

Canadian mandatory disclosure rules update: first list of designated notifiable transactions released

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The Canadian Minister of National Revenue published the first [list of designated notifiable transactions](#) under the mandatory disclosure rules on November 1, 2023. First announced in [Budget 2021](#), the notifiable transaction rules introduced new reporting obligations in respect of transactions that are the same or substantially similar to those included on the list. Failure to comply with the new rules results in an extension of the normal reassessment period and can result in significant penalties.

One day after releasing the list of designated notifiable transactions, the Canada Revenue Agency (CRA) updated its guidance on the mandatory disclosure rules. The updates include important changes to the contractual protection hallmark of the reportable transaction rules. A separate Osler Update will follow setting out these changes and their implications for taxpayers' obligations under the mandatory disclosure rules.

The designation of the first list of notifiable transactions effective November 1, 2023 marks the beginning of potential disclosure obligations under the new rules. Although the legislative framework for the notifiable transaction rules received Royal Assent on [June 22, 2023](#), the rules were ineffectual prior to the designation of any notifiable transactions.

Compared to the sample list of notifiable transactions included with the initial draft legislation released on [February 4, 2022](#), the first official list omits one of the sample transactions relating to the manipulation of Canadian-controlled private corporation (CCPC) status to circumvent anti-deferral rules applicable to investment income. This omission reflects the fact that [specific legislation was subsequently introduced](#) to address this tax issue.

Overview of notifiable transaction rules

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

The term "substantially similar" is to be interpreted broadly in favour of disclosure, and includes a transaction or series in respect of which a person is expected to obtain the same or similar tax consequences and that is either factually similar or based on the same or a

similar tax strategy as a transaction or series designated by the Minister.

Notifiable transactions must be reported by all persons who (1) obtain (or expect to obtain) a tax benefit from the transaction(s), (2) enter into the transaction(s) for the benefit of a person in category 1, (3) are advisors or promoters (as defined) in respect of the transaction(s), and (4) are not dealing at arm's length with advisors or promoters in category 3 and who are entitled to a fee in respect of the transaction(s).

Unlike the reportable transaction rules, the reporting obligation for notifiable transactions is the same for all of the above-listed persons and does not depend on whether the advisors or promoters (category 3) receive a fee. However, a reporting obligation exemption applies where an advisor or promoter (plus those not dealing at arm's length with them — categories 3 and 4 above) does not know and should not reasonably be expected to know that the transaction was a notifiable transaction.

A separate due diligence defense is available to persons in categories 1 and 2 (generally, participants in the transaction) 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. This standard generally requires the person to have taken active steps to ensure compliance.

The deadline to report a notifiable transaction is generally 90 days after the earliest of the date that a participant in the transaction became contractually obligated to enter into the transaction, or the date on which the transaction was entered into. Reporting is required by way of prescribed form [RC312 \[PDF\]](#), which, among other things, requires the filer to identify the relevant transaction designated by the Minister and whether it is the same versus substantially similar to the transaction(s) being reported.

Late filing and failure to file both extends the normal reassessment period and can result in significant penalties for all persons who fail to report on a timely basis.

Lawyers and other legal professionals are currently exempted from the application of the mandatory disclosure rules, including in respect of notifiable transactions. The Federation of Law Societies of Canada obtained a temporary injunction pending the outcome of its application for an injunction. The hearing for the application was held on October 20, 2023. The temporary injunction will apply until the earlier of December 1, 2023, and the date on which the court releases its decision in response to the application. It is possible that the court would further extend the deadline. The injunction relates to the challenge brought by the Federation of Law Societies of Canada as to the constitutionality of the mandatory disclosure rules now in force.

Five notifiable transactions

For each of the designated transactions, the list published by the Minister of National Revenue includes two sections: an introduction, which sets out general information about and the rationale for including the relevant transactions in the list, and a "designated transactions" section that formally identifies the designated series of transactions and provides the effective date.

Straddle loss creation transactions using a partnership

The introduction notes generally the existence of "financial arrangements that seek to reduce tax by generating artificial losses with the use of complex financial instruments or

derivatives". It acknowledges that some straddle transactions were addressed by specific anti-avoidance rules introduced in the [2017 Federal Budget](#), which operate to suspend the recognition of any loss from the straddle arrangement until the related gain is realized. The Minister explained her decision to designate certain straddle transactions as being prompted by new variations of transactions using partnerships that have been identified by the CRA as circumventing the specific anti-avoidance rules in place.

Accordingly, the following series of transactions is designated:

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 (legs) 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. Following the acquisition of the partnership interest by the taxpayer, the loss leg(s) are realized and a business loss is allocated to the taxpayer.

Avoidance of deemed disposal of trust property

Most trusts are subject to a deemed realization rule every 21 years: capital property of trusts is deemed to have been disposed of and reacquired every 21 years. Various rules seek to prevent deferral past the 21 years, including by transferring the property to another trust, to a capital beneficiary, or to a non-resident beneficiary.

In response to various series of transactions entered into by taxpayers to avoid or defer the 21-year deemed realization rule, the Minister designated three types of series:

1. Indirect property transfers to another trust: prior to its 21-year anniversary, Trust A transfers property to a Canadian corporate beneficiary, the shares of which are held by Trust B.
2. Indirect property transfers to a non-resident: prior to its 21-year anniversary, a trust transfers property to a Canadian corporate beneficiary, the shares of which are held by a non-resident beneficiary of the trust.
3. Transfers of trust value by means of deemed dividend as follows:
 - Trust A owns shares in an Opco.
 - Prior to Trust A's 21-year anniversary, Opco redeems those shares in exchange for a promissory note or cash, resulting in a dividend deemed to be paid to Trust A.
 - Trust A designates that deemed dividend as being receivable by a Canadian corporate beneficiary, Holdco, the shares of which are held by Trust B.

- Trust A also provides the promissory note or cash to Holdco.
- Holdco deducts the deemed dividend under subsection 112(1).

Manipulation of bankrupt status to reduce a forgiven amount in respect of a commercial obligation

Debt forgiveness rules provide that where a commercial debt obligation is settled or extinguished for less than its principal or issuance amount, the “forgiven amount” applies to reduce various tax attributes or potentially result in an income inclusion. The forgiven amount is reduced by the principal amount of the obligation if the debtor is bankrupt at the time of the settlement. The Minister explains that some taxpayers temporarily enter into bankruptcy, settle commercial debt obligations, and then reverse their bankruptcy having reduced the forgiven amount to nil without any reduction in tax attributes or income inclusion.

Accordingly, the following series of transactions is designated:

1. A person or partnership (Debtor) is placed into bankruptcy.
2. A commercial obligation of the bankrupt Debtor is settled, deemed to be settled, or extinguished for an amount that is less than the principal amount of the obligation.
3. The Debtor takes steps to annul the bankruptcy status through the judicial process.

Reliance on purpose tests in section 256.1 to avoid a deemed acquisition of control

Various deeming provisions apply in respect of the acquisition of control rules, which impact the use of corporate tax attributes. Some of the deeming provisions refer to situations where one the main reasons of a person or group of persons is to either acquire or avoid acquiring control of a corporation. The Minister states that some taxpayers have relied on these purpose tests to avoid the application of the relevant deeming rules on acquisition of control.

As a result, the Minister designated three types of series in respect of three provisions with purposes tests: paragraph 256.1(2)(d), paragraph 256.1(4)(a), and subsection 256.1(6).

1. Purpose test in paragraph 256.1(2)(d):
 - Lossco is a taxable Canadian corporation that has some tax attributes, the use of which is restricted under section 256.1 and certain other provisions as envisaged in the definition “attribute trading restriction” in subsection 256.1(1).
 - Aco does not hold shares of Lossco with a fair market value (FMV) that satisfies the 75% FMV threshold test.
 - At a particular time, Aco acquires shares of Lossco resulting in the satisfaction of the 75% FMV threshold test, but without acquiring control over Lossco, and the taxpayer takes the position that since the purpose test in paragraph 256.1(2)(d) is not met, subsection 256.1(3) does not apply.
1. Purpose test in paragraph 256.1(4)(a):
 - Lossco is a taxable Canadian corporation that has some tax attributes, the use of which is restricted under section 256.1 and certain other provisions as envisaged in the definition “attribute trading restriction” in subsection 256.1(1).

- Profitco and Aco (which does not deal at arm's length with Profitco) acquire shares of Lossco.
 - Following the acquisition, Profitco does not control Lossco and does not hold shares of Lossco with a FMV that satisfies the 75% FMV threshold test, but it would satisfy the 75% FMV threshold test if the Lossco shareholding by non-arm's length Aco is disregarded.
 - The taxpayer takes the position that subsection 256.1(3) does not apply since the purpose test in paragraph 256.1(4)(a) is not met.
1. Purpose test in subsection 256.1(6):
 - Lossco is a taxable Canadian corporation that has some tax attributes, the use of which is restricted under section 256.1 and certain other provisions as envisaged in the definition "attribute trading restriction" in subsection 256.1(1).
 - Lossco acquires control of Profitco.
 - It can reasonably be concluded that one of the reasons for the acquisition of control is so that a specified provision as defined in subsection 256.1(1) does not apply.
 - However, the taxpayers take the position that subsection 256.1(6) does not apply since the purpose test is not met.

Back-to-back arrangements

Canada's thin capitalization rules deny a deduction (or require an income inclusion) for certain interest paid or payable to certain non-residents. Specific rules address back-to-back arrangements where intermediaries are used to avoid the thin capitalization rules, while similar rules address the use of back-to-back arrangements in the withholding tax context.

The Minister designated the following series in respect of the financing and certain other arrangements structured through intermediaries:

1. Thin capitalisation: Canco would be subject to the thin capitalization rules for interest paid to Forco1, but Forco1 enters into an arrangement with arm's length Forco2 to indirectly provide financing to Canco and the latter takes the position for its income tax returns that the interest paid is not subject to the thin capitalization rules.
2. Withholding tax: Canco makes some payments (interest, rents, royalties, or similar payments) to Forco2 that would have been subject to withholding tax had it been paid to Forco1 and takes the position for its income tax returns that the payment is not subject to withholding tax (or benefits from a lower rate than would have applied had the amount been paid to Forco1).

Implications and takeaways

The two key challenges for the notifiable transaction rules are clarifying the scope of (1) the meaning of "substantially similar", and (2) the due diligence and reasonable to know defences. Understanding the former concept is critical for knowing when a reporting obligation may arise. The scope of the due diligence and reasonable to know defences is uncertain, and is likely to remain uncertain until the courts are able to provide guidance. For example, there is no explanation regarding how the defences might apply to organizations (including corporations and partnerships). Do the tests apply to the organization as a whole, aggregating all their collective knowledge even if in practice that knowledge was not shared, or would the tests apply to individual members of the organization?

Lawyers and other legal professionals should closely monitor the battle of the Federation of Law Societies of Canada in the British Columbia Supreme Court and the court verdict on the application of the mandatory disclosure rules to them.