The Joint Committee on Taxation of
The Canadian Bar Association

and

Chartered Professional Accountants of Canada
Chartered Professional Accountants of Canada, 277 Wellington St. W., Toronto ON, Canada M5V3H2
The Canadian Bar Association, 66 Slater St., Suite 1200, Ottawa, ON, Canada K1P 5H1

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Robert Demeter
Director General
Tax Legislation Division
Tax Policy Branch
Department of Finance Canada
90 Elgin Street
Ottawa, ON K1A 0G5

Email: Robert.Demeter@fin.gc.ca

Dear Mr. Demeter:

Subject: Impact of CAE case

The purpose of this submission is to request that the Department of Finance ("Finance") consider taking action to respond to the recent decisions of the Federal Court of Appeal and Tax Court in *CAE Inc. v. Canada*[1] ("**CAE**"). There is significant concern within the tax community on the implications of this decision. In particular, we are concerned that the decision in CAE may result in immediate income inclusions under paragraph 12(1)(x) and/or the immediate denial of investment tax credits pursuant to section 127 of the *Income Tax Act* (Canada) (the "Act")[2] in inappropriate circumstances from a policy perspective, as summarized below.

Members of the Joint Committee on Taxation of the Canadian Bar Association and Chartered Professional Accountants of Canada ("Joint Committee") and others in the tax community participated in the discussion concerning this submission and contributed to its preparation, including:

- Michael Ding – WeirFoulds LLP
- John Oakey – CPA Canada

[1] The Federal Court of Appeal 2022 FCA 178 affirmed the decision of the Tax Court in 2021 DTC 1050. On May 26, 2023, the Supreme Court of Canada denied leave to appeal.
[2] Unless otherwise stated, all statutory references herein are to the provisions of the Act.

- Anu Nijhawan – Bennett Jones LLP
- Carrie Smit – Goodmans LLP

We trust that you will find our submission helpful. We would be pleased to discuss it further at your convenience.

Yours very truly,

Carmela Pallotto

Carmela Pallotto
Chair, Taxation Committee
Chartered Professional Accountants of Canada

Ian Crosbie

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Chair, Taxation Section
Canadian Bar Association

CAE Reasons

The taxpayer in CAE received, over a five-year period, "contributions" in the principal amount of $250 million from Industry Canada, pursuant to the Strategic Aerospace and Defence Initiative ("**SADI**") program,[3] including $57 million in 2012 and $59 million in 2013, related to a certain project. The amounts were used by CAE to incur scientific research and experimental development ("**SR&ED**") expenditures (approximately $41 million in each of 2012 and 2013) and other research and development costs in the larger amount of $700 million. Under the agreement with Industry Canada, CAE was required to repay 135% of the amounts (or $337.5 million) beginning after the last advance was made and in escalating specified amounts in annual installments over a 15-year period. CAE claimed investment tax credits ("**ITCs**") in respect of the SR&ED expenditures. The repayment conditions provided Industry Canada with a rate of return of approximately 2.5% on an annual basis.[4] The agreement also imposed various restrictions on CAE, including a requirement that products be manufactured exclusively in Canada, that certain SR&ED work be conducted by post-secondary institutions in Canada, and restrictions on CAE's ability to transfer title or intellectual property rights relating to the project.

The Tax Court concluded that the arrangement was a loan, which CAE had an unconditional obligation to repay. In then considering whether the loan constituted "government assistance", the Tax Court framed the test as follows:

> Having read *Consumers' Gas, CCLC Technologies* and *Immunovacci*ne, I am of the opinion that in order to determine whether payments made under an agreement constitute "government assistance", it is not enough to determine whether payments were made in exactly the same way and for exactly the same reasons as those made by private companies. Rather, I am of the opinion that in order to determine whether the test established by these judgments is met, **the Court must determine whether the payments were made in order to promote the commercial interests of the payer, that is to say whether they were made under an "ordinary commercial arrangement"**. Indeed, I believe that an agreement can be an "ordinary commercial agreement" even if the payments made under it were not made in exactly the same way and for exactly the same reasons as those made by private companies. Given the circumstances, a company may very well determine that it is expedient for it, in the interest of furthering its commercial interests, to enter into an agreement whose terms differ from comparable agreements entered into between private companies during the same period. Finally, I also believe that since payments made under an agreement are made in accordance with its terms, it is appropriate to examine those terms to determine whether they correspond to the terms of an ordinary commercial agreement. **In this regard, it is logical to conclude, unless there is evidence to the contrary, that it is generally contrary to the commercial interests of an enterprise to be party to an agreement whose terms are substantially less advantageous than those of agreements ordinarily concluded under the same circumstances**. (emphasis added)

The Tax Court concluded that the loan agreement was not an "ordinary commercial agreement" and therefore constituted government assistance, within the meaning of subsections 127(9) and 12(1)(x),

[3] The SADI program is, as we understand it, intended to support research and development projects in the aerospace, space, defence and security sectors: https://ised-isde.canada.ca/site/industrial-technologies-office/en/strategic-aerospace-and-defence-initiative-sadi

[4] Early termination was also permitted upon the payment by CAE of an amount representing a return on investment of 2.75% on an annual basis.

since:[5] (1) the implicit interest rate of 2.5% was significantly less than the typical market rate for a comparable loan, (2) there was a lack of commercial covenants and (3) several conditions in the agreement were motivated by political considerations rather than commercial reasons. Focusing on the first point, the Federal Court of Appeal upheld the Tax Court's decision, affirming that the test for determining whether a payment constitutes "government assistance" turns on the underlying mechanism and purpose of the payment. On May 26, 2023, the Supreme Court of Canada dismissed CAE Inc.'s application for leave to appeal.

Principles and Concerns Emerging from CAE

The CAE decision stands for the proposition that a government loan lacking sufficient "ordinary commercial terms" – including one that is made other than to promote the commercial interests of the government or one that has a lower-than-market interest rate – will be considered "government assistance" within the meaning of paragraph 12(1)(x)[6] and subsection 127(9).

A finding that an amount is "government assistance" can result in one or more of the following:

- the amounts received or receivable in each year in respect of SR&ED expenditures are excluded from qualified SR&ED expenditures for ITC purposes by subsection 127(18),
- the amounts received in relation to the SR&ED activities are not deductible in computing income from the taxpayer's business by virtue of paragraph 37(1)(d),
- the amounts received are includible in income under paragraph 12(1)(x),[7] or
- the amounts received or receivable, in respect of, or for the acquisition of, property will reduce the capital cost of the property under paragraph 127(11.1)(b) for purposes of calculating ITC's under subsection 127(9).

The Courts' reasoning, coupled with the broad language used in paragraph 12(1)(x) and subsection 127(9) may cause various loan amounts to be captured as government assistance. The reasoning appears to apply to loans that don't meet normal commercial terms including low-interest loans which are made directly by the government, by a Crown corporation, or by other public authority. The treatment of unconditionally repayable loans as government assistance appears to be inconsistent with the tax policy objectives of the Act.

For example, we understand that the mandates of each of the Business Development Bank of Canada, Canada Infrastructure Bank, Export Development Canada, and Farm Credit Canada, each of which could be viewed as a government entity, include acting as lenders (complementary to the private sector) providing financing to projects which are desirable for socio-political reasons (*e.g.,* to promote the long-

[5] Notably, the decision in CAE is a departure from the Canada Revenue Agency's historical position. See, for example, Interpretation bulletin IT-273R2 (September 13, 2000), paragraph 16 [now archived], whereunder the CRA had previously stated that:

> The fact that a loan is interest-free or that the rate of interest on the loan is less than the existing commercial rate of interest will not normally cause a loan to be considered as assistance for the purpose of paragraph 12(1)(x).

[6] Although paragraph 12(1)(x) of the Act does not specifically define government assistance, the wording of the paragraph produces a similar result as the defined term government assistance in subsection 127(9)

[7] Subject to certain elections which, if made, reduce the quantum of other tax attributes.

term success of particular industries or projects where returns are measured by more than dollars and cents) but might not be able to be fully financed from the private sector. Given the broader policy reasons for financing by these entities, such loans could, in some circumstances, not have fully commercial terms. It does not appear, however, that from a policy perspective, such amounts should be treated as government assistance under paragraph 12(1)(x) or subsection 127(9), as such treatment might result in the desired projects not being economically viable because of the increased tax burden.

Further, treatment of government loans as "government assistance" seems contrary to the policy considerations underlying the Budget 2023 announcements relating to measures, including a number of new ITCs, in pursuit of advancing Canada's "clean" economy. Where government financing is involved in such ventures, the potential for immediately denied ITCs or immediate income inclusions may make such projects undesirable.

Furthermore, the CAE decision gives rise to added, and we believe, inappropriate uncertainty as to the scope of paragraph 12(1)(x) and subsection 127(9), which we believe should be clarified.

Recommendation

We recommend that the Act be amended to exclude loans which are unconditionally repayable from being "government assistance" for the purposes of paragraph 12(1)(x) and subsection 127(9). In the interim, we would urge Finance to issue a comfort letter on this issue.