a non-resident person, subsection 214(18) deems the amount to be a dividend for the purposes of Part XIII of the Act. However, where the taxpayer demonstrates that an amount in respect of the payment has subsequently been included in foreign ordinary income of a payee, paragraph 20(1)(yy) allows a deduction for all or a portion of the amount that had previously been denied.

New subsection 227(6.3) provides for a refund of Part XIII tax where paragraph 20(1)(yy) applies. The starting point in determining the refund amount is the lesser of the total amount of withholding tax paid in respect of the portion of the payment that is now deductible under paragraph 20(1)(yy) (the “deductible amount”), and the amount of withholding tax that would be payable on the deductible amount in the year the paragraph 20(1)(yy) deduction is claimed if the deductible amount were paid as a dividend to the non-resident person. The lesser of those two amounts is then reduced by the amount of withholding tax that would have been payable if the deductible amount had been interest paid or credited to the non-resident person in the year the paragraph 20(1)(yy) deduction is claimed, to reflect that the deductible amount is now properly treated as an interest payment for the purposes of Part XIII.

In order to obtain the refund, application must be made to the Minister of National Revenue within two years of the day on which the assessment in respect of the application of paragraph 20(1)(yy) is made. Where the non-resident person is otherwise liable, or about to be become liable, to make a payment to His Majesty in right of Canada, paragraph 227(6.3)(b) permits the

Minister to apply the amount of the refund to that payment and requires that the non-resident be notified of that action.

Application for determination

ITA
227(7.1)

Subsection 227(7.1) requires, where the Minister of National Revenue is not satisfied that a person is entitled to claim an amount under subsection 227(6.1), that the Minister, upon request, determine the amount payable under that subsection and send a notice of determination to that person.

Subsection 227(7.1) is amended to add references to new subsection 227(6.3), so that subsection 227(7.1) applies, upon request, where the Minister is not satisfied that a person is entitled to claim an amount under subsection 227(6.3).

Clause 64

Reportable transactions

ITA
237.3

Section 237.3 of the Act provides mandatory reporting requirements in respect of reportable transactions, requiring reporting within defined time periods.

Consequential on amendments to the GAAR in section 245, subsection 237.3(12.1) and (12.2) are added to allow for voluntary filing of disclosure in respect of transactions potentially subject to the GAAR. Such a filing is not an admission that the GAAR applies in respect of a transaction. It can result in an exclusion from the new GAAR penalty in subsection 245(5.1) and from the extended reassessment period for GAAR assessments in new subparagraph 152(4)(b)(viii).

Subsection (12.1) allows a taxpayer to file reportable transaction disclosure in respect of a transaction (or series of transactions of which a transaction is a part) in circumstances where it is not otherwise required under section 237.3. This disclosure is required to be filed on or before the taxpayer’s filing-due date for the taxation year in which the transaction occurs.

Subsection (12.2) allows disclosure under subsection (12.1) to be filed up to a year late. However, this late filing results in a one-year extension of the assessment period in respect of the transaction.

This amendment applies to transactions that occur on or after January 1, 2024.

Clause 65

Where taxpayer information may be disclosed

ITA
241(4)(d)(vi.1)

Subparagraph 241(4)(d)(vi.1) permits the communication of taxpayer information to the Department of Natural Resources solely for the purpose of determining whether property is prescribed energy conservation property or whether an outlay or expense is a Canadian renewable and conservation expense.

Subparagraph 241(4)(d)(vi.1) is amended to allow the communication of taxpayer information solely for the purposes of determining whether:

- a process is a CCUS process, whether property is dual use equipment, whether a project is a qualified CCUS project or whether a property is described in Class 57 or 58 of Schedule II to the *Income Tax Regulations*;
- a property is a clean technology property; and
- a cost is a ZETM cost of capital or a ZETM cost of labour, and activities are qualified zero-emission technology manufacturing activities.

The sharing of this information, and the technical advice of the Department of Natural Resources, will assist the Minister of National Revenue in administering the above-noted benefit programs.

These amendments come into force on Royal Assent.

ITA
241(4)(d)(xx.1)(A)

Subparagraph 241(4)(d)(xx.1) permits the sharing of taxpayer information with an official of the Department of Employment and Social Development Canada and the Department of Health for the purpose of administering or enforcing the Canadian Dental Care Plan and with an official of the Department of Health for the evaluation or formulation of policy for the Canadian Dental Care Plan.

Clause 241(4)(d)(xx.1)(A) is amended to also permit the sharing of taxpayer information with an official of the Department of Public Works and Government Services for the purpose of administering or enforcing the Canadian Dental Care Plan.

This amendment comes into force on royal assent.

Clause 66

General Anti-Avoidance Rule

ITA
245

Section 245 of the Act contains the general anti-avoidance rule, which is intended to prevent abusive tax avoidance transactions or arrangements, but at the same time is not intended to interfere with legitimate commercial and family transactions.

Several amendments are being made to section 245 to: introduce a preamble; change the avoidance transaction standard; introduce an economic substance rule; and introduce a penalty. These amendments apply to transactions that occur on or after January 1, 2024, except for the preamble which comes into force on royal assent.

Preamble

ITA
245(0.1)

Subsection 245(0.1) is added to introduce a preamble to the GAAR, which sets out some key considerations relating to its intended purpose and operation. It is intended to inform the application of the GAAR, despite not forming a part of its analytic framework.

The subsection opens by noting that section 245 “of the Act contains the general anti-avoidance rule.” The reference to “of the Act” is intended to reinforce that the GAAR is a provision in the Act. It forms part of the context of the Act and is an important part of ensuring that the Act meets its objectives. It cannot be said that a transaction complies with the provisions of the Act if it doesn’t comply with the GAAR.

Paragraph (a) of the preamble reflects that the GAAR is intended to serve as a limit on tax planning. It is appropriate for taxpayers to engage in certain forms of tax planning; indeed, incentives delivered through the tax system (such as registered retirement savings plans for retirement saving and certain accelerated capital cost allowance rates for capital investment) rely on the ability of tax benefits to incentivize and modify behaviour. However, this freedom does not extend to misusing or abusing the tax rules. As noted in the Supplementary Information Relating to Tax Reform Measures tabled in the House of Commons on December 16, 1987, the GAAR was intended “to block sophisticated strategies designed to yield tax advantages that were not intended by Parliament.”

In enacting a measure, Parliament cannot of course be expected to anticipate every possible iteration of transactions or interaction among provisions of the Act that could give rise to a particular tax benefit. However, borrowing the terminology used by the Supreme Court of Canada in *Deans Knight* (2023 SCC 16), Parliament would be expected to contemplate the rationale of each measure before it. This could include "why relief is being provided, the conduct that Parliament sought to encourage, or the result or mischief that Parliament sought to prevent" (*Deans Knight* headnote, and see para. 61) For example, in a transaction that engages rules generally intended to ensure corporate integration of income (e.g., the low/general rate income

pool, eligible/non-eligible refundable dividend tax on hand or capital dividend account rules), it may be reasonable to conclude that Parliament contemplated the rules being used in a way that achieves integration and would not have contemplated the rules being used in a way that breaks integration. That may be the case, even if Parliament did not envision the specific series of transactions that use the rules to achieve a particular tax benefit.

In a sense, paragraph (b) of the preamble imports into the Act ideas expressed in the original explanatory notes accompanying the GAAR. In particular, the original explanatory notes provided that the GAAR "seeks to distinguish between legitimate tax planning and abusive tax avoidance and to establish a reasonable balance between the protection of the tax base and the need for certainty for taxpayers in planning their affairs." The notion of fairness in subparagraph (b)(i) is intended to be broad, referring to the unfair distributional effects of tax avoidance as it shifts the tax burden from those willing and able to avoid taxes to those who are not.

This fairness objective is to be balanced with the taxpayer's need for certainty in planning their affairs (subparagraph (b)(ii)). This is to say, consideration of the GAAR involves an objective, thorough and step-by-step analysis. Within this analysis, principles of certainty, predictability and fairness do not play an independent role; rather, they are reflected in the carefully calibrated GAAR test that Parliament enacted in 1988.

An earlier version of draft legislative proposals released by the Department of Finance also included a statement in the preamble clarifying that the GAAR could apply regardless of whether a tax strategy was foreseen. This is demonstrated by the fact that, when the GAAR was initially adopted by Parliament, Parliament repealed several specific anti-avoidance rules.

Notwithstanding that specific types of tax avoidance were anticipated (and previously dealt with through those targeted rules), the GAAR was intended to be available to address those situations. This language is no longer included in the preamble because the Supreme Court of Canada has since clarified and confirmed that the GAAR is not limited to unforeseen situations (see *Deans Knight*).

Avoidance transaction

ITA
245(3)

The GAAR applies to a transaction only if it is an "avoidance transaction" as defined in subsection 245(3). Currently, the rule looks to whether a transaction (or series) was "undertaken or arranged primarily for bona fide purposes other than to obtain the tax benefit."

Subsection (3) is amended to change the "primarily" threshold in the avoidance transaction test to a "one of the main purposes" threshold. While that is the sole intended effect of the amendments, the change in wording necessitates a reorganization of the subsection.

Economic substance

ITA
245(4.1) and (4.2)

New subsections (4.1) and (4.2) introduce an explicit economic substance test into the GAAR. While much certainty has been obtained through the jurisprudence on many aspects of the GAAR, the appropriate role of economic substance in the GAAR analysis has been unclear. The amendments are intended to provide clarity and consistency in the economic substance test under the GAAR.

These changes reflect the importance that economic considerations play in the development of tax policy. Rules are generally designed with a view towards appropriately taxing income (an inherently economic concept) or incentivising behaviours. Accordingly, the amendments are intended to ensure that economic substance receives proper consideration when assessing whether an avoidance transaction frustrates the object and purpose of the relevant rules. The starting point in such an analysis should not be an assumption that economic substance does not matter unless the rules explicitly say that it matters. Such a strict, formalistic analysis risks undermining Parliament's intention. While the *Income Tax Act* does allow for and even encourage certain transactions that lack economic substance, a more rigorous analysis is appropriate in those cases to ensure that the transactions are consistent with (or do not frustrate) the object and purpose of the relevant rules, including the relevant scheme of the rules in which the specific rules relied upon are found.

Subsection (4.1) sets out how the concept of economic substance is to be integrated into the GAAR analysis. In particular, it provides that, if a transaction is significantly lacking in economic substance, this is an important consideration that tends to indicate that the transaction results in a misuse under paragraph (4)(a) or an abuse under paragraph (4)(b), depending on which of those paragraphs applies in the particular situation.

A prior release of draft legislative proposals for these GAAR amendments provided that a significant lack of economic substance would give rise to a rebuttable presumption that there is a misuse or abuse. This wording has been changed to avoid subsection (4.1) being interpreted simply as a procedural shifting of the onus to demonstrate misuse or abuse from the Crown to the taxpayer. Rather, the amendments are intended to cause the lack of economic substance to be taken into account as an important substantive factor in the analysis. Moreover, this is a factor that weighs in favour of finding that there has been a misuse or abuse. Accordingly, where there is a lack of economic substance, the starting point would be that there is a misuse or abuse. However, depending on the relevant facts and law, other considerations may demonstrate that the transaction does not actually frustrate the rationale of the provisions.

An analytical framework has been developed by the courts for applying the "misuse or abuse" test in subsection 245(4). Integrating these amendments into the framework used by the Supreme Court in the *Deans Knight* decision, a transaction significantly lacking in economic substance is a result that is, as a starting point, considered to frustrate the rationale of the provision (or provisions) relied upon or circumvented. For simplicity, these notes refer to a provision or a transaction rather than provisions or a series of transactions, unless otherwise indicated.

The rule in subsection (4.1) is not determinative of economic substance, and other considerations could result in a finding that there is no misuse or abuse in appropriate circumstances. For example, where the rationale underlying a provision is to encourage particular activities, a taxpayer could show that there is no misuse or abuse by demonstrating that the effect of the transaction was what Parliament intended to encourage through enacting the provision. In less abstract terms, a taxpayer moving $100 from a taxable account to a tax-free savings account could be argued to lack economic substance, based on the facts that the taxpayer's opportunity for gain or profit (and risk of loss) hasn't changed and the sole reason for moving the funds to the TFSA was to obtain a tax benefit. As noted in the 2008 Budget documents, the TFSA was introduced "to improve incentives for Canadians to save." As such, while it is possible that a transaction could be implemented which does misuse or abuse the TFSA rules, the taxpayer in this example simply responded to a tax incentive and did precisely what the government intended to encourage. Another factor that would rebut a finding of abuse in this example is that, if the GAAR were to take away the tax benefit each time a person transfers funds from a taxable account into a TFSA, that would render the TFSA rules essentially ineffective at achieving their objective and frustrate the intent of Parliament.

A more complex example is that of corporate loss trading transactions, where losses of a corporation are sought to be used by another corporation to reduce its taxable income. Assume a transaction implemented to transfer losses within a related group is found to be significantly lacking in economic substance. In such a case, the lack of economic substance would be a strong factor weighing in favour of concluding that the transaction would result in a misuse under paragraph (4)(a) or an abuse under paragraph (4)(b) because of new subsection (4.1). However, this conclusion could be countered by demonstrating that the transaction is consistent with the rationale (to use the term from *Deans Knight*) of the provision. Looking at the text of the relevant provisions and considering their context and purpose, along with the relevant legislative history and extrinsic evidence, it should be clear that Parliament intended to provide access to certain tax benefits (i.e., loss carryforwards) based upon the existence of certain relationships. This effectively allows for the utilization of losses in certain circumstances within a related group. This policy is constrained by the existence of certain relationships, as it was noted in *Deans Knight* that "Parliament sought to ensure that a lack of continuity in a corporation's identity was accompanied by a corresponding break in its ability to carry over non-capital losses."

The meaning of the phrase "significantly lacking in economic substance" is provided in new subsection (4.2). It provides a number of factors which may establish that a transaction is significantly lacking in economic substance. Certain factors will be more or less relevant, depending on the particular circumstances and it is not an exhaustive list. The determination of whether a transaction is significantly lacking is economic substance is binary and feeds into the rule in subsection (4.1). If it is lacking, subsection (4.1) applies when engaging in the 'misuse or abuse' analysis; if not, the standard 'misuse or abuse' analysis applies.

The "significantly" qualifier ensures that transactions which merely have some tax-planning element are not included. This is reflected in the specific factors set out in paragraphs (a) to (c), each of which contains a fairly high threshold for the test to be met. As a general matter, these factors are intended to distinguish between transactions that are undertaken largely for non-tax reasons and transactions that are fundamentally about achieving a particular tax outcome.

Paragraph (a) looks to whether the economic position of the taxpayer has changed as a result of the transaction. The language "opportunity for gain or profit and risk of loss of the taxpayer" is used to refer to economic exposure or economic position. If there are non-arm's length taxpayers involved in the transaction, they are to be taken into consideration in making this determination unless it is reasonable to conclude that they have economic interests that are largely adverse to those of the taxpayer. The test takes into account non-arm's length people because, where people have economic interests that are aligned (particularly in the context of corporate groups), assessing opportunity for gain and risk of loss on a standalone basis would often provide a very inaccurate picture.

The exception for arm's length persons who are adverse in interest is intended to provide a limited narrowing of the arm's length concept to recognize that sometimes people who do not deal at arm's length within the meaning of subsection 251(1) may nonetheless operate separately from an economic point of view and may have interests or motivations that are largely unaligned. This distinction is expected to be primarily relevant in the context of individuals who deal not at arm's length solely due to the deeming rule in paragraph 251(1)(a).

Whether people are adverse in interest will require a determination based on all the relevant facts. For example, in most situations spouses in an ongoing relationship would likely have economic interests that are relatively aligned, but in the context of a marriage breakdown their economic interests may become largely separate. Similarly, parents and minor children would typically not have economic interests that are separate, but a parent and adult child may have separate economic interests. Adult siblings may also have separate economic interests.

Moreover, as noted above, certain factors will not be as relevant in all situations. The importance (or lack thereof) of a factor requires a holistic assessment of the facts and circumstances. For example, the factor in paragraph (a) may be less relevant when applied to genuine commercial transactions between family members, even if it is difficult to show that the parties are generally adverse in interest. For example, one sibling may sell their business to another sibling in a transaction that broadly reflects arm's length terms. In that situation, notwithstanding that the siblings are non-arm's length for purposes of the Act, it would not be appropriate to apply paragraph (a) strictly to find a significant lack of economic substance.

On the other hand, paragraph (a) will be important where a transaction results in the shifting of rights or assets from one subsidiary to another within a wholly owned group of corporations in circumstances where the economic position of the group hasn't changed. It would not be reasonable to conclude that corporations within the same group are adverse in interest, therefore their economic positions would need to be assessed together.

Paragraph (a) may also be important in the context of transactions between shareholders and corporations that they control. For example, assume that Jane, a Canadian resident individual, holds all the shares of a corporation (Opco) resident in Canada that has undistributed after-tax business income on hand (retained earnings). The fair market value (FMV) of the shares exceeds their nominal paid-up capital (PUC) and adjusted cost base (ACB). Rather than distribute Opco's

retained earnings as a dividend, Jane undertakes the following series of transactions to receive the distribution in the form of a lower-taxed capital gain.

i. Jane transfers a portion of her Opco shares in exchange for a new class of shares of Opco pursuant to an election under subsection 85(1) of the Act. The elected amount of the share exchange gives rise to a capital gain for Jane upon which no lifetime capital gains exemption amount is claimed. Jane's new shares have an ACB equal to their FMV and a nominal legal stated capital and paid-up capital.
ii. Jane then sells the new shares to another purchaser corporation (Buyco) that she controls and wholly owns in exchange for a promissory note payable to her.
iii. Opco distributes its retained earnings to Buyco in the form of a tax-free inter-corporate dividend.
iv. Buyco then pays the retained earnings to Jane in satisfaction of the promissory note.

At the end of this series of transactions, Jane remains the sole shareholder of Opco and Buyco, corporations with which she does not deal at arm's length and is not adverse in economic interest. Following these steps, there has been no change in the opportunity for profit or gain or risk of loss for Jane, Opco and Buyco, taken together. Rather, there has simply been a movement of funds within the group, without any change in economic position (other than with respect to the tax paid on the capital gain).

Subparagraphs (i) to (iv) provide examples of techniques that may be used to effect transactions which leave a taxpayer's economic position effectively unchanged (more precisely, all or substantially all of the taxpayer's opportunity for gain or profit and risk of loss remains unchanged). This is an inclusive list and is intended to allow for the fact that other techniques could be used to achieve the same economic effect.

Subparagraph (i) relates to a circular flow of funds. This is drafted to be general and economic in nature, such that it could apply regardless of the legal technique by which funds are flowed (e.g., by the creation of debt, the payment of dividends or through some other sort of arrangement). It is intended to capture situations like that described in the *Canada Trustco* (2005 SCC 54) decision, including where the flow of funds is imperfect (e.g., where some funds are left with an accommodating third party as a sort of facilitation fee).

Subparagraph (ii) looks to whether or not offsetting financial positions are used. An example would be where a taxpayer has both a long and a short position in respect of the same share such that they have eliminated all or substantially all of their economic exposure to the share. For example, these sorts of techniques were used in the planning that led to the introduction of the synthetic equity arrangement rules.

Subparagraph (iii) relates to the timing of steps within a series of transactions. Year-end straddle planning is an example of a transaction that uses this technique, where the loss leg of a transaction is closed out immediately before the end of a taxation year and the income leg is closed out immediately after, with the time gap between the two transactions being sufficiently short that the taxpayer has effectively no economic exposure to the underlying investment. In general, the duration of any economic exposure during a series of transactions can be sufficiently

short so that, when the series is viewed in its totality, the taxpayer has effectively eliminated all or substantially all of their economic opportunity and risk even though, for a period of time, the taxpayer is fully exposed.

Subparagraph (iv) deals with accommodating parties. In such a case, the accommodating party might take some sort of facilitation fee (whether direct or indirect) for helping to obtain the tax benefit, but the taxpayer's economic position remains essentially unchanged. As such, that accommodating party participates in the transaction but does not assume any (or much) economic exposure in respect of the transaction.

The factor in paragraph (b) compares the relative weight of the expected commercial and tax aspects of a transaction. It would apply where, from the outset, the tax benefits sought are expected to exceed any commercial return. The test would account for both the possibility of a modest amount of income that is eclipsed by the tax benefit sought (e.g., $1,000 of deductions leading to $150 of tax savings with a $20 non-tax return, perhaps earned as income on a bond that is incorporated into a series of transactions) and the remote possibility of significant economic returns in the context of a tax-driven deal (e.g., a $150 tax benefit with a 2% chance of earning $1,000). In making this determination, foreign (or other) tax savings are not to be included as a commercial, non-tax return. As such, a transaction that is intended to yield $60 in foreign tax savings, $50 in Canadian income tax savings and produce a $1 commercial return would be within the scope of this factor.

The factor in paragraph (c) applies where a transaction is entirely (or almost entirely) tax driven. In such a case, as commercial goals are essentially immaterial in the context of planning the transaction, it is reasonable to infer that there is likely nothing going on economically. In other words, purpose may be a strong proxy for identifying economic substance (or lack thereof). While the factors in paragraphs (a) and (b) focus on the specific actual or anticipated economic effects, this factor looks more to the big picture. In many cases where a transaction is entirely (or almost entirely) tax driven, it is expected that the factors in paragraphs (a) or (b) would also be present. While related to the avoidance transaction "purpose" test, the test in paragraph (c) goes a step further to apply where none of the main purposes for undertaking or arranging the transaction is a bona fide non-tax purpose.

Subsection (4.1) applies to the avoidance transaction or the series of transactions that includes the avoidance transaction. Accordingly, economic substance may be tested based on either the transaction or the series. In general, where a transaction forms part of a series, it is expected that testing the series as whole would typically provide the best lens through which to assess economic substance, particularly where the series includes a number of highly integrated transactions orchestrated to obtain a particular result. In limited circumstances it may be more appropriate to assess economic substance having regard to a transaction or subset of transactions within a series.

Several of the factors listed in subsection (4.2) lend themselves to a broader assessment of the series. In some of the examples listed above (for example, the circular flow of funds and the offsetting financial positions) a narrow application of the economic substance analysis could result in the conclusion that certain steps in the series do, taken alone, have economic substance.

However, when the series is considered as a whole, the interaction of the transactions within the series has the combined effect of largely eliminating the taxpayer's economic risk. Accordingly, economic substance should generally be assessed having regard to the series as a whole.

Similarly, where a true commercial transaction involves several steps (which may on their own constitute "avoidance transactions"), a narrow application of the economic substance test to an integral step in a series could result in subsection (4.1) applying inappropriately. For example, assume a foreign corporation decides to purchase all the shares of a Canadian operating corporation (Canco) from an arm's length vendor in an acquisition that is solely motivated by commercial objectives. Typically, tax considerations will impact choices that are made with respect to structuring the acquisition. The non-resident may choose to acquire Canco indirectly using a newly formed Canadian acquisition company. This could provide tax benefits going forward relative to a direct acquisition of the shares, such as higher cross-border paid-up capital and the ability to deduct acquisition debt against operating income. Viewed in isolation, there may be steps in the series that constitute avoidance transactions and that would not, on their own, have economic substance. This type of narrow analysis would be inappropriate in this situation as it would disregard the fact that the transactions are integral to achieving a broader commercial objective that clearly has significant economic substance (i.e., the acquisition of a business).

Nonetheless, the concept of series of transactions is broad, and it is not intended that the existence of an arm's length commercial transaction within the broader series automatically means that everything that occurs throughout the series is considered to have economic substance. There may be situations where a transaction (or subset of transactions) is more appropriately assessed on its own, notwithstanding that there may be some link between the transaction(s) and an arm's length transaction that is arguably part of the same series. For example, a corporate taxpayer may engage in an internal reorganization to step-up the cost base of assets with a view to reducing tax on an eventual arm's length sale of those assets. While that sale may form part of the same series as the internal reorganization, the reorganization is not integral to the sale and should be assessed independently. Similarly, the inclusion of an extraneous transaction with commercial elements (such as the opportunity for profit) in a series of transactions ought to be disregarded, where that transaction is not integral to the planning which gives rise to the tax benefit. For example, the purchase of an Ontario savings bond as part of the series of transactions in the *Canada Trustco* case doesn't mean that the series of transactions at issue (the purchase of trailers, circular flow of funds, etc.) which led to the tax benefit necessarily had significant economic substance.

In summary, the amendments provide flexibility for a holistic and common-sense assessment of the relevant facts and circumstances. As a result, the fact that an integral step in a fundamentally commercial series of transactions was done solely for tax purposes (or otherwise meets the factors in subsection (4.2)) does not necessarily tend to indicate that the transaction results in a misuse or abuse. The other side of that coin is that simply inserting an extraneous commercial transaction into a series of transactions which is significantly lacking in economic substance would not avoid the application of subsection (4.1) for that series, or the other transactions in it.

The following are some additional examples that discuss how subsections (4.1) and (4.2) would apply in different scenarios.

Example 1 – Incorporation of Business

Jack, who is an architect resident in Canada, decides to incorporate his business and operate through a corporation (Opco), instead of directly. He transfers his existing business assets into Opco on a tax-deferred basis under section 85 of the Act. Jack owns all the shares of Opco. Going forward, Ocpo operates the business and pays Jack a salary for his services. Opco claims the small business deduction to reduce its tax rate on its business income.

Applying the first factor in paragraph (4.2)(a), it could argue that there is no change in Jack's economic position taken together with that of Opco since all the assets that were owned by Jack are now owned by Opco. However, given Opco is carrying on a real business, there has been a change in Jack's position in the sense that liabilities and obligations related to the business will accrue to Opco going forward, which could have legal and commercial differences notwithstanding that Jack and Opco are not at arm's length.

Paragraph (4.2)(b) is not readily applicable in this situation (given both the tax and non-tax benefits are not immediate and are not easily quantifiable), and should be given minimal or no weight in the analysis.

In this example there are not sufficient facts to determine whether Jack's entire, or almost entire, purpose for incorporating was to obtain a tax benefit (paragraph (4.2)(c)). However, it is reasonable to expect that decisions to operate a business directly or through a corporation will typically be made for multiple reasons, including tax and non-tax reasons. While incorporation may result in tax savings it also has important legal and commercial implications.

On balance, strong arguments could be made that this transaction is not significantly lacking in economic substance. However, even if it was considered to lack economic substance (such that subsection (4.1) applied), it should be clear that there is no misuse or abuse having regard to the relevant provisions of the Act.

The small business deduction is an incentive intended to encourage small business development and growth (for example, Budget 2015 noted that this preferred rate allows small businesses to retain more earnings that can be used to reinvest and create jobs). This objective would be undermined if people could not establish corporations to operate their businesses. Moreover, there is a scheme in the Act relating to incorporated businesses. As noted, section 85 allows for a tax-deferred transfer of a business to a corporation. Furthermore, there is an integration scheme which, including the dividend tax credit in section 121 (and other related rules), seeks to ensure that both business and investment income are taxed on distribution to the individual shareholder at a combined individual and corporate rate that roughly corresponds to the rate that would have been paid if the individual had earned the income directly. This implies a choice to incorporate. More particularly, the non-eligible dividend tax credit rules are specifically designed to apply in circumstances where an individual receives dividends from a corporation on income taxed at the low small business deduction rate (see statements in Annex 5.1 of Budget 2015, which reduced the small business rate and made corresponding adjustments to the non-eligible dividend rules). Applying GAAR to deny the small business deduction or to otherwise alter the basic tax

consequences of incorporation would be inconsistent with the scheme of the rules relating to private corporations established by Parliament.

Example 2 – Incorporation of Business Before Sale

Emma, a Canadian resident individual, has been carrying on a catering business as a sole proprietor for the past 10 years. She recently accepted an offer from an arm's length third party to purchase her business. Before proceeding with the sale, Emma transfers all the assets used in her active business to Opco, a newly incorporated taxable Canadian corporation, in consideration for 100 common shares of Opco on a tax-deferred basis under section 85 of the Act. Immediately after this transaction, Emma sells the shares of Opco to the third party and realizes a $500,000 capital gain. She uses a portion of her lifetime capital gains exemption (LCGE) to exempt the entirety of the gain from tax.

The series of transactions carried out by Emma results in a tax benefit in the form of a tax-exempt gain on the sale of her business. It is also reasonable to assume that the incorporation of Opco and the transfer of Emma's business assets to the corporation on a tax deferred basis under section 85 would constitute avoidance transactions as they have been undertaken primarily to obtain the tax benefit.

Viewed on their own, these avoidance transactions could be viewed as significantly lacking in economic substance since there is no change in the beneficial ownership of the assets and Emma never intended to (nor did) carry on her business through Opco; the incorporation of Opco and subsequent transfer of assets were undertaken for the sole purpose of obtaining the tax benefit. However, given the transactions are closely linked to the sale of Emma's business, arguably they should be assessed as part of that series. The series as a whole clearly has economic substance since there was a change in Emma's economic position (she disposed of her business for cash), the economic benefit exceeded the tax benefit and the purpose of the overall transaction was not tax-related.

Furthermore, even if this transaction was considered to be significantly lacking in economic substance, it should not be considered abusive since the tax results sought by Emma are consistent with the rationale of the provisions underlying the LCGE. Emma simply responded to a tax incentive and did precisely what Parliament intended to encourage when it enacted these provisions. Looking at the text of the provisions relied on by the taxpayer (including section 54.2 and clause 110.6(14)(f)(ii)(A)), it should be clear that Parliament specifically intended for the series of transactions carried out by Emma to give right to the lifetime capital gains exemption. This is also confirmed by the 1988 technical notes for the definition "qualified small business corporation share" in section 110.6.

Example 3 - Exchangeable Shares

Assume a US public corporation (US Pubco) that carries on a global manufacturing business decides to purchase all the shares of a Canadian public company (Canco) with a similar Canadian business in a share-for-share exchange transaction. Canco's shares are widely held, including by many taxable Canadian residents. If taxable Canadian shareholders received shares

of US Pubco directly they would be subject to tax on any accrued gain realized on the exchange of their Canco shares for US Pubco shares (because there is no rule that allows for Canadian corporation shares to be exchanged for foreign corporation shares on a rollover basis).

In order to provide a rollover for Canadian shareholders, US Pubco makes the acquisition using a typical “exchangeable share” structure. This provides Canadian shareholders the choice to receive shares of a Canadian acquisition company that can be exchanged (“exchangeable shares”), in the future, for shares of US Pubco. The exchangeable shares are economically equivalent to the US Pubco shares. Shareholders who do not elect to receive exchangeable shares would receive US Pubco shares directly. Canadian shareholders can receive their exchangeable shares on a tax-deferred basis by making a joint election with the Canadian acquisition company under section 85. This allows Canadian shareholders to defer their accrued gain until they eventually exchange their shares for US Pubco shares (which may not occur for several years).

Although this transaction is structured to achieve certain tax benefits (in particular, a deferral of capital gains tax) this does not mean that it necessarily lacks economic substance. Similarly, the fact that the Canadian shareholders receive shares that are economically equivalent to the US Pubco shares does not mean that the transaction lacks economic substance. Viewed as a whole, the transactions within this series should be considered to have economic substance. First, applying paragraph 245(4.2)(a), a Canadian shareholder who receives exchangeable shares clearly has opportunity for gain and risk of loss. They have traded their narrow exposure to Canco for broader exposure to US Pubco. Depending on the relative performance of Canco compared to the rest of US Pubco’s businesses, this could result in material economic gain or loss.

Paragraph 245(4.2)(b) considers whether the tax benefits outweigh the economic benefits. This factor is not particularly meaningful in this situation since the economic benefits are not easily quantifiable relative to the deferral tax benefit. In any event, it is not clear from the facts that the tax benefit exceeds the anticipated economic benefit.

Finally, paragraph (4.2)(c) considers whether the transaction is entirely (or almost entirely) tax motivated. While the narrow choice to obtain exchangeable shares (instead of US Pubco shares) may be solely tax-motivated, there is no indication that the decision to participate in the sale transaction more broadly is motivated by anything other than commercial objectives. The use of exchangeable shares allows the commercial objective to be achieved in a tax-efficient manner but is not, on its own, indicative of the purpose of the transaction.

Accordingly, this transaction should not be considered to significantly lack economic substance.

Example 4 - Flow-through shares

Carly is a Canadian resident who earns a large amount of income from a consulting business, as well as from various investments. In order to reduce her taxes payable Carly decides to subscribe for flow-through shares. She is able to negotiate a relatively short holding period for the shares. (Flow-through share agreements allow certain corporations to renounce or "flow through" both Canadian Exploration Expenses and Canadian Development Expenses to investors, who can

deduct the expenses in calculating their taxable income. In addition to claiming the regular flow-through deductions, individuals may also be able to claim investment tax credits, such as the Mineral Exploration and Critical Mineral Exploration Tax Credits.)

Carly sells the shares as soon the holding period expires in order to minimize her exposure to the shares. Accordingly, the shares are sold at an economic loss. For example, assume Carly pays a $100 cash subscription price for a flow-through share that, without the flow-through benefits, has a fair market value of $83.33 (meaning the tax benefits generate a 20% premium on the share price). The issuer renounces $100 of Canadian Exploration Expenses that are eligible for the Critical Mineral Exploration Tax Credit. This would provide Carly with an initial benefit of $63 in federal tax savings ($33 for the flow-through deductions (assuming a 33% federal tax rate) and $30 for the Critical Mineral Exploration Tax Credit). She would pay $9.90 in federal tax on the Critical Mineral Exploration Tax Credit (investment tax credits are generally taxable and included in income the year after they are claimed) and $13.75 on the capital gain on the sale of the share (the adjusted cost base of flow-through shares is deemed to be nil, so she would have a capital gain of $83.33, half of which would be included in income). On a net basis, she has a federal tax benefit worth $39.35 ($33 + $30 - $9.90 - $13.75) and an economic loss of $16.67.

Applying the factors in subsection (4.2), this transaction arguably has a significant lack of economic substance. First, while there is some opportunity for gain and risk of loss (since the shares are common shares that could go up or down in value while Carly holds them), Carly tried to minimize her economic exposure by negotiating a short holding period and disposing of the shares as soon as possible after acquiring them (subparagraph (4.2)(a)(iii)). Second, the tax benefits of the investment exceed the economic benefits, as detailed above (paragraph (4.2)(b)). Finally, it is reasonable to conclude that Carly's entire purpose for investing in flow-through shares was to obtain a tax benefit, given the deductions and credits that she claims and the fact that she seeks to minimize her economic exposure to the shares (paragraph (4.2)(c)). The factors therefore suggest that there is a significant lack of economic substance.

Based on this conclusion, subsection (4.2) would apply and would dictate that the lack of economic substance weighs in favour of finding that this transaction is abusive. However, when considering the rationale of the relevant rules, it should be clear that other considerations more strongly show that this transaction is not in fact abusive.

Flow-through shares and related investment tax credits are intended to facilitate the raising of equity to fund exploration by enabling companies to issue shares at a premium (see statements made in Budget 2022 when then the Critical Mineral Exploration Tax Credit was first announced, as an example of support for this statement). In light of this objective, it is reasonable to conclude that this benefit is intended to be available for Carly. High-income individuals are most likely to have money that they can invest in flow-through shares (thus achieving the objective of helping exploration and development companies raise capital) and are most likely to purchase them due to the tax benefits (flow-through share deductions are worth the most for those in the top income tax bracket). Carly responded to this government incentive by acquiring the flow-through shares at a premium so that she could obtain the corresponding tax benefits. Moreover, while the transaction may lack economic substance when analyzing the facts as they apply to Carly, the issuer does receive a real economic investment to finance exploration or

development, consistent with the goal of the flow-through share regime. This investment is not diminished by a rapid sale of the flow-through shares.

Finding that subsection 245(2) applies to a straight-forward flow through share investment followed by a sale of the shares would undermine Parliament's objective in implementing these programs and would render them ineffective. Therefore, the GAAR should not apply in this situation to deny Carly the benefits of investing in flow-through shares.

Penalty

ITA
245(5.1) and (5.2)

Subsection (5.1) introduces a penalty to the GAAR. The amount of the penalty is determined by the formula "(A + B) x 25% - C". The penalty applies in respect of a transaction only if the transaction or series that includes the transaction was not disclosed to the Minister of National Revenue in accordance with section 237.3 (reportable transactions) or 237.4 (notifiable transactions). For more information, see the commentary on section 237.3.

Variable A is the amount by which a person's tax payable for a taxation year is increased as a result of the application of the GAAR. Variable B is the amount by which a person's refundable tax credits for a taxation year are reduced as a result of the application of the GAAR. The penalty is computed as 25% of these amounts.

Variable C reduces the amount of the penalty by the amount of any penalty payable under subsection 163(2) in respect of the transaction or series that includes the transaction. This is intended to prevent duplication where the gross negligence penalty in subsection 163(2) applies in respect of the same transaction or series as the GAAR penalty. Where the tax benefit obtained is the creation of a tax attribute (i.e., it is described in paragraph (c) of the definition "tax benefit" in subsection 245(1)) that has not been used to reduce tax payable, no penalty would apply until the year in which the tax attribute is used to reduce tax payable (absent the application of the GAAR). In circumstances where an unutilized tax attribute is successfully challenged under the GAAR, the penalty formula would produce a nil result.

Subsection (5.2) provides an exclusion to the GAAR penalty. It is intended to be available in circumstances where a taxpayer demonstrates that it would have been reasonable to conclude that a transaction or series would not be subject to the GAAR at the time it was entered into.

The exclusion in subsection (5.2) assures the GAAR penalty will not apply to a taxpayer that entered into a transaction reasonably relying upon the current state of the case law and administrative guidance from the Minister of National Revenue. In order for this exclusion to apply, the taxpayer must demonstrate that their transaction or series was identical or almost identical to a transaction or series that was the subject of published administrative guidance or a court decision, such that it was reasonable to have concluded that the GAAR would not apply. The "identical or almost identical" threshold is quite high and, as a result, using the same tax strategy or entering into a transaction that is merely similar would not be enough to qualify for

the exclusion. As the test is applied as at the time the transaction was entered into, it could be relied upon even where there are subsequent changes in administrative position or jurisprudence.

Subsection (5.2) is intended to be a narrow rule that provides greater certainty to taxpayers that they may rely on directly relevant administrative guidance and case law without fear that they could be subject to a GAAR penalty because of subsequent changes to law or policy. It is not intended to replace any other defences that may be available under applicable law.

Clause 67

Definitions

ITA
248(1)

Subsection 248(1) of the Act defines various terms that apply for the purposes of the Act.

Subsection 248(1) is amended to add the definitions “absorbed capacity”, “cumulative unused excess capacity”, “excess capacity”, “interest and financing expenses”, “interest and financing revenues” and “transferred capacity”, so that the definitions of these terms in subsection 18.2(1) apply for the purposes of the Act (except, in the case of the definition “interest and financing expenses”, for the purposes of the definition “economic profit” in subsection 126(7)).

Subsection 248(1) is also amended to add the definition “restricted interest and financing expense”, so that the definition of this term in subsection 111(8) applies for the purposes of the Act.

These EIFEL-related amendments apply in respect of taxation years beginning on or after October 1, 2023. However, they also apply in respect of a taxation year that begins before and ends after that date if any of the three immediately preceding taxation years is shorter as a result of a transaction or event or series of transactions or events and it can reasonably be considered that one of the purposes of the transaction, event or series was to defer the application of the EIFEL regime.

Additional amendments are also made to subsection 248(1) related to other measures, as set out below.

“disposition”

Paragraph (f) of the “disposition” definition in subsection 248(1) excepts transfers of property without a change of beneficial ownership where certain conditions are met, including transfers between the same type of registered plans.

Subparagraph (f)(vi) is amended to add FHSAs to the types of registered plans specified for this purpose.

This amendment comes into force on April 1, 2023.

“distribution equipment”

This definition, which has the meaning assigned by subsection 1104(13) of the Regulations, is added to subsection 248(1) of the Act.

This definition supports the introduction of the clean technology investment tax credit in new section 127.45.

This amendment comes into force on March 28, 2023.

“employee benefit plan”

The definition “employee benefit plan” is amended to exclude employee ownership trusts (as defined in subsection 248(1)) from the ambit of the definition. A trust that is an employee ownership trust will therefore not be an employee benefit plan.

“employee ownership trust”

Subsection 248(1) provides the new definition “employee ownership trust” (EOT). An EOT is an irrevocable trust, which at all relevant times, satisfies all of the conditions provided under paragraphs (a) through (j) of the definition.

Residence

Paragraph (a) requires that the trust is resident in Canada. This determination is made without reference to subsection 94(3).

Employee Beneficiary Conditions

Paragraph (b) provides employee beneficiary conditions. The EOT must be exclusively for the benefit of all individuals that meet the requirements provided in subparagraphs (i) to (iv).

Clause (b)(i)(A) requires that each of the beneficiaries of the EOT are individuals who are employed by one or more qualifying businesses controlled by the EOT. (For more information on the definition “qualifying business”, see the commentary to this definition in subsection 248(1).) Though not required, an EOT may exclude employees that have not yet completed an applicable probationary period of employment from being a beneficiary, but such exclusionary period may not exceed a maximum duration of 12 months.

Clause (b)(i)(B) permits the trust to include individuals (including estates of individuals) who are former employees of one or more qualifying businesses controlled by the trust, and who were employees of the qualifying business after the trust first acquired control of the qualifying business. If the trust includes former employees as beneficiaries of the trust, the former employees must meet the same conditions applicable to current employees provided in

subparagraphs (b)(ii) to (iv) to qualify as beneficiaries. If an individual described in clause (b)(i)(A) ceases to be employed by a qualifying business or dies, depending on the terms of the EOT's trust deed and other relevant facts, the individual or their estate may retain any right to receive amounts payable by the EOT to the former employee.

Subparagraph (b)(ii) excludes as beneficiaries individuals that own, directly or indirectly in any manner whatever (other than through an interest in the EOT), 10% or more of the fair market value of any class of shares of the capital stock of a qualifying business controlled by the EOT.

Subparagraph (b)(iii) provides an additional limitation on a beneficiary's share ownership in the qualifying business(es). This rule requires that each beneficiary does not own, directly or indirectly, together with any person or partnership that is related to or affiliated with the individual, 50% or more of the fair market value of any class of shares of the capital stock of a qualifying business controlled by the EOT.

Subparagraph (b)(iv) excludes as beneficiaries individuals who immediately before the time of a qualifying business transfer to the EOT, owned, directly or indirectly in any manner whatever, together with any person or partnership that is related to or affiliated with the individual, 50% or more of the fair market value of the shares of the capital stock and indebtedness of the qualifying business.

Distribution Criteria

Paragraph (c) provides the conditions governing the determination of beneficiaries' income and capital interests in the EOT and corresponding distributions from the EOT. Specifically, the interest of each beneficiary must be determined in the same manner as other current employee beneficiaries, or (if applicable) in the same manner as other former employee beneficiaries of a qualifying business controlled by the trust, based solely on any combination of the following criteria:

- the total hours of employment service provided by the beneficiary to the qualifying business in respect of a particular time period,
- the total salary, wages and other remuneration paid or payable to the beneficiary by the qualifying business in respect of a particular time period, not exceeding a limit of twice the highest marginal income tax bracket for a calendar year (as adjusted for inflation) and prorated for the number of days in the calendar year in the particular time period, and
- the total period of employment service the beneficiary has provided to the qualifying business since a particular time (which may include time accrued prior to the EOT's acquisition of the business).

Other criteria external to the above-listed criteria must not be taken into account in determining the beneficiaries' income and capital interests in the EOT. Developing a distribution formula using any combination of the above-listed criteria requires that the formula includes at least one factor.

An EOT could apply a different combination of the above-listed criteria for income distributions versus capital distributions. For example, an EOT could distribute income amounts to beneficiaries based on a formula incorporating all three criteria but distribute capital based on only 2 of the 3 criteria listed.

Similarly, an EOT could apply different formulas for current employees (described under clause (b)(i)(A)) and (if applicable) former employees (described under clause (b)(i)(B)). Where an EOT is set up for the benefit of both current and former employees, it could administer a single formula for both current and former employee beneficiaries or up to four different distribution formulas:

- a formula for current employees in respect of distributions of income;
- a formula for current employees in respect of distributions of capital;
- a formula for former employees in respect of distributions of income; and
- a formula for former employees in respect of distributions of capital.

Example – Application of Distribution Criteria

A qualifying business began in Year 1 and was purchased by an EOT in Year 4. It is now Year 9, and the EOT is distributing the $2 million dividend it received from its wholly-owned qualifying business based on an equal weighting of current seniority (total period of employment service since Year 1) and employment income (total salary, wages and other remuneration paid) over the last five years (i.e., Year 4 to Year 8) using the following formula:

$$(\mathrm{A} \div \mathrm{B} \times 50\%) + (\mathrm{C} \div \mathrm{D} \times 50\%)$$

where

A is the beneficiary's years of employment service to the qualifying business since Year 1,
B is the total years of employment service of all beneficiaries to the qualifying business since Year 1,
C is the beneficiary's employment income in the last five years (including overtime pay) from the qualifying business, and
D is the total employment income of all beneficiaries in the last five years from the qualifying business.

Kristina has worked for the EOT-owned qualifying business for nine years and earned $300,000 of employment income from the qualifying business in the last five years. Together, the EOT beneficiaries have accumulated 5,000 years of employment service and $120 million in employment income over the last five years. At this time, Kristina would be eligible to receive 0.215% of the distributed amount.

$$(9 \div 5{,}000 \times 50\%) + (\$300{,}000 \div \$120{,}000{,}000 \times 50\%) = 0.215\%$$

This equates to a distribution of $4,300 to Kristina.

Example – Application of Distribution Criteria with Salary Caps

At the end of Year 3, an EOT is distributing the $2 million dividend it received from its wholly-owned qualifying business based solely on a beneficiary's employment income (total salary, wages and other remuneration paid) between July of Year 1 to June of Year 3 using the following formula:

$$A \div B$$

where

A is the beneficiary's employment income in the two-year period (including overtime pay) from the qualifying business that does not exceed the salary cap, and
B is the total employment income of all beneficiaries in the two year period from the qualifying business that does not exceed the salary cap.

For a given time period, the total employment income eligible for the formula will be determined by the relevant salary cap for the calendar year within the time period, as described in clause (c)(ii). The salary cap will equal twice the highest personal income tax bracket. If the time period covers a partial calendar year, a prorated salary cap will apply. This EOT's distribution formula covers one full calendar year and two half calendar years.

Babar has earned $1,000,000 of employment income from the qualifying business in the two-year period. In total, only $965,000 of Babar's employment income during this period would be eligible for inclusion in the distribution formula. This calculation is determined as follows:

- During the last six months of Year 1, Babar earned $200,000 of employment income. The salary cap for the full calendar year in Year 1 is $500,000. The prorated cap for half of Year 1 is $250,000. Because Babar's $200,000 of employment income earned during half of Year 1 does not exceed the prorated cap, the full $200,000 amount is eligible to be included in the distribution formula.
- Throughout Year 2, Babar earned $500,000 of employment income. The salary cap for the full calendar year in Year 2 is $515,000. Because Babar's $500,000 of employment income does not exceed the Year 2 cap, the full $500,000 amount is eligible to be included in the distribution formula.
- During the first six months of Year 3, Babar earned $300,000 of employment income. The salary cap for the full calendar year in Year 3 is $530,000. The prorated cap for half of Year 3 is $265,000. Because Babar's $300,000 of employment income earned during half of Year 3 exceeds the prorated cap, only $265,000 of Babar's income is eligible to be included in the distribution formula.

Together, the EOT beneficiaries have accumulated $8 million in employment income over the two-year period (excluding any amounts in excess of the salary cap).

At this time, Babar would be eligible to receive 12.063% of the distributed amount.

$$(\$965{,}000 \div \$8{,}000{,}000) = 12.063\%$$

This equates to a distribution of $241,250 to Babar.

Even-Hand Rule

Paragraph (d) prohibits the trustees of the EOT from acting in the interest of one beneficiary (or group of beneficiaries) to the prejudice of another beneficiary (or group of beneficiaries). For example, if the trustees of the EOT resolved to amend the distribution criteria listed in paragraph (c) so that they were determined solely based on an employee's total salary for the year (not exceeding twice the highest personal income tax bracket), this change alone would not necessarily violate this even-hand rule. However, any additional weighting of salaries in favour of employees earning higher salaries (such as salary to the power of two) could prejudice lower-income employee beneficiaries.

Eligible Trustees

Paragraph (e) provides the eligibility conditions for each trustee to the EOT. Specifically, each trustee must be either an individual (other than a trust) or a corporation resident in Canada that is licensed or otherwise authorized under the laws of Canada or a province to carry on in Canada the business of offering to the public its services as a trustee.

Governance and Trustee Representation

Paragraphs (f) to (h) provide conditions for the governance of the EOT, including the composition of the trustees of the EOT. These conditions are intended to balance the interests of the selling shareholders of a qualifying business with the interests of the purchasing employees of the qualifying business to ensure that a qualifying business transfer occurs on arm's length terms and to ensure that the EOT acquires control of the qualifying business upon the qualifying business transfer.

Paragraph (f) provides that each trustee has an equal vote in the conduct of the affairs of the trust.

Paragraph (g) provides that at least one-third of the trustees must be beneficiaries of the EOT as current employees of a qualifying business controlled by the trust. Such employee trustees may be appointed, or otherwise elected to the position of trustee within the last five years by the beneficiaries described in clause (b)(i)(A).

Paragraph (h) provides that if any trustee is appointed (other than by an election within the last five years by the beneficiaries of the trust described in clause (b)(i)(A)), at least 60% of all trustees must be persons that deal at arm's length with any person who has, directly or indirectly in any manner whatever, as part of a series of transactions or events, sold shares of a qualifying business to the EOT (or to any person controlled by the trust) prior to the trust acquiring control

of the qualifying business. Provided that the requirements in paragraphs (g) and (h) are met, all of the trustees of the EOT could be appointed rather than elected.

Fundamental Changes

Paragraph (i) requires that beneficiaries of the EOT who are current employees of one or more of the qualifying businesses of the EOT must approve certain fundamental changes to the qualifying business(es) controlled by the trust, which could materially impact current employee-beneficiaries' employment and beneficial interest in the business(es). More than 50% of the beneficiaries of the trust described in clause (b)(i)(A) must approve the following transactions or events:

i. any transaction or event or series of transactions or events that causes at least 25% of the beneficiaries to lose their status as current employee-beneficiaries (unless the change in status is in respect of a termination of employment for cause); and
ii. a winding-up or amalgamation of a qualifying business (other than in the course of a transaction or event or a series of transactions or events that involves only persons or partnerships that are affiliated with the qualifying business).

Trust Property

Paragraph (j) requires that all or substantially all the fair market value of the property of the trust is attributable to shares of the capital stock of one or more qualifying businesses that the trust controls.

"employee trust"

The new definition "employee trust" is amended to exclude employee ownership trusts (as defined in subsection 248(1)) from the ambit of the definition. A trust that is an employee ownership trust will therefore not be an employee trust.

"fossil fuel"

This definition, which has the meaning assigned by subsection 1104(13) of the Regulations, is added to subsection 248(1) of the Act.

This definition supports the introduction of the clean technology investment tax credit in new section 127.45.

This amendment comes into force on March 28, 2023.

"mineral resource"

The definition "mineral resource" in subsection 248(1) lists several types of mineral deposits as "mineral resources" for the purposes of the Act.

In particular, “mineral resource” is relevant in determining the eligibility of a taxpayer to claim Canadian exploration expenses (CEE) (defined in subsection 66.1(6)) and Canadian development expenses (CDE) (defined in subsection 66.2(5)).

A taxpayer that is a principal-business corporation (as defined in subsection 66(15)) may also renounce qualifying CEE and CDE to investors under subsections 66(12.6) and (12.62), respectively, by entering into flow-through share agreements.

In addition to claiming the flow-through deductions, individuals (other than trusts) who invest in flow-through shares of a principal-business corporation may also be eligible to claim the Critical Mineral Exploration Tax Credit (CMETC) or the Mineral Exploration Tax Credit (METC) under subsection 127(5) in respect of certain specified CEE.

Previously, lithium was not a listed mineral resource, but a lithium deposit could be certified as a “mineral resource” by the Minister of Natural Resources under subparagraph (d)(i) if it was contained in a non-bedded deposit. However, lithium originating from brines could not be certified as it is usually found in bedded deposits.

Paragraph (d) of the “mineral resource” definition is amended by adding lithium to the list of minerals in subparagraph (ii). This allows for lithium extracted from brines (generally located in bedded deposits) to qualify as a mineral resource, and it also removes the requirement for taxpayers engaged in traditional lithium mining projects to apply to the Minister of Natural Resources for mineral resource certification.

This amendment is deemed to have come into force on March 28, 2023, and for greater certainty, does not apply in respect of expenses incurred before March 28, 2023.

“qualifying business”

The new definition “qualifying business” is relevant for the rules applicable to employee ownership trusts (EOTs). A qualifying business is defined as a corporation controlled by a trust that satisfies the conditions in paragraphs (a) to (c).

Canadian-controlled Private Corporation

Paragraph (a) requires that the corporation be a Canadian-controlled private corporation.

Governance and Board Representation

Paragraph (b) provides a restriction on the governance of the qualifying business. Specifically, not more than 40% of the directors of the qualifying business can be individuals that, immediately before the time that the EOT acquired control of the corporation, owned, directly or indirectly in any manner whatever, together with any person or partnership that is related to or affiliated with the director, 50% or more of the fair market value of the shares of the capital stock or indebtedness of the corporation.

Paragraph (c) requires that the qualifying business deals at arm's length and is not affiliated with any person or partnership that owned 50% or more of the fair market value of the shares of the capital stock or indebtedness of the corporation immediately before the time the EOT acquired control of the corporation.

"qualifying business transfer"

The new definition "qualifying business transfer" means a disposition by a taxpayer of shares of the capital stock of a corporation ("subject corporation") to a trust or to a Canadian-controlled private corporation ("purchaser corporation") that is controlled and wholly-owned by a trust, provided that certain conditions are met. These conditions are provided in paragraphs (a) through (c).

Paragraph (a) provides requirements for the subject corporation being disposed of. Specifically, immediately before the disposition, all or substantially all the fair market value of the assets of the subject corporation must be attributable to assets (other than an interest in a partnership) that are used principally in an active business carried on by the subject corporation or by a corporation that is controlled and wholly-owned by the subject corporation.

Paragraph (b) provides requirements applicable to the time of the disposition of the shares of the subject corporation described in paragraph (a). Specifically, at the time of the disposition, the taxpayer must deal at arm's length with the trust (and any purchaser corporation), the trust must acquire control of the subject corporation, and the trust must be an employee ownership trust (EOT), the beneficiaries of which are employed in the business described in paragraph (a).

Paragraph (c) provides requirements following the disposition described in paragraph (b). First, at all times after the disposition, the taxpayer must deal at arm's length with the subject corporation, the trust and any purchaser corporation. Second, at all times after the disposition, the taxpayer must not retain any right or influence that, if exercised, would allow the taxpayer (whether alone or together with any person or partnership that is related to or affiliated with the taxpayer) to control, directly or indirectly in any manner whatever, the subject corporation, the trust, or any purchaser corporation.

This definition is intended to ensure that only genuine business transfers to EOTs on arm's length terms can benefit from the new 10-year capital gain reserve, the new 15-year exception to the shareholder loan rule and the new 15-year exception to the deemed interest benefit rule. Relevant facts in determining arm's length dealing could include, for example, that the EOT conducted its own due diligence with respect to the acquisition and obtained independent legal, tax and financial advice, including an independent valuation from a qualified professional.

These amendments to subsection 248(1) come into force on January 1, 2024.

"substantive CCPC"

Neutrality is a fundamental principle of Canadian tax policy. The Canadian income tax system aims to achieve neutrality by ensuring that income earned directly by a Canadian resident

individual is taxed at roughly the same rate as income that is earned through a corporation. This objective is commonly referred to as integration.

To encourage business investment and growth, the business income of a corporation is subject to a low rate of tax in the corporation and is integrated only once dividends are paid out to shareholders. In contrast, investment income earned by Canadian-controlled private corporations (CCPCs) is subject to additional refundable tax that approximates the highest marginal tax rate payable by Canadian resident individuals. This ensures no tax deferral advantage can be obtained by Canadian resident individuals earning their investment income through a holding corporation rather than directly.

In comparison, investment income earned by non-CCPCs is taxed at the same rate as business income and is therefore subject to a low rate of tax. This is because, theoretically, the same tax-deferral concern does not arise with non-CCPCs because they are controlled (and thus presumed to be owned) by public corporations or non-resident persons.

The distinction between a CCPC and a non-CCPC is determined by the CCPC definition. A CCPC is subject to the most comprehensive integration measures in the Act and its investment income is subject to comprehensive anti-deferral rules. However, because the CCPC definition was designed to restrict certain tax benefits to "true" Canadian-controlled private corporations, it is a restrictive definition. This has made the CCPC definition more susceptible to manipulation by taxpayers seeking to avoid the anti-deferral rules that apply to CCPCs.

The new definition of "substantive CCPC" is added to subsection 248(1) to address this concern.

A corporation will be a substantive CCPC if it is a private corporation (other than a Canadian-controlled private corporation) that

a. is controlled, directly or indirectly in any manner whatever, by one or more Canadian resident individuals, or
b. would, if each share of the capital stock of a corporation that is owned by a Canadian resident individual were owned by a particular individual, be controlled by the particular individual.

The following scenarios provide examples where the substantive CCPC definition would, or would not, apply.

Example 1

Facts

Opco is a CCPC all of the issued and outstanding shares of which are held by a Canadian resident individual. In the course of an arm's length commercial transaction, a right (described under paragraph 251(5)(b)) to acquire all of the shares of Opco is granted to a "public corporation" (as defined in subsections 89(1) and 248(1)). After a period of time, the public corporation exercises the right and acquires all of the shares of Opco.

Analysis

Opco ceases to be a CCPC (pursuant to the definition in subsection 125(7)) when the right to acquire all of its shares is granted to the public corporation. However, since it remains a "private corporation" (as defined in subsections 89(1) and 248(1)) controlled by a Canadian resident individual, Opco becomes a substantive CCPC at that time.

Opco ceases to be a substantive CCPC upon the acquisition of all of its shares by the public corporation. At that time, Opco ceases to be a "private corporation" and thus ceases to be a substantive CCPC.

Example 2

Facts

Opco is a Canadian resident corporation that is a wholly-owned subsidiary of a non-resident corporation (which, in turn, is wholly-owned by non-resident individuals).

Analysis

Opco is not a substantive CCPC because it is not controlled, directly or indirectly in any manner whatever, by one or more Canadian resident individuals (nor would it be under the aggregator test in paragraph (b) of the substantive CCPC definition).

Example 3

Facts

Year 1: Opco is a CCPC all of the issued and outstanding shares of which are held by a Canadian resident individual.

Year 2: At the beginning of Year 2, Opco is granted articles of continuance under the corporate laws of a foreign jurisdiction. However, Opco remains resident in Canada by maintaining central management and control in Canada throughout the year.

Year 3: At the beginning of Year 3, Opco emigrates from Canada to become resident in the foreign jurisdiction.

Analysis

Year 1: Opco is a CCPC, and is consequently not a substantive CCPC.

Year 2: Upon its continuance under the corporate laws of the foreign jurisdiction, Opco ceases to be a "Canadian corporation" (as defined in subsections 89(1) and 248(1) and pursuant to subsection 250(5.1)), and thus also ceases to be a CCPC (pursuant to the definition in subsection

125(7)). However, since Opco remains a "private corporation" (other than a CCPC) that is controlled by a Canadian resident individual, Opco becomes a substantive CCPC at that time.

Year 3: Opco ceases to be resident in Canada upon its emigration and thus ceases to be a substantive CCPC at that time. However, upon its emigration, Opco becomes a "controlled foreign affiliate" (as defined in subsection 95(1)) of the Canadian resident individual who will now be subject to the international anti-deferral regime in respect of Opco's investment income.

The substantive CCPC definition is relevant in determining the taxation of investment income earned directly as well as investment income earned through a foreign affiliate. Generally, a substantive CCPC will be subject to the same anti-deferral and integration mechanisms that apply to CCPCs. These rules include:

- the additional 10 2/3% tax under section 123.3 on the corporation's "aggregate investment income" for the year, as defined in subsection 129(4) (which includes taxable capital gains, interest, rent, royalties, and income under subsection 91(1) in respect of a share of a controlled foreign affiliate with foreign accrual property income (FAPI)),
- denial of the 13% general rate reduction under section 123.4 on the corporation's aggregate investment income for the year,
- an addition to the "non-eligible refundable dividend tax on hand" account as defined in subsection 129(4) equal to 30 2/3% of the corporation's aggregate investment income for the year, and
- the loss of the eligible dividend tax credit for dividend distributions of aggregate investment income pursuant to an addition to the corporation's "low-rate income pool" as defined in subsection 89(1).

While substantive CCPCs are subject to the same anti-deferral rules as CCPCs, they are not eligible for the same special tax benefits provided to CCPCs, including the small business deduction and the enhanced credit for scientific research and experimental development. This is because the CCPC definition provides a more robust and comprehensive set of rules to prevent non-residents and public corporations from accessing these special tax benefits.

The new substantive CCPC definition applies to taxation years that end on or after April 7, 2022. To provide certainty for genuine commercial transactions entered into before April 7, 2022, an exception to this application date is provided where the following conditions are met:

i. the corporation's first taxation year that ends on or after April 7, 2022 ends due to a loss restriction event (as defined in subsection 251.2(2)) caused by a sale of all or substantially all of the shares of a corporation to a purchaser before 2023,
ii. the purchaser deals at arm's length (determined without reference to a right referred to in paragraph 251(5)(b)) with the corporation immediately prior to the loss restriction event, and
iii. the sale occurs pursuant to a written purchase and sale agreement entered into before April 7, 2022.

Where the three aforementioned conditions are met, the substantive CCPC definition applies to taxation years that begin on or after April 7, 2022. Accordingly, where the exception applies to a corporation, it will not be subject to the rules applicable to substantive CCPCs in its taxation year that includes April 7, 2022 (assuming the taxation year does not begin on April 7, 2022), because it will not be a substantive CCPC in that taxation year.

For more information, see the commentary on the definition "low rate income pool" in subsection 89(1), section 123.3, the definition "full rate taxable income" in subsection 123.4(1), paragraph 129(1)(b), the definitions "eligible portion" and "non-eligible refundable dividend tax on hand" in subsection 129(4), subsections 152(3.1) and new (4.31), and on new subsection 248(43).

“transmission equipment”

This definition, which has the meaning assigned by subsection 1104(13) of the Regulations, is added to subsection 248(1) of the Act.

This definition supports the introduction of the clean technology investment tax credit in new section 127.45.

This amendment comes into force on March 28, 2023.

Qualifying arrangement

ITA
248(3.2)

Subsection 248(3.2) describes a qualifying arrangement for the purposes of paragraphs 248(3)(b) and (c) (i.e., for the purposes of deeming certain arrangements established under Quebec law to be trusts for the purpose of the Act). Paragraph 248(3.2)(d) requires that for an arrangement to a qualifying arrangement, it must be presented as an arrangement in respect of which the issuer (being a trust company) is to take action for the arrangement to become an RDSP, RESP, RRIF, RRSP or TFSA.

The amendment adds the FHSA to the types of arrangements listed in paragraph 248(3.2)(d).

This amendment comes into force on April 1, 2023.

Substantive CCPC – anti-avoidance

ITA
248(43)

The substantive CCPC concept is intended to cause corporations that are not CCPCs, but that are factually or legally controlled by Canadian resident individuals, to be subject to the same anti-

deferral rules on investment income that apply to CCPCs. Subsection 248(43) is an anti-avoidance rule that is intended to apply where a corporation or its shareholders undertake planning that causes a corporation not to be a CCPC or a substantive CCPC.

In general, this anti-avoidance rule may apply in situations where Canadian resident individuals have a material economic interest in a corporation, directly or indirectly, but do not have legal or factual control of the corporation. For example, this could be the case because ownership of a corporation's voting shares is misaligned from economic ownership of the corporation. This could also be the case where an intermediary entity, such as a partnership or trust, is interposed between Canadian resident individuals and the corporation in a way that causes the corporation to technically not be a CCPC or a substantive CCPC (see examples below).

More specifically, new subsection 248(43) applies to deem a corporation to be a substantive CCPC where it is reasonable to consider that one of the purposes of any transaction (as defined in subsection 245(1)), or series of transactions, is to cause a corporation that is resident in Canada (other than a Canadian-controlled private corporation or a corporation that is, in absence of this subsection, a substantive CCPC) to avoid tax otherwise payable under section 123.3 on the corporation's aggregate investment income. The corporation is deemed to be a substantive CCPC from the time the transaction or series of transactions commenced until the earliest time at which the corporation

a. becomes a Canadian-controlled private corporation,
b. is subject to a loss restriction event, or
c. ceases to be resident in Canada.

While the application of new subsection 248(43) is a question of fact, it is expected that the rule would apply in the following examples (note that these examples are not exhaustive, but are intended only to provide additional context when interpreting the text and purpose of new subsection 248(43)).

Example 1

Facts

Canco is a CCPC with a single class of issued and outstanding shares. Its shares are held in equal proportion by three arm's length Canadian-resident individuals (33 1/3% each).

Prior to realizing significant capital gains, non-participating voting preferred shares (skinny voting shares) are issued to the non-resident children of the Canadian-resident shareholders. The skinny voting shares confer a controlling interest in the corporation to their non-resident holders causing Canco to lose its CCPC status. The Canadian resident individuals assert the skinny voting shares were issued to their non-resident children for estate planning purposes.

Canco then earns significant aggregate investment income in the form of taxable capital gains. After paying tax at the low corporate tax rate on the taxable capital gain, Canco invests the after-tax proceeds in several rental properties.

Analysis

One or more of the Canadian-resident shareholders may be found to exercise de facto control over Canco. In such case, Canco would be a substantive CCPC under paragraph (a) of the definition "substantive CCPC" in subsection 248(1).

However, should the Canadian-resident shareholders be found not to have de facto control of Canco (individually or as a group), new subsection 248(43) would apply to deem Canco to be a substantive CCPC. This conclusion would be supported by the fact that the corporation's taxable capital gain would, absent the transaction (i.e. the issuance of the skinny voting shares to non-resident persons), have been subject to tax under section 123.3. Accordingly, absent clear facts indicating otherwise, it would be reasonable to conclude that one of the purposes of the transaction was to avoid tax otherwise payable under section 123.3 on the corporation's aggregate investment income.

Example 2

Facts

Canco, a Canadian corporation, is a wholly-owned subsidiary of a limited partnership ("LP").

GPCo, a Canadian resident corporation all of the issued and outstanding shares of which are owned by a Canadian resident individual, is the general partner of LP. GPCo holds a nominal interest in LP.

Canadian resident individuals own, directly or indirectly, all the limited partnership interests in LP.

The partnership agreement allows 75% of the limited partners to replace the general partner.

Immediately prior to Canco realizing significant capital gains, the sole shareholder of GPCo sells all the shares of GPCo to a non-resident individual. This transaction causes Canco to lose its CCPC status. After paying tax at the low corporate tax rate on the taxable capital gain, Canco invests the after-tax proceeds in portfolio assets.

Analysis

The Canadian resident partners of LP may be found to exercise de facto control over Canco. In that case, Canco would be a substantive CCPC under paragraph (a) of the definition "substantive CCPC" in subsection 248(1).

However, should the Canadian-resident partners be found not to have de facto control of Canco, new subsection 248(43) would apply to deem Canco to be a substantive CCPC. This conclusion would be supported by the fact that the corporation's taxable capital gains would, absent the transaction (i.e., the sale of GPCo's shares to a non-resident individual), have been subject to tax

under section 123.3. Accordingly, absent clear facts indicating otherwise, it would be reasonable to conclude that one of the purposes of the transaction was to avoid tax otherwise payable under section 123.3 on Canco's aggregate investment income.

New subsection 248(43) applies to taxation years that end on or after April 7, 2022. To provide certainty for genuine commercial transactions entered into before April 7, 2022, an exception to this application date is provided where the following conditions are met:

i. the corporation's first taxation year that ends on or after April 7, 2022 ends due to a loss restriction event caused by a sale of all or substantially all of the shares of a corporation to a purchaser before 2023,
ii. the purchaser deals at arm's length (determined without reference to a right referred to in paragraph 251(5)(b)) with the corporation immediately prior to the loss restriction event, and
iii. the sale occurs pursuant to a written purchase and sale agreement entered into before April 7, 2022.

Where a corporation satisfies the three aforementioned conditions, subsection 248(23) applies to taxation years of the corporation that begin on or after April 7, 2022.

For more information, see the commentary on the definition of "substantive CCPC" in subsection 248(1).

Clause 68

Associated corporations

ITA
256(7)(j)

New paragraph 256(7)(j) provides that control of a qualifying business (as defined in subsection 248(1)), which is controlled by an employee ownership trust (EOT), will not be considered to have been acquired solely because of a change in trustee(s) of the EOT. Paragraph (j) is only applicable if the trust remains an EOT immediately after the change in trustee(s).

This amendment comes into force on January 1, 2024.

Clause 69

Definitions

ITA
256.1(1)

“specified provision”

The definition “specified provision” is relevant in applying the anti-avoidance rules in subsections 256.1(3) and (6), which deem an acquisition of control to occur in certain circumstances.

This definition is amended to add a reference to new subsection 111(5.01), which restricts the extent to which amounts may be included in determining a taxpayer’s cumulative unused excess capacity (as defined in new subsection 18.2(1)) following a loss restriction event. This amendment ensures that the restriction in subsection 111(5.01) is treated similarly to other provisions referred to in this definition.

This amendment applies in respect of taxation years beginning on or after October 1, 2023. However, it also applies in respect of a taxation year that begins before and ends after that date if any of the three immediately preceding taxation years is shorter as a result of a transaction or event or series of transactions or events and it can reasonably be considered that one of the purposes of the transaction, event or series was to defer the application of the EIFEL regime.

Clause 70

Subsections 112(2.01) and 112(2.3) – ordering

ITA
Subsection 260(6.3)

Section 260 sets out rules relating to certain types of securities lending or repurchase transactions. As part of these rules, subsections 260(6.1) and (6.2) allow particular taxpayers to claim a full deduction for dividend compensation payments made under certain arrangements.

Subsection 260(6.1) provides a full deduction for certain payments made under a dividend rental arrangement (as defined in subsection 248(1)) that is described in paragraph (b) of that definition. Similarly, subsection 260(6.2) provides a full deduction for certain payments made under a dividend rental arrangement that is a specified hedging transaction (also as defined in subsection 248(1)).

Under paragraph (b) of both subsections 260(6.1) and (6.2), the amount of the payment that is deductible is generally limited to the amount of dividends received, in respect of the particular dividend rental arrangement referenced above, and that are not deductible because of subsection 112(2.3). However, new subsection 112(2.01) may also deny the dividend received deduction for dividends received by financial institutions on shares that are mark-to-market property. Consequently, in certain circumstances, dividends received by a financial institution in respect of the dividend rental arrangements described in subsections 260(6.1) and (6.2) may not be deductible under both subsections 112(2.01) and (2.3).

Subsection 260(6.3) provides clarity that where an amount of dividends is not deductible under both subsections 112(2.01) and (2.3), that for the purposes of subsections 260(6.1) and (6.2), the amount is deemed to be an amount that was not deductible because of subsection 112(2.3).

Subsection 260(6.3) applies to dividends received after 2023.

Amendments to the Excise Tax Act

Clause 71

Where confidential information may be disclosed

Excise Tax Act
295(5)(d)(xi.1)(A)

Subparagraph 295(5)(d)(xi.1) of the *Excise Tax Act* permits the sharing of confidential information with an official of the Department of Employment and Social Development Canada and the Department of Health for the purpose of administering or enforcing the Canadian Dental Care Plan and with an official of the Department of Health for the evaluation or formulation of policy for the Canadian Dental Care Plan.

Clause 295(5)(d)(xi.1)(A) is amended to also permit the sharing of confidential information with an official of the Department of Public Works and Government Services for the purpose of administering or enforcing the Canadian Dental Care Plan.

This amendment comes into force on royal assent.

Amendments to the Excise Act, 2001

Clause 72

Where confidential information may be disclosed

Excise Act, 2001
211(6)(e)(xii.1)(A)

Subparagraph 211(6)(e)(xii.1) of the *Excise Act, 2001* permits the sharing of confidential information with an official of the Department of Employment and Social Development Canada and the Department of Health for the purpose of administering or enforcing the Canadian Dental Care Plan and with an official of the Department of Health for the evaluation or formulation of policy for the Canadian Dental Care Plan.

Clause 211(6)(e)(xii.1)(A) is amended to also permit the sharing of confidential information with an official of the Department of Public Works and Government Services for the purpose of administering or enforcing the Canadian Dental Care Plan.

This amendment comes into force on royal assent.

Amendments to the Income Tax Regulations (the “Regulations” or “ITR”)

Clause 73

Retirement compensation arrangement

ITR
103(7)

Paragraph 103(7)(a) of the Regulations excludes certain contributions to a retirement compensation arrangement (RCA) from the requirement to withhold and remit a refundable tax in respect of the RCA.

New subparagraph 103(7)(a)(iv) provides that where a contribution is an "excluded contribution" (as defined under subsection 207.5(1) of the Act), there is no withholding on the amount.

This amendment comes into force on March 28, 2023.

Clause 74

Estates and Trusts

ITR
204(3)

Section 204 generally requires that a person receiving income, gains or profits in a fiduciary capacity file an information return in respect of such amounts within 90 days from the end of the taxation year in which the amounts arose.

Paragraph 204(3)(h) is added so that this requirement does not apply to a trust governed by a tax-free first home savings account (FHSA), as these trusts are required to file information returns under the reporting rules in section 219 of the Regulations. If a trust governed by a former FHSA continues to exist after it ceases to be an FHSA, this filing exclusion would no longer apply, subjecting the trust to the ordinary trust return filing requirements of section 204.

This amendment comes into force on April 1, 2023.

Clause 75

Prescribed information returns

ITR
205(3)

Where information returns prescribed in subsection 205(3) are filed late, subsection 162(7.01) of the Act provides for a graduated penalty (the penalty is based on the number of prescribed

information returns of a particular type that are late-filed and the number of days that they are late).

Subsection 205(3) of the Regulations is amended to update "First Home Savings Account Annual Information Return" to “First Home Savings Account Statement” (i.e., the T4FHSA) on the list of prescribed returns for the purposes of subsection 162(7.01).

This amendment comes into force on April 1, 2023.

Clause 76

Electronic Filing

ITR
205.1(1)

Section 205.1 of the Regulations provides that, under certain conditions, an information return must be filed electronically through the Internet.

Subsection 205.1(1) is amended to update "First Home Savings Account Annual Information Return" to “First Home Savings Account Statement” (i.e., the T4FHSA) on the list of prescribed forms that must be electronically filed.

This amendment comes into force on April 1, 2023.

Clause 77

Distribution of Taxpayers Portions of Returns

ITR
209(5)

Subsection 209(5) permits the issuer of certain types of information returns (i.e., slips) to provide a slip to a taxpayer electronically, without having received the taxpayer's express consent to receive it in this format.

Subsection 209(5) is amended to update the name of the "FHSA information return" to “First Home Savings Account Statement (T4FHSA)”.

This amendment comes into force on April 1, 2023.

Clause 78

Prescribed Annuity Contracts

ITR
304(1)

Section 304 prescribes certain annuity contracts for exclusion from the rules in section 12.2 of the Act that require income from life insurance policies to be reported on an accrual basis. Paragraph 304(1)(a) provides an exclusion for annuity contracts purchased pursuant to a registered retirement savings plan (RRSP) or certain other registered plans.

Paragraph 304(1)(a) is amended to extend the exclusion from the accrual rules to annuity contracts issued as an FHSA. This change is implemented by extending the existing reference to include annuity contracts issued as or pursuant to an arrangement described in paragraph 148(1)(b.4) (which excludes FHSA annuity contracts from the rules in subsection 148(1) that require an income inclusion on the disposition of a life insurance policy).

This amendment comes into force on April 1, 2023.

Clause 79

ITR
1100

Section 1100 of the Income Tax Regulations (the "Regulations") is amended to introduce various Capital Cost Allowance (CCA) classes relevant for carbon capture, utilization and storage.

These amendments apply to property acquired after 2021.

ITR
1100(1)

Paragraph 1100(1)(a) of the Regulations provides various declining-balance CCA rates applicable to certain classes of depreciable property. It is amended by adding new subparagraphs 1100(1)(a)(xliii) to (xlvi), which set the general CCA rate for Classes 57 to 60. The rates are 8% (for Class 57), 20% (for Class 58), 100% (for Class 59) and 30% (for Class 60).

ITR
1100(2)

Subsection 1100(2) of the Regulations provides rules for computing the CCA deduction in respect of a property for the year in which the property first becomes available for use.

Subsection 1100(2) has two main parts. The first part, as expressed by elements A and B, relates to the enhanced first year CCA in respect of "accelerated investment incentive property" of a taxpayer, as defined in subsection 1104(4), and property included in Classes 54 and 55, relating to "zero-emission vehicles", as defined in subsection 248(1) of the Act. The second part, as expressed by element C, is the so-called "half-year rule", which applies to any other depreciable property and limits a taxpayer's CCA claim to one-half of the otherwise applicable amount, for the year in which the property first becomes available for use.

Subsection 1100(2) is amended to add a reference to Class 59 in paragraph (a) of element A of the formula in the subsection. Since the CCA rate for Class 59 is already 100%, this amendment excludes property included in Class 59 from being eligible for the enhanced first year CCA.

Clause 80

Interpretation

ITR
4901(2)

"governing plan"

Subsection 4901(2) defines a number of terms that apply for the purposes of Part XLIX (Registered Plans — Investments).

A "governing plan" is defined to include a DPSP, RDSP, RESP, RRIF, RRSP or TFSA. The expression is used in describing conditions that apply to various types of investments that qualify for these plans under subsection 4900(1) of the Regulations.

The definition is amended to add a reference to an FHSA.

This amendment comes into force on April 1, 2023.

Clause 81

Definitions

ITR
5202

"qualified zero-emission technology manufacturing activities"

The definition "qualified zero-emission technology manufacturing activities" in section 5202 of the Regulations describes the activities that may qualify for the zero-emission technology manufacturing deduction. A qualified zero-emission technology manufacturing activity must be a qualified activity performed in connection with the manufacturing or processing of certain property described in clauses (a)(i)(A) to (K) (subject to the restriction in subparagraph (a)(ii)). Alternatively, the activity could be performed in connection with the production of certain gases or fuels described in subparagraphs (b)(i) to (iv), or it could consist of the conversion of a vehicle described in paragraph (c).

Subparagraph (a)(i) is amended to expand the list of eligible property the manufacturing or processing of which may constitute a qualified zero-emission technology manufacturing activity to include the following:

- nuclear energy equipment (clause (L)),
- heavy water used for nuclear energy generation (clause (M)),
- nuclear fuels used for nuclear energy generation (clause (N)), and
- nuclear fuel rods (clause (O)).

Consequential on the amendment to subparagraph (a)(i), clause (a)(i)(I) is amended to ensure manufacturing (or processing) of equipment that is a component of property included in new clauses (L) to (O) may be a qualified zero-emission technology manufacturing activity.

These amendments apply for taxation years that begin after 2023.

Clause 82

Deductible Loss

ITR
5903(5)

Subsection 5903(5) provides for the flow-through of foreign accrual property losses (FAPLs) on certain foreign mergers or liquidations involving foreign affiliates.

Consequential on the introduction of the new excessive interest and financing expenses limitation (EIFEL) regime, subsection 5903(5) is amended to extend its application to new section 18.2. This ensures that, in computing the adjusted taxable income (as defined in new subsection 18.2(1)) of a taxpayer, a foreign merger or liquidation does not prevent the application of certain add-backs in respect of FAPLs of controlled foreign affiliates.

For more information, see the commentary on the definition “adjusted taxable income” in subsection 18.2(1).

This amendment applies in respect of taxation years of foreign affiliates ending in taxation years of taxpayers beginning on or after October 1, 2023. However, it also applies in respect of a taxation year of a foreign affiliate that ends in an earlier taxation year of a taxpayer if any of the three immediately preceding taxation years of the taxpayer is shorter as a result of a transaction or event or series of transactions or events and it can reasonably be considered that one of the purposes of the transaction, event or series was to defer the application of the EIFEL regime.

Clause 83

Interpretation

ITR
5907(1)

Subsection 5907(1) provides definitions for the purposes of Part LIX of the Regulations.

In connection with the introduction of the new excessive interest and financing expenses limitation (EIFEL) regime, the definitions “earnings”, “net earnings” and “net loss” are being amended. The definition “earnings” is also being amended in connection with the introduction of the hybrid mismatch rules in new sections 12.7 and 18.4.

Consequential on the amendments, in connection with the hybrid mismatch rules, to paragraph (a) of variable A and variable H of the definition “foreign accrual property income” in subsection 95(1), and the introduction of new clause 95(2)(f.11)(ii)(F), the definitions “exempt surplus”, “hybrid surplus” and “taxable surplus” are also being amended.

The amendments relating to EIFEL apply in respect of taxation years of foreign affiliates ending in taxation years of taxpayers beginning on or after October 1, 2023. However, they also apply in respect of a taxation year of a foreign affiliate that ends in an earlier taxation year of a taxpayer if any of the three immediately preceding taxation years of the taxpayer is shorter as a result of a transaction or event or series of transactions or events and it can reasonably be considered that one of the reasons for the transaction, event or series was to defer the application of the EIFEL regime.

The amendment to the definition "earnings” that relates to the hybrid mismatch rules applies in respect of payments arising on or after July 1, 2022, and the amendments to the definitions “exempt surplus”, “hybrid surplus” and “taxable surplus” apply in respect of dividends received on or after July 1, 2024.

“earnings”

The definition “earnings” is relevant for the purpose of computing the surpluses and deficits of a foreign affiliate. Subparagraph (a)(iii) of the definition provides that earnings from an active business of a foreign affiliate of a taxpayer resident in Canada for a taxation year means the amount that would be the affiliate’s income from the active business for the year under Part I of the Act if the business were carried on in Canada, the foreign affiliate were resident in Canada and the Act were read without reference to certain of its provisions. That subparagraph applies only where the affiliate is not required by the income tax law of the country in which it is resident, or carries on the business, to compute the income or profits from the active business.

Subparagraph (a)(iii) is amended to add a reference to new subsections 12.7(3), 18.2(2) and 18.4(4) so that, in determining the amount that would be the foreign affiliate’s income from an active business, the Act is to be read without reference to the main operative rule of the new EIFEL regime and the primary and secondary operative rules of the hybrid mismatch rules.

“exempt surplus”

The definition “exempt surplus” is primarily relevant for the purpose of determining the deductibility of dividends received from a foreign affiliate, pursuant to paragraph 113(1)(a) of the Act.

Consequential on the extension of certain of the hybrid mismatch rules to foreign affiliates, subparagraph (iii) of variable A in paragraph (c) of the definition is amended to ensure that a dividend that is received by a foreign affiliate (the "subject affiliate") from another foreign affiliate is not included in the subject affiliate's exempt surplus to the extent that:

- subsection 113(5) of the Act would apply to the dividend if the subject affiliate were a corporation resident in Canada (this will generally be the case where the dividend is deductible for foreign tax purposes); or
- the dividend gives rise to the application of subsection 12.7(3) in computing the foreign accrual property income of a foreign affiliate of a taxpayer.

"hybrid surplus"

The definition "hybrid surplus" is primarily relevant for the purpose of determining the deductibility of dividends received from a foreign affiliate, pursuant to paragraph 113(1)(a.1) of the Act.

Subparagraph (iv) of variable A in paragraph (c) of the definition is amended on a similar basis to the amendment to subparagraph (iii) of variable A in paragraph (c) of the definition "exempt surplus". For more information, see the commentary on the definition "exempt surplus".

"net earnings"

The definition "net earnings" is relevant for the purposes of computing the surpluses and deficits of a foreign affiliate. Paragraph (b) of the definition ensures that the foreign accrual property income (FAPI) of a foreign affiliate is included in computing the affiliate's "taxable earnings" and, ultimately, "taxable surplus" or "taxable deficit".

Paragraph (b) is amended to provide that a controlled foreign affiliate's FAPI for purposes of determining its net earnings is to be determined without regard to the application of new clause 95(2)(f.11)(ii)(D) of the EIFEL rules. This ensures that the affiliate's "taxable earnings" and "taxable surplus" or "taxable deficit" are determined without regard to any of the following:

- a denied deduction under new subclause 95(2)(f.11)(ii)(D)(I) in respect of the affiliate's relevant affiliate interest and financing expenses; and
- a FAPI inclusion under new subclause 95(2)(f.11)(ii)(D)(II) in respect of interest and financing expenses of partnerships of which the affiliate is a member.

For more information, see the commentary on clause 95(2)(f.11)(ii)(D).

"net loss"

The definition "net loss" is relevant for the purposes of computing the surpluses and deficits of a foreign affiliate. Subclause (b)(i)(A)(I) of the definition is amended on a similar basis to the amendment to paragraph (b) of the definition "net earnings", described above. Similarly, where an election is made under new clause 95(2)(f.11)(ii)(E) to, in effect, forgo deductions for interest

and financing expenses that would otherwise have given rise to a foreign accrual property loss, a net loss is determined without regard to that election.

“taxable surplus”

The definition “taxable surplus” is primarily relevant for the purpose of determining the deductibility of dividends received from a foreign affiliate, pursuant to paragraph 113(1)(b) of the Act.

Subparagraph (iii) of variable A in paragraph (c) of the definition is amended on a similar basis to the amendment to subparagraph (iii) of variable A in paragraph (c) of the definition “exempt surplus”. For more information, see the commentary on the definition “exempt surplus”.

Clause 84

Prescribed Non-reporting Financial Institution

ITR
9005

Section 9005 of the Regulations prescribes certain entities for the purposes of the definition “non-reporting financial institution” in subsection 270(1) of the Act.

Section 9005 is amended to add an FHSA to the list of prescribed entities. This amendment ensures that FHSA trusts are considered non-reporting financial institutions for Common Reporting Standards purposes.

This amendment comes into force on April 1, 2023.

Clause 85

Prescribed Excluded Accounts

ITR
9006

Section 9006 of the Regulations prescribes certain accounts for the purposes of the definition “excluded account” in subsection 270(1) of the Act.

Section 9006 is amended to add an FHSA to the list of prescribed accounts. This amendment ensures that FHSAs are considered excluded accounts for Common Reporting Standards purposes.

This amendment comes into force on April 1, 2023.

Clause 86

Schedule II to the Regulations lists the properties that are included in each capital cost allowance (CCA) class. A portion of the capital cost of depreciable property is deductible as CCA each year. CCA rates for each type of property, identified by their CCA classes, are set out in section 1100 of the Regulations.

These amendments are deemed to have come into force on January 1, 2022.

Class 8

ITR
Schedule II

Consequential on the introduction of Classes 57 and 58, the preamble to Class 8 in Schedule II to the Regulations is amended to add references to the new classes. This amendment ensures that a property that is included in Classes 57 or 58 is not included in Class 8.

Clause 87

Class 17

ITR
Schedule II

Consequential on the introduction of Classes 57 and 58, the preamble to Class 17 in Schedule II to the Regulations is amended to add references to the new classes. This amendment ensures that a property that is included in Classes 57 or 58 is not included in Class 17.

Clause 88

Class 41

ITR
Schedule II

Consequential on the introduction of Classes 57 and 58, the preamble to Class 41 in Schedule II to the Regulations is amended to add references to the new classes. This amendment ensures that a property that is included in Classes 57 or 58 is not included in Class 41.

Clause 89

Class 41.1

ITR
Schedule II

Consequential on the introduction of Classes 57 and 58, the preamble to Class 41.1 in Schedule II to the Regulations is amended to add references to the new classes. This amendment ensures that a property that is included in Classes 57 or 58 is not included in Class 41.1.

Clause 90

Class 41.2

ITR
Schedule II

Consequential on the introduction of Classes 57 and 58, the preamble to Class 41.2 in Schedule II to the Regulations is amended to add references to the new classes. This amendment ensures that a property that is included in Classes 57 or 58 is not included in Class 41.2.

Clause 91

Class 43

ITR
Schedule II

Consequential on the introduction of Classes 57 and 58, the preamble to Class 43 in Schedule II to the Regulations is amended to add references to the new classes. This amendment ensures that a property that is included in Classes 57 or 58 is not included in Class 43.

Clause 92

Class 43.1 clause (d)(xviii)(A) and subclause (d)(xviii)(B)(I)

ITR
Schedule II

Subparagraph (d)(xviii) of Class 43.1 describes fixed location energy storage property that is used primarily for the purpose of storing electrical energy. Clause (d)(xviii)(A) and subclause (d)(xviii)(B)(I) are amended to improve readability and to clarify that this property only qualifies as part of Class 43.1 if it both stores and discharges electrical energy. Fixed location energy storage property that discharges thermal energy is not included in the class.

These amendments come into force on Royal Assent.

Class 43.1 subparagraph (d)(xix)

ITR
Schedule II

Subparagraph (d)(xix) of Class 43.1 describes certain pumped hydroelectric energy storage installations that may qualify under that class. The opening words of the subparagraph are amended to clarify that this property only qualifies if it both stores and discharges electrical energy. Accordingly, pumped hydroelectric energy storage installations that discharge thermal energy are not included under this subparagraph.

These amendments come into force on Royal Assent.

Class 43.1 subparagraph (e)(i)

ITR
Schedule II

Subparagraph (e)(i) of Class 43.1 requires that Class 43.1 property must be situated in Canada. Subparagraph (e)(i) is amended to clarify that certain wind and water energy properties, as described in subparagraphs (d)(v) and (d)(xiv) of Class 43.1, are considered to be situated in Canada if they are installed in Canada's exclusive economic zone.

These amendments come into force on Royal Assent.

Clause 93

Class 49

ITR
Schedule II

Consequential on the introduction of Classes 57 and 58, the preamble to Class 49 in Schedule II to the Regulations is amended to add references to the new classes. This amendment ensures that a property that is included in Classes 57 or 58 is not included in Class 49.

Clause 94

Class 53

ITR
Schedule II

Consequential on the introduction of Classes 57 and 58, the preamble to Class 53 in Schedule II to the Regulations is amended to add references to the new classes. This amendment ensures that a property that is included in Classes 57 or 58 is not included in Class 53.

Clause 95

Class 57 to 60

ITR
Schedule II

Class 57 in Schedule II to the Regulations describes certain property that is part of a CCUS project. Generally, such property includes equipment (including ancillary integrated equipment) that is to be used solely for capturing carbon dioxide (other than oxygen production equipment), to prepare or compress captured carbon for transportation, for transporting captured carbon or for storage of captured carbon in a geological formation. For these purposes, captured carbon means carbon dioxide that would otherwise be released into the atmosphere, or is captured directly from the ambient air, and carbon storage does not include storage for the purpose of enhanced oil recovery.

The integrated ancillary equipment must be ancillary equipment that is used solely to support the carbon capture, its preparation for transportation, carbon transportation or carbon storage and in performing its functional duties within a CCUS process as part of a supporting subsystem. The integrated ancillary equipment must be physically and functionally integrated with the equipment that is used to capture, prepare for transport, transport or store carbon. The supporting subsystems are the electrical system, fuel supply system, liquid delivery and distribution system, a cooling system, process material storage and handling and distribution system, process venting system, process waste management system, or utility air or nitrogen distribution system.

Class 57 also includes water supply equipment and equipment that generates or distributes electrical energy or heat energy or a combination of electrical and heat energy (the “energy generation and distribution equipment”).

The water supply equipment delivers, collects, recovers, treats or recirculates water, or a combination of any of those activities, that solely supports a qualified CCUS project.

The energy generation and distribution equipment is only included in Class 57 if it directly and solely supports a qualified CCUS project. If the energy generation and distribution equipment uses fossil fuels, it must not emit carbon dioxide that is not subject to capture by a qualified CCUS project. . Class 57 also includes transmission equipment that transmits electrical energy generated by the energy generation and distribution equipment that directly and solely supports a qualified CCUS project. For greater certainty, the energy generation and distribution equipment does not include equipment that supports the qualified CCUS project indirectly by way of an electrical utility grid, or distribution equipment that expands the capacity of existing distribution equipment that supports the qualified CCUS project.

In addition, Class 57 includes control, monitoring and safety system equipment. The control, monitoring and safety system is equipment that is acquired for system safety or integrity or is used as part of a control, monitoring or safety system solely to support the carbon capture, transportation or storage equipment, integrated ancillary equipment, or the energy generation and distribution equipment. However, for greater certainty neither the control, monitoring and safety system equipment nor the integrated ancillary equipment includes construction equipment, all or part of any furniture, office equipment or vehicles.

A building or other structure all or substantially all of which is used, or to be used, for the installation or operation of equipment that is to be used solely for capturing, transporting or storing carbon dioxide, integrated ancillary equipment, energy generation and distribution equipment or the control, monitoring and safety system equipment is also included in Class 57.

In addition, property that is used solely to convert another property so that the converted property could be used for capturing carbon dioxide, for transporting captured carbon, for storage of captured carbon in a geological formation, as integrated ancillary equipment, as energy generation and distribution equipment or as control, monitoring and safety system equipment is also included in Class 57. Class 57 also includes property used to refurbish other Class 57 property.

However, Class 57 does not include equipment that is required for hydrogen production, natural gas processing or acid gas injection, even if such equipment is part of a CCUS project.

Class 57 is relevant for determining whether property is eligible for CCUS tax credit under section 127.44 of the Act. Expenditures (referred to as the qualified CCUS expenditure in subsection 127.44(1) of the Act) for certain type of properties included in Class 57 could qualify for investment tax credits of up to 60%. For further details, refer to commentary accompanying the definitions of these different types of qualified CCUS expenditures in new subsection 127.44(1) of the Act.

Class 57 is eligible for an 8 per cent CCA rate and is deemed to have come into force on January 1, 2022.

Class 58

ITR
Schedule II

Class 58 in Schedule II to the Regulations describes certain property that is part of a CCUS project. Such property includes equipment that is used solely for using carbon dioxide in industrial production (including integrated ancillary equipment). For the purposes of Class 58, industrial production includes carbon dioxide storage for enhanced oil recovery.

The integrated ancillary equipment must be ancillary equipment that is used solely to support equipment that is used solely for using carbon dioxide in an industrial production in performing its functional duties within a CCUS process as part of a supporting subsystem. The ancillary equipment must be physically and functionally integrated with the equipment that is used solely for using carbon dioxide in industrial production. The supporting subsystems are the electrical system, fuel supply system, liquid delivery and distribution system, a cooling system, process material storage and handling and distribution system, process venting system, process waste management system, or utility air or nitrogen distribution system.

In addition, Class 58 includes control, monitoring and safety system equipment. The control, monitoring and safety system is equipment that is used as part of a control, monitoring or safety system that is used solely to support equipment for using carbon dioxide in an industrial production or to support the integrated ancillary equipment. However, for greater certainty neither the control, monitoring and safety system equipment nor the integrated ancillary equipment includes construction equipment, all or part of any furniture, office equipment or vehicles.

Class 58 also includes a building or other structure all or substantially all of which is used, or to be used, for the installation or operation of equipment for using carbon dioxide in industrial production, the integrated ancillary equipment or the control, monitoring and safety system equipment.

In addition, property that is refurbished property or property used solely to convert another property (that is not part of taxpayer's own CCUS project) so that the converted property could be used for using carbon dioxide in industrial production, as integrated ancillary equipment or as control, monitoring and safety system equipment is also included in Class 58.

Class 58 is relevant for determining whether property is eligible for the CCUS tax credit under section 127.44 of the Act. Expenditures for certain properties included in Class 58 (referred to as qualified carbon use expenditures in new subsection 127.44(1) of the Act) could qualify for an investment tax credit of 37 ½% (for expenditures incurred after 2021 and before 2031) or 18 ¾% (for expenditures incurred after 2030 and before 2041).

Class 58 is eligible for a 20 per cent CCA rate and is deemed to have come into force on January 1, 2022.

Class 59

ITR
Schedule II

Class 59 in Schedule II to the Regulations provides for a 100 per cent CCA rate and includes intangible property that is acquired for the purpose of determining the existence, location, extent or quality of a geological formation to permanently store captured carbon in Canada.

Class 59 also includes intangible property acquired as a result of undertaking environmental studies or community consultations (including studies or consultations that are undertaken to obtain a right, license or privilege for the purpose of determining the existence, location, extent or quality of a geological formation to permanently store captured carbon). Class 59 includes property deemed to have been acquired under subsection 13(7.6) of the Act that is not included in any other class. However, Class 59 does not include property acquired for the purpose of drilling or completing an oil or gas well or for building a temporary access road to, or preparing a site in respect of, any such well. Class 59 also excludes property that is acquired for the purpose of storing captured carbon in a geological formation to support enhanced oil recovery.

Class 59 is deemed to have come into force on January 1, 2022, and applies to property acquired after 2021 that is included in the class.

Class 60

ITR
Schedule II

Class 60 includes intangible property, not included in any other class, that is acquired for the purposes of drilling or converting a well in Canada for the permanent storage of captured carbon, including intangible property acquired for the purpose of monitoring pressure changes or other phenomena in captured carbon permanently stored in a geological formation. In addition, the class includes intangible property acquired for building a temporary access road to the well or preparing a site in respect of the well that is to be used for carbon storage.

Class 60 also includes the cost of intangible property that is a right, license or privilege to determine the existence, location, extent or quality of a geological formation to permanently store captured carbon in a dedicated geological storage. Class 60 includes property deemed to have been acquired under subsection 13(7.6) of the Act that is not included in any other class. However, for the purposes of Class 60, a well does not include a well that could also be used for enhanced oil recovery.

Class 60 is deemed to have come into force on January 1, 2022, and only applies to property acquired after 2021 that is included in the class.