“Government Assistance”: Recipient Beware

July 25, 2023

On May 25, 2023, the Supreme Court of Canada (SCC) refused CAE Inc. leave to appeal[1] its loss before the Federal Court of Appeal (FCA) in a case[2] involving the tax treatment of low-interest loans CAE had received from Industry Canada, a federal government department. The FCA had in turn dismissed CAE’s appeal from the Tax Court of Canada decision[3] in favour of the Canada Revenue Agency (CRA), concluding that the CRA had correctly applied the *Income Tax Act* (Canada) (ITA) to these government loans.

At the outset, it is important to understand that the adverse tax rules in question applied not merely to the benefit of the below-market interest rate of these loans, **but to the entire principal amount of the loans themselves** . As a result, the amounts at stake for *CAE* were quite large, and if the CRA administers these rules in the manner seen in the *CAE* case without those rules being fixed, the potential implications are enormous for taxpayers that avail themselves of various incentives offered by governments and quasi-governmental entities. It is virtually unimaginable that Parliament intended the results of the interaction of these incentive programs and the ITA to be this. A wide range of federal and provincial government incentives exist to address the continuing lack of productivity in Canada’s economy, encourage creating a business environment that is sustainable to combat climate change, and various other worthy and important objectives. These government initiatives will not be effective in achieving their goals unless Parliament acts to ensure that the ITA rules on government assistance are compatible with them.

This combination of circumstances is both surprising and alarming and it would be a mistake to believe the concern is limited to the scientific research and experimental development (SR&ED) sector. While the negative impact of an amount being characterized as “government assistance” is generally reversed upon a repayment by the taxpayer in a later year (somewhat mitigating the impact of true loans that get repaid), where the numbers are as significant as they were in the *CAE* case the immediate adverse tax effect of a fully repayable loan can still be quite negative. The SCC’s refusal to hear CAE’s case is somewhat surprising, given the importance of the issue and the impressive list of supporting letters from various business organizations the taxpayer assembled in furtherance of its application for leave to appeal.[4] Government action to clarify when taxpayers should expect to have these adverse tax rules applied to them is urgently needed. In the meantime, taxpayers need to consider very carefully the potentially negative tax impact of receiving various forms of government aid, and cannot assume that the department or agency they are dealing

with has considered (or is even aware of) the potentially adverse tax impact of their programs on those who use them.

The facts

CAE is a Canadian company whose shares are publicly listed. Its primary business is manufacturing, selling and servicing flight simulators. In 2007, it participated in the Canadian government's Aerospace and Defence Strategic Initiative Program (ISAD Program), administered by Industry Canada and designed to encourage innovative strategic research and development, enhanced competitiveness and greater collaboration between the private sector and research facilities and universities.

Industry Canada and CAE entered into an agreement (ISAD Agreement) whereby CAE would undertake $700 million of SR&ED expenditures over the period 2009-2014 (Project Falcon). In turn, Industry Canada agreed to make up to $250 million in "contributions" to CAE during this period. From 2015-2029, CAE was obligated to repay a total of $337.5 million, giving Industry Canada an implicit 2.5% annual rate of return (a rate well below the 7%+ rate at which CAE could borrow from a private-sector lender). The ISAD Agreement contained various commitments from CAE relating to working with Canadian research institutions, committing to manufacturing in Canada, and restricting transfers of intellectual property arising from Project Falcon. The ISAD Agreement did not contain a variety of covenants and commitments that would be found in a typical private-sector loan agreement, and CAE's repayment obligations were unsecured.

The ITA provisions

The primary ITA provisions in question were those dealing with SR&ED. Briefly, qualifying SR&ED expenditures meeting various requirements are treated favourably, in terms of:

- being deductible from income immediately under s. 37(1), even if they would normally not be because of being capital in nature; and
- entitling the taxpayer to an "investment tax credit" (ITC), *viz.* a deduction against taxes owing, under s. 127(9).[5]

However, the amount of the taxpayer's currently deductible SR&ED expenditures is reduced by "the total of all amounts each of which is the amount of any government assistance or non-government assistance ... that at the taxpayer's filing-due date for the year the taxpayer has received, is entitled to receive or can reasonably be expected to receive"[16] Similarly, the taxpayer's pool of SR&ED qualified expenditures for ITC purposes is reduced by any "government assistance, non-government assistance or a contract payment that can reasonably be considered to be in respect of scientific research and experimental development" that the taxpayer "has received, is entitled to receive or can reasonably be expected to receive" on or before the taxpayer's filing due-date for the year.[7] For both purposes, "government assistance" is defined as follows:[8]

> ***government assistance*** means assistance from a government, municipality or other public authority whether as a grant, subsidy, forgivable loan, deduction from tax, investment allowance or as any other form of assistance other than as a deduction under subsection 127(5) or 127(6)

Other ITCs for non-SR&ED amounts are also effectively reduced by amounts received, receivable or expected to be received for government or non-government assistance, and it is anticipated that various new "green economy" ITCs announced over the past 12 months and for which legislation is still being drafted will include similar provisions.[9]

Separately, s. 12(1)(x) is a residual rule of general application, designed to capture and bring into income various forms of benefits that are not otherwise included in income or deducted in computing the amount of a taxpayer's expenditure or cost of property. Specifically, this provision includes amounts "received by the taxpayer in the year, in the course of earning income from a business or property" from a payer that is, *inter alia*, "a government, municipality or other public authority ... (iv) as a refund, reimbursement, contribution or allowance or as assistance, whether as a grant, subsidy, forgivable loan, deduction from tax, allowance or any other form of assistance, in respect of an amount included in, or deducted as, the cost of property, or an outlay or expense." Such amounts are included in the recipient's income, subject to a potential election to instead apply them to reduce certain outlays or expenses.

The judgment

In *CAE Inc.*, the parties were considering contributions (which the Tax Court ruled constituted loans) made to CAE under the ISAD Agreement of $57,084,395 in respect of its 2012 taxation year and $59,148,888 in respect of its 2013 taxation year. Of those amounts, the CRA concluded that $41,003,491 for 2012 and $40,652,951 for 2013 had been used by CAE for SR&ED purposes. The Tax Court ruled that the CRA's re-assessment of CAE was correct in all respects. Specifically, the Tax Court found that the CRA was correct in:

- characterizing the full $57,084,395 for 2012 and $59,148,888 for 2013 as "government assistance";
- subtracting from CAE's deductible SR&ED expenditures under s. 37(1) the amounts of $41,003,491 for 2012 and $40,652,951 for 2013 determined to have been used for SR&ED expenditures;
- subtracting from CAE's pool of qualifying SR&ED expenditures for ITC purposes the entire $57,084,395 for 2012 and $59,148,888 for 2013; and
- for 2012, including in CAE's income under s.12(1)(*x*) the difference ($14,806,939) between the amount actually "received" by CAE in 2012 under the ISAD Agreement ($55,810,430) and the $41,003,491 used for SR&ED expenditures.

On the core issue of what constitutes "government assistance," the Tax Court reviewed prior jurisprudence on this issue and concluded fairly readily that the phrase "or as any other form of assistance" was broad enough to capture fully repayable loans. In this regard, the Tax Court's review of previous caselaw found that the question to ask to determine what constitutes "government assistance" has been interpreted as follows (at para. 108):

> whether payments have been made in exactly the same way and for exactly the same reasons as those made by private companies, *i.e.* to promote the interests of the payer.

The Tax Court went on to rule 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, whether they were made pursuant to an 'ordinary commercial agreement'" [para. 116]. In this regard, various aspects of the ISAD Agreement were found to render it *not* an "ordinary commercial agreement", including the absence of various protections for lenders normally found in "ordinary" commercial loan documents, the below-market rate of return Industry Canada received under the ISAD Agreement, and various terms found in the ISAD Agreement that were "driven primarily by political considerations or government action, rather than commercial motives" (para. 128).

Discussion

Various aspects of the *CAE* saga are of great concern to the Canadian business community. It does not appear that the tax policy around government incentives is being fully considered and effectively coordinated with the myriad of economic and social policy programs that different branches of government (including quasi-government agencies under government supervision) are administering. The result is considerable uncertainty for the business community and potentially costly disputes with the CRA over how the existing rules should be administered.

In particular, the fact that s. 12(1)(x) was applied to a fully repayable loan is surprising. Historically, the CRA's administrative policy has been that unconditionally repayable loans should not engage s. 12(1)(x), even if at a favourable rate of interest:[10]

> 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*).

As a result, the impact of this case extends beyond taxpayers who engage in SR&ED and other activities that generate ITCs, to any taxpayer receiving "any other form of assistance" in respect of outlays, expenses or the cost of property.

As to ITCs themselves, there is no reason to think that the scope of this case will be limited to the SR&ED community. New ITC programs announced over the past 12 months include those to incentivize the following:

- clean technology;
- clean manufacturing;
- clean electricity;
- carbon capture, utilization and storage; and
- clean hydrogen generation.

Anyone pursuing these new ITCs (which generally involve very capital-intensive activities) will need consider what "government assistance" they are receiving or "can reasonably be expected to receive" in connection thereto.

The scope of the term "government, municipality or other public authority" is also not clear, and could potentially encompass a wide range of quasi-governmental agencies and entities. It is noteworthy that in the context of what constitutes "government assistance" the CRA has previously stated as follows:[11]

> Such assistance includes amounts received from a federal, provincial or foreign government, a municipality, a crown corporation or any other public authority (referred to collectively as "government organizations" in this bulletin). Although consideration should also be given to the nature of the functions performed by the entity, a public authority is generally an entity which:
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> a. has a duty to the public;
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> b. is subject to a significant degree of governmental control; and
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> c. uses its profits for the benefit of the public.

The vagueness of this term, when combined with the inclusion of fully repayable loans within the scope of what the CRA is pursuing, is of great concern to businesses that obtain financing from various bodies that have significant connection to different levels of government. Rather than requiring each taxpayer to assess the level of risk on this issue for itself, the CRA and the Department of Finance should consult with the various government and quasi-governmental agencies potentially affected by the "assistance" provisions in the ITA (including s. 12(1)(x)) to develop and articulate a comprehensive policy for under what circumstances different forms of activity will be considered "assistance" and which quasi-governmental entities will be viewed as "other public authorities." In the meantime, taxpayers will need to ensure that they fully understand the potential tax impact of incentives and assistance that they are considering applying for.

This article was written by Steve Suarez, BLG (Toronto)

Footnotes

[1] See *CAE Inc. v. His Majesty the King*

[2] *CAE Inc. v. Canada*, 2022 FCA 178

[3] 2021 TCC 57. There is no official English translation of the decision, which was rendered in French. An unofficial Google Translate English translation can be found here.

[4] The author is the Co-Chair of the Taxation and Economics Committee of the Canadian Chamber of Commerce, which wrote one such letter.

[5] For a summary of Canada's tax rules on SR&ED, see here under Section 9. Scientific Research & Experimental Development.

[6] S. 37(1)(d).

[7] S. 127(18).

[8] S. 127(9).

[9] The term “government assistance” is also relevant in the context of determining appropriate arm’s length transfer pricing of transactions between Canadian taxpayers and non-arm’s-length non-residents: see for example CRA document TPM-17, The Impact of Government Assistance on Transfer Pricing”

[10] See Archived CRA Interpretation Bulletin IT 273R2, para. 16.

[11] *Ibid*., para. 3.

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