International TAX HIGHLIGHTS

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In This Issue

In this issue of *International Tax Highlights*, we cover a lot of jurisprudence, mainly because there have not been very many legislative or administrative developments in the international tax context since the last issue. The federal budget was light in this area, although the Budget Implementation Act, 2023, No. 1 (Bill C-47)—now working its way through Parliament after the related notice of ways and means motion was released on April 17, 2023—includes several items of interest. On a quick review, it looks like most of these items appeared among the August 9, 2022 legislative proposals. We continue to await revised or new legislative proposals on the EIFEL rules and the hybrid mismatch rules, and, of course, on pillar 2, among other initiatives.

We are particularly grateful to our contributors to this issue. Many of them agreed to address topics arising from the budget's release while also identifying alternative topics in the event that the budget provided little in the way of new material (which turned out to be the case).

So what do we have to offer in this issue? We begin with Patrick Marley and Oleg Chayka, who review the budget measures on various green tax incentives through the lens of pillar 2, explaining the treatment of qualified refundable tax credits in relation to other types of tax incentives. This article provides a useful reminder that even purely domestic measures can have significant international tax implications in the new world of pillar 2. Kevin Chan and John J. Tobin then provide an interesting review of recent OECD and Canadian reports on dispute prevention and resolution practices, with a focus on advance pricing agreements (APAs). Stretching a little further back, Christopher Montes and John Farquhar take a fresh look at the August 9, 2022 proposed revisions to the definition of "relevant tax factor" in respect of foreign affiliates of CCPCs, highlighting the important retroactive implications they may have.

Balaji (Bal) Katlai and Hugh Neilson then sound the alarm about the new underused housing tax, showing some of its counterintuitive implications for various common situations. Also on the theme of real property, Alex Cook and Suhaylah Sequeira review the recent decision in *3792391 Canada Inc.* (2023 TCC 37), which serves as a useful reminder to tenants that they might be hit with charges and penalties for failure to withhold and remit part XIII taxes even if they had no reason to believe that their landlord was a non-resident.

Payments to non-residents are also the topic of the issue's next two contributions, both of which cover the recent decision of the BC Supreme Court in *Hootsuite Inc.* (2023 BCSC 358). This decision involves the application of BC PST to payments for (the use of) software and services provided on or through the cloud by Amazon Web Services. Robert G. Kreklewetz and Peter Werhun take us through the court's analysis of the facts and the PST issues, reminding us that income taxes are not the only important consideration in the international tax context. Kim Maguire and Ilana Ludwin then take us through some of the potential income tax implications of the court's factual determinations, reminding us that income tax cases are not the only good source of knowledge, even for income tax practitioners.

Rounding out our coverage of judicial developments, Ehsan Wahidie provides background and an update regarding two cases—namely, *Paletta* (SCC, no. 40325) and *Deegan* (SCC, no. 40552). *Paletta* involved a foreign-currency straddle strategy, which did not succeed at the FCA and failed to get leave to appeal from the SCC. That case is concluded, but its implications for other cases may persist. *Deegan* is a case in which leave to appeal to the SCC has been applied for; it involves a challenge to Canada's implementation of the intergovernmental agreement with the United States to streamline the application of the US FATCA reporting rules. That case may yet produce some additional jurisprudence, although the

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chances of getting leave, as Ehsan demonstrates, are not great in general when it comes to tax cases. His contribution includes an interesting statistical analysis—based on data collected over the last 15 years—of the probability of a tax case getting leave.

Finally, Joannie Ethier takes us through some inconsistencies and potential pitfalls relating to the "throughout the year" requirement for the recharacterization of active business income under the foreign affiliate rules. This article is a very good reminder that, in this area of tax law, one should never assume that one knows anything, and that one should always read the relevant legislation again—and then again—with each new set of facts.

Thanks again to everyone for stepping up and being flexible and helping to keep our very nice IFA Canada/CTF collaboration going.

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Impact of Pillar 2 on Budget 2023's Proposed Investment Tax Credits

Canada, as a member of the OECD/G20 Inclusive Framework on BEPS, has committed to implementing pillar 2. This includes the implementation of a 15 percent global minimum tax for large multinational enterprises (MNEs) that is based on the global anti-base erosion (GloBE) model rules, which were adopted by the OECD/G20 Inclusive Framework on BEPS on December 14, 2021.

The 2023 federal budget did not include any details on the manner in which pillar 2 will be adopted into Canadian law. Rather, the budget merely reiterated Canada's plans to introduce—using a phased approach—the global minimum tax in line with (1) the GloBE model rules, (2) the commentary to the rules, and (3) the agreed-upon administrative guidance. In particular, the budget announced that two primary elements of the GloBE model rules—namely, the income inclusion rule (IIR) and a domestic minimum top-up tax—would be introduced later in 2023, with effect for taxation years beginning on or after December 31, 2023; and that the undertaxed profits rule (UTPR), which will serve as a backstop, should follow in 2024, with effect for taxation years beginning on or after December 31, 2024.

The federal government also announced an intention to share with provinces and territories the revenues from the global minimum tax. The 2023 federal budget estimates that about Cdn$2.8 billion and Cdn$2.4 billion will be collected from the global minimum tax in 2025-26 and 2027-28, respectively, if the 18-month period for the filing of the GloBE reportings is factored into the estimates. Time will show whether these estimates are realistic (in light of the behavioural responses of taxpayers and other countries—including the possibility that IIR estimates may be overstated to the extent that other countries adopt a QDMTT).

Historically, Canada has offered numerous federal and provincial tax credits aimed at creating incentives for investment in certain industries or activities. Federal investment tax credits (ITCs) in respect of scientific research and experimental development, mineral exploration, and film production activities are only a few notable examples of the tax incentives already in place. The 2023 budget proposed additional ITCs for clean technology and green energy.

In 2022, the federal government announced its plans to introduce three new ITCs. First, after the release, on March 29, 2022, of the 2030 emissions reduction plan, the 2022 federal budget introduced a refundable ITC for carbon capture, utilization, and storage ("CCUS ITC") and a non-refundable 30 percent critical mineral exploration tax credit ("CMETC"). Second, in the 2022 fall economic statement, the government of Canada announced its ambitious plans to introduce a refundable clean technology ITC and a refundable clean hydrogen ITC. The introduction of these new refundable ITCs was also driven by Canada's desire to remain competitive in attracting investment in clean energy projects after the enactment of the US Inflation Reduction Act, which provided generous tax credits to investors in US clean energy projects.

In general terms, the 2023 budget has expanded the application of some tax credit programs and provided further details on the design of the CCUS ITC and on the federal government's plans to introduce the clean hydrogen ITC in accordance with its promises in the 2022 fall economic statement. The 2023 budget has also introduced two new refundable ITCs—namely, a 15 percent ITC for clean electricity and a 30 percent clean technology manufacturing ITC.

By expanding the existing tax credit programs and introducing new ones, the federal government expects that the fiscal incentives will make investments in the relevant Canadian projects more attractive to investors, including MNEs.

In this context, it is important to consider the pillar 2 treatment of the ITCs and to understand whether the implementation of pillar 2 could undermine the attractiveness of ITCs. In particular, a 15 percent global minimum tax could potentially apply to domestic Canadian activities (under an IIR or QDMTT) in situations where the effective tax rate, for pillar 2 purposes, falls below the 15 percent threshold.

In general terms, the GloBE treatment of ITCs depends on whether such credits are

- qualified refundable tax credits,
- non-qualified refundable tax credits, or
- qualified flowthrough tax benefits.

Qualified Refundable Tax Credit

A "qualified refundable tax credit," defined in article 10 of the GloBE model rules, is a tax credit that is refunded in cash or cash equivalents within four years from the date on which a constituent entity meets the requirements for receiving the tax credit.

A tax credit is considered to be refundable if it is paid in cash or cash equivalent, including in situations where a tax credit balance is left after reducing covered taxes. An eligible cash equivalent can include, inter alia, a discharge of other tax liabilities that are not covered taxes. It is important to note that if a tax credit is designed to reduce covered taxes only, it is not refundable and, accordingly, is not a qualified refundable tax credit.

Qualified refundable tax credits have been accorded favourable treatment from a GloBE perspective. Conceptually, they are assimilated to government grants in the sense that the refunded or credited taxes are still considered to be paid by the constituent entity and to form part of its covered taxes, while the tax benefit is viewed as income (a grant) that is included in the GloBE income. For example, a qualified refundable tax credit of $100 would result in $100 of additional GloBE income—but it would not reduce covered taxes for the purposes of computing the effective tax rate. To the extent that the accounting treatment of qualified refundable tax credits differs from the GloBE treatment, it should be reversed in determining GloBE income/loss and covered taxes.

When a portion of the tax credit is actually refundable and meets the qualified refundable tax credit requirements, only this portion of the tax credit is included both in the covered taxes and in GloBE income.

Non-Qualified Refundable Tax Credit

Article 10 of the GloBE model rules also defines a "non-qualified refundable tax credit"—a tax credit that is fully or partially refundable but that does not meet the qualified refundable tax credit requirements. This definition also includes tax credits that are commonly referred to as non-refundable tax credits since they can be used only to eliminate or reduce covered taxes but are not refundable in cash or cash equivalents.

A non-qualified refundable tax credit is excluded from both GloBE income/loss and covered taxes to the extent that it is reflected in the accounting net income (loss) and tax expense in the applicable financial statements. For example, a non-qualified refundable tax credit of $100 would result in a $100 reduction to covered taxes, with no additional income for the purposes of computing the GloBE income/loss.

For MNEs, qualified refundable tax credits are usually more valuable than non-qualified refundable tax credits. For example, assume that an MNE earns $500 of GloBE income and pays $100 of income tax (at a 20 percent effective tax rate). If that MNE received a $100 qualified refundable tax credit, it would have, for the purposes of pillar 2, $600 of GloBE income and $100 of covered taxes, which would result in a 16.7 percent effective tax rate and no global minimum tax. However, if that MNE received a $100 non-qualified refundable tax credit, it would have $500 of GloBE income and no covered taxes—resulting in a 0 percent effective tax rate and a global minimum tax of $75.

Despite the foregoing discussion, it may be beneficial in some circumstances to receive a non-qualified refundable tax credit. For example, in a situation where a material substance-based income exclusion effectively eliminates all or almost all excess profits that are subject to the global minimum tax, non-qualified refundable tax credits can be more beneficial because they do not give rise to additional GloBE income that could otherwise increase excess profits.

Qualified Flowthrough Tax Benefits

Qualified flowthrough tax benefits are tax credits (other than qualified refundable tax credits) and tax loss benefits, which flow to an investor as a return of (rather than a return on) the investment. The tax loss benefit is a tax-deductible loss multiplied by the applicable statutory tax rate.

The GloBE concept and treatment of qualified flowthrough tax benefits were introduced in the administrative guidance that was released on February 2, 2023 to accommodate certain US tax-transparent structures (also known as "partnership flips") widely used by investors to invest in certain US real estate or green energy projects. In broad outline, these structures involve the following: US tax equity investors provide project financing to become holders of a majority interest in a US partnership in order to obtain access to non-refundable tax credits and losses generated by the eligible projects, and to use them to decrease or eliminate the investors' US income tax liabilities. Once the investors get a return of their investment and, where applicable, an agreed rate of return thereon, ownership interests in the partnership flip and the investors become holders of minority interests in the partnership.

The administrative guidance has clarified that the character of tax credits is preserved regardless of whether they are received directly or through tax-transparent entities. The guidance also allows MNEs to opt for an alternative GloBE treatment of equity investments (including investments in US partnership-flip structures) by filing a five-year equity investment inclusion election.

If an investor has a qualified ownership interest (as defined in the administrative guidance) in a tax-transparent entity that is a partnership flip and receives an income or loss allocation therefrom, the investor's GloBE income or loss would not include such income or loss, and its adjusted covered taxes would not include any taxes or tax benefits relating to the disregarded GloBE income or loss, as the case may be.

Instead, the qualified flowthrough tax benefits (that is, eligible tax credits and tax loss benefits) received are included in computing the adjusted covered taxes of the investor to the extent that these benefits have reduced tax expenses for accounting purposes.

The investor decreases its investment in a qualified ownership interest to the extent of the qualified flowthrough tax benefits, distributions (including returns of capital), and proceeds from a disposition of the qualified ownership interest (or a portion thereof).

If an investment in a qualified ownership interest is reduced below zero, the excessive investment reduction decreases the adjusted covered taxes of the investor provided that it is attributable to the tax benefits or, where applicable, to the non-tax benefits that previously increased the adjusted covered taxes.

Deferred Taxes and Tax Credits

Article 4.4.1(e) of the GloBE model rules prescribes an adjustment in determining the total deferred tax adjustment amount that is accounted for in computing adjusted covered taxes; with this adjustment, all deferred taxes relating to the generation or use of any tax credits should be disregarded. It follows from this that if there is a change in the deferred taxes relating to the generation and use of the tax credits, the relevant changes in deferred taxes should also be excluded from the computations.

Conclusion

If the federal government contemplates using the tax incentives announced in the 2023 budget to attract investments from MNEs in the relevant projects, it should consider designing the ITCs in a way that will ensure their favourable treatment from a GloBE perspective. It would be helpful, too, if Finance reviewed the existing tax incentives, including those associated with the flowthrough shares of Canadian resource companies, from a GloBE standpoint and—where necessary or appropriate—adapted or replaced them so that Canada remains tax-competitive and attractive to foreign investors in the post-pillar 2 era. The OECD's report on the impact of the global minimum tax on tax incentives can help achieve this goal. The recommendation above applies equally to provincial governments that have introduced, or plan to introduce, tax incentives that are targeting MNEs.

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APAs in the Spotlight

Advance pricing arrangements (APAs) play an important role in preventing international tax disputes before they arise, reducing the need for taxpayers to rely on the mutual agreement procedure (MAP) mechanism to resolve significant tax disputes. This article provides a brief summary of the OECD's recent guidance on APAs and provides an update on Canada's current APA program.

Bilateral and multilateral tax disputes are becoming increasingly common, and the OECD has noted that many jurisdictions face challenges in keeping up with the many new cases added each year. In accordance with BEPS action 14, the OECD is making significant efforts to monitor, review, and implement minimum standards to improve dispute resolution processes among OECD jurisdictions. It recently released several reports that aim to improve the MAP and APA processes.

Recent OECD Publications on APAs

A full review of all efforts undertaken by the OECD to improve dispute resolution processes is beyond the scope of this article. However, several recently published reports are worth highlighting.

Bilateral and Multilateral APA Manuals

The OECD's Forum on Tax Administration (FTA) recently developed (1) the Bilateral Advance Pricing Arrangement Manual and (2) the Manual on the Handling of Multilateral Mutual Agreement Procedures and Advance Pricing Arrangements.

The Bilateral APA Manual, published in September 2022, provides guidance on streamlining the bilateral APA (BAPA) process. The FTA surveyed nearly two dozen countries and certain taxpayers with a view to understanding the practical aspects of how BAPA cases are handled. On the basis of these surveys, the FTA concluded that BAPAs are an effective tool for providing advance certainty but that certain obstacles impede their utilization. These obstacles include the following:

- BAPAs take a long time to complete,
- the differences among different jurisdictions' BAPA processes increase the length of the BAPA process unnecessarily,
- BAPA processes require significant resources both from competent authorities and from taxpayers, and
- there is a lack of transparency among stakeholders and in key parts of the BAPA process.

To address these obstacles, the FTA identified 29 best practices that broadly relate to the following:

- mitigating, where possible, delays created by differences among the BAPA processes in different jurisdictions;
- avoiding information asymmetries between competent authorities by ensuring that these authorities have access to the same information, in the same form and at the same time;
- increasing transparency between competent authorities and taxpayers throughout the BAPA process; and
- ensuring that competent authorities and taxpayers have realistic expectations at each stage.

Interestingly, the FTA called out the important role of the taxpayer in ensuring an effective and efficient BAPA process. Competent authorities shared with the FTA that the BAPA process is more efficient and effective when both taxpayers and treaty partners take principled and reasonable positions from the outset. Competent authorities noted that a key difficulty in obtaining agreement arises when the positions initially adopted by the parties are not necessarily considered to be in line with arm's-length principles and when opening positions are seen as bargaining positions.

In that regard, one of the best practices proposed by the FTA is that taxpayers should file their tax returns in the relevant jurisdictions for the proposed covered years on the basis of the positions taken in their BAPA application. The FTA expects that this would ensure that positions in the BAPA are both reasonable and defensible, with a realistic likelihood of being acceptable to both jurisdictions involved.

In February 2023, the FTA released the Manual on the Handling of Multilateral MAPs and APAs, which explores different approaches to handling multilateral disputes. As the manual notes, multilateral disputes involve several challenges beyond those encountered in bilateral disputes (both in the MAP and APA contexts). These added challenges include the following:

- a lack of consensus among jurisdictions regarding the situations in which multilateral solutions are appropriate;
- a lack of agreement among jurisdictions on the most appropriate legal basis for dealing with multilateral issues (for example, on whether multiple requests are required, and on whether treaty relationships need to exist between all jurisdictions involved);
- uncertainty regarding how filing periods and time limits under the various treaties and the domestic law affect multilateral disputes; and
- various procedural concerns, such as how to effectively conduct multilateral discussions and share information.

Perhaps disappointingly, the Manual on the Handling of Multilateral MAPs and APAs does not prescribe any particular methods for handling multilateral MAPs and APAs; instead, it is focused on providing general information and suggestions for tax administrators, with the understanding that the administrators tasked with handling such multilateral disputes have varying levels of experience.

Notably, neither the best practices identified in the Bilateral APA Manual nor the general suggestions in the Manual on the Handling of Multilateral MAPs and APAs are binding on member jurisdictions, and the FTA will not be reviewing or monitoring the progress of the implementation of the guidance.

Revised Peer Review Process

The OECD also recently released a revised assessment methodology for the peer review process related to BEPS action 14. BEPS action 14 created minimum standards in order to make dispute resolution processes more effective and efficient, and the peer review process (established in 2016) created a mechanism that enables jurisdictions to evaluate their peers in the implementation of those minimum standards.

The revised assessment methodology provides for a process of continual monitoring. The scope of the monitoring under the revised process is based on whether the particular jurisdiction is considered to have a "meaningful MAP experience." A jurisdiction has a "meaningful MAP experience," as defined, if it either has 10 MAP cases, on average, in its year-end inventory over the three previous years or receives feedback from member countries that its policy or practice concerning MAP cases requires improvement. Member jurisdictions will be subject to monitoring as follows:

- A full peer review process will be undertaken for jurisdictions (one of which is Canada) that are considered to have a meaningful MAP experience. This process will begin in January 2024, and each qualifying jurisdiction will be reviewed once every four years. The assessment schedule for the full peer review process will be released by the end of 2023.
- A simplified peer review process will be undertaken for jurisdictions that do not have a meaningful MAP experience, with the aim of helping them set up a more robust MAP program for future MAP cases. This process started in January 2023.

APA Reporting Framework

The final item of note is the new APA reporting framework, released in January 2023, which will require all OECD Inclusive Framework jurisdictions to start reporting annual statistics on APAs from 2024 onward. These statistics will provide a more complete and accurate picture of a jurisdiction's efforts with respect to dispute prevention and resolution and is expected to increase transparency. The new framework will require, among other things, jurisdictions to report the following on an annual basis:

- the number of APAs in inventory at the start of the reporting period,
- the number of APA applications filed during the reporting period,
- the number of APAs granted during the reporting period,
- the number of APA applications rejected during the reporting period,

- the number of APAs in inventory at the end of the reporting period, and
- the average time taken to grant APAs during the reporting period.

The APA reporting framework is similar in many respects to the MAP statistics that have been reported on for several years as part of BEPS action 14. The annual MAP statistics provide interesting data points, and it is hoped that the APA reporting will lead to the same transparency among the jurisdictions of the OECD Inclusive Framework.

Canada's APA Program

Canada already has a robust reporting system for its APA program, and the CRA publishes an annual report that includes most of the information that will be required under the OECD's reporting framework.

In the *Advance Pricing Arrangement Program Report 2021*, released in January 2023, the CRA reported 30 pre-filing meetings, 6 new accepted cases, and 9 completed cases (8 bilateral and 1 unilateral), with a closing inventory of 66 active APA cases in progress. There were 41 applications under consideration for acceptance to the program as of December 31, 2021.

In 2021, the average time required to complete a bilateral APA, from the time of acceptance to the time of completion, was 49.4 months. For the 8 bilateral APAs that were completed in 2021, it took an average of 25 months to complete the due diligence phase, an average of 16 months to negotiate with the corresponding tax authority, and an average of 8 months to draft and finalize the agreement. The total average time of 49.4 months in 2021 is a pronounced increase from the 36.9-month average in 2020, but it is roughly in line with the historical average, as shown below:

	2017	2018	2019	2020	2021	Five-year average
Time to completion (in months)	48.5	44	51.1	36.9	49.4	46.0

The CRA's 2021 report also noted a consistent trend in the completed APAs: most have been bilateral or multilateral. On the basis of this trend, the CRA has concluded that applicants and the CRA continue to be focused on bilateral or multilateral arrangements to eliminate double taxation and secure the highest degree of tax certainty. This is consistent with the OECD's findings in its two manuals (the Bilateral APA Manual and the Manual on the Handling of Multilateral MAPs and APAs), as described above.

Conclusion

The OECD's recent reports indicate that many jurisdictions continue to have limited experience in coordinating bilateral and multilateral MAP and APA cases. The time and effort required to achieve a BAPA or a multilateral APA remain a large impediment to countries' efforts to achieve more streamlined dispute prevention and resolution processes. It is hoped that documents such as the OECD manuals are important steps toward the achievement of more effective and efficient processes in the future.

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Retroactive Effects of the Proposed Amendment to the Definition of "Relevant Tax Factor"

On August 9, 2022, the Department of Finance released draft legislation to implement measures previously announced in the 2022 federal budget. That draft legislation proposes to reduce the "relevant tax factor" (RTF) for a CCPC or a substantive CCPC (both types are referred to in this article as "a CCPC") from 4 to 1.9, effective for taxation years commencing on or after April 7, 2022. The draft legislation also includes related amendments to the definitions of "capital dividend account" (CDA) and "general rate income pool" (GRIP). As we discuss below, the proposed amendment to the definition of RTF has significant retroactive effects.

Background

There are two points in time when the definition of RTF is relevant in calculating the amount of relief provided to a Canadian taxpayer for foreign taxes paid by its FA.

First, when the Canadian taxpayer has an income inclusion under subsection 91(1) for foreign accrual property income (FAPI) earned by its controlled foreign affiliate (CFA), it is entitled to a deduction, under subsection 91(4), that is equal to the RTF multiplied by the foreign tax paid in respect of the FAPI. The net income inclusion is subject to Canadian tax (as "aggregate investment income" [AII], which is subject to high-rate refundable tax if the recipient is a CCPC) and is added, under subsection 92(1), to the ACB of the shares of the Canadian taxpayer's CFA.

Second, when a Canadian corporation receives a dividend from its FA that is paid out of the FA's "hybrid surplus" or "taxable surplus" pool (the latter pool includes previously imputed FAPI less foreign tax paid thereon), the Canadian corporation is entitled to (1) a section 113 deduction based on the RTF and the foreign tax paid, and (2) a deduction under subsection 91(5) to the extent of a previous ACB addition under subsection 92(1). The portion of the dividend that is deductible is generally included in a taxpayer's GRIP and is not AII of a CCPC.

The policy objective of the proposed amendment to the definition of RTF is to have a CCPC or its CFA pay tax on passive income earned by the CFA at a rate of roughly 52.63 percent (that is, a rate of 1/1.9), which is close to the rate the CCPC would pay if it earned passive income directly rather than through the CFA. In other words, the proposed amendment is intended to prevent a CCPC from deferring tax on passive income by earning it indirectly (through a CFA) rather than directly. The non-deductible portion of the dividend received by a CCPC from its FA continues to be included in AII and therefore is subject to high-rate refundable tax. The actual effective tax rate on FAPI earned by the CFA of a CCPC will depend on the provincial tax rate that applies to the CCPC.

To maintain integration, the proposed amendments to CDA and GRIP include the portion of a dividend from an FA that is deductible under section 113 (less the foreign withholding tax) in the CCPC's CDA and not in its GRIP. The CDA can then be paid out to individual shareholders without personal-level tax.

Retroactive Effects of the Proposed Amendment

The proposed amendment to the definition of RTF has at least two retroactive effects.

First, the proposed amendment effectively imposes a "repatriation tax" on previously earned, unrepatriated FAPI. Such a tax is inconsistent with the longstanding policy of taxing FAPI in the year in which it is earned rather than when it is repatriated.

Assume that, prior to the proposed amendment, the CFA of a CCPC earned FAPI and paid foreign tax of approximately 25 percent when it was earned, such that the CCPC had no net FAPI inclusion (based on an RTF of 4). After the proposed amendment, the CCPC will be subject to significant tax when the CFA repatriates that previously earned FAPI to the CCPC by way of a taxable surplus dividend (based on an RTF of 1.9).

Under the old rules, the CCPC would have been entitled to a paragraph 113(1)(b) deduction equal to three times the foreign tax paid (RTF $- 1 = 4 - 1 = 3$) upon repatriation. Therefore, if the CFA had previously earned \$100 of FAPI and paid 25 percent foreign tax thereon, the CCPC would have been entitled to a full deduction (that is, $3 \times \$25 = \$75$) of the \$75 dividend upon repatriation.

After the proposed amendment, however, the CCPC is entitled to a paragraph 113(1)(b) deduction of only 0.9 times the foreign tax paid (RTF $- 1 = 1.9 - 1 = 0.9$) upon repatriation. Therefore, the CCPC is entitled to deduct only \$22.50 (that is, $0.9 \times \$25 = \$22.50$) of the \$75 dividend it receives under paragraph 113(1)(b), resulting in a \$52.50 income inclusion to the CCPC that is subject to high-rate refundable tax. There is no ability to claim a deduction under subsection 91(5) because there was no net FAPI inclusion (and, therefore, no ACB addition) in the year in which the FAPI was earned.

If the proposed amendment is not modified to eliminate this repatriation tax, it is likely that many CCPCs that have CFAs with previously earned, unrepatriated FAPI will choose not to repatriate those funds to Canada (or will at least defer doing so until their individual owners want to take funds out of the CCPC that would otherwise be subject to personal-level tax). This choice may have an adverse effect on investment in Canadian businesses.

CCPCs that nevertheless choose to (or have to) repatriate previously earned FAPI will need to model the tax results under various alternative scenarios—including a taxable surplus dividend, a share redemption, a subsection 88(3) liquidation and dissolution of the CFA, and certain elective mechanisms—to determine whether it is possible to mitigate, in part, the retroactive effects.

The second retroactive effect of the proposed amendment is that, even though the amendment applies to taxation years commencing after April 7, 2022, it can also apply to FAPI earned or realized before that date, given that a CCPC may have a different taxation year than its CFA. Assume, for example, that a CCPC has a June 30 taxation year-end and that its CFA has a December 31 taxation year-end. If the CFA earned significant FAPI (for example, a large capital gain on non-excluded property) in January 2022 (that is, before the proposed amendment was announced), that FAPI would be included in the CCPC's income at the CFA's December 31, 2022 year-end, which would be included in the CCPC's June 30, 2023 year-end. The CCPC's taxation year ending June 30, 2023 would be subject to the proposed amendment.

These retroactive effects are very significant because (1) the implied rate increase (that is, from 25 percent to 52.63 percent) is substantial, and (2) a significant amount of previously earned, unrepatriated FAPI may have been accumulated in a CFA. Accordingly, these effects are not analogous to the retroactive effect of routine, minor increases in tax rates.

Possible Modifications To Avoid the Retroactive Effects

Historically, the Department of Finance has tried to avoid retroactive amendments to income tax legislation because they can be fundamentally unfair to taxpayers and can erode confidence in the tax system. To avoid the retroactive effects described above, the coming-into-force provisions should be drafted to allow CCPCs to elect to have the old rules (that is, the old RTF, CDA, and GRIP rules) apply to FAPI earned in the taxation years of the CFA that end before April 7, 2024, and to foreign tax paid thereon. Such measures would allow CFAs to repatriate previously earned FAPI under the old rules and to avoid the retroactive application of the rules to FAPI earned before the proposed amendment was announced. Similar grandfathering measures have been used in other legislative contexts, especially in the cross-border context (for example, for upstream loans).

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Underused Housing Tax: Some International Challenges

Effective January 1, 2022, the government of Canada imposed the underused housing tax (UHT), which is an annual 1 percent tax on the ownership of vacant or underused housing in Canada. This tax is meant to apply to foreign owners. Canadian citizens and residents (as defined in section 2 of the Immigration and Refugee Protection Act) are "excluded owners" (as defined in paragraph (b) of section 2 of the Underused Housing Tax Act [UHTA]). Residence for income tax purposes does not affect liability for the UHT. In this article, we will refer to individuals who are not excluded owners as "non-Canadians," thus highlighting some of the challenges facing such individuals when they own residential property in Canada.

A number of articles have discussed the basics of the UHT, including articles from EY and Baker Tilly, and a summary sheet prepared by Video Tax News. To summarize, even if the owner of the residential property (the person(s) registered on the title of the property) is exempt from the tax, they are required to file a return (form UHT-2900) unless they are an excluded owner. The CRA refers to those required to file as "affected owners." An affected owner who fails to file is subject to significant penalties. On March 27, 2023, the CRA announced transitional relief for 2022: penalties and interest for the 2022 calendar year will be waived for any late-filed return and late-paid UHT, provided that the return is filed or the UHT is paid by October 31, 2023. This defers the issues but does not eliminate them.

Many Canadian residents and citizens have international connections. It is easy to envision scenarios where the UHT will apply in unexpected, and possibly unintended, situations.

Scenario 1

Consider Mr. and Mrs. Finch, who are Canadian citizens. They have a Canadian residential property. For tax- and estate-planning reasons, however, this property is held in a discretionary trust of which they are trustees. Their children are included among the discretionary beneficiaries, as are the spouses and descendants of these children. This structure was implemented well before the 2022 enactment of the UHTA. One of their children, Mandy, is a dual citizen of Canada and the United States. Initially, the Finches believed that they were excluded owners. However, Canadian citizens holding property as trustees are not excluded owners. The Finches proceed to review the exemption for property held for a specified Canadian trust—an exemption that requires that all beneficiaries be either excluded owners or specified Canadian corporations. Mandy's husband Alvin, however, is an American citizen, not a Canadian.

Because the Finches pay no rent for their use of the property, their use will not give them access to the "qualifying occupancy" exemption. Unless another exemption applies, the property will be subject to UHT (1 percent of the taxable value of the property). In cities such as Toronto or Vancouver, where average home prices are in the range of $1 million, the Finches may have to pay annual UHT of $10,000 or more.

Scenario 2

Consider a different fact pattern. The Singhs, who passed away several years ago, lived in Canada and had a disabled child (Harpreet). Their other child, Arvinder, did not move to Canada and remains a non-Canadian. The parents left the family home in trust under their will. Harpreet continues to reside in the family home. The trustees are Arvinder and a Canadian trust company—a subsidiary of a Canadian chartered bank. Harpreet and Arvinder are beneficiaries of the trust, with Harpreet having the right to reside in the property throughout her lifetime. The trustees have discretion to distribute trust income to either of Harpreet or Arvinder, or to retain such income in the trust. No distributions have been made to Arvinder, and he has agreed that none should be made during Harpreet's lifetime. Title to the property is registered only in the name of the trust company.

The trust company is not listed and is therefore not an excluded owner. It is believed that non-Canadian ownership of the parent bank exceeds 10 percent, so the trust company is not a specified Canadian corporation on the basis that the trust company's shares are indirectly held by its parent corporation. Because Arvinder is a beneficiary, the testamentary trust is not a specified Canadian trust. Because Harpreet pays no rent, her occupancy of the property cannot provide access to the "qualifying occupancy" exception. Unless another exemption is available, UHT will be payable.

Scenario 3

The Nakamuras are Japanese citizens who have resided in Canada under a series of work permits. They are therefore not excluded owners of any residential properties owned in Canada. They can claim an exemption for their primary place of residence for the calendar year. Alternatively, they can claim a "qualifying occupancy" exemption for periods in which they occupy the property for the purpose of work under their work permits (qualifying occupancy periods must be periods of continuous occupancy of at least 30 days, and must total at least 180 days in the year).

If they own multiple properties, Mr. and Mrs. Nakamura must elect a single property that will be eligible for these exemptions. If, for example, the Nakamuras own two residences because their workplaces are geographically distant, only one of these residences can be exempt from the UHT. Alternatively, if they own a vacation property in addition to their main residence, only one of these properties can be exempt from the UHT. If they do not spend sufficient time occupying even a single Canadian property in any specific year, UHT will be payable.

Scenario 4

Non-residents owning Canadian rental property must be concerned about vacancies. Periods of occupancy must be under written rental agreements, and each must last at least 30 continuous days, for a total of at least 180 days in the calendar year. For a non-arm's-length tenant, the UHTA further requires annual rent of at least 5 percent of the property's taxable value (prorated for the duration of any qualifying occupancy period). Advancing any exemption claim for qualifying occupancy will also require additional record keeping for many non-residents that own residential property in Canada.

Scenarios similar to those set out above are not uncommon. With the introduction of the UHT, a new tax compliance burden exists, even if an exemption from the tax itself is available. Furthermore, the discussion above highlights the reality that exemptions are not always available, even in circumstances where an exemption may seem appropriate. A careful review of the requirements of each exemption is essential. It is hoped that the Department of Finance will use the transitional period to assess whether exemptions should be added or broadened, either by regulation or, if necessary, by legislative amendment.

It is tempting to ask whether the UHT is consistent with international tax conventions, given that it is determined on the basis of citizenship; typically, such a basis for determination is not the intent of tax conventions and may violate their terms. And another question comes to mind: What if contracting states begin to impose similar tax charges for Canadians that own residential property outside Canada? If this happens, Canadian snowbirds may face some nasty surprises or may have to be prepared to foot new tax costs.

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Tenants Beware: Is Your Landlord a Non-Resident?

The TCC concluded, in *3792391 Canada Inc. v. The King* (2023 TCC 37), that subsection 215(6) is devoid of any requirement that a Canadian-resident payer have knowledge that a payee is a non-resident. In this case, the taxpayer was reassessed under subsection 215(6) for failure to withhold and remit part XIII tax on rent paid in the 2011 to 2016 taxation years to a landlord who, unbeknownst to the taxpayer, was a non-resident of Canada. Under subsection 215(6), a Canadian resident who fails to withhold and remit part XIII tax on certain payments to a non-resident is liable for the tax due. In addition, subsections 227(8) and (8.3) impose penalties and interest on the resident payer on the amount of the tax due. The taxpayer in this case was found to be liable for the tax, penalties, and interest due on the rental payments to the landlord. This decision may result in harsh consequences for taxpayers that have not confirmed the residence of a payee to which they make payments that could be subject to part XIII tax.

The Court's Findings and Arguments

Subsection 215(6) Does Not Have a Knowledge Requirement

The TCC relied on the "textual, contextual and purposive interpretation" used in *Canada Trustco Mortgage Co. v. Canada* (2005 SCC 54) to determine that subsection 215(6) does not have a knowledge requirement. The court first took the position that the wording of the provision, in its current form, is clear and unambiguous. The court then analyzed the history of the provision, the predecessor of which was first introduced in 1933. Citing the bill that introduced the predecessor to subsection 215(6), the court determined that the purpose of the provision, in its original form, was to support the administration of the charging provision imposing tax on non-residents. The court found that few amendments have been made to the provision since 1960, and it emphasized that, since 1960, the legislator has not introduced any requirement that a resident payer have knowledge of the non-resident status of a payee.

The court, in support of the position that subsection 215(6) does not contain an inherent requirement that a payer have knowledge of the non-resident status of a payee, identified another provision, subsection 116(5), whose text specifically includes a knowledge requirement. Subsection 116(5) imposes a liability to pay and remit tax at 25 percent of the gross purchase price on a taxpayer that purchases taxable Canadian property from a non-resident. The text of that provision provides for an exception in a situation where the purchaser has no reason to believe that the non-resident person is not resident in Canada. The court reasoned that when the legislator wants to limit a resident's liability to circumstances where the resident has knowledge or belief regarding a person's non-resident status, it expressly does so, as in subsection 116(5). Therefore, in a situation where the legislator has not expressly drafted such a knowledge requirement, it is not appropriate to assume one.

The Availability of a Due Diligence Defence

The court took the position that subsection 215(6) is a charging provision rather than a penalty provision and that, as a result, a due diligence defence is not available. Conversely, the court held that subsection 227(8) is a penalty provision under which a due diligence defence is available for a penalty imposed on the failure to withhold. The court cited *J.K. Read*

Engineering Ltd. v. The Queen (2014 TCC 309) in support of this position.

As a result of this finding, a taxpayer that fails to withhold under subsection 215(6) will not be able to use a due diligence defence to circumvent the taxpayer's own liability for the amount of the withholding tax due, but it may be able to invoke such a defence to prevent a penalty of up to 20 percent from applying, under subsection 227(8). A due diligence defence may be possible under subsection 227(8) if the taxpayer can show that it has exercised a high degree of diligence in attempting to comply with its obligations under the Act.

In this case, the taxpayer argued that it had not taken steps to ensure compliance with withholding obligations under the Act because it had no reason to believe that the recipient of the payments was a non-resident. The court found that this was not enough to meet the standard of a high degree of diligence—the standard necessary for a due diligence defence.

Impact on Canadian Taxpayers

This decision confirms that the onus is on Canadian taxpayers to determine the residence of any person to which they make payments that may be subject to part XIII tax, and these taxpayers should take steps accordingly. This decision indicates that there will be no relief for taxpayers that are liable for part XIII tax under subsection 215(6), regardless of whether the taxpayer had any reason to believe that the payee was a non-resident. Although a due diligence defence is available to taxpayers under subsection 227(8) (the penalty provision), case law has shown that this provision imposes a heavy burden on the taxpayer arguing this defence. In particular, a due diligence defence will not be available in a situation where a taxpayer—having no reason to believe that a payee was a non-resident—did not take steps to ensure a payee's compliance with withholding obligations.

Taxpayers should ensure that they are exercising reasonable care to comply with the Act, including by the confirmation of the residence of payees that could potentially be subject to part XIII tax. At the very least, it is sensible for lessees to ensure that the lease agreement includes a representation from the lessor regarding its residence status. In practice, the options are limited for a lessee who, in light of this decision, seeks further protection from liability for part XIII tax arising on rent payments, and the available options may be difficult to negotiate with a lessor. Such options may include the addition of contractual protection in a lease agreement, whereby the lessor is obligated to pay any part XIII tax that may arise as a result of the lease if it is later determined that the lessor is a non-resident of Canada (although subsection 215(6) already technically entitles the recovery of the part XIII tax from the non-resident person in such circumstances). Alternatively, the lessee might consider withholding part XIII tax regardless of the residence of the lessor, subject to obtaining proof that the lessor is a Canadian resident. As shown in this case, any potential indicators of non-residence (for example, overseas addresses, phone numbers, and bank accounts) should immediately alert a lessee that further protection may be needed when a lease is entered into. Note, too, that during the term of the lease, the status of the lessor could change, or the property could be sold or otherwise transferred to a non-resident; thus, it may not be enough to consider the facts and circumstances at the time the lease is entered into.

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BC PST: Silver Lining for Cloud Services

For more than 30 years, Canadian provinces that continue to implement stand-alone provincial sales taxes (PSTs) have struggled with the question of how to tax the use of computer software (and, more recently, the use of various software-based apps, cloud-based solutions, and online marketplaces). Although several provinces, including British Columbia, have recently focused on cracking down in these areas (especially online marketplaces), the new rules have been directed more at how and where transactions are made than at how to tax the underlying use of software and the provision of software-related services that enable all of this to happen in the first place. (For a discussion of British Columbia's efforts in this regard, see Rob Kreklewetz and Laura Burlock, "New PST Rules for BC Online Marketplaces," *Tax & Trade Blog*, September 30, 2020.)

This shortcoming in the new measures was on full display in *Hootsuite Inc. v. British Columbia (Finance)* (2023 BCSC 358), a recent case of the BC Supreme Court (BCSC). The court concluded in *Hootsuite* that various Amazon-provided platform services (and, it would seem, many other cloud-based services) effectively fall *outside* taxation in British Columbia.

Facts

Hootsuite is a platform that allows users (including businesses) to manage their social media presence across multiple social media platforms. In order to offer its service during the relevant periods, Hootsuite paid for and used Amazon Web Services (AWS), which provided servers and technology infrastructure, including the following:

- AWS support,
- cloud computing services, and
- AWS direct connect.

Part of the AWS offering to Hootsuite was an online platform known as the AWS management console, which allowed Hootsuite to access and manage all of its AWS services, including subscriptions.

In 2017, the BC Ministry of Finance assessed Hootsuite for PST under British Columbia's Provincial Sales Tax Act

(PSTA). British Columbia's position was that Hootsuite had a self-assessment obligation both as a user of software under section 105 of the PSTA and as a purchaser of a telecommunication service under section 130. Hootsuite appealed to the BCSC.

BCSC Analysis

The court analyzed each of the AWS offerings in turn, ultimately concluding that *none* of them were taxable for BC PST purposes, either under the province's "software" rules or its "telecommunication services" rules. Much of the court's analysis focused on an evaluation of the issue related to AWS support services.

AWS Support

In addressing the AWS support services, the court began by reviewing part 4 of the PSTA (which taxes software) and, in particular, section 105(1), which provides as follows:

> A purchaser in British Columbia who purchases software for use on or with an electronic device ordinarily situated in British Columbia must pay to the government tax at the rate of 7% of the purchase price of the software.

The court observed that while "electronic device" and "software" are defined in the PSTA, "software" is defined in reference to a "software program"—a phrase that is not itself defined in the PSTA, as the following definition from the statute demonstrates:

> **"software"** means the following:
> (a) a *software program* that is delivered or accessed by any means;
> (b) the right, whether exercised or not, to use a *software program* that is delivered or accessed by any means;
> (c) a contractual right
> (i) to receive modifications to or new versions of *software programs* described in paragraph (a) or (b) if modifications or new versions become available, whether or not that right is exercised. [Emphasis added.]

The court—relying in part on the PSTA's predecessor, the Social Service Tax Act (SSTA)—concluded that for the purposes of the PSTA, a "software program" differs from "software" in that it requires the user to "interact with the software and create an output based in part on those interactions" (that is, a software program is an "application"). (In the SSTA, "software" was also defined in reference to "software programs," but a further definition in the regulations defined "software programs" in reference to "software"—a somewhat circular definitional approach.)

In the court's view, the PSTA, unlike the SSTA, treats all "software programs" as "software," but that does not mean that all "software" constitutes "software programs." The court viewed this as a significant and deliberate change made by the BC legislature, given how ubiquitous software has become today, with a role in almost all electronic goods and services, from "a refrigerator or an automobile to telehealth."

With respect to the AWS support services, the court found that the software was not a software program and thus was not taxable under the PSTA. The court determined that the purpose of the purchase was to obtain technical expertise, and the use of any software was merely meant "to facilitate the exchange of technical information."

The court also reviewed some alternative arguments, finding that the "use" requirement in section 105(1) would be decisive. Because the software did not require a direct interaction in order to create an output, there was no "use" in British Columbia for the purposes of section 105(1).

The court then considered the situation through the lens of the PSTA's telecommunication services rules. It concluded that in a situation where the telecommunication services included in a sale were "merely incidental" to a contract for non-taxable services (as was the case here), the inclusion of the telecommunication services would not itself be taxable. It is worth noting that the court said that this reasoning would apply regardless of whether the AWS support services were "software" or a "software program."

Cloud Computing Services

With respect to the cloud computing services, the court observed that "[t]here is no one way to characterize cloud computing services": some are taxable and some are not. However, the court did consider two broad types of cloud computing services:

1) "software as a service" (SaaS), where users are provided with an application that uses remote hardware either for computational resources, data storage, or both; and
2) "infrastructure as a service" (IaaS), where the cloud provides access to computational resources or data storage but where a variety of applications can take advantage of this boost in hardware resources.

The court determined that the cloud computing services were an on-demand infrastructure service (presumably because they are, in the court's view, not a provision of software at all) and not subject to PST.

In the alternative, the court proceeded to characterize the software in the cloud computing services, finding that none of these services were subject to section 105(1). The court's reasoning regarding these services was similar to its reasoning regarding the AWS support services, although the court's treatment of the Linux operating system is worth noting. The court found that the Linux operating system was "solely used on the virtual machine to allow Hootsuite's application programs, installed on the virtual machine, to interact with the virtual machine," and thus that this system (whether or not it was a software program—a question on which the court felt it had insufficient evidence to rule) was not used on an electronic device situated in British Columbia.

AWS Direct Connect

With respect to AWS direct connect, the parties agreed that the service was a telecommunication service under the PSTA. The court determined, however, that this service was not taxable because AWS direct connect was used and controlled solely by AWS personnel in order to improve the other AWS offerings, and because all AWS direct connect links were confined to the United States—tying in solely to the virtual machine, not to an electronic device in British Columbia.

Commentary

The case study of *Hootsuite* exemplifies how provincial attempts to tax software have evolved. In the initial iteration of these attempts, signed licence agreements, which were in vogue in the late 1980s and early 1990s, were viewed as an indication of a non-taxable acquisition of services, whereas "in-the-box" software was viewed as taxable. As this distinction became less tenable, provinces began to focus less on the specific medium of access and more on whether the software was "custom" or "general application" in nature.

This focus is reflected in the definition of "software" in the SSTA, a definition that includes packaged or prewritten software (which is taxable) but excludes wholly or partly customized software. (This is particularly clear in an older version of the SSTA, RSBC 1979, c. 388, where the equivalent definition of "computer software" was much less clearly medium-neutral).

In the second iteration of provincial attempts to tax software (which has now been in place for about 15 to 20 years), provinces began to tax software if the devices providing access to it were located within the province. As *Hootsuite* shows, that approach represents more or less where the PSTA now stands, with the added condition that what is being provided must actually be an application, not just the interface or code needed to provide another electronic product or service.

In light of *Hootsuite* and of the greater role played by Cloud computing (the driving force in most interactions between social media and e-commerce platforms), the provinces seem about to discover that if they want to keep taxing software, they may find it hard not to tax everything.

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An Income Tax Perspective on Hootsuite Inc. v. British Columbia (Finance)

We were reluctant to write this case comment, for two reasons. First, the case takes a deep dive into the world of cloud computing, an area that is, perhaps, even more mind-boggling than income tax. Second, the case concerns the application of BC PST, a tax that we rarely consider in our practices. Lucky for us authors (and you taxpayers), Thomas J's reasons include a clear analysis of the suite of products and services purchased by the taxpayer—an analysis that may be useful to even the most technologically inept of income tax practitioners. If you are more interested in the PST angle of this case, we recommend the previous article by Kreklewetz and Werhun.

Overview

At issue in *Hootsuite Inc. v. British Columbia (Finance)* (2023 BCSC 358) was whether Hootsuite Inc., because it had purchased "software for use on or with an electronic device" (that is, computers) ordinarily situated in the company's BC premises, should have self-assessed PST on the purchase of cloud computing products and services provided by Amazon Web Services Inc. ("AWS"). An alternative issue was whether PST applied because Hootsuite had purchased a telecommunication service that was not "merely incidental" to a contract for services.

The BC minister of finance assessed Hootsuite on the basis that (1) the cloud computing and storage was a purchase of software because software was used to virtually access remote hardware; (2) a faster, non-Internet-based communication connection ("direct connect") between AWS and Hootsuite was a telecommunication service accessed from British Columbia; and (3) access to the technical support of AWS engineers outside Canada (which was provided through a web interface known as "the console," by e-mail and through telephone/Internet lines) was either a purchase of software or a telecommunication service.

The Court's Determinations

In his reasons, Thomas J began with a detailed analysis of the relevant statutory provisions, including an analysis of the term "software" and its meaning for the purposes of the BC Provincial Sales Tax Act (PSTA). In sum, he concluded that the ordinary meaning of "software" is broad but that in the PSTA context, "software" refers to software programs. Relying on expert witness evidence, he found that the key distinction between "software" and "a software program" is that the latter requires the user to utilize the software as an application—that is, the user must be able to interact with the software and create an output based in part on those interactions with the program.

With respect to the technical support provided by AWS, Thomas J found that Hootsuite was purchasing services performed by AWS engineers and that using a computer located in British Columbia to access such services should not trigger PST. He found that access to the console was not a purchase of a software program because the console was an "opaque application" and users could not interact directly with the software and create an output. Furthermore, according to Thomas J, even if there was a software program, it was not used on or with an electronic device located in British Columbia; rather, it was merely a "conduit" to gain access to the AWS engineers. Finally, he found that if Hootsuite had purchased a telecommunication service, it was merely incidental to a contract for services and thus exempt from PST.

With respect to the cloud computing and storage, Thomas J found that some cloud computing products may be taxable but some may not be. In the case at bar, he concluded that the fundamental nature of the product provided to Hootsuite was "an on-demand computer infrastructure service" and that this service did not involve a software program used in British Columbia because Hootsuite was not able to directly access or manipulate any software.

With respect to direct connect, Thomas J found that it was a non-taxable telecommunication service because all infrastructure and transmissions occurred in the United States and were neither sent from nor received in British Columbia.

Income Tax Implications

From an income tax perspective, we consider this case relevant in a number of ways. First, Thomas J lays out a detailed description of common Cloud computing services and products, as well as the ordinary meaning of "software"—concepts and terms with which many of us are familiar but do not clearly understand. In particular, his analysis is relevant when it comes to differentiating between the provision of services and the provision of property in the cross-border context, and may be extended to other forms of SaaS ("software as a service") and IaaS ("infrastructure as a service") offerings.

In the cross-border context, one example of this distinction arises under the withholding rules in the Income Tax Act (Canada), in a determination of whether part XIII withholding should apply to a payment to a non-resident under paragraph 212(1)(d) (subject to a rate reduction or exemption in the "royalty" article in an applicable treaty). Alternatively, if the payment is for services, the determination relates to whether the payment is subject to the business profits article in an applicable treaty.

The reasons for judgment in *Hootsuite* suggest that Hootsuite was fundamentally purchasing services despite the fact that such services are accessed through software. The case could also be interpreted as reinforcing the principle that the delivery of services remotely from outside Canada, through software, telephone, or Internet, should not be viewed as the provision of services *in* Canada, such that regulation 105 withholding should not apply and the non-resident service provider should not be considered to be carrying on business in Canada merely because of the remote service offering. Had Thomas J suggested that the installation and access to the console on a computer in British Columbia, for example, constituted a physical presence in British Columbia, the decision could have muddied the income tax analysis.

Thomas J's reasons also shed some light on the meaning of the phrase "use of," which appears in subparagraph 212(1)(d)(i)—a provision that generally imposes part XIII withholding tax on payments to non-residents for "the use of or for the right to use in Canada" any property. In his analysis of the AWS technical support, Thomas J finds that the "use of" software (which should be considered property in the form of a copyright of a literary work—see, for example, *Angoss International Ltd. v. The Queen*, 99 DTC 567 (TCC)) must involve more than merely accessing a service through software. His analysis suggests that "the use of software" means that one must be able to interact directly with a software application to create an output. The phrase "use of," in reference to software, also appears in the definition of "royalty" in many of Canada's tax treaties, and in the computer software exception to "royalty" in certain treaties (see, for example, articles XII(4) and (3) in the US-Canada income tax convention).

Outside the withholding context, the provision of services as opposed to property may be relevant to a determination of whether a foreign affiliate is earning (1) foreign accrual property income because it is earning income from property or income from an investment business (as defined in subsection 95(1)) or (2) income from an active business of providing services (subject, of course, to recharacterization under paragraph 95(2)(b)).

Although Thomas J's findings in *Hootsuite* do not significantly change the landscape for income tax purposes, his analysis does add some colour and definition.

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Lessons from Paletta and the Expected Outcome in Deegan

On March 16, 2023, the SCC dismissed the application for leave to appeal by the taxpayer in *Estate of Pasquale Paletta v. The King* (no. 40325), bringing final resolution to the eight-year-long saga of a rather costly tax strategy. At about the same time, the appellant plaintiffs in *Gwendolyn Louise Deegan v. Attorney General of Canada, et al.* (SCC, no. 40552) filed their application for leave to appeal following their own nine-year struggle in challenging the constitutionality of part XVIII of the Income Tax Act and the legislation implementing an intergovernmental agreement between Canada and the United States. The journey for the taxpayer in *Paletta* ended with a tax bill amounting to tens of millions of dollars, but the outcome in *Deegan* remains to be seen. However, given the historical treatment of such cases by the SCC, it is likely that the journey is over in *Deegan*, too. In this article, we provide some lessons learned from the *Paletta* decision and some general observations on the SCC's tendencies, over the past few years, when it comes to hearing tax-related disputes.

Paletta

Paletta involved the taxpayer's use of straddle transactions to generate tax losses that could be used to offset income earned or generated by the taxpayer from other business activities. The straddle strategy itself is fairly complicated. Generally speaking, it involves entering into pairs of derivative contracts in order to buy and sell the same amount of some commodity (in the case of *Paletta*, foreign currencies). As the value of the underlying commodity fluctuates over time, one of the contracts results in a gain while the other gives rise to a loss. Economically speaking, there is little upside or downside to entering into a straddle transaction unless it is used in conjunction with some underlying business activity. The tax benefits, however, are significant, and they arise from the taxpayer's control over when losses are realized (in the current year) and when gains are realized (in the following year). Granted, the taxpayer's control in this regard has been limited by amendments to the Act introduced in the 2017 federal budget. (Interestingly, given the proposed amendments to the general anti-avoidance rules in the 2023 budget, such straddle transactions would also seem to imply abusive avoidance on the basis that all or substantially all of the opportunity for gain or profit and risk of loss of the taxpayer remains unchanged, including because of a circular flow of funds, offsetting financial positions, or the timing between steps in the series.)

The minister of national revenue—despite her meagre success with similar arguments in recent cases—challenged the structure used in *Paletta* by contending that the arrangements were a "sham," "window dressing," and otherwise "legally ineffective transactions" (*Paletta*, 2022 FCA 86). The minister also argued, in the alternative, that the trading activities did not give rise to a business—that there was no source of income, and therefore the transactions could not create a loss that was deductible under the Act. In oral arguments, the minister relied on a single overarching point—namely, that the taxpayer's trading was not a source of income (with the implication that there was no business that could generate deductible losses).

Spiro J of the TCC found himself bound by the decisions in *Friedberg v. Canada* ([1993] 4 SCR 285) (interestingly, a case on which he was co-counsel in 1993, representing the minister) and *Stewart v. Canada* (2002 SCC 46), and ruled (for the most part) in favour of the taxpayer. The FCA reversed the TCC in a decision that did not pull any punches. In simple terms, the reversal turned on the foundational concept of "source," which the FCA ultimately concluded did not exist (because there was no intention to profit from the straddle transactions). The taxpayer in *Paletta* filed an application for leave to appeal to the SCC, which was dismissed with costs.

Deegan

In January of this year, the plaintiffs in *Deegan* filed an application for leave to appeal to the SCC the decision of the FCA dismissing their appeal. The leave application has yet to be considered by the SCC. It is noteworthy that although *Deegan* involves tax legislation, the issues raised are constitutional.

In *Deegan*, the appellants challenged the constitutionality of part XVIII of the Act and of the legislation ("the impugned legislation") enacting into law in Canada the intergovernmental agreement between Canada and the United States that was intended to mitigate the impact of the US Foreign Account Tax Compliance Act (FATCA) on Canadian individuals and businesses. The impugned legislation effectively streamlines the collection of information and the disclosure of that information from Canadian financial institutions to the CRA and from the CRA to the IRS. The impugned legislation was challenged on the basis that it results in the unreasonable seizure of financial information belonging to US persons in Canada (under section 8 of the Charter) and imposes a burden on such individuals because of their citizenship or their national or ethnic origin (contrary to section 15 of the Charter).

In disposing of the arguments under section 8 of the Charter, the FC found that the appellants had some subjective expectation of privacy with respect to their banking information; objectively, however, because of their pre-existing legal obligation to provide their banking information to the US government, they could have only a limited expectation of privacy in respect of such information. The FC also found—on the basis of evidence that was adduced regarding the potentially serious consequences of compliance with FATCA for the Canadian economy, financial institutions, and bank customers—that the seizure of banking information contemplated by the impugned legislation was reasonable.

Under section 15 of the Charter, the plaintiffs effectively argued that the impugned legislation discriminates between Canadian citizens and residents who are US persons (on the one hand) and those who are not (on the other hand) on the basis of their national original or citizenship. And they argued, further, that the impugned legislation is discriminatory because it denied them access to a "fundamental social institution"—namely, Canadian sovereignty (because it permitted extraterritorial enforcement of US law on Canadian soil). The FC held that the impugned legislation draws a distinction between US persons and non-US persons on the basis of one of section 15's enumerated grounds, but the court found that such a distinction is not discriminatory because, inter alia, it does not reinforce, perpetuate, or exacerbate disadvantage or violate the norm of substantive equality in section 15(1) of the Charter. At the FCA, the appellant plaintiffs advanced an argument only under section 8 of the Charter, but the appeal was dismissed, for the most part, on the basis outlined in the FC decision.

Observations

Paletta, in addition to providing the analytical framework for assessing transactions that are solely tax-driven, may have far-reaching implications for taxpayers who have engaged in similar tax-deferral strategies. The refusal of the SCC to grant leave is a notable victory for the minister (especially when we consider that a corporation related to the taxpayer had engaged in straddle trading on an even larger scale involving losses of about $150 million) and only bolsters the minister's arguments. The refusal to grant leave may embolden revenue collection efforts because it potentially opens the door for the minister to reassess a broad range of taxpayers who have also used straddle transactions to achieve tax deferral.

Paletta also provides important lessons on the practice of engaging in transactions solely motivated by tax avoidance. The first lesson is that, although the law on this front is not new, the facts in *Paletta* provide a new perspective from which to assess existing tax planning. Second, taxpayers who have engaged in such transactions would be well advised to revisit, in light of the pronouncements in *Paletta*, the merits of the positions adopted with their advisers. Finally, needless to say, *Paletta* and the refusal of the SCC to grant leave will cause a shift in the strategy of taxpayers who are embroiled with the CRA in disputes involving similar issues (that is, they might be more—or less—inclined to settle, in light of this decision).

The decision also highlights the importance of formal, written opinions from tax advisers when it comes to avoiding substantial penalties. Mr. Paletta had received verbal (that is, unwritten) comfort from three different lawyers in respect of the straddle trading and advanced these discussions as a defence to the imposition of gross negligence penalties. The FCA rejected these arguments and held that had a formal opinion been obtained, all material facts would have been disclosed and, as a result, the source issue would not have gone unnoticed—the court's implication being that the taxpayer was indifferent or wilfully blind to whether the tax-deferral plan complied with the law. Notably, the FCA implicitly imposes certain standards of inquiry and comprehensiveness on written opinions, and although practitioners generally adhere to these standards, the decision is a useful reminder of them.

More generally, *Paletta* and (most likely) *Deegan* highlight the SCC's tendency not to grant leave to appeal in tax-related cases. The bar to being heard by the SCC is quite high. Except in situations where an automatic right of appeal exists, the SCC will hear an appeal only if permission to appeal has been granted by the court. Generally, leave to appeal is granted if the question involved is—by reason of its public importance or the importance of any issue of law or mixed fact and law—one that ought to be decided by the SCC or is, for any other reason, of such a nature or significance as to warrant a decision by the SCC (see sections 35-43 of the Supreme Court Act).

Over the past 15 years (that is, since 2009), 7,594 applications for leave to appeal have been filed with the court. During this period, 725 applications have been granted leave, which is on average less than 10 percent of the total applications submitted (assuming that the number of applications filed but not considered in the year is approximately the same as the number filed in the prior year and considered in the following). Generally, the number of applications related to tax or tax legislation are between 2 and 4 percent of the total applications submitted (according to data for the 2019-2021 period). Statistically, then, refusal to grant leave in *Paletta* does not seem out of the ordinary. More importantly, the chances of *Deegan*'s application for leave being granted are, as the SCC puts it in its FAQ, "remote."

Moreover, there is a plethora of jurisprudence from the appellate courts, including the SCC, on the principles applicable to the constitutionality of legislation. The bulk of the jurisprudence may not relate directly to tax legislation, but the applicable principles are sufficiently developed to permit counsel in a taxation matter to assess, with fair accuracy, the chances of success in respect of any impugned piece of legislation. Of course, this jurisprudence is not meant to deter applications for access to the SCC, but it does, to some degree, free up judicial resources. From the perspective of that jurisprudence, the issues in *Deegan* do not appear to meet the requisite bar for the SCC to grant leave to appeal.

That said, the court may grant leave in *Deegan* on the basis that the applicable constitutional principles (rather than specific issues) raised in this case are of public importance or of such a nature or significance as to warrant a decision by the SCC in light of the international instruments that have been and are expected to be introduced into law in Canada. Historical data and the TCC's 140-page decision, however, along with the narrowing of the plaintiffs' issues list at the FCA, suggest that such an outcome is unlikely.

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The "Throughout the Year" Requirement in Paragraph 95(2)(a)

Income from the property of a taxpayer's foreign affiliate (FA) is generally included in computing the foreign accrual property income (FAPI) of the FA for a taxation year, unless it can be recharacterized as active business income under paragraph 95(2)(a) of the Act. The preamble of paragraph 95(2)(a) requires that the taxpayer have a qualifying interest in the recipient affiliate "throughout the year" or that the affiliate be a controlled foreign affiliate (CFA) of the taxpayer "throughout the year." The interaction of these requirements with each other and with certain other provisions of the ITA can lead to surprising and inconsistent outcomes in certain cases.

Qualifying Interest and CFA

Pursuant to paragraph 95(2)(m), a taxpayer has a qualifying interest in an FA if the taxpayer owns (1) not less than 10 percent of the issued and outstanding shares having full voting rights under all circumstances in the FA, and (2) shares of the FA having a fair market value of not less than 10 percent of the fair market value of all the issued and outstanding shares of the FA. It should also be noted that the Act contains various deeming rules to meet qualifying interest status for the purposes of paragraph 95(2)(a). For example, paragraph 95(2)(n) deems a non-resident corporation to be an FA of a particular corporation resident in Canada (CRIC) and an FA in respect of which the particular corporation has a qualifying interest if, at that time, the non-resident corporation is an FA of another CRIC that is related to the particular corporation (otherwise than because of a right referred to in paragraph 251(5)(b)) and that other corporation has a qualifying interest in respect of the non-resident corporation. However, there are no such rules if the non-resident corporation is an FA of a Canadian individual or a Canadian trust, or if the non-resident corporation is held by a related non-resident person.

A CFA is defined in subsection 95(1) as an FA of the taxpayer that is controlled by the taxpayer either alone or with certain other persons, subject to a number of supporting rules that apply to attribute share ownership for these purposes.

Throughout the Year

In cases where shares of an FA are acquired or disposed of during the year, relieving provisions in subsections 95(2.2) and (2.201) enable taxpayers to meet the "throughout the year" requirement in paragraph 95(2)(a). Pursuant to subsection 95(2.2), for the purposes of paragraphs 95(2)(a) and (g), a non-resident corporation that is not an FA of a particular taxpayer in respect of which the taxpayer has a qualifying interest throughout a particular taxation year is deemed to be an FA of the particular taxpayer in respect of which the taxpayer has a qualifying interest throughout the year if two conditions are met:

1) A person or partnership has, in that particular year, acquired or disposed of shares of the capital stock of that non-resident corporation or of any other corporation and, as a result, that non-resident corporation becomes or ceases to be an FA of the taxpayer in respect of which the taxpayer has a qualifying interest.
2) The non-resident corporation is an FA of the taxpayer in respect of which the taxpayer has a qualifying interest at the beginning or end of the relevant taxation year.

Subsection 95(2.201) contains a parallel rule to enable taxpayers to meet the throughout-the-year requirement with respect to CFA status. The rule essentially deems a non-resident corporation to be a CFA of the taxpayer throughout a particular taxation year if a person or partnership acquires or disposes of shares of the capital stock of a corporation and, as a result, the non-resident corporation becomes or ceases to be a CFA of the taxpayer, and the non-resident corporation is a CFA of the taxpayer at the beginning or end of the taxation year.

However, the scope of subsection 95(2.2) is limited by subsection 95(2.21), which essentially prevents paragraph 95(2)(a) from applying to recharacterize income or loss that arose before or after the required qualifying interest is acquired or disposed of (subsection 95(2.21) effectively refers to the earlier of two times, but the latter time covers a very specific situation—where the taxpayer is a corporation that did not exist at the beginning of the taxation year and the shares of the affiliate were acquired from another person resident in Canada that was related to the taxpayer and that had a qualifying interest in the affiliate).

This rule is somewhat similar to, and is intended to interact with, the carve-out rule in paragraph 95(2)(f.1), but whereas paragraph 95(2)(f.1) carves out from the income of the affiliate any property income that accrued during the pre-affiliate status period, subsection 95(2.21) limits the application of the recharacterization rule for the period before the existence of the affiliate's qualifying interest status. In many cases, subsection 95(2.21) will not be relevant because paragraph 95(2)(f.1) will apply in the first place to exclude from the income of the affiliate any income or loss from property that accrued before the non-resident became an FA of the taxpayer. In other words, qualifying interest status will be obtained at the same time as FA status. However, there may be cases where paragraph 95(2)(f.1) will not be applicable, and subsection 95(2.21) will need to be considered. This could be the case in a situation where the non-resident corporation was already an FA of the taxpayer but the taxpayer did not have a qualifying interest in that affiliate, or a situation where the non-resident corporation

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was not an FA of the taxpayer but was a specified person or partnership in respect of the taxpayer. This should be the case if, inter alia, the non-resident corporation was an FA of another Canadian-resident person that was not dealing at arm's length with the taxpayer.

Interestingly, subsection 95(2.21) limits the application of the deeming rule in subsection 95(2.2) only for deemed qualifying interest status; there is no corresponding limitation with respect to subsection 95(2.201) for deemed CFA status. As a result, despite the limitation in subsection 95(2.21), income or loss of an affiliate that accrued before the qualifying interest status is acquired may still be recharacterized as active business income if that affiliate is a CFA of the taxpayer at the end of the year.

Consider, for example, the case of a Canadian individual who directly owns all of the shares of an FA (FA1) and indirectly owns all of the shares of another FA (FA2) through its Canadian holding company (Canco). FA1 receives interest income from FA2, and that interest is deductible in computing FA2's prescribed earnings from an active business that it carried on in a country other than Canada. The interest income is recharacterized as active business income under clause 95(2)(a)(ii)(B) and thus is not FAPI. During the year, the individual transfers the shares of FA1 to Canco. In this case, the income earned by FA1 before the transfer should not be carved out by paragraph 95(2)(f.1) because the income accrued while FA1 was a specified person or partnership in respect of Canco. FA1 can rely on both subsections 95(2.2) and (2.201) to ensure that the throughout-the-year requirement is met vis-à-vis Canco. Although subsection 95(2.21) should limit the application of subsection 95(2.2) in respect of the income that accrued before the transfer, subsection 95(2.201) should still deem FA1 to be a CFA of Canco throughout the year in respect of all income earned in the year. The interest income earned by FA1 before its transfer to Canco should therefore be recharacterized as active business income and should be included in the exempt surplus of FA1 vis-à-vis Canco.

The result would be different if FA1 were not a CFA of Canco at the end of the year. If we now assume that the Canadian individual owns 10 percent of the shares of FA1 (the remaining 90 percent interest being held by a non-resident third party), FA1 would become an FA of Canco upon the transfer, but not a CFA. In this case, subsection 95(2.21) would limit the application of subsection 95(2.2) in respect of the income earned by FA1 before the transfer, and FA1 would not be able to rely on the deeming rule in subsection 95(2.201) to have CFA status throughout the year. Although there would be no FAPI inclusion in the income of Canco (because FA1 is not a CFA of Canco), the income earned by FA1 before the transfer should be included in FA1's taxable surplus vis-à-vis Canco, and such income may be subject to tax in Canada upon repatriation if there is not sufficient underlying foreign tax applicable to such income.

The absence of a corresponding limitation rule for subsection 95(2.201) may simply be an oversight, given the various amendments made to these rules throughout the years. In 1995, the year in which paragraph 95(2)(a) and subsection 95(2.2) were introduced, the taxpayer was required to have a qualifying interest in the recipient affiliate throughout the year. The condition in paragraph 95(2)(a) regarding CFA status was added in 2007, the year in which the limitation provision in subsection 95(2.21) also came into force—although subsection 95(2.21) had been proposed many years before its enactment in a different version. It was only two years later, in 2009, that the deeming provision for CFA status in subsection 95(2.201) was enacted. All of these amendments were applicable to taxation years of an FA of a taxpayer that ended after 1999 (or, subject to an election, after 1994), which seems to suggest that the legislator has tried, over the years, to fill perceived gaps in the rules.

In any case, the absence of a parallel limitation rule gives rise to inconsistent surplus results, and it would be difficult, from a policy perspective, to justify this inconsistency between qualifying interest status and CFA status in the context of paragraph 95(2)(a). Perhaps the answer lies in better coordination between the application of the limitation rule in subsection 95(2.21) and the carve-out rule in paragraph 95(2)(f.1), such that the limitation rule would not apply if the carve-out rule does not apply.

For taxpayers, these inconsistencies can perhaps give rise to traps and opportunities.

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