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Canadian federal government releases significant draft tax legislation

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On August 12, 2024, the Canadian federal government released several packages of draft legislation to implement various tax measures, update certain previously released draft legislation, and make certain technical changes (August 12 Proposals). The August 12 Proposals include measures first announced in the 2024 Federal Budget (Budget 2024), as well as updated versions of draft legislation released in Budget 2024 and earlier. The news release that accompanied the August 12 Proposals invites Canadians to make submissions with respect to most of the measures by September 11, 2024 (September 3, 2024 for the capital gains inclusion rate and lifetime capital gains exemption amendments).

The August 12 Proposals cover a wide variety of measures, many of which are addressed in this Update. The tax changes relating to green economy initiatives will be addressed in a separate Update.

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Capital gains inclusion rate

Budget 2024 proposed to increase the capital gains inclusion rate from one half (50%) to two thirds (66 2/3%) for corporations and trusts, and to increase the rate for individuals to two thirds for capital gains exceeding $250,000 in a taxation year (net of certain amounts).

On June 11, 2024, the House of Commons voted to approve a Notice of Ways and Means Motion (NWMM) that set out the amendments to the *Income Tax Act* (Canada) (ITA) to implement the proposed increase.

The August 12 Proposals include revisions to the NWMM version of the amendments. The Department of Finance also published explanatory notes for all the amendments required to implement the capital gains inclusion rate increase.

Capital dividend account

The capital dividend account (CDA) is a notional account that tracks the non-taxable portion of capital gains net of the non-allowable portion of capital losses realized by private corporations. CDA is an important tax attribute for private corporations because any positive balance of CDA can generally be used to make tax-free distributions to Canadian-resident shareholders by designating such distributions as “capital dividends”.

The proposed amendments to the capital gains inclusion rate impact the calculation of CDA because the non-taxable portion of capital gains and non-allowable portion of capital losses realized by private corporations is now one-third (as opposed to one-half.

As explained in our Osler Update dated June 19, 2024, the draft legislation provides specific rules on how the inclusion rate will be calculated for taxation years that include both June 24 and 25, 2024 (transitional years). In general, a transitional year will be subject to an inclusion rate between the previous 50% rate and the new 66 2/3% rate depending on the timing and quantum of dispositions in the transitional year. In other words, a transitional year will be subject to a “blended” inclusion rate between 50% and 66 2/3%, which is generally intended to provide taxpayers with an appropriate overall inclusion for the transitional year based on whether dispositions occurred before or after June 25, 2024.

However, the “blended rate” applicable to transitional years created issues relating to the calculation of CDA because it was impossible to determine the “blended rate” until the end of the transitional year, whereas the calculation of the CDA balance is a “point in time” test that can be relevant at any time in the year. This situation created uncertainty for taxpayers that may have, for example, realized capital gains prior to June 25, 2024, and subsequently made distributions (or intended to make distributions) by paying capital dividends equal to 50% (i.e. the non-taxable portion) of that gain prior to the end of the transitional year. If the “blended rate” for the transitional year was subsequently determined to be higher than 50%, then the non-taxable portion of that gain would be less than 50%, resulting in the taxpayer potentially having made an excessive designation of CDA (which could have been subject to a punitive tax).

The August 12 Proposals address this issue. The explanatory notes acknowledge that “a corporation can only determine its inclusion rate in the transition year after the year ends. This timing consideration may be incompatible with the computation of the CDA balance, which is determined at any time in the year to establish the amount of dividends that the corporation can elect to pay as tax-free capital dividends”.

New paragraph 89(1.4)(a) addresses this timing issue by deeming, for purposes of the computation of CDA, a corporation's taxable capital gain or allowable capital loss from the disposition of property in a transitional year to be

a. if the disposition occurred before June 25, 2024, one-half, or

b. if the disposition occurred after June 24, 2024, two-thirds.

In other words, for purposes of calculating CDA in a transitional year, each disposition is subject to *either* the previous one-half inclusion rate *or* the new two-thirds inclusion rate, depending on when the disposition occurred, as opposed to the blended rate that otherwise generally applies to transitional years (other than for the purposes of calculating CDA) and is generally only determinable at the end of the transitional year.

The August 12 Proposals also include other computational rules that are intended to (i) prevent an overstatement or understatement of CDA because of the difference between the inclusion rate applied under new paragraph 89(1.4)(a) and the inclusion rate that otherwise applies and is determined at the end of the transitional year, and (ii) ensure that capital losses carried back or forward between taxation years with different inclusion rates are appropriately reflected in CDA.

Hybrid surplus

Under existing rules, Canadian-resident corporations can deduct certain portions of dividends received from their foreign affiliates depending on whether such dividends are prescribed by the *Income Tax Regulations* to be paid out of the affiliate's exempt surplus, hybrid surplus, taxable surplus, or pre-acquisition surplus, or if certain taxes were paid in respect of such dividends. Hybrid surplus (and hybrid deficit) generally reflect, among other things, capital gains and losses realized by foreign affiliates from dispositions of shares of other foreign affiliates and partnership interests that are excluded property, as well as dividends received from other affiliates that were paid out of the hybrid surplus of such other affiliates.

The August 12 Proposals bifurcate "hybrid surplus" into two separate surplus pools, being "legacy hybrid surplus" and "successor hybrid surplus". Dividends paid out of these two surplus pools receive different treatment in the hands of the Canadian recipient. Hybrid surplus dividends would first be treated as paid out of an affiliate's legacy hybrid surplus (to the extent of its legacy hybrid surplus balance), with the remainder treated as paid out of the affiliate's successor hybrid surplus.

Generally, the calculation of "legacy hybrid surplus" takes into account only capital gains and capital losses from dispositions occurring before June 25, 2024, dividends paid before June 25, 2024, and dividends paid out of the legacy hybrid surplus of a foreign affiliate. On the other hand, the calculation of "successor hybrid surplus" takes into account only capital gains and capital losses from dispositions occurring after June 24, 2024 and dividends paid out of the successor hybrid surplus of a foreign affiliate. Taxpayers must separately track the taxes applicable to the legacy hybrid surplus and successor hybrid surplus of their foreign affiliates.

Dividends paid out of legacy hybrid surplus (reflecting capital gains that should be subject to the 50% inclusion rate) receive the same treatment as is currently available for dividends paid out of hybrid surplus, i.e.one-half of such dividends are deductible, along with a deduction in respect of hybrid underlying taxes applicable to such dividends. On the other hand, for dividends paid out of successor hybrid surplus (reflecting capital gains that should be subject to the 66 2/3% inclusion rate), only one-third of such dividends are deductible, along with a deduction in respect of hybrid underlying taxes applicable to such dividends.

As noted in the prior Osler Update dated June 19, 2024, these amendments are intended to ensure that the deduction available to Canadian-resident corporations in respect of hybrid surplus dividends paid by foreign affiliates reflects the capital gains inclusion rate in effect at the time of the underlying disposition that created the hybrid surplus, regardless of when the hybrid surplus dividends are paid or received. Conforming changes have also been proposed for other rules impacting foreign affiliates, including for purposes of determining whether the amount of an upstream loan from a foreign affiliate is supported by sufficient underlying surplus balances.

Unfortunately, these proposals (together with the new FABI regime referred to below) add even more complexity to an already over-complicated foreign affiliate regime, rather than following the approach adopted by many European and other countries to simply provide a broad participation exemption applicable to dividends received from foreign affiliates. It is hoped that with the introduction of the *Global Minimum Tax Act* and other new measures Canada will, at some point, provide much needed reform to simplify its patchwork of international tax rules that have been introduced over the past decades. Doing so could reduce administrative and compliance costs and encourage cross-border investment with Canadians.

Global Minimum Tax Act

The August 12 Proposals include amendments to the *Global Minimum Tax Act* (GMTA) and the *Income Tax Conventions Interpretation Act*.

The GMTA was enacted into law on June 20, 2024 and is Canada's version of Pillar Two, which is part of the OECD's two-pillar initiative to reform the international tax system. As enacted, the GMTA includes two tax measures: a 15% top-up tax under the income inclusion rule (IIR) and a 15% qualified domestic minimum top-up tax (QDMTT). The enacted GMTA closely followed the OECD's global anti-base erosion (GloBE) model rules and three sets of administrative guidance that were released before 2024, but did not include the third tax measure set out in the GloBE model rules — the undertaxed profits rule (UTPR). Each of the IIR and QDMTT apply to taxation years beginning on or after December 31, 2023.

The August 12 Proposals include the following important changes to the GMTA to implement the UTPR, the transitional UTPR safe harbour, and certain elements of the OECD's fourth set of administrative guidance released on June 17, 2024 (Fourth AG):

1. UTPR: New Part 2.1 of the GMTA sets out the UTPR rules, which is intended to serve as a back-stop rule for the other two measures (i.e., the IIR and the QDMTT). The UTPR rules set out a formulaic approach to determine the total UTPR top-up amount, Canadian top-up amount, and UTPR top-up amount of constituent entities located in Canada. An exclusion from the payment of the UTPR top-up amount is available for the initial phase of international activity. The UTPR rules (including the UTPR safe harbour election referred to below) are proposed to apply to fiscal years of qualifying MNE groups that begin on or after December 31, 2024. This timing is in line with the previous announcements of the federal government in respect of the introduction of the UTPR in Canada.
2. UTPR safe harbour election: this transitional measure deems the top-up tax of the relevant entities located in the jurisdiction where the ultimate parent entity (UPE) of the MNE group

is located (UPE jurisdiction) to be nil, provided that all of the following apply

- an election for the UPE jurisdiction is made
- the corporate income tax rate of the UPE jurisdiction is 20% or more
- the fiscal year begins before January 1, 2026 and ends before December 31, 2026

The transitional UTPR safe harbour should allow additional time before the UTPR would otherwise come into effect in respect of countries that have not otherwise adopted qualifying Pillar 2 rules (most notably the United States). In particular, the UTPR (together with similar rules in other countries) could otherwise allow Canada and other countries to tax certain low-tax income of U.S. companies and their foreign subsidiaries. Not surprisingly, this prospect has led to certain proposed retaliatory measures that the U.S. could enact against Canada or other countries that seek to tax such income.

3. Securitization entities: The Fourth AG gave countries the option to exclude "securitization entities" from their QDMTT without losing their QDMTT safe harbour status. Canada has opted to implement this exclusion by introducing a new definition of "securitization entity" (which reflects the definition of the same term in the Fourth AG), and amending certain other provisions of the GMTA to provide that (1) a QDMTT is not payable by (or in respect of) a constituent entity that is a securitization entity, and (2) a securitization entity is neither assessable nor liable in respect of a QDMTT. Due to the QDMTT carve out in Canada, the OECD's switch off rule applies and income of Canadian securitization entities could potentially be subject to a top-up tax under the IIR and, potentially, the UTPR in other jurisdictions. The proposed amendments are generally set to apply to fiscal years of qualifying MNE groups that began on or after December 31, 2023.
4. Flow-through entities: The definition of "reverse hybrid entity" is repealed, and subsection 17(6) of the GMTA (Financial accounting income — flow-through entity), the only GMTA provision where the repealed term was used, is amended to account for the deletion and to reflect the Fourth AG's approach to flow-through entities for GloBE purposes. The proposed amendments are set to apply to fiscal years of qualifying MNE groups that began on or after December 31, 2023.
5. Deferred tax assets: Transition rules in paragraph 48(5)(b) of the GMTA are amended to reflect the fourth administrative guidance on deferred tax assets in connection with asset transfers before the GloBE transition year (generally, the first year the MNE group of a constituent entity is subject to a qualified QDMTT, IIR or UTPR in the constituent entity's jurisdiction). The amendments provide that a deferred tax asset is deemed to exist for GMTA purposes even if no such deferred tax asset would arise, or would arise in a different amount, under the relevant accounting standard, and includes a deferred tax asset of the transferor (or the entity that pays taxes in respect of the transferor under a group taxation regime) that is demonstrated to have been reversed or not created solely because any gain arising on the transfer was included in the domestic taxable income of the transferor. New subsection 48(5.1) is added to implement guidance in the Fourth AG

that the creation of a deferred tax asset under paragraph 48(5)(b)(ii) shall not reduce the adjusted covered taxes of any constituent entity. The proposed amendments are set to apply to fiscal years that begin on or after December 31, 2023.

Although the August 12 Proposals propose to implement certain elements of the Fourth AG, many important simplification measures, guiding principles and approaches in the Fourth AG are not reflected in the August 12 Proposals, including an unclaimed accrual five-year election. More amendments to the recently enacted GMTA may follow.

In addition to the GMTA's amendments, the August 12 Proposals introduce amendments to the *Income Tax Conventions Interpretation Act* to provide that the application of the GMTA in Canada is not affected by Canada's double tax treaties, and that Canada is not required to provide relief for tax imposed under similar laws in other jurisdictions. These amendments are deemed to have come into force on January 1, 2024. Importantly, these changes allow Canada's UTPR to specifically override Canada's prior bilateral tax treaty obligations. Many commentators have observed that without such a treaty override the application of the UTPR could otherwise have been restricted.

Synthetic equity arrangements

Intercorporate dividends paid by a taxable Canadian corporation to a Canadian resident corporation are generally received tax-free under the ITA. This important principle ensures that corporate income is not taxed more than once. Exceptions to this principle take the form of highly targeted anti-avoidance rules intended to address specific transactions that have been identified over time. The proposed changes to the "synthetic equity arrangement" rules found in the August 12 Proposals reflect an incremental expansion of these anti-avoidance rules, including to transactions not identified in Budget 2024.

Budget 2024 announced an intention to eliminate two exceptions from the application of the paragraph (c) "synthetic equity arrangement" branch of the "dividend rental arrangement" anti-avoidance rule, pursuant to which a dividend received deduction may be denied to a corporate taxpayer in respect of a particular share (called the DRA share), generally where the taxpayer provides under an agreement or arrangement all or substantially all of the risk of loss and opportunity for gain or profit in respect of the DRA share to a counterparty. The ITA currently excepts from this rule an agreement that is traded on a recognized derivatives exchange, and a "synthetic equity arrangement" where a taxpayer establishes that the counterparty is not a "tax-indifferent investor" (generally, exempt from tax or a non-resident of Canada).

The August 12 Proposals contain draft legislative measures apparently intended to implement the Budget 2024 "synthetic equity arrangement" proposals. As part of these measures, the paragraph (d) branch of the "dividend rental arrangement" anti-avoidance rule would also be eliminated. Paragraph (d) applies in cases where the paragraph (c) "synthetic equity arrangement" branch does not. Under paragraph (d), a person must enter into one or more agreements or arrangements that have the effect of eliminating all or substantially all of the person's risk of loss and opportunity for gain or profit in respect of a DRA share of the person and, as part of a series of transactions, a tax-indifferent investor must obtain all or substantially all of the risk of loss and opportunity for gain or profit in respect of the DRA share. It must be reasonable to conclude that one of the purposes of the series of transactions was to obtain this result.

Budget 2024 identified the target of the proposed amendments to the "synthetic equity arrangement" rules to be "agreements that provide all or substantially all of the risk of loss and opportunity for gain and profit (the 'economic exposure') in respect of a share to another person". However, the August 12 Proposals omits the condition that such economic exposure be provided to anyone.

In particular, the requirement that a taxpayer "provide" all or substantially all of the risk of loss and opportunity for gain or profit in respect of the DRA share to a counterparty under the current "synthetic equity arrangement" rule, would be changed under the August 12 Proposals to import in part the paragraph (d) concept that the agreement or arrangement have the effect of "eliminating" the taxpayer's risk of loss and opportunity for gain or profit in respect of the DRA share. However, the August 12 Proposals would apply where a taxpayer eliminates its risk of loss and opportunity for gain or profit with respect to a DRA share, regardless of whether it provides such risk and opportunity to a counterparty, or (as is the case with the existing paragraph (d) rule) a counterparty obtains such risk and opportunity. This substantive change was not announced as part of Budget 2024 and addresses a fact pattern not identified therein.

These proposals would apply to dividends received after 2024.

Trust reporting

The August 12 Proposals contain amendments to the trust reporting rules that seek to reduce the number of bare trusts affected by the trust reporting requirements. Although the existing reporting rules apply to bare trusts with taxation years ending after December 30, 2023, the Canada Revenue Agency (CRA) administratively suspended the trust reporting obligations for the 2023 tax year just days before the April 2, 2024 reporting deadline.

In addition to proposing to modify the trust reporting rules, the August 12 Proposals propose to repeal the existing rules for years ending after December 30, 2024. Combined with the CRA's administrative suspension for the 2023 taxation year, this means the old rules will not apply in most circumstances. The new rules apply to taxation years ending after December 30, 2025. Since most trusts have a December 31 year-end, this means that, under the new rules, the 2025 taxation year of affected trusts will be the first year for which reporting will be required.

The Department of Finance stated that it is "[c]larifying bare trust reporting rules to significantly reduce the number of Canadians with bare trusts who would have to file, and ease the related administrative burden."

Among those not required to report are partnerships holding property through a general partner, which already file certain partnership returns that would contain much of the same information.

Relief is also granted to public companies in the oil and gas and mining sectors that may utilize certain nominee or bare trust arrangements to hold "Canadian resource property", which is generally oil and gas properties and mineral resource properties, other than bituminous sands deposits or oil shale deposits. This measure falls short of what industry advocated, as Canadian resource property does not include tangible assets, and the relief does not extend to non-public corporations, which will still face significant compliance burdens as a result of these rules.

Changes to the bare trust reporting rules

The current bare trust reporting rules in the ITA, which were enacted in 2022, impose a reporting obligation on (i) "express trusts" and (ii) for civil law purposes, a trust that is not established by law or by judgment (referred to here as a “civil law trust”), in each case other than those trusts that are specifically exempted from reporting. The August 12 Proposals replace the existing scheme with a more targeted approach by both adding new exceptions and broadening some existing exceptions to the reporting obligation for express trusts and civil law trusts.

The August 12 Proposals aim for greater clarity by more clearly connecting the concept of a bare trust to the previously undefined concept of an express trust, by deeming an “express trust” to include an arrangement in which one or more persons (referred to as the “legal owner”) hold legal title to property for the benefit of another person or partnership, and that legal owner can reasonably be considered to act as agent for the persons or partnerships. This does not appear to be a substantive change, as the existing rules already generally covered such arrangements, though with less precise wording. Moreover, no part of the August 12 Proposals seems to change the applicability of the trust reporting rules to Québec *prête-nom* arrangements.

Additional reporting relief

More significantly, the August 12 Proposals expand the list of trusts that are exempted from trust reporting. It contains new exemptions applicable to trusts that are express trusts or civil law trusts where the trust holds

- property solely for the benefit of a partnership throughout the year, and each legal owner is a partner (excluding limited partners) — such that, for example, where a general partner of a limited partnership is a legal owner of partnership property it will be clear that there is no trust reporting obligation
- property that is real estate that qualifies as a principal residence under section 54, and is held for related individuals or the spouse or common-law spouse of the legal owner
- Canadian resource property held solely for the benefit of publicly-listed corporations, a corporation they control, and certain partnerships of the publicly-listed corporations
- property pursuant to a court order
- funds received from the Crown, where the legal owner(s) are tax-exempt entities described under subsection 149(1), and the property is used exclusively for the benefit of tax-exempt entities described under subsection 149(1)

The August 12 Proposals also broaden the existing exceptions to the trust reporting rules. First, trusts holding assets with a fair market value of less than $50,000 are now unconditionally exempted, regardless of the nature of the assets they own. Secondly, trusts with individuals as trustees where each beneficiary is an individual related to each trustee are exempted from the trust reporting rules if the fair market value of the trust’s assets does not exceed $250,000, and the assets are limited to certain types of assets including money, GICs, certain debt obligations, shares listed on a designated stock exchange, and personal-use property of the trust. A trust with corporate beneficiaries, as is the case for most family discretionary trusts, would not qualify for this exemption.

Finally, trusts required to hold funds under rules of professional conduct, or the laws of Canada or a province, are already exempted if the trust is not maintained as a separate trust for a particular client; the August 12 Proposals add that they are also exempt if their assets consist only of money not exceeding $250,000 throughout the year. Finally, a new exception applies to trusts established to comply with the laws of Canada or a province that require a person to act as the trustee of a trust for specified purposes.

Anti-deferral rule for CCPCs and substantive CCPCs with CFAs

In the 2022 federal budget (Budget 2022), Finance proposed two measures targeting perceived tax-deferral strategies used by Canadian-controlled private corporations (CCPCs) and their shareholders earning investment income and realizing capital gains; draft legislation for both measures was subsequently released in August 2022. The first measure introduced the concept of a "substantive CCPC"; that measure was included in Bill C-59, which received royal assent on June 20, 2024. The second measure was purportedly targeted at CCPCs and their shareholders that earn "highly-mobile" investment income through controlled foreign affiliates (CFAs). For Osler's coverage of both Budget 2022 proposed measures, see our Federal budget briefing 2022 and August 2022 update.

The second CFA measure in Budget 2022 was widely criticized as being overly broad and Finance indicated that it would reconsider the proposed approach. The August 12 Proposals include a revised version of the CFA proposals that provides a narrow carve-out for certain types of services and real estate businesses, but only on an elective basis.

Budget 2022 proposal

Under existing rules in the ITA, where a Canadian corporate taxpayer has a CFA that pays foreign tax at a rate of 25% or greater on income that constitutes "foreign accrual property income" (FAPI) and is included in the Canadian corporate taxpayer's Canadian income, the Canadian corporate taxpayer benefits from a deduction in respect of such foreign tax that fully offsets the taxpayer's corresponding FAPI inclusion. In contrast, individual taxpayers must pay foreign tax at a rate of 52.63% or greater to fully offset the individual's FAPI inclusion.

The availability of the full deduction for corporate taxpayers that pay foreign tax at a rate of 25% or greater allows CCPCs and their individual shareholders to defer taxes on passive investment income earned through CFAs because such passive investment income would have been taxed at a higher rate if it were earned directly by the CCPC in Canada. Certain amounts in respect of FAPI are also included in the general rate income pool (GRIP) of CCPCs. The GRIP inclusions entitle CCPCs to distribute FAPI as eligible dividends, which are subject to a lower tax rate at the shareholder level.

Budget 2022 proposed to eliminate a perceived tax-deferral advantage available to CCPCs and their shareholders earning investment income through CFAs by effectively reducing the deduction in respect of foreign tax paid by the CFA mainly through an amendment to the definition of "relevant tax factor" in subsection 95(1). As a result, if a CFA is subject to foreign tax at a rate lower than 52.63%, the corresponding FAPI inclusion would not be fully offset.

Related amendments were proposed to address the integration of FAPI once repatriated to and distributed by CCPCs and substantive CCPCs to individual shareholders by

a. removing certain deductions from the GRIP of a CCPC made in respect of (i) repatriations of a foreign affiliate's hybrid surplus and taxable surplus and (ii) the payment of withholding tax on inter-corporate dividends paid out of taxable surplus

b. including in the capital dividend account of a CCPC on repatriation of (i) the amount of an inter-corporate dividend deduction claimed with respect to a dividend paid out of hybrid surplus less the amount of withholding tax paid with respect to the dividend (ii) the amount of an inter-corporate dividend deduction claimed with respect to a dividend paid out of taxable surplus and (iii) the amount of a withholding tax deduction claimed less the withholding tax paid in respect of repatriations of taxable surplus.

The Budget 2022 proposed measures were to apply to taxation years that began on or after April 6, 2022. However, the Budget 2022 measures were widely criticized as applying to FAPI derived from all sources — including businesses carried on by CFAs with material links to the foreign jurisdictions where the CFA was resident or operating — rather than merely to FAPI derived from the passive investment income that arguably could have been earned by the CCPC (or substantive CCPC) directly rather than through the CFA.

August 12 proposals

The most significant difference between the August 12 Proposals and the August 2022 draft legislation in respect of the Budget 2022 measures is the August 12 Proposals provide a relatively narrow carve-out in proposed section 93.4 for "foreign accrual business income" (or FABI) of a foreign affiliate. In general terms, FABI is defined to include FAPI taking into consideration only amounts in respect of

a. the provision by the affiliate of certain types of services, the income from which is included in computing the affiliate's FAPI because of the recharacterization rule in subparagraph 95(2)(b)(i) (with some modifications) and

b. the affiliate's "investment business" (as defined in subsection 95(1)) that is the development of real property or immovables for sale, or the leasing of real property or immovables, where the business would have met the more than five full-time employees and equivalents condition in subparagraph (c)(ii) of the investment business definition exception if services provided by employees of related corporations or other designated entities both *inside and outside Canada* were counted.

This carveout will only apply if an election is made under proposed subsection 93.4(2).

If a CCPC (or substantive CCPC) elects for the FABI carveout to apply and the CFA pays foreign tax of at least 25% in respect of the FABI, then the deduction under subsection 91(4) should fully offset the FABI portion of the FAPI included in income under subsection 91(1).

The August 12 Proposals also introduce a FABI carveout for purposes of computing deductions under paragraphs 113(1)(b) and (c) for taxable surplus dividends in respect of FABI and introduce yet another surplus account, "FABI surplus", with a corresponding concept of "underlying FABI surplus tax".

Similar to the Budget 2022 proposals, most of the August 12 Proposals for this measure apply to taxation years that begin on or after April 7, 2022. The August 12 Proposals contain certain deemed election provisions for pre-2025 years.

While any carveout is a welcome change, the FABI carveout is relatively narrow and does not provide relief for many CCPCs (and substantive CCPCs) with CFAs engaged in FAPI-earning businesses with material commercial ties to foreign jurisdictions or commercial or regulatory reasons to be carried on through a foreign corporation, and that are already subject to a high rate of foreign tax. Further, the proposals introduce yet another level of complexity to the taxation of CCPCs and to the foreign affiliate regime — which in its existing form is already one of the most complex set of rules in the ITA.

EIFEL

The excessive interest and financing expenses limitation (EIFEL) rules generally apply to restrict the deductibility of certain net interest and financing expenses where the amount of such expenses exceeds 30% of tax EBITDA (as computed under the rules). The definition of "exempt interest and financing expenses" (EIFE) is relevant for purposes of providing an exemption for certain types of interest and financing expenses (IFE) from the EIFEL rules. Currently, only specified IFE incurred in respect of the financing of certain Canadian public-private partnership (P3) projects are exempt under the EIFE definition.

The August 12 Proposals add two types of IFE to the EIFE definition

1. regulated energy utility business: IFE paid directly or indirectly to an arm's length person for a borrowing used to earn income from a "regulated energy utility business"
    a. "regulated energy utility business" is defined as a business carried on by a person or partnership to produce, generate, store, transmit, distribute, sell, deliver or provide electricity, natural gas or steam, or any other input to produce light, heat, cold or energy, on the condition that the prices of the business's products or services are either established or approved by a government entity
    b. all or substantially all of the taxpayer or partnership's property must be (1) used or held to earn income from their regulated energy utility business and (2) located in Canada
    c. this exemption must be elected into for the year or a prior year (such that once an election is made it also applies to later years)
2. purpose-built residential rental: IFE paid directly or indirectly to an arm's length person for a borrowing used to earn income from a "purpose-built residential rental"
    a. "purpose-built residential rental" is defined as all or part of a building located in Canada that either have (1) at least four residential rental units that have private kitchen, bathroom, and living areas or (2) at least 10 residential rental units, and all or substantially all of the residential rental units are rented for at least 28 consecutive days
        i. the "residential rental units" definition specifies that it does not include housing units provided to travelers or vacationers
    b. the borrowing must be used to buy, build, or convert a purpose-built residential rental owned by the taxpayer or partnership
    c. this exemption is only available for IFE paid or payable before 2036 and must be elected into on a yearly basis

The amendments are proposed to be effective back to the original effective date of the EIFEL rules, namely taxation years beginning on or after October 1, 2023.

Application of hybrid mismatch rules to foreign affiliates

The August 12 Proposals address concerns with the application of the hybrid mismatch rules to foreign affiliates. The proposed changes adjust inclusions to foreign accrual property income (FAPI) and prevent instances of double taxation that could arise from inter-affiliate dividends within the same country.

Historically, a dividend received by a foreign affiliate from another foreign affiliate was not included in computing FAPI of the recipient affiliate.

The initial draft of the hybrid mismatch rules released in April 2022 did not address whether the proposed rules would apply in the context of transactions (including dividends) involving foreign affiliates of taxpayers resident in Canada. Bill C-59 amended the relevant variables in the definition of FAPI to include any portion of an inter-affiliate dividend that would have been denied under subsection 113(5) if the recipient affiliate had been a corporation resident in Canada. The August 12 Proposals provide relief for dividends received by a foreign affiliate from another foreign affiliate resident in the same country. Under the August 12 Proposals, such dividends continue to be excluded from the computation of FAPI under the amendments to paragraph (b) of the description of A in the FAPI definition in subsection 95(1).

For dividends from a foreign affiliate resident in one country to an affiliate resident in another country, the amendments provide that only the portion of the dividend that exceeds any deduction/non-inclusion mismatch will be excluded from FAPI. This change means that where a cross-border dividend is paid in the foreign affiliate context, the dividend will be included in FAPI to the extent of any deduction/non-inclusion mismatch. For example, where a dividend is deductible by the payor and not included in the income of recipient, the amount of the dividend may be included in computing the recipient's FAPI.

Withholding taxes paid on inter-affiliate dividends that are included in FAPI generally should be included in computing foreign accrual tax (FAT), providing relief similar to the mechanism in subsection 113(6) for purposes of applying subsection 113(5) in the domestic context.

These amendments are proposed to be effective July 1, 2024.

Canadian Entrepreneurs' Incentive

The draft legislation for the Canadian Entrepreneurs' Incentive (CEI) generally reflects the proposal in Budget 2024, except as described below. The CEI reduces the capital gains inclusion rate to one-third on dispositions of qualifying shares by eligible individuals (other than trusts) up to a lifetime individual limit of $2 million in capital gains. This incentive applies in addition to any available lifetime capital gains exemption.

The August 12 Proposals provide further details on the types of businesses that are excluded from the CEI. There are 10 categories of excluded businesses. The list of excluded businesses generally accords with those in Budget 2024, but expands on them. For example, Budget 2024 excludes businesses operating in the accommodation sector, while the August 12 Proposals exclude "short-term lodging and complementary services to travellers, vacationers and others, in facilities such as hotels, motor hotels, resorts, motels, casino hotels, bed and breakfast accommodations, cottages and cabins, recreational vehicle parks and campgrounds, hunting and fishing camps, and recreational and adventure camps." The excluded professional practices are also exhaustively defined as accountants, lawyers, notaries, physicians, mental health practitioners, health care practitioners, veterinarians, optometrists, dentists, chiropractors, engineers and architects.

Three key conditions for CEI eligibility have been relaxed compared to the Budget 2024 proposal. First, the individual claiming the CEI need only have owned 5% or more of the shares, partnership interest or interest by fair market value for the 24 months prior to the disposition (Budget 2024 proposed that the individual must have owned at least 10% at all times from the time of the initial subscription until the time immediately before the disposition). Second, the claimant need only have been actively engaged on a regular, continuous, and substantial basis in the activities of the business for a total period of at least three years prior to the disposition (whereas Budget 2024 proposed to require that the claimant have been actively engaged in the business throughout the five-year period ending immediately prior to the disposition). Third, the condition set out in the Budget 2024 that the individual claiming the CEI must have been a founding investor when the corporation was first capitalized has been removed.

The August 12 Proposals also no longer require the shares to have been obtained for fair market value consideration as a condition to claim the CEI in respect of those shares. However, the August 12 Proposals include provisions that limit access to the CEI under some circumstances that parallel existing rules applicable for purposes of the lifetime capital gain exemption.

Finally, the phase-in period of the CEI is halved: the $2 million limit will be phased in between 2025 and 2029 in $400,000 increments (Budget 2024 proposed to phase in the CEI between 2025 and 2034 in $200,000 increments).

Settlement of tax appeals

The Minister of National Revenue is permitted under the ITA to reassess a taxpayer at any time, with the written consent of the taxpayer, to implement a settlement of an appeal by that taxpayer. The August 12 Proposals propose to expand the scope of this power and allow the Minister to reassess (with written consent) in implementing the settlement of an appeal by another taxpayer (for example, the counterparty to the transaction in dispute). The August 12 Proposals also make it clear that the Minister's power to reassess can be used in settling an appeal after the Tax Court of Canada renders its trial decision; in other words, a settlement reached before, during or after an appeal to the Federal Court of Appeal.

Graduated rate estates: carry back to final taxation year of deceased

Currently, graduated rate estates can carry back capital losses to the last taxation year of the deceased as long as the loss is incurred within the first year of the estate. Similarly, the undepreciated capital cost for a prescribed class can be deducted in the deceased's final taxation year as long as all of the depreciable property in that class is disposed of within the first year of the estate. Certain losses and deductions relating to employee stock options can also be carried back to the last taxation year of the deceased if the option is exercised or disposed of, or if the securities are acquired, within the first year of the estate.

The August 12 Proposals extend that period from one year to the first three years of the estate. This extension provides more time for estate planning and implementation. The change now aligns the carry back period for capital losses by an estate with the three-year period already available to individuals.

Other measures

The August 12 Proposals include several other previously announced measures and certain technical amendments, including the following

- Bankruptcy and debt forgiveness rules: extended to apply to partnerships and trusts, effective for bankruptcy proceedings that commence on or after August 12, 2024
- CRA information requests: new provision added that would deem a notice of non-compliance to be vacated if the Minister does not complete her review within 180 days of receiving the request for review — unfortunately, no other changes have been made that would restrict this proposal to something more reasonable and proportionate to the issue the federal government has stated it is attempting to address
- Withholding on services: additional "conditions" referred to in proposed subparagraph 153(8)(a)(ii) were not concurrently released in the August 12 Proposals, nor has there been any update regarding what they might be, when they will be published, or how they will be enacted
- Various technical amendments to the ITA, including amendments to the shareholder benefit rules in section 15, the rules applicable to elections to cease being a public corporation following an acquisition transaction, and the rules applicable to certain standby charges and other fees in respect of debt — if you require further information about these technical amendments, please contact any member of our National Tax Department
- Avoidance of tax debts
- Mutual fund corporations
- Employee ownership trusts
- Alternative minimum tax
- Accelerated CCA for certain classes

If you have any questions or require additional analysis on the August 12 Proposals, please contact any member of our National Tax Department.