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CRA Designates Notifiable Transactions

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The “notifiable transaction” rules were first announced in the 2021 Federal Budget, requiring reporting of certain transactions identified by the Minister of National Revenue (Minister) as being avoidance transactions or other transactions of interest. The notifiable transaction rules received Royal Assent on June 22, 2023. Pursuant to the legislation, a transaction becomes a notifiable transaction if it is the same or substantially similar to one that is designated by the Minister with the concurrence of the Minister of Finance.

On November 1, 2023, the Minister published a list of five designated notifiable transactions.

Overview of the Notifiable Transaction Rules

New section 237.4 of the *Income Tax Act* (Tax Act) requires reporting of transactions or series of transactions that are the same as, or substantially similar to, a transaction or series of transactions that has been designated by the Minister as being notifiable.

For purposes of the notifiable transaction rules, the term “substantially similar” is to be interpreted broadly in favour of disclosure, and means a transaction that is “substantially similar” to a designated transaction or series of transactions and includes any transaction or series of transactions, in respect of which a person is expected to obtain the same or similar types of “tax consequences” (as defined in subsection 245(1)) and that is either factually similar or based on the same or similar tax strategy.

“Tax consequences” to a person means (a) the amount of income, taxable income or taxable income earned in Canada of the person under the Tax Act, (b) the tax or other amount payable by, or refundable to, the person under the Tax Act, or (c) any other about that is, or could at a subsequent time be, relevant for the purpose of computing an amount referred to in (a) or (b).

Notifiable transactions must be reported by *every person* who:

a. obtains (or expects to obtain) a tax benefit based on the person’s tax treatment of the notifiable transaction, any other notifiable transaction that is part of the series of transactions that includes the notifiable transaction, or any series of transactions that includes the notifiable transaction;
b. has entered into, for the benefit of a person described in (a), the notifiable transaction;
c. is a promoter or an advisor in respect of the notifiable transaction; and

d. does not deal at arm's length with the promoter or advisor in respect of the notifiable transaction and who is entitled to a fee in respect of the notifiable transaction.

An advisor in respect of a notifiable transaction means each person who provides, directly or indirectly in any manner whatever, any assistance or advice with respect to creating, developing, planning, organizing, or implementing the notifiable transaction, to another person (including any person who enters into the notifiable transaction for the benefit of another person). Unlike reportable transactions, advisors, and promoters in respect of notifiable transactions are required to report, whether or not they receive a fee in respect of the notifiable transaction.

The notifiable transaction rules contain two due diligence defences. First, participants in the transaction are not required to report if they exercised the degree of care, diligence, and skill in determining whether the transaction is a notifiable transaction that a reasonably prudent person would have exercised in comparable circumstances. Second, advisors, promoters (and persons not dealing at arm’s length with advisors or promoters) are not required to report if the person does not know and should not reasonably be expected to know that the transaction was a notifiable transaction. Further, information that is subject to solicitor-client privilege is not required to be disclosed.

Notifiable transactions must be reported on Form RC312, Reportable Transaction and Notifiable Transaction Information Return 90 days after the earlier of (a) the date on which the transaction was entered into, and (b) the date on which a participant becomes contractually obligated to enter into the transaction. The CRA Guidance to the Mandatory Disclosure Rules clarifies that the 90-day timeline to report will not begin prior to the designation of a transaction as a notifiable transaction. However, reporting will be required for transactions that “straddle” the date of designation. If a person contracted to enter into a notifiable transaction prior to November 1, 2023 but did not enter into the transaction until after that date, reporting would be required with the 90-day period beginning on the date the transaction was entered into. If a person enters into a series of transactions that straddle November 1, 2023, reporting will be required within 90 days after the first transaction in the series that occurs after November 1.

A failure to report a notifiable transaction attracts significant penalties: for participants, up to the greater of $100,000 and 25% of the tax benefit in respect of the notifiable transaction, and for advisors and promotors, up to $110,000 plus the amount of fees charged in respect of the notifiable transaction. In addition, a failure to file extends the normal reassessment period.

The Federation of Law Societies of Canada has filed a petition in the British Columbia Supreme Court challenging the constitutionality of the mandatory disclosure rules as they apply to members of the legal profession. The Federation of Law Societies of Canada has obtained a temporary injunction, such that legal professionals are currently exempt from the application of the mandatory disclosure rules (including the notifiable transaction rules) until the earlier of December 1, 2023 and the date on which the court releases its decision in respect of the application.

Notifiable Transactions

(1) Straddle Loss Creation Transactions Using a Partnership

The Minister notes that some taxpayers are engaging in financial arrangements that reduce tax by generating artificial losses with the use of complex financial instruments or derivatives. Basic straddle transactions involve two or more financial instrument positions entered into concurrently by a taxpayer. The instruments are expected to generate substantially equal and offsetting gains and losses. The taxpayer disposes of the position with the accrued loss (the loss leg) and realizes the loss shortly before the taxation year-end. Shortly after the beginning of the following taxation year, the taxpayer disposes of the offsetting position with the accrued gain (the gain leg) and realizes the gain. The taxpayer claims a deduction in respect of the realized loss against other income in the initial taxation year and defers the income recognition from the gain leg until the following taxation year. Taxpayers may indefinitely defer the gain by entering into successive straddle transactions.

Certain straddle transactions have been addressed by specific anti-avoidance rules in the 2017 Federal Budget. However, the Minister has detected new variations of transactions using partnerships that attempt to avoid the specific anti-avoidance rules, and as such has designated the following series of transactions.

1. A taxpayer enters into an agreement to acquire a partnership interest from an existing partner.
2. The partnership trades foreign exchange forward purchase and sale agreements on margin through a foreign exchange trading account. The foreign exchange forward agreements are essentially straddle transactions where it is reasonable to conclude that each agreement is held in connection with the other and where, in the aggregate, the individual agreements will generate substantially equal and offsetting gains and losses.
3. Shortly before the taxpayer's acquisition of the interest in the partnership, the partnership disposes of the gain leg(s) of the foreign exchange forward agreement(s).
4. The income from the gain leg(s) is then reflected in the income of the partnership and is allocated to the original partner immediately prior to the acquisition of the interest in the partnership by the taxpayer.
5. The loss leg(s) are realized following the acquisition of the partnership interest by the taxpayer and a business loss is allocated to the taxpayer.

(2) Avoidance of Deemed Disposal of Trust Property

Trusts are generally subject to a 21-year deemed realization rule. Every 21 years, the capital property of certain trusts is deemed to have been disposed of and reacquired. Taxpayers may seek to defer the capital gain beyond the 21-year period by transferring trust property to capital beneficiaries of the trust on a tax-deferred basis, transferring the property to another trust, or transferring the property to non-resident beneficiaries. The Tax Act contains rules to prevent a deferral in such circumstances, however, the Minister notes that some taxpayers are engaging in transactions that seek to avoid or defer the 21-year deemed realization rule or that seek to avoid these rules even though the property continues to be held, directly or indirectly, by a trust or by a non-resident beneficiary.

In response to such transactions, the Minister designated the following types of series of transactions:

(i) Indirect Transfer of Trust Property to Another Trust

A Canadian resident trust (New Trust) holds shares of a corporation resident in Canada (Holdco). Holdco is a beneficiary of a Canadian resident trust (Old Trust). Prior to its 21-year anniversary, Old Trust transfers capital property to Holdco on a tax-deferred basis pursuant to subsection 107(2) of the Tax Act. The 21-year deemed realization rule will not apply to Old Trust, and a new 21-year period will begin to run for New Trust.

(ii) Indirect Transfer of Trust Property to a Non-Resident

One or more of the non-resident beneficiaries of a Canadian resident trust hold shares of a corporation resident in Canada (Holdco) that is or will become a beneficiary of the trust. The trust transfers certain property to Holdco on a tax-deferred basis pursuant to subsection 107(2) of the Tax Act prior to its 21-year anniversary.

The result is that the 21-year deemed realization rule will not apply to the trust, and the transfer of the trust's property to Holdco provides for a longer period of deferral. The non-resident beneficiaries of the trust hold shares of Holdco that reflect their former indirect interest in the property of the trust.

(iii) Transfer of Trust Value Using a Dividend

A Canadian resident trust (Old Trust) holds shares of a Canadian corporation (Opco). A Canadian resident trust (New Trust) holds shares of a Canadian corporation (Holdco). Holdco is or becomes a beneficiary of Old Trust.

Prior to Old Trust's 21-year anniversary, Opco redeems the shares held by Old Trust in exchange for cash and a promissory note, resulting in a deemed dividend pursuant to subsection 84(3) of the Tax Act. Old Trust designates the deemed dividend pursuant to subsection 104(19) of the Tax Act to have been received by Holdco. The dividend is deductible in the hands of Holdco pursuant to subsection 112(1) of the Tax Act. The cash or the promissory note is paid or made payable in the year by Old Trust to Holdco as payment for the dividend allocated to it.

The result is that the 21-year deemed realization rule will not apply to Old Trust, and a new 21-year period will start to run for New Trust, providing for a longer period of deferral.

(3) Manipulation of Bankrupt Status to Reduce a Forgiven Amount in Respect of a Commercial Obligation

The debt forgiveness rules in the Tax Act provide that where a commercial debt obligation is settled or extinguished for less than its principal amount or the amount for which it was issued, the "forgiven amount" will be first applied to reduce various tax attributes and may result in an income inclusion. Where the debtor is bankrupt at the time the debt is settled, the forgiven amount is reduced by the principal amount of the obligation.

The Minister notes that some taxpayers are entering into arrangements in which they are temporarily assigned into bankruptcy prior to settling or extinguishing a commercial obligation to reduce a forgiven amount to nil. As a result, there is no reduction in the taxpayer's tax attributes and no income inclusion even though the bankruptcy is subsequently annulled. In response to such arrangements, the Minister designated the following series of transactions:

1. A person or partnership (Debtor) is assigned into bankruptcy.
2. While Debtor is a bankrupt, a commercial obligation of the Debtor is settled, deemed to be settled, or extinguished for an amount that is less than the principal amount of the obligation.
3. At any point in time, Debtor files a proposal under Part III of the *Bankruptcy and Insolvency Act* and the bankruptcy is annulled.

(4) Reliance On Purpose Tests in Section 256.1 to Avoid a Deemed Acquisition of Control

Section 256.1 of the Tax Act is an anti-avoidance rule aimed at certain corporate attribute trading transactions. The rule applies to deem an acquisition of control to occur at a particular time if:

a. a person or group of persons holds shares of the corporation with a fair market value (FMV) that exceeds 75% of the FMV of all the shares of the corporation (the 75% FMV threshold test);
b. the person or group of persons did not, immediately before the particular time, hold shares of the corporation with a FMV that satisfied the 75% FMV threshold test; and
c. the person or group of persons does not control the corporation at the particular time.

There are three purpose tests in section 256.1 of the Tax Act:

1. Paragraph 256.1(2)(d) provides that there will only be a deemed acquisition of control for purposes of the attribute trading restrictions if it is reasonable to conclude that *one of the main reasons* that the person or group does not control the corporation is to avoid the application of one or more of the attribute trading restrictions.
2. Paragraph 256.1(4)(a) provides that, if it is reasonable to conclude that *one of the reasons* that one or more transactions or events occur is to cause a person, or a group of persons, not to hold shares having a FMV that satisfies the 75% FMV threshold test, the 75% FMV threshold test is to be applied without reference to those transactions or events.
3. Subsection 256.1(6) deems an acquisition of control to occur for purposes of the attribute trading restrictions if, at any time as part of a transaction or event or series of transactions or events, control of a particular corporation is acquired by a person, or a group of persons, and it can reasonably be concluded that *one of the main reasons* for the acquisition of control is to avoid the application of an attribute trading restriction.

The Minister designates the following transactions, which are aimed at identifying situations where taxpayers rely on one of the purpose tests to conclude that the attribute trading restrictions in section 256.1 do not apply to transactions or events that otherwise have satisfied the conditions in section 256.1:

(i) Purpose Test in Paragraph 256.1(2)(d)

Lossco is a taxable Canadian corporation that has tax attributes that are subject to the application of one of the provisions listed in the definition of "attribute trading restriction" in subsection 256.1(1). Another person (Aco) does not, immediately before the particular time, hold shares of Lossco with an FMV that satisfies the 75% FMV threshold test. At a particular time, Aco acquires shares of Lossco and, following the acquisition, Aco does not control Lossco but satisfies the 75% FMV threshold test. The taxpayer takes the position that because the purpose test in paragraph 256.1(2)(d) is not satisfied, subsection 256.1(3) does not apply.

(ii) Purpose Test in Paragraph 256.1(4)(a)

Lossco is a taxable Canadian corporation that has tax attributes that are subject to the application of one of the provisions listed in the definition of "attribute trading restriction" in subsection 256.1(1). A corporation (Profitco) and another person (Aco) not dealing at arm's length with Profitco acquire shares of Lossco. Following the acquisition of the Lossco shares, Profitco does not control Lossco and does not hold shares of Lossco with a FMV that satisfies the 75% FMV threshold test. However, Profitco would satisfy the 75% FMV threshold test if the acquisition of the Lossco shares by Aco is ignored. The taxpayer takes the position that subsection 256.1(3) does not apply solely because the purpose test in paragraph 256.1(4)(a) is not satisfied.

(iii) Purpose Test in Subsection 256.1(6)

Lossco is a taxable Canadian corporation that has tax attributes that are subject to the application of one of the provisions listed in the definition of “attribute trading restriction” in subsection 256.1(1). Lossco acquires control of a particular corporation (Profitco) and it can reasonably be concluded that one of the reasons for the acquisition is so that none of the attribute trading restrictions will apply. However, the taxpayers take the position that subsection 256.1(6) does not apply solely because its purpose test is not satisfied.

(5) Back-To-Back Arrangements

The thin capitalization rules in the Tax Act apply to deny a deduction (or provide for an inclusion of a deemed amount of income) in respect of interest paid or payable to certain non-residents. The Tax Act contains specific rules to prevent the circumvention of the thin capitalization rules through the use of certain back-to-back lending arrangements involving intermediaries.

Similar rules apply in Part XIII of the Tax Act to ensure that withholding tax is not circumvented through the use of back-to-back lending arrangements, or back-to-back arrangements in respect of rents, royalties, and similar types of payments.

The Minister and the Department of Finance consider the following transactions and series of transactions to have the potential for tax avoidance or evasion, but they lack sufficient information to make that determination. As a result, the Minister designates the following transactions and series of transactions:

(i) Thin Capitalization

Non-resident 1 (NR1) is a relevant non-resident in respect of a taxpayer. NR1 enters into an arrangement with an arm’s length non-resident (NR2) to indirectly provide financing to the taxpayer. The taxpayer files, or anticipates filing, its income tax returns on the basis that the debt or other obligation owing by it, and the interest paid thereon, is not subject to the thin capitalization rules.

(ii) Part XIII Tax

A non-resident person (NR1) enters into an arrangement to indirectly provide financing to a taxpayer through another non-resident person (NR2). If interest had been paid by the taxpayer directly to NR1, it would have been subject to Part XIII tax. The taxpayer’s income tax reporting reflects, or is expected to reflect, the assumption that the interest it pays in respect of the arrangement is either not subject to withholding tax at all or is subject to a lower rate of withholding tax than the rate that would apply on interest paid directly by it to NR1.

Alternatively, similar arrangements are entered into in respect of rents, royalties, or other payments of a similar nature, or to effect a substitution of the character of the payments.

This grouping of designated transactions is very broad, and unlike the rest of the list, does not identify specific transactions that are of concern to the Minister. Rather, it appears that the Minister is using this designation to assist in identifying the specific transactions that are being implemented. Without further guidance from the CRA, taxpayers and advisors are left with significant uncertainty with respect to reporting transactions where it has been determined that the rules described above do not apply.

If you have any questions about the foregoing designated transactions or the notifiable transaction rules, please contact any member of the Cassels Taxation Group.

This publication is a general summary of the law. It does not replace legal advice tailored to your specific circumstances.