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The Mandatory Disclosure Rules: New CRA Guidance in the Employment Context

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Expanded mandatory disclosure rules under the *Income Tax Act* (Canada) came into effect in Canada on June 22, 2023, requiring the reporting of reportable transactions, notifiable transactions, and uncertain tax treatments. For a detailed overview of the mandatory disclosure rules click here.

In the employment context, a debate emerged among certain advisors whether an allocation to non-taxable heads of damages in the context of a settlement of a wrongful dismissal claim would be a reportable transaction for the employee and/or the employer. A similar concern can be voiced for parties entering into an independent contractor agreement where the worker could be properly characterized as an employee (had the parties agreed to that characterization).

Updated guidance from the Canada Revenue Agency released on November 2, 2023 ("guidance") and accessible here appears to address these scenarios. Unfortunately, we do not believe that the updated guidance resolves the uncertainty.

Discussion

In general, a reportable transaction is a "transaction" (which term is defined in the rules to include an arrangement or event) where it may reasonably be considered that (i) one of the main purposes of the transaction or a series of transactions that includes the transaction is to obtain a "tax benefit" (an "avoidance transaction"), and (ii) one of three hallmarks is present, one of which is contractual protection (such as a tax indemnity).[1]

The reportable transaction rules may apply to the above referenced employment law scenarios because, among other things, the standard representations and indemnities (including with respect to taxes, penalties and interest) provided by the employee/contractor to the counterparty could constitute contractual protection.

In an apparent attempt to address this issue (at least in the context of a severance agreement), the updated guidance provides:

The contractual protection hallmark will not apply in a normal commercial or investment context in which parties deal with each other at arm's length and act prudently, knowledgeably and willingly, and does not extend contractual protection for a tax treatment in respect of an avoidance transaction. Without providing an exhaustive list of examples, these can include:

> Tax indemnities in employment agreements and severance agreements

First, it is important to note that CRA administrative guidance is not law, and the CRA is not bound to follow it (though they generally can be expected to). Second, the guidance does not provide a blanket exemption from the contractual protection hallmark in all severance agreements (and other commercial and investment agreements such as independent contractor agreements). Conditions to

engage the hallmark include (A) it has to be given in a normal commercial context, (B) the parties need to deal with each other at arm's length, (C) such parties need to be acting prudently, knowledgeably and willingly, and (D) the contractual protection must not extend to a tax treatment in respect of an avoidance transaction.

These conditions make it unclear to what extent parties can rely on the guidance to not report. For example, where the parties have agreed to an *unreasonable* allocation to non-taxable heads of damages or have *unreasonably* characterized a worker as an independent contractor, it is unclear whether the CRA would take the position that the parties were not acting prudently (or were not dealing at arm's length in the context of the allocation or characterization, with the counterparty merely being an accommodating party).

Even if the allocation and worker characterization are reasonable, can it be said that the tax indemnity does not protect for a tax treatment in respect of an avoidance transaction? Typically, the tax indemnity would be broad enough to protect the employer/counterparty from penalties and costs for insufficient income tax deductions. That protection might be considered protection for (i) the employee/contractor's tax treatment of not reporting the allocation in the context of a severance agreement or the claiming of benefits (such as deductions that an employee would not otherwise be allowed to claim) associated with being an independent contractor, and/or (ii) the employer/counterparty's tax treatment to not report remuneration payable on a T4 slip (or under-report remuneration on a T4 summary return). In this connection, "tax treatment" is defined in the rules to include the person's decision not to include a particular amount in a return of income or an information return.

However, under the rules, an employer/counterparty would not need to file an information return unless, along with other conditions being satisfied, it entered into the transaction for the benefit of the employee/contractor. Arguably, and particularly where the allocation or worker characterization, as applicable, is reasonable, the employer/counterparty should be seen as acting on its own behalf and not as entering into the transaction for the benefit of the employee/contractor.[2] This position is more tenuous when the allocation or worker characterization, as applicable, is unreasonable where the employer/counterparty may be seen as an accommodating party with no adverse interest to the allocation/characterization.

We hope the guidance will continue to develop to provide more clarity and certainty for taxpayers and their advisors.

We Can Help

We can assist advisors and taxpayers in determining if they have a reporting obligation under the reportable transaction rules. Where we advise reporting is not required, our advice will give such parties a strong due diligence defence to avoid penalties under the rules (should the CRA take a contrary position). Where the rules are applicable, we can assist with completing the information return.

The information and comments herein are for the general information of the reader and are not intended as advice or opinion to be relied upon in relation to any particular circumstances. For particular application of the law to specific situations, the reader should seek professional advice.

[1] Broadly classified, the other two hallmarks are contingency fees and confidential protection.

[2] This argument does not impact any obligation of the employee to report the transaction.

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