

Modernizing and Strengthening the General Anti-Avoidance Rule

Consultation Paper

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A. Introduction

This paper follows through on the *2020 Fall Economic Statement* commitment to improve tax fairness by consulting with Canadians on approaches to strengthening the General Anti-Avoidance Rule (GAAR) in the *Income Tax Act* (the Act).

Since the GAAR was added to the Act in 1988, it has proven to be a reasonably effective tool for preventing abusive tax avoidance. It was meant to be an all-encompassing rule that would prevent abusive tax avoidance transactions while not interfering with legitimate commercial and family transactions. The GAAR was intended to strike a balance between taxpayers' need for certainty in planning their affairs and the government's responsibility to protect the tax base and the fairness of the tax system.

The concept of tax fairness is broad and cannot be assessed from the perspective of one individual stakeholder. Fairness was discussed briefly in the 1987 Tax Reform Measures¹ and Supplementary Information² in the context of stabilizing tax revenues. A more detailed explanation of fairness of the tax system as a whole was provided by David Dodge³, who was a Senior Assistant Deputy Minister of Finance at the time of the GAAR's introduction. He cited the *Report of the Royal Commission on Taxation's* identification of the problems with tax avoidance as including “the sense of injustice and inequality felt by those who do not benefit from tax avoidance” and “the unfair shifting of the tax avoider's burden to other taxpayers.” It was recognized that the proposed GAAR would inevitably carry with it a degree of uncertainty. Nevertheless, the GAAR was intended to introduce a coherent approach to tax avoidance while balancing these objectives.

A large body of case law has developed, which has helped assuage the concerns expressed at the time of the GAAR's introduction that it would introduce too much uncertainty into the Canadian tax system. Nevertheless, a number of decisions and other developments have pointed to some issues with the GAAR that should be addressed so that it better meets its objective of preventing abusive tax avoidance. Annex A contains a table of all court cases (subsequent to the first Supreme Court of Canada GAAR decision) where the GAAR was held not to apply, organized by the element of the GAAR under which the case was decided.

When it was introduced, the objectives of the GAAR included ending, in the words of the Supreme Court of Canada in *Stuart Investments Ltd.*,⁴ the “action and reaction endlessly produced by complex, specific tax measures aimed at sophisticated business practices, and the inevitable, professionally guided and equally specialized taxpayer reaction.” As discussed below, this objective has not been achieved.

¹ Canada, Department of Finance, *Tax Reform 1987: Income Tax Reform* (Ottawa: Department of Finance, June 18, 1987).

² Canada, Department of Finance, *Supplementary Information Relating to Tax Reform Measures* (Ottawa: Department of Finance, December 16, 1987).

³ David A. Dodge, “A New and More Coherent Approach to Tax Avoidance” (1988) 36:1 *Canadian Tax Journal* 1-22.

⁴ *Stuart Investments Ltd. v. The Queen*, [1984] 1 SCR 536 at page 580.

Despite the issues noted above, it is important to recognize the effectiveness of the GAAR since its introduction, influenced by the constructive manner in which the rule has been administered by the CRA and adjudicated upon by the courts. While this paper focuses on, for practical reasons, the court cases where the GAAR was held not to apply, it is acknowledged that the Crown has been successful in the courts in a significant proportion of GAAR cases and that many aggressive tax plans do not go forward due to the likelihood that the GAAR would apply. In addition, the GAAR is a living rule that has evolved over time as the jurisprudence develops and its flexibility allows it to respond and adapt to the changing legislative landscape. At the same time, new rules are developed and drafted with the GAAR in mind. In this context, the potentially disruptive impact of any change to the GAAR must be taken into consideration in the analysis of the options discussed in this paper.

This consultation represents a targeted and practical diagnostic on the GAAR, having regard to the decided case law, commentary made by academics and tax practitioners, the experiences of the Canada Revenue Agency (CRA) and Department of Justice (Justice) in dealing with taxpayers (and their advisers) and the courts, and the perspectives of the Department of Finance on constraining abusive tax avoidance. This document is organized based upon a number of specific issues identified with the GAAR. Each of these issues is discussed by first setting out the issue to be addressed, providing some relevant background and context, and then setting out possible approaches for addressing the issue. The government is also interested in hearing about other issues with the GAAR that people believe have led to inappropriate outcomes.

In addition to the substantive merits of each approach, consideration must be given to the interaction of the various alternatives. For any given issue to be addressed, some of the alternatives will be functionally redundant (such that there is no need to do both) or even mutually exclusive. In some cases, an approach to addressing a particular issue may be appropriate in isolation, but lead to inappropriate results if combined with an approach to addressing another issue. Bearing that in mind, the government is interested in comments on these interactions and the optimal approach for modernizing the GAAR as a whole.

The Supreme Court of Canada recently released its decision on the application of the GAAR in the context of a tax treaty and a case involving treaty shopping.⁵ The government is in the process of evaluating the decision, including, among other considerations and potential courses of action, the effect or relevance of the decision in, for example, cases where the new preamble and the principal purpose test in the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting apply. The government is also considering the implications of the decision on other forms of tax treaty abuse. Therefore, the application of the GAAR to treaty abuse is not discussed in this paper. The government intends to announce more on its plans to curb tax treaty abuse at a later date.

⁵ *Canada v. Alta Energy Luxembourg S.A.R.L.*, 2021 SCC 49.

While this consultation paper deals with a discrete topic, it exists in the context of other efforts to improve the integrity of the Canadian income tax system. This includes Canada joining a two-pillar plan for international tax reform as part of the OECD/G20 Inclusive Framework on Base Erosion and Profit Shifting. The government is also consulting on a significant enhancement of Canada's mandatory disclosure rules and intends to release a consultation paper on Canada's transfer pricing rules in the near future.

The government is accepting written representations on the relative merits of the approaches set out in this paper until September 30, 2022. Comments may be sent to GAAR-RGAE@fin.gc.ca.

B. Background and context

In general, the CRA can apply the GAAR to deny a "tax benefit" obtained by a taxpayer if the tax benefit results from an "avoidance transaction" and if it may reasonably be considered that the transaction results in a misuse of the provisions of the Act or in an abuse having regard to those provisions read as a whole.

A "tax benefit" is defined as a reduction, avoidance or deferral of tax or other amount payable under the Act, or an increase in a refund of tax or other amount under the Act (including in cases involving a tax treaty). Budget 2022 announced the government's intention to amend this definition (and other consequential amendments) to ensure that the CRA can issue a notice of determination to give effect to the application of the GAAR. Subject to a taxpayer's normal rights of objection and appeal, this would allow for the reversal of tax attributes (e.g., the adjusted cost base of a property and the paid-up capital of a share) that arise as a result of abusive tax avoidance before they are used to reduce tax.

An "avoidance transaction" is a transaction from which a tax benefit directly or indirectly results, unless the transaction may reasonably be considered to have been undertaken or arranged primarily for *bona fide* purposes other than to obtain the tax benefit. An avoidance transaction also includes a transaction undertaken as part of a series that results in a tax benefit. (In this document, references to a transaction producing a tax benefit include a transaction that is part of a series of transactions that produces a tax benefit and, consistent with the definition of "transaction" that applies for the purposes of the GAAR, includes arrangements and events.)

When a transaction constitutes an avoidance transaction, the GAAR will apply to the transaction only if it results in a misuse or abuse of the provisions of the Act relied upon to produce the tax benefit. While this test is usually in relation to the Act, it also applies to misuses or abuses of the provisions of the *Income Tax Regulations*, *Income Tax Application Rules*, a tax treaty or other enactments relevant to computing amounts under the Act. (For convenience, in this document, only the Act is referenced.)

The CRA can assess a taxpayer using the GAAR to deny a tax benefit obtained as a result of an avoidance transaction. As with any tax dispute, the taxpayer generally has

the burden of refuting the factual assumptions made by the CRA that support the assessment. However, case law has developed which has imposed on the CRA the burden of establishing that the avoidance transactions frustrate the object, spirit and purpose (misuse or abuse) of the provisions of the Act.

The process of applying the GAAR and the current judicial approach are resource intensive for the government. It requires detailed analyses of the impugned transactions and a case for the application of the GAAR being presented to a committee that includes representatives of the CRA and the Departments of Justice and Finance (the GAAR Committee).

From the enactment of the GAAR in 1988 to March 2021, the application of the GAAR was considered at the audit stage in approximately 1,600 cases (a number of these "cases" represent transactions involving multiple taxpayers spanning multiple years and as a result, the number of taxpayers reassessed considerably exceeds this number). In 80 percent of those cases (over 1,300 times), the GAAR was ultimately applied by the CRA as a primary or alternative reassessing position. Of this number, the GAAR has been the primary assessing position in approximately 50 percent of the cases and an alternate or secondary position in the remainder.

It is not feasible to quantify the potential fiscal impact of any measures that may be undertaken to strengthen the GAAR. Nevertheless, to provide a sense of the significance of the provision, over the last 6 years (fiscal years 2016 to 2021), \$4.1 billion of "tax earned by audit"⁶ was assessed using the GAAR (as either the primary or the alternative assessing position). Although the final amount assessed and ultimately collected pursuant to the GAAR will be lower, it should also be recognized that the CRA cannot realistically audit, detect and reassess 100 per cent of abusive tax planning arrangements. Despite the fact that it does not deter or prevent all aggressive tax planning, the GAAR is an important safeguard against abusive tax avoidance and likely maintains the integrity of the tax system to a much greater extent than suggested by the assessed amounts above. Measures to strengthen the GAAR would be expected to ensure that the GAAR is a more effective tool for preventing abusive tax avoidance and that taxpayers will be increasingly deterred from undertaking such transactions.

C. Consultation

1. Tax benefit

Statement of Issue

⁶ Provincial taxes, federal interest and penalties are not included in the "tax earned by audit" (TEBA) figure. It also excludes any impact that stems from appeals reversals and uncollectable amounts. The government recognizes that the propriety of the TEBA measure is questioned in some contexts; however, in light of the safeguards in place in the context of GAAR assessments, including, in particular, the role of the GAAR Committee, the TEBA measure provides a reasonable sense of the quantum of on-going GAAR disputes.

There is a concern that, despite its broad definition, a tax benefit has not been found in every appropriate case.

Background

As indicated above, “tax benefit” is defined as a reduction, avoidance or deferral of tax or other amount payable under the Act or an increase in a refund of tax or other amount under the Act. Proposals announced in Budget 2022 would also include as a tax benefit amounts that could become relevant in computing tax at a subsequent time (i.e., tax attributes). The threshold for a tax benefit is low: if a transaction involves a tax planning consequence, it is generally expected to give rise to a tax benefit.

The determination of whether there is a tax benefit is a factual determination.⁷ While the identification of a tax benefit has been interpreted as a step in the GAAR analysis, it feeds into two key tests: whether there is an avoidance transaction under subsection 245(3) and the appropriate (reasonable) tax consequences under subsection (5).

There have been a very small number of cases where there was found to not be a tax benefit even though tax planning was evident.⁸ While it is premature to conclude that a clear pattern exists, the government is concerned that the concept is being interpreted too narrowly and continues to monitor the developing case law to ensure that the concept of “tax benefit” is applied as intended in the context of the GAAR.

Addressing the Issue

The government is not proposing any specific changes to address this issue.

- Are there any changes to the wording of the “tax benefit” definition required in order to ensure that it applies appropriately?

2. Avoidance transaction: mixed-purpose transactions

Statement of Issue

The GAAR fails to prevent abusive tax avoidance when a tax benefit is achieved in the context of a transaction with a primarily non-tax purpose. As a result, a transaction with significant tax planning objectives may be exempt from the GAAR, even where that transaction results in abusive tax avoidance.

Background

⁷ *Copthorne Holdings Ltd. v. Canada*, 2011 SCC 63 at paragraph 34.

⁸ *Univar Canada Ltd. v. The Queen*, 2005 TCC 723, *The Bank of Montreal v. The Queen* (2018 TCC 187, affirmed 2020 FCA 82) and *Damis Properties Inc. v. The Queen*, 2021 TCC 24 (under appeal).

A transaction that results in a tax benefit (or that is part of a series of transactions that results in a tax benefit) is not subject to the GAAR if it “may reasonably be considered to have been undertaken or arranged primarily for *bona fide* purposes other than to obtain the tax benefit”. In such a case, it would not be an “avoidance transaction,” which is one of the three main components of the GAAR test. The avoidance transaction test is often considered to serve an important gatekeeper function for the GAAR analysis, obviating the need for primarily non-tax-motivated transactions to go through the more complex misuse or abuse analysis.

While the existence of an avoidance transaction is admitted in many cases and not litigated, in approximately 29 per cent of the cases since *Canada Trustco*⁹ where the GAAR was found to not apply, it was because the avoidance transaction test had not been satisfied¹⁰.

In *Swirsky*¹¹, the Tax Court of Canada found that a sale of shares of a family business between spouses with a view to refinancing a shareholder loan and creating losses that could be attributed back to the seller was done primarily for creditor-proofing purposes, and thus failed the avoidance transaction test. More specifically, the judge accepted that the shareholder loan planning was “one of the main purposes” of the transactions, but it was not the “primary” purpose. In *obiter*, the decision suggested that the tax planning may have constituted abusive tax avoidance, but this determination was unnecessary because the avoidance transaction test was not met. Similarly, in *McClarty Family Trust*¹², the Tax Court of Canada found that “the primary motivating element” for each transaction was creditor proofing and as such, the avoidance transaction test was not met.

In *Loblaw*¹³ the Tax Court of Canada found that although the tax benefit was clearly one of the purposes of the transactions at issue, there were also two non-tax purposes for the transactions and they outweighed the tax avoidance purpose. The decision also went on to say that there was a misuse of a provision of the Act (the bank exemption in the foreign accrual property income rules) and, had it not been for the finding that there was no avoidance transaction, the GAAR would have applied. The following quote, from paragraph 288 of the decision, is particularly relevant:

So, I find a somewhat unusual situation where I can conclude a tax benefit has been achieved through the misuse of provisions of the Act, yet GAAR may not

⁹ *Canada Trustco Mortgage Co. v. Canada*, 2005 SCC 54 was the first Supreme Court of Canada decision on the GAAR, which established an analytical framework that has since been followed. The Supreme Court of Canada has now decided five GAAR cases.

¹⁰ See Annex A for a complete list of the 24 cases post *Canada Trustco* where the GAAR was held not to apply. Seven of these cases were decided on the basis of the avoidance transaction test not having been met. Of the 11 cases that were decided on the basis of the misuse or abuse test, the existence of an avoidance transaction was admitted by the taxpayer in 10 of them (all but *MacDonald*).

¹¹ *Swirsky v. The Queen* (2013 TCC 73, affirmed 2014 FCA 36); GAAR was not discussed in detail at the Federal Court of Appeal, so the discussion focuses on the Tax Court of Canada decision. The Federal Court of Appeal case was decided in favour of the Crown on non-GAAR technical grounds.

¹² *McClarty Family Trust v. The Queen*, 2012 TCC 80.

¹³ *Loblaw Financial Holdings Inc. v. The Queen*, 2018 TCC 182. GAAR was not considered at the Federal Court of Appeal or the Supreme Court of Canada. The cases were decided on non-GAAR technical grounds.

apply if there has been no avoidance transaction. Though it is a close call, I have not been persuaded that Loblaw Financial entered any of the transactions other than for the principal commercial purpose of making money from an elaborate investment strategy in a low tax jurisdiction.

One of the two non-tax purposes referred to in that *Loblaw* decision was the avoidance of foreign tax. Although it is not clear how much weight was given to that purpose relative to the other non-tax purpose of “making money from an elaborate investment strategy”, it is inappropriate for the outcome of the avoidance transaction test to turn merely on the relative importance of foreign tax avoidance versus Canadian tax avoidance. For example, this could result in inconsistent outcomes where the same tax planning technique is used in two different circumstances, one where the Canadian tax benefit is greater and the other where the foreign tax savings happen to be greater.¹⁴

Although the GAAR comments in both *Swirsky* and *Loblaw* were made in *obiter*, as both cases were decided on non-GAAR technical grounds, they do help illustrate some potential deficiencies in the current formulation of the “avoidance transaction” definition:

1. Whether it is appropriate to consider certain purposes, such as foreign tax avoidance, to be *bona fide* non-tax purposes; and
2. Whether the “primarily” threshold is appropriate.

The *Spruce Credit*¹⁵ case focuses on a slightly different limitation of the avoidance transaction test, namely whether the purpose test in the avoidance transaction definition applies to a choice in structuring a transaction. In *Spruce Credit*, the Federal Court of Appeal upheld the Tax Court of Canada’s decision that the GAAR was not applicable. A deposit insurance corporation was required to repay funds that it held on behalf of its member credit unions to help those members pay for an assessment made on them by another deposit insurance corporation. Instead of paying the funds to the members as a return of amounts previously assessed, which would have given rise to taxable income to the members, it chose to pay the funds to the members as dividends. This enabled the members (which included the taxpayer) to both claim the inter-corporate dividend deduction and obtain an additional deduction on the payment of the funds to the second deposit insurance corporation.

Both the Tax Court of Canada and the Federal Court of Appeal found that there was no avoidance transaction. In particular, the trial judge determined that the decision to return the funds to Spruce Credit in the form of dividends rather than as a return of assessments was not, in itself, a transaction for the purposes of the avoidance transaction test. In affirming the Tax Court’s decision, the Federal Court of Appeal stated the following, at paragraph 61:

¹⁴ The CRA has indicated that they have had difficulty establishing an avoidance transaction in certain cases where they have to refute taxpayer representations and evidence as to the existence of a primary foreign tax (and related commercial) purpose, even in cases where many of the same transactions involved significant Canadian tax planning and benefits.

¹⁵ *Spruce Credit Union v. The Queen* (2012 TCC 357, affirmed 2014 FCA 143).

The fact that tax implications played a role, and potentially even an important role, in the choice of transaction does not necessarily mean that the primary purpose of the transaction was to obtain a tax benefit and that this was an avoidance transaction.

The *Canadian Pacific*¹⁶ case is an earlier example of the reasoning in the *Spruce Credit* case that a decision element within a commercial transaction is not itself a transaction. In *Canadian Pacific*, it was the decision to borrow Australian dollars (at the time, a so-called “weak currency”) that was the tax planning element of the commercial transaction. *Canadian Pacific* also illustrates that the current formulation of the avoidance transaction test can lead to inconsistent outcomes based on the manner in which an abusive tax plan is implemented. In that case, the court held that the weak currency borrowing transaction at issue was not an avoidance transaction because its primary purpose was to raise capital.

However, the facts in *Canadian Pacific* may be contrasted with a hypothetical situation where a borrowing is already in place that is restructured to use the same weak currency tax strategy. In the hypothetical situation, since the capital has already been raised, it would seem reasonable to conclude that the primary purpose of the restructuring transaction is to reduce tax. In such a case, the GAAR may apply to the latter transaction but not the former (assuming the misuse or abuse test is met), despite both transactions producing the same tax benefit, relying on the same provisions of the Act, using essentially the same planning technique and being implemented in a similar commercial context. The only difference is that one strategy is structured as two or more transactions (including an identifiable tax step) and the other is bundled into a single transaction.

Spruce Credit and *Canadian Pacific* may illustrate a more fundamental problem with using a purpose-based “avoidance transaction” test. In both of those cases there were tax benefits that resulted from the transactions, the choice to effect the transactions in a particular way was made in order to obtain those tax benefits and the tax planning abused the provisions of the Act relied upon (or at least a reasonable argument could be made to that effect). However, both were found not to be avoidance transactions under the GAAR.

Addressing the Issue

With a view to appropriately limiting the circumstances in which Canadian tax benefits may be achieved in cases that are not subject to the misuse or abuse analysis under the GAAR, the government has identified for consideration the following possible solutions:

- providing an interpretive rule to specify what is not a “*bona fide*” purpose;
- extending the definition of “transaction” to include a choice; and
- lowering the threshold under the purpose test.

¹⁶ *The Queen v. Canadian Pacific Ltd.*, 2001 FCA 398 (*Canadian Pacific*). Although *Canadian Pacific* is a pre-*Canada Trustco* decision, its comments are arguably still relevant for the avoidance transaction test.

Specifying what is not a “bona fide” purpose

The first potential change would be to provide explicit exclusions from what is considered a “*bona fide* purpose” for the avoidance transaction test. This could be effected by introducing an interpretation rule to specify what is meant by “*bona fide* purpose”. For example, foreign or provincial tax savings could be deemed not to be a *bona fide* non-tax purpose (since they are tax purposes in nature). This raises the question of what other purposes might be deemed not to be *bona fide*. For example, creditor proofing is frequently asserted as a primary purpose yet the extent to which it is a compelling *bona fide* purpose (or indeed whether it can even be considered to be *bona fide*) varies widely and it can in fact be particularly difficult for the Crown to confirm or refute. This example also highlights whether a list of non-*bona fide* purposes should be developed or whether the nature or qualities of purposes that are not *bona fide* should be specified instead. Although this approach may address certain aspects of this issue, it would add another layer of interpretation and related uncertainty.

Another question is what it means to exclude purposes from being considered *bona fide*. For example, say a transaction could be described as having the following three purposes (and those purposes could be quantified precisely): commercial (40%), foreign tax (35%) and Canadian tax (25%). If foreign tax savings are simply not taken into consideration, the transaction would presumably be primarily commercial (40% vs 25%). If foreign tax savings are considered to be in the “not *bona fide*” category along with Canadian tax savings, then the avoidance transaction test would presumably be met (40% vs 35% plus 25%). Of course, in real world examples it would be difficult (if not impossible) to quantify and compare purposes with this level of precision. As such, the example is simply intended to illustrate some of the design challenges for this approach.

This change would seem to address particular situations, such as where a purely tax-motivated transaction produces more foreign tax savings than Canadian tax savings. However, it is debatable whether such a change would be sufficient to establish the existence of an avoidance transaction in every appropriate case (since the commercial purpose could still outweigh the Canadian and foreign tax purposes). Moreover, it would not address the broader potential deficiencies described in the next two options.

Extending the definition of “transaction” to include a choice

The current definition of “transaction” in subsection 245(1) provides that it includes an arrangement or event. While this is quite broad, consideration could be given to amending the definition to explicitly include choices made by a taxpayer. This could include the choice to effect a transaction in a particular way. This consideration responds to the notion that choices that are motivated significantly by tax benefits should not be exempted from the misuse or abuse analysis merely because such choices were embedded in, for example, a larger commercial decision. Is it appropriate that the choice in *Canadian Pacific* to borrow in a weak currency – a choice that entailed significant tax benefits and was a prominent aspect of the transaction – was not an avoidance transaction and therefore not subject to the misuse or abuse analysis? A

case can be made that the avoidance transaction stage of the GAAR analysis was not intended to protect transactions with such a prominent tax planning element.

On the other hand, it is recognized that including all choices that result in tax benefits in the definition of “transaction” may have the effect of overly broadening the definition of avoidance transaction and diminishing its gatekeeper role in the GAAR analysis. It seems reasonable to expect that in the vast majority of transactions that produce a tax benefit, some choice has been made to realize that benefit. For example, the choice to borrow money rather than raise equity, to sell shares rather than assets, or to return capital rather than pay a dividend could then become subject to a misuse or abuse analysis. Although the application of the misuse or abuse exception in many of these cases may be straight forward and relieving, this could introduce an incremental compliance burden and a degree of uncertainty that may be difficult to justify in tax policy terms, having regard to the significance of the particular issue.

It is intended that this approach would preserve the right for taxpayers to choose to organize their affairs in such a way as to minimize tax, provided that those choices do not result in a misuse or abuse of the tax rules. Although it would remain the case that the GAAR would apply only in cases where the misuse or abuse test is met, this change would shift more importance to the misuse or abuse analysis. Indeed, the avoidance transaction definition would largely serve to identify the transaction, arrangement, event or choice that leads to the tax benefits to be denied in circumstances of abusive tax avoidance. As the scale of this particular issue may not warrant such a fundamental reform of the GAAR, the question then becomes which types of choices would be included in the definition of transaction. This would not be straightforward, but conceptually the choices to be included would be those the nature and consequences of which are most likely to raise abusive tax avoidance concerns.

Lowering the threshold under the purpose test

The Act contains a number of purpose tests, which may be organized by descending thresholds as follows: the (sole) purpose; the principal or primary purpose; one of the main purposes; and one of the purposes. Lower-threshold purpose tests help address the following situations:

- where it is used in an anti-avoidance rule, there is a robust set of other conditions that help ensure the rule does not apply more broadly than its intended scope;
- the purpose being tested is contrary to the scheme of the rules in which it is used (for example, using a specific anti-avoidance rule to obtain a tax benefit);
- there is a concern that taxpayers and their advisors may add “window dressing” features to a transaction; or
- due to complexity or other factors, it is difficult to rank or quantify the various purposes underlying a transaction.

Changing the avoidance transaction definition so that it applies where “one of the main purposes for undertaking the transaction (or series) is to obtain the tax benefit” would carry the following benefits:

- it would eliminate the need to specifically determine a primary purpose, adding certainty and predictability to borderline cases where it is difficult to determine whether the magnitude of the tax purpose outweighs the commercial or other non-tax purpose(s);
- it would be in line with several anti-avoidance rules in the Act, which show a trend towards the use of a lower-threshold purpose test¹⁷;
- it would be in line with the purpose test used in certain tax treaty-based GAARs¹⁸;
- it would be consistent with the purpose test used in other jurisdictions' GAARs (New Zealand, United Kingdom and the European Union); and
- acceptable tax planning would still be protected by the misuse or abuse test.

It is uncertain though, whether the use of a “one of the main purposes” test would be sufficient to establish the existence of an avoidance transaction in all appropriate cases, since the tax purpose could still be found to not be a main purpose, despite the fact that the tax savings are significant. For example, in *Gerbro Holdings*¹⁹ (a non-GAAR case), the Federal Court of Appeal upheld the Tax Court of Canada’s determination that the tax deferral achieved by the taxpayer did not satisfy the “one of the main reasons” test in subsection 94.1(1) of the Act, even though the tax purpose was substantial.

The issue could be addressed by having a lower threshold, such as a “one of the purposes” test. Other alternatives might also be considered such as a “material purpose” or a “non-incidental purpose” test. This approach could be justified as the transactions in question would still need to be found to be abusive before the GAAR could be applied. In this manner, more transactions would fall under the scope of “avoidance transaction” resulting in the “misuse or abuse” element being the key deciding factor in the GAAR’s application.

- Should the definition of “transaction” be extended to include certain choices and if so, which choices ought to be included?
- Which, or which combination, of the alternatives discussed above is most appropriate for ensuring that the GAAR is effective in preventing abusive tax avoidance?
- Are there other alternatives for achieving this objective?

3. Misuse or abuse: determining object, spirit and purpose and general schemes

Statement of Issue

¹⁷ For example, see paragraph 39(2.02)(b) [debt parking to avoid foreign exchange gains]; subsection 125.7(1) definition of “eligible remuneration” in (d)(iii) and paragraph 125.7(6)(b) [COVID-19 relief]; and clause 212(3.9)(b)(ii)(B) [back-to-back loan arrangements].

¹⁸ Organisation for Economic Co-operation and Development, *Model Tax Convention on Income and on Capital*, 21 November 2017. Paragraph 9 of Article 29 refers to “one of the principal purposes of any arrangement or transaction”.

¹⁹ *Gerbro Holdings Company v. Canada*, (2016 TCC 173, affirmed 2018 FCA 197).

It can be difficult to ascertain the object, spirit and purpose of a provision of the Act, or the existence and relevance of a general scheme in the Act read as a whole, in order to determine whether abusive tax avoidance has occurred. Moreover, the courts have looked to the Crown to make persuasive submissions on the object, spirit and purpose of provisions and where the existence of abusive tax avoidance is uncertain, the courts have given the benefit of the doubt to the taxpayer.

Background

Subsection 245(4) of the Act provides that a transaction that:

- results directly or indirectly in a tax benefit; and
- has been carried out primarily to obtain the tax benefit,

will be subject to the GAAR if it may reasonably be considered that the transaction would result directly or indirectly in a:

- misuse of the provisions of the Act; or
- an abuse of the provisions of the Act read as a whole.

The GAAR is not intended to deny the tax benefits that result from transactions that are carried out within the object, spirit and purpose of the provisions of the Act. The question then is how to go about the “misuse or abuse” analysis. In *Canada Trustco*²⁰, the Supreme Court of Canada described the required two-step exercise as follows:

The heart of the analysis under s. 245(4) lies in a contextual and purposive interpretation of the provisions of the Act that are relied on by the taxpayer, and the application of the properly interpreted provisions to the facts of a given case. The first task is to interpret the provisions giving rise to the tax benefit to determine their object, spirit and purpose. The next task is to determine whether the transaction falls within or frustrates that purpose.

Contextual interpretation generally involves consideration of the text of the specific relevant provision as it fits with, and relates to, other provisions of the Act.²¹ Purposive interpretation is less a textual exercise, given the traditional methods of interpreting tax legislation, and often requires inferences based on the text and context and material that is extrinsic to the legislation (referred to as “extrinsic aids”).

Reference to some extrinsic aids to assist in determining the object, spirit and purpose of specific provisions of the Act in the context of a GAAR analysis is accepted by the courts.²² Supplementary information produced in budgetary tax measure announcements and explanatory notes accompanying draft legislation are often quoted

²⁰ *Canada Trustco* at paragraph 44.

²¹ See for example, paragraph 39 of *Canada Trustco*, and paragraph 91 of *Cophorne Holdings*.

²² *Canada Trustco* at paragraph 55.

in court decisions and can be relevant extrinsic aids, in particular when they are produced contemporaneously²³ with the provisions in question.

In *Kaulius*²⁴, the Federal Court of Appeal found that the taxpayers' planning abused a scheme in the Act against loss trading between unrelated parties as further evidenced in the interaction between subsection 18(13) and section 96 of the Act. In upholding the decision, the Supreme Court of Canada²⁵ did not accept basing the misuse or abuse analysis on a policy of the Act as a whole. Rather, the court held that a "unified textual, contextual and purposive approach to interpretation"²⁶ is required. In *Deans Knight*²⁷, the Federal Court of Appeal also recognized a statutory scheme against loss trading, but did so in the context of its analysis of the object, spirit and purpose of subsection 111(5) of the Act. This raises the question of to what extent should emphasis be placed on the provisions of the Act read as a whole in the interpretive process.

In the *Alta Energy* decision, in the context of the application of the GAAR to a tax treaty, the majority of the Supreme Court of Canada stated that the GAAR "was enacted to catch unforeseen tax strategies."²⁸ This could be read as supporting a restricted application of the GAAR and does not recognize the complex interaction of the GAAR with specific anti-avoidance rules. For example, the introduction of the GAAR was motivated, in large part, by the Supreme Court of Canada's rejection of a judicial business purpose test in the context of a transaction involving the use of tax losses. Although the manner of profit and loss consolidation within a group in the particular case may not have been considered abusive, transactions involving tax losses are an area of aggressive tax planning that was prevalent at the time and remains so today.²⁹ It also seems difficult to reconcile this assertion with the repeal of existing specific anti-avoidance rules³⁰ on the enactment of the GAAR on the basis that it was expected that the GAAR would apply in circumstances where the repealed rules would have applied.³¹

The Act is a very large and complex statute with many purposes, schemes and provisions, which evolve over time. Some of these operate independently while others interact and intersect with each other. Adding to the complexity are a growing number of anti-avoidance rules that are frequently introduced in on-going efforts to maintain the integrity and fairness of the tax system. The GAAR is the provision of last resort in this regard and applies to deny tax benefits arising from a misuse or abuse of the provisions of the Act that would otherwise be available but for the GAAR. The

²³ See paragraph 62 of *Canada Trustco Mortgage Co. v. Canada*, 2003 TCC 215, which says "what the government says after the fact is not as enlightening as what the government says at the time of introduction of the provisions."

²⁴ *Kaulius v. Canada*, 2003 FCA 371 at paragraphs 12 and 13.

²⁵ *Mathew v. Canada*, 2005 SCC 55 (*sub nom Kaulius*).

²⁶ *Mathew* at paragraphs 41 and 42.

²⁷ *Canada v. Deans Knight Income Corporation*, 2021 FCA 160 at paragraph 93 (note that the taxpayer's leave to appeal to the Supreme Court of Canada has been granted).

²⁸ *Alta Energy* at paragraph 80.

²⁹ See *Stuart Investments*; Canada, Department of Finance, "New Measures to Prevent Tax Avoidance from Offsets of Losses and Other Deductions," *News Release 87-09*, January 15, 1987; and Canada, Department of Finance, *Tax Reform 1987: Income Tax Reform* (Ottawa: Department of Finance, June 18, 1987) at page 130.

³⁰ Such as former section 247, an anti-surplus stripping rule.

³¹ 1987 Supplementary Information Relating to Tax Reform Measures.

Supreme Court of Canada has said the following about the judicial role under the GAAR:

The GAAR is a legal mechanism whereby Parliament has conferred on the court the unusual duty of going behind the words of the legislation to determine the object, spirit or purpose of the provision or provisions relied upon by the taxpayer.³²

As reflected in the brief background provided above, the interpretive process is a difficult one for taxpayers, advisors, the CRA and the courts. However, the courts have established that the existence of abusive tax avoidance must be clear, and where the existence of abusive tax avoidance is unclear, that the taxpayer is to be given the benefit of the doubt.³³ As the determination of the object, spirit and purpose of a statutory provision gives rise to a pure question of law, the question arises as to whether the burden should be changed in the interest of improving the effectiveness of the GAAR and the fairness of the tax system.

Addressing the Issues

The government is considering the following possible solutions to these issues:

- the inclusion of preambles and purpose statements in income tax legislation;
- greater emphasis on purpose statements in extrinsic aids;
- greater emphasis on the “abuse of the Act read as a whole” portion of the existing legislation;
- the inclusion of an interpretive rule for assessing certainty, predictability and fairness; and
- changing the judicially established onus under the misuse or abuse exception such that the taxpayer would be required to demonstrate, in particular circumstances, that it can reasonably be concluded that the tax benefit would be consistent with the object, spirit and purpose of the provisions relied upon by the taxpayer.

Legislative preambles and purpose statements

Outside of tax statutes, Canadian federal legislation sometimes includes preambles³⁴ and purpose statements. An example of a preamble is found in the *Greenhouse Gas Pollution Pricing Act*³⁵, which provides a comprehensive statement of the general purpose and scope of the statute. An example of a purpose statement is found in section 718 of the *Criminal Code*³⁶, which describes in detail the fundamental purpose for the sentencing of offenders.

³² *Copthorne* at paragraph 66.

³³ *Canada Trustco* at paragraphs 50 and 66.

³⁴ Section 13 of the *Interpretation Act* (R.S.C., 1985, c. I-21) specifies that: “The preamble of an enactment shall be read as a part of the enactment intended to assist in explaining its purport and object.”

³⁵ *Greenhouse Gas Pollution Pricing Act*, S.C. 2018, c. 12, s. 186.

³⁶ *Criminal Code*, R.S.C., 1985, c. C-46.

Some countries incorporate purpose statements into their income tax legislation. For example, the Australian *Income Tax Assessment Act 1997*, which is generally divided into chapters, divisions and subdivisions, contains object statements at the beginning of most divisions and subdivisions.

Although it would be difficult to devise a meaningful preamble for the Act, given its complexity and multiple objectives, purpose statements could be set out at the beginning of certain discrete provisions. These could be included with new provisions as they are introduced, added to provisions when they are substantially amended, or a project could be undertaken to introduce purpose statements into existing legislation. A simple example of a purpose statement would be to set out that a specific anti-avoidance rule is intended to prevent a specific type of tax planning from obtaining a specific tax benefit. Then, if alternative tax planning were undertaken to achieve the same tax benefit, in the same or a substantially similar factual context, it would be clear (or at least easier to establish) that the underlying rationale of the SAAR was defeated or frustrated. While statements of purpose may be useful in interpreting the specific provisions to which they relate, they may also be useful in identifying general schemes in the Act of which a particular provision is a part (see also the discussion below under “Abuse of the Act read as a whole”).

Often, provisions of the Act accomplish many purposes. Within a given section of the Act, there may be multiple subsections, paragraphs, subparagraphs and so on. Many of these provide exceptions to a general rule or rules that serve to support other rules in other provisions. Therefore, a statement of purpose at the section level may need to be quite general and possibly allow for the existence of exceptions. The more general the statements are, the more difficult it would be to determine their relevance to each particular set of facts. While more specificity could be obtained by introducing statements of purpose at the subsection, paragraph or lower levels, this would be a significant undertaking for potentially uncertain benefits.

Extrinsic aids

As an alternative, or in addition, to providing statements of purpose in specific income tax legislative provisions, a clear description of the purpose of such provisions could be provided in government publications relating to the enactment of such provisions. Explanatory notes and supplementary information accompanying legislative amendments often already do this. However, in the case of explanatory notes, they often focus on details and do not emphasize the broader purposes of the legislative amendments and how amendments are intended to interact with other provisions. Also, a potential limitation of explanatory notes may be that they are not enacted or specifically approved by Parliament, although the text of explanatory notes is provided to Parliament as an aid for their clause-by-clause study of a bill.

To bolster the significance of extrinsic aids, certain portions of these extrinsic aids could be referenced in specific provisions of the law, as considered appropriate. There are precedents for this type of reference in the Act. For example, the Common Reporting Standard rules refer to a document produced by the Organisation for Economic Co-

operation and Development as an interpretive aid³⁷. More recently, draft legislative proposals to address hybrid mismatch arrangements specify that the rules are to be interpreted consistently with the “Final Report on Neutralizing the Effects of Hybrid Mismatch Arrangements” published by the Organisation for Economic Cooperation and Development, with appropriate adaptations to the Canadian income tax context.

Abuse of the Act read as a whole

The *OSFC Holdings*³⁸ decision interpreted the GAAR as including two separate enquiries, one for determining whether specific provisions have been misused and another for determining whether all of the provisions of the Act, read as a whole, have been abused. However, the *Canada Trustco* and *Mathew*³⁹ decisions of the Supreme Court of Canada preferred a single, unified approach to the misuse or abuse analysis under subsection 245(4). This approach was more recently followed by the Supreme Court of Canada in *Alta Energy*.⁴⁰ There is a concern that this single, unified approach has unduly weakened the relevance of considerations of general schemes of the Act in the GAAR analysis. This is particularly concerning in cases where the element of “misuse” of a particular provision may not be as apparent as the “abuse” element.

The government is considering whether to amend subsection 245(4) so as to ensure that general schemes that can reasonably be established upon reviewing the Act as a whole are taken into consideration (and given appropriate weight) in the GAAR analysis, notwithstanding that a misuse of specific provisions of the Act cannot be identified. The amendment to subsection 245(4) in 2005, which more clearly sets out the two tests, in separate paragraphs, and better aligns the French and English versions of the text, could conceivably have warranted a different interpretation. However, given that the courts continue to adopt the single, unified approach used in *Canada Trustco* and *Mathew*, which was based on the pre-2005 version of subsection 245(4), further legislative action may be desirable.

Interpretive rule for assessing certainty, predictability and fairness

In *Alta Energy*, the Supreme Court of Canada underscored the importance of certainty, predictability and fairness in the tax system. In its decision, the majority linked certainty, predictability and fairness with the right of taxpayers to legitimate tax minimization as the bedrock of tax law. This construction could be interpreted as implying that fairness should be construed individually, such that fairness implies simply an individual’s right to rely on their tax minimization strategies.

The dissent however recognized the GAAR as striking a balance between providing certainty to taxpayers and “fairness to the tax system as a whole.”⁴¹ As indicated in the *Introduction*, ensuring the fairness of the Canadian income tax system was a prominent

³⁷ See subsection 270(2).

³⁸ *OSFC Holdings Ltd. v. Canada*, 2001 FCA 260.

³⁹ *Canada Trustco* at paragraphs 38 to 43 and *Mathew* at paragraph 42.

⁴⁰ *Alta Energy* at paragraph 49.

⁴¹ *Alta Energy* at paragraphs 101 and 177.

goal when the GAAR was introduced. This broader notion of fairness reflects the unfair distributional effects of tax avoidance as the shifting of tax burden from those willing and able to avoid taxes to those who are not. If tax avoidance is perceived to be a significant problem in society, it can undermine attitudes toward tax compliance and more generally the rule of law itself. Viewed this way, a broader notion of fairness is key to maintaining the confidence of all taxpayers in the effective functioning of the tax system. This goal of fairness could be assisted by including an interpretation rule in the GAAR that would help achieve a more appropriate balance with respect to the consideration of fairness. Interpretation rules could also be introduced to address application issues that arise from time-to-time. For example, an interpretation rule could be added in light of the *Alta Energy* decision to provide that the GAAR applies to foreseen as well as unforeseen tax planning.

Changing the burden under the misuse or abuse test

As noted above, where it is uncertain as to whether abusive tax avoidance has occurred, the benefit of the doubt goes to the taxpayer. In order for the misuse or abuse test to be relevant, there must be an avoidance transaction that produced a tax benefit. Where a taxpayer enters into an avoidance transaction purposefully to use the provisions of the Act to obtain a tax benefit, it stands to reason that taxpayers and their advisors are well placed to form and express opinions with respect to the object, spirit and purpose of the relevant provisions upon which they are relying. Yet, in *Canada Trustco*, the Supreme Court of Canada noted at paragraph 65 that:

The Minister is in a better position than the taxpayer to make submissions on legislative intent with a view to interpreting the provisions harmoniously within the broader statutory scheme that is relevant to the transaction at issue.

As the object, spirit and purpose of the relevant provisions is a question of law to be determined based on the words in the Act and other permissible extrinsic aids (all of which are publicly available), it is not clear that the Crown is in a better position (or has any special knowledge) to establish that abusive tax avoidance exists than taxpayers are to establish that the tax benefits sought are consistent (or are at least not inconsistent) with the object, spirit and purpose of the provisions relied upon.

Consideration could be given to changing the burden under the misuse or abuse test in a variety of ways. For example, instead of the Crown having the burden of establishing abusive tax avoidance, this could be changed to require the taxpayer to clearly demonstrate that the tax benefit sought would be consistent with the object, spirit and purpose of the provisions relied upon by the taxpayer. An alternative formulation would be to presume that abusive tax avoidance has occurred unless the taxpayer can establish to an appropriate standard that the provision or provisions being used to provide the tax benefit were used in the manner that Parliament intended them to be used. As Parliament cannot possibly anticipate all possible situations, changes to the burden could be required only in particular circumstances, such as for transactions lacking in economic substance (discussed next).

- Do respondents have comments or suggestions on ways to clarify the object, spirit and purpose of provisions of the Act?
- Do respondents have comments or suggestions on ways to improve the interpretive process under subsection 245(4) by, for example, adding targeted interpretive rules or changing the burdens and standards of clarity established by the courts?
- With respect to potentially changing the burdens and standards of clarity established by the courts, in which circumstances would it be appropriate to change them and how might the current clarity standard be modified, recognizing the complexity of the Act?
- Regarding the objectives of certainty, predictability and fairness (including the broader notion of fairness), do respondents have comments or suggestions on how best to maintain an appropriate level of, and balance among, certainty, predictability and fairness?

4. Economic substance

Statement of Issue

The GAAR does not sufficiently take into consideration the economic substance of transactions.

Background

In *Canada Trustco*, the Supreme Court of Canada expressly precluded the consideration of the economic substance of what was purported to be an ordinary sale-leaseback transaction in the application of the GAAR's misuse or abuse test in the context of an avoidance transaction that relied upon the capital cost allowance rules. It went on to say that economic substance is relevant only if, and to the extent that, the text of the law says that it is relevant. As a result, courts do not regularly or expressly apply an "economic substance" test when determining if an avoidance transaction is an abuse or a misuse of a particular provision of the Act.

Canada Trustco established a limited role for economic substance at the stage in the GAAR analysis involving the factual inquiry into abusive tax avoidance; however, the Supreme Court of Canada effectively precluded a role for economic substance in the determination of the object, spirit and purpose of the relevant provisions (absent express legislative language) and any finding that transactions could be found to be abusive merely because they were lacking economic substance. This limitation on the role of economic substance in the GAAR analysis may not align completely with the government's statement in the lead-up to enacting the GAAR that "the new rule would not supplant other provisions of the Act but would apply together with these other provisions to require economic substance in addition to literal compliance with the words of the Act".⁴²

⁴² Canada, Department of Finance 1987, Supplementary Information Relating to Tax Reform Measures (Ottawa: Department of Finance, December 16, 1987).

Together with the limited role accorded economic substance in non-GAAR cases⁴³, the exclusion of, or limitations on, economic substance as a relevant consideration in the GAAR analysis have had a pervasive impact on the tax system. However, a review of the case law does not yield many instances, after the decision in *Canada Trustco*, where a lack of economic substance has led to a conclusion that a transaction is abusive. Given the Supreme Court of Canada's guidance in *Canada Trustco* on the limited role of economic substance in the GAAR analysis, it is not surprising that the argument is rarely made by the Crown (and cases are not pursued).

Some cases⁴⁴ may suggest that economic substance is a factor that is given weight in GAAR decisions. However, other cases⁴⁵ tend to minimize the role and weight accorded economic substance. Moreover, those cases that show some deference to economic substance usually involve some type of attribute duplication, preservation or manipulation and are found to be abusive on that basis. In any event, this limited or *ad hoc* role for economic substance is unsatisfying from a policy perspective.

It should be noted that the avoidance transaction test is, in a sense, a form of economic substance test. By looking to whether the primary purpose of a transaction is to obtain a tax benefit, purely tax motivated transactions that are devoid of economic substance will be considered avoidance transactions. However, the "misuse or abuse" exception in subsection 245(4) does not explicitly attribute significance to the economic substance of a particular transaction. Even though the commentary accompanying the introduction of the GAAR explicitly contemplated economic substance, the precise role of economic substance in the interpretive process was not established. As discussed above, the courts have limited the role of economic substance to one of ascertaining the relevant factual context of transactions and have not considered it in determining how the provisions of the Act should be interpreted and applied in particular cases⁴⁶. This judicial approach suggests that if a factor (such as economic substance) is to form part of the misuse or abuse analysis, it should be as part of a clear and explicit test.

Addressing the Issue

The government intends to add an explicit economic substance rule to the GAAR, so that it applies more appropriately. In this regard, three main issues need to be addressed. First, it is necessary to define economic substance so that it is possible to determine when it is lacking. Second, an economic substance rule would need to be integrated into the GAAR analysis. Third, the appropriate consequences associated with a lack of economic substance would need to be determined.

The government is considering the following solutions, grouped into these three categories, which are discussed in more detail below:

⁴³ See, for example, *Shell Canada Ltd v. Canada* [1999] 3 SCR 622 at paragraphs 39 and 46.

⁴⁴ See for example, *Canada v. Global Equity Fund Ltd.*, 2012 FCA 272 at paragraphs 67 and 68; and *Magren Holdings Ltd. v. The Queen*, 2021 TCC 42 at paragraph 255.

⁴⁵ See, for example, *Damis Properties* at paragraph 290 (under appeal).

⁴⁶ *Canada Trustco* at paragraphs 56 to 60.

Meaning of, or ascertaining the existence or lack of, “economic substance”

There are various alternative ways to test whether a transaction lacks economic substance. These include:

- introducing a sole or dominant purpose test;
- determining whether a transaction has the potential for pre-tax profit;
- determining whether the transfers of rights and assumptions of obligations under the transaction affected the economic positions of the participants in the transaction;
- assessing whether the legal form of the transactions differs significantly from the accounting treatment of the transactions; and
- using a hybrid approach based on the above considerations.

Integration of economic substance into the GAAR

There are several alternative ways in which an economic substance test could be integrated into the GAAR. These include:

- incorporating it into the avoidance transaction test;
- introducing a separate deeming rule;
- introducing an interpretive rule; and
- incorporating it into the misuse or abuse analysis.

Consequences when the economic substance rule applies

Where a transaction is found to be lacking in economic substance, there are various alternative consequences that could reasonably follow. These include:

- automatically deeming the transaction to be abusive;
- reversing the misuse or abuse burden (e.g., the taxpayer would be required to demonstrate that the tax benefit sought would be consistent with the object, spirit and purpose of the provisions relied upon);
- introducing a more stringent misuse or abuse test; and
- adjusting the “reasonable consequences” rules in subsection 245(5).

Some of these alternative solutions may need to take into account other changes that could be made to the GAAR. For example, if the misuse or abuse burden were reversed for all transactions, as raised for consideration in the “misuse or abuse” section of this paper, there would be no point in doing so specifically for transactions lacking in economic substance.

Meaning of, or ascertaining the existence or lack of, economic substance

- *a sole or dominant purpose test*

The current avoidance transaction test looks to whether a transaction may reasonably be considered to have been undertaken primarily for *bona fide* purposes other than to obtain a tax benefit. This may be considered to be a form of economic substance test, in

that it compares the relative importance of the tax benefit and the *bona fide* non-tax reasons for entering into the transaction. However, rather than test economic substance directly it uses intentionality as a proxy for economic substance; implicitly, a transaction that is entirely (or almost entirely) tax motivated could be presumed to lack economic substance.

Where a taxpayer has no *bona fide* commercial or other non-tax purpose (or almost no such purpose), the relevant transactions could be considered to be sufficiently lacking in economic substance that it should result in the application of one of the special rules discussed below. This level of purpose may be analogized with an “all or substantially all” test, which is commonly treated as meaning around 90%.

- *potential for pre-tax profit*

Commercial transactions seek to increase a firm’s profit by increasing its revenues or by reducing its costs. For this purpose, taxes are one of the costs that businesses pay, along with things like salary and rent. Since an economic substance test seeks to distinguish tax-motivated transactions from commercially motivated ones, one approach to testing whether a transaction lacks economic substance is to determine if it could result in pre-tax profits.⁴⁷

At the most basic level, if the reasonably expected revenues associated with a transaction are exceeded by the costs of the transaction, it would seem to lack economic substance. This will generally be the case for tax shelters and other purely tax-motivated plans. Costs of the transaction would generally include the legal costs of implementing the transaction along with any amounts paid, either directly or indirectly, as advisory or facilitation fees.

A key benefit of this approach is that it provides a determinable calculation that could result in greater certainty for taxpayers and their advisors. However, it may be difficult in practice to precisely quantify expected economic returns and transaction costs in certain circumstances. Another difficulty with such a mechanical calculation is that it leaves open the possibility for planners to build an insignificant amount of profit (or potential for profit) into a transaction, in order to satisfy the test even though the quantum of profit is immaterial in the broader context of the transaction.

In order to address this concern, an economic substance test could compare a transaction’s reasonably expected pre-tax profit with its expected tax savings. When the potential for pre-tax profit associated with a transaction is immaterial in relation to the anticipated tax benefit, it would be considered to lack economic substance.

Instead of using a somewhat vague “materiality” threshold, the comparison of the expected economic profit and tax benefits associated with a transaction could be expressed mathematically. For example, the test could provide that a transaction lacks economic substance when the expected tax benefit exceeds 10 times the expected

⁴⁷ See, for example, subsection 126(4.1) for the use of a pre-tax profit rule in the foreign tax credit context.

economic profit. The factor of 10 used in the example is somewhat arbitrary and could be higher or lower if warranted. It roughly corresponds to the “all or substantially all” test commonly used in the Act, which is generally interpreted to mean approximately 90% or more. Another threshold is found in Private Member’s Bill C-362, *An Act to amend the Income Tax Act (economic substance)*, 1st session, 42nd Parliament, which looked to whether the amount of the tax benefit exceeded the actual or anticipated financial benefit (akin to expected economic profit) of the transaction.

In many cases, the value of a tax benefit will simply reflect the amount of tax avoided. However, in the case of tax planning that creates tax attributes, the valuation of unutilized tax attributes could present a challenge. This is because of the time value of money and the fact that it is impossible to know precisely when (or if) a tax attribute will be utilized. However, in order to provide certainty, a reasonable approach would seem to be to value the tax attribute for the purposes of this analysis as if it were immediately utilized in the most tax-advantaged way.

- *change in economic positions*

One difficulty with the previous approach is that it requires the computation of pre-tax profits and the tax benefits associated with a transaction. This may be difficult in many cases, as *bona fide* commercial transactions can be effected by taxpayers in situations where the expected pre-tax profit associated with the transaction is difficult to quantify. Another approach is to look at whether a taxpayer’s economic position has changed as a result of a transaction.

This approach to testing economic substance involves analyzing the constituent elements of the relevant transaction. A transaction fundamentally involves transfers and assumptions of rights and obligations. In a commercial context, these rights and obligations give rise to opportunities for gain or profit and risks of loss (this is a common way to describe economic exposure in the Act). Before and after a transaction, each participant has a set of rights and obligations that give rise to certain opportunities for profit and risks of loss. If the economic exposure of the participants to a transaction is not materially affected by the transfers of rights and obligations under the transaction, then the transaction can be said to be lacking in economic substance notwithstanding that the transactions were legally effective in transferring those rights and obligations. As such, this type of rule could be effective in addressing cases involving circular and offsetting transactions and funds-flows, like *Canada Trustco* and other cases where money moves around (within a corporate group but also through external intermediaries) in a circle with a view to creating tax benefits arising from interest expense or other deductible payments with no corresponding income inclusion.

While this approach has the potential to measure the economic substance of a transaction with some precision and certainty, it also poses certain risks. Perhaps most significantly, the interaction between legal substance and economic exposure might be difficult to track within a group. For example, assume that a parent company has two wholly owned subsidiaries (Xco and Yco) that enter into a transaction designed to artificially increase the tax cost of an asset held by Xco. Parent is indifferent as to whether the asset is held by Xco or Yco and so, as part of the series of transactions, it

is moved to Yco. The issue is that if you look at the participants to the transactions (Xco and Yco) and accept their separate legal existence, their economic positions are very much changed – Yco has an asset that Xco used to have. But, when viewed holistically, the transaction is largely devoid of economic substance. As such, the test would need to be applied at the group level. In some cases, the group may include entities or persons who are neither resident in Canada nor liable to tax in Canada.

If an economic substance test is applied at the group level, it would have to be determined how best to deal with reorganization transactions within a group that may not result in a change in the economic position of the group. Given the extensive sets of rules within the Act dealing with corporate (and other) reorganizations, it may be preferable to simply treat such transactions as having economic substance and apply the current misuse or abuse test. Although this may in some cases increase pressure on the object, spirit and purpose analysis, that is not inherently inappropriate or problematic.

- *different accounting treatment*

Generally accepted accounting principles often present transactions according to their economic substance rather than their legal form. For example, many types of preferred shares of a corporation are presented as liabilities of the corporation given their economic similarities to debt obligations. Also, leases may be treated as sales for accounting purposes if the risks and burdens of property ownership are transferred, having regard to the terms of the lease. Tax planning is sometimes aimed at creating transactions whose legal characteristics differ significantly from their economic substance and, as such, their presentation for accounting purposes could be very different than their characterization under legal principles. Where this is the case, these transactions could be considered to lack economic substance or reflect economic substance that is fundamentally different than the legal form of the transaction to which tax rules are applied.

Although accounting treatment may be a useful indicator of economic substance, there would be significant limitations on the use of such an indicator. For example, accounting standards are in constant evolution and subject to pressures of their own, standards may vary across jurisdictions and as between public and private firms, their application is based on professional judgement and, most importantly, they are not legislated by Parliament. In addition, financial statements are often prepared on a consolidated basis, which may have the effect of eliminating or reversing transactions between members of the consolidated group whether or not devoid of economic substance. As such, a rule that relies on the accounting presentation of transactions should be approached with caution. For this reason, it may be desirable to consider the accounting treatment as a non-binding interpretive aid. The best use of such an option would likely be in a hybrid model that takes into account two or more of the approaches noted above.

- *hybrid approach*

The approaches noted above each have their pros and cons. In addition, some of the approaches work better in certain circumstances and worse in others. For example, the

second approach (which tests whether a transaction has the potential for pre-tax profit) works particularly well for discrete transactions where it is easy to quantify the potential for pre-tax profit. This is the case for tax shelters, in which a taxpayer is often assured that their economic exposure to the transaction is limited to the facilitation fees paid to a promoter. It works less well for transactions that are not discrete tax shelters or transactions for which the potential for pre-tax profit is difficult to measure. For example, this approach would be relatively more difficult to apply where the taxpayer acquires property that could theoretically become highly profitable but the acquisition is truly incidental to the main tax objective (e.g., the taxpayer acquires common shares of a corporation that could theoretically provide unlimited growth but where arrangements have been implemented to constrain the underlying growth characteristics).

In light of the above, consideration could be given to an approach that combines the discrete approaches discussed above into an integrated, more general economic substance test. Each of these approaches could be factors that are taken into account in determining whether transactions lack economic substance. This would be conceptually similar to a number of tests in the income tax context.⁴⁸ This leads to the question of whether each factor must be taken into consideration in each case or whether more flexibility is preferable to give different factors different weight depending on the circumstances.

Please refer to Annex B for examples that illustrate how, in a general way, the proposed tests for ascertaining the existence or lack of economic substance might apply in certain fact patterns.

Integration of economic substance into the GAAR

- *incorporating the economic substance test into the avoidance transaction test*

As noted above, the current avoidance transaction test could be viewed as containing an economic substance component, insofar as having a *bona fide* commercial purpose serves as a proxy for economic substance. Rephrasing the test somewhat, where a transaction resulting in a tax benefit is primarily tax motivated, it is subject to the GAAR unless the misuse or abuse exception is met.

The avoidance transaction test could be reworked so that, where a transaction resulting in a tax benefit is primarily tax motivated but not entirely (or almost entirely) tax motivated, the current scheme would continue to apply (i.e., the transaction will be subject to the GAAR unless the current misuse or abuse exception is met). However, where such a transaction or series is entirely (or almost entirely) tax motivated, assuming that a test for economic substance is adopted, different consequences would result. The potential different consequences are discussed in more detail below, but, for

⁴⁸ See for example, paragraphs 94.1(1)(c) to (e) of the Act (which sets out factors for determining offshore investment fund property status), *Regulation 6302* (which sets out factors for determining caregiver status for purposes of the Canada Child Benefit), and judicially developed factors in the employee/independent contractor test in *1392644 Ontario Inc. (Connor Homes) v. Canada (National Revenue)*, 2013 FCA 85 (which is relevant for, among other things, determining whether expenses are limited by section 8 of the Act).

example, the misuse or abuse exception could be made unavailable or the misuse or abuse burden could be reversed.

This approach would have the benefit of integrating an economic substance test into the GAAR while maintaining the current rules, except for transactions that are entirely (or almost entirely) tax motivated.

- *introducing a separate deeming rule*

A standalone rule could be introduced which deems certain consequences to arise where a transaction lacks economic substance (see discussion of potential consequences below). One benefit of this approach is that it does not require an amendment to the existing wording of the GAAR. As a result, where the conditions of this standalone rule are not met, the existing rules and accompanying jurisprudence are maintained.

- *introducing an interpretive rule*

An interpretive rule could be introduced providing that, for the purpose of applying the GAAR, tax benefits are intended to be conferred only in the context of transactions with economic substance. This would effectively override the Supreme Court of Canada's statement in *Canada Trustco* that economic substance is to be taken into consideration only when the legislation specifically requires it. However, it would be important to ensure that transactions which appear to lack economic substance but are not objectionable from a policy perspective are not made subject to the GAAR. Thus, this approach, which may not seem invasive at first blush, shares some of the same challenges as incorporating economic substance into the misuse or abuse analysis discussed next.

- *incorporating economic substance into the misuse or abuse analysis*

The misuse or abuse test could be amended by adding an explicit requirement to take into account the economic substance of the relevant transactions. This could be effected as a standalone rule or included with other factors, such as whether the transaction falls within or frustrates the identified purpose of the provisions relied upon.

This approach would instruct courts to always consider the economic substance of transactions in applying the misuse or abuse test, but a finding that transactions are lacking in economic substance would not necessarily result in the application of the GAAR. The economic substance of a transaction would simply be a consideration in the analysis. A key issue with this approach is that it would either require a workable definition of economic substance or introduce additional uncertainty into the application of the interpretive process under subsection 245(4) of the GAAR. As discussed below, it could significantly affect the body of case law that has developed on the misuse or abuse analysis as well as settled areas of the tax law where the rules have been written on the premise that tax rules apply to the legal form of transactions. Both of these potential effects would introduce additional uncertainty.

While other approaches would involve ascertaining whether transactions lacked economic substance in a binary fashion, this approach would embed economic substance in the misuse or abuse analysis. This can be done in a number of ways, each with their pros and cons. For instance, economic substance could be set out as a factor to be taken into consideration in applying the GAAR (perhaps together with other factors) or a lack of economic substance could be a hallmark that tends to indicate abusive tax avoidance. A more granular approach would be to provide interpretive rules on how economic substance is to be considered in general or in certain circumstances. For example, for provisions that are designed to incentivize certain economic behaviour, an economic analysis of the taxpayer's behaviour could be required to ensure that the incentive achieved its purpose. Likewise, for provisions intended to provide support to a class of taxpayers suffering particular economic conditions, an economic analysis of whether a taxpayer is within the intended scope of the relief could be required. One issue with this approach is that it may be difficult to describe every type of circumstance where economic considerations should be considered and it could give rise to adverse inferences for circumstances not listed. Another challenge is that the identification of particular behaviours or circumstances may not be obvious in the context of many provisions in the Act and tax planning is often aimed at staying within the boundaries established by the tax rules and schemes in the Act.

Another approach would be to legislate, as part of determining the object, spirit and purpose of a provision, a presumption that provisions of the Act are to be interpreted having regard to the economic substance of the transactions to which they apply. For example, this could entail a consideration of whether dividend treatment is appropriate given the object, spirit and purpose of a provision where the dividend is paid on shares that are economically equivalent to debt. A significant challenge with this approach is that the Act has evolved over many decades on the premise that tax rules are generally applied to the legal results of transactions and incorporating economic substance into the interpretive process in this manner at this time could be viewed as a fundamental change.

The main challenge lies in how to integrate such a test into the misuse or abuse analysis, given its current two-step analytical framework. For instance, if economic substance is determined to not otherwise be relevant to the object, spirit and purpose of a provision, then what does it mean to have a rule requiring that economic substance be taken into account at that stage of the analysis? Likewise, unless economic substance is relevant to the object, spirit and purpose of a provision, it is unclear how an avoidance transaction lacking in economic substance would frustrate that object, spirit and purpose. As such, this approach may require modifying (possibly legislatively) one or both steps in the misuse or abuse interpretive process or the development of a new analytical process.⁴⁹

⁴⁹ As indicated above, the Supreme Court of Canada in *Canada Trustco* generally accorded a role for economic substance only in the second step of the misuse or abuse interpretive process. That said, the Supreme Court of Canada in *Copthorne* seems to have taken economic substance into account, without expressly saying so, in finding a surplus stripping scheme (see the reference to investing with tax-paid funds in, for example, paragraph 122). Thus, the question arises as to whether a mere codification or clarification of the analytical framework established under existing jurisprudence would suffice.

As noted at the outset, the GAAR has proven to be a reasonably effective tool for preventing abusive tax avoidance. In addition, the body of jurisprudence that has developed since its introduction has provided much additional certainty in its application. Any effort to improve the GAAR must be cognizant of any uncertainty that would be created, inadvertently or otherwise, to the extent the precedential value of existing jurisprudence on misuse or abuse is eroded or rendered irrelevant.

Consequences when the economic substance rule applies

- *automatically deeming a transaction to be abusive*

One consequence that could result from the failure of an economic substance test is the automatic application of the GAAR. This could be effected by deeming transactions to be abusive where they lack economic substance or by making the misuse or abuse exception unavailable where the economic substance test is failed. The tax benefit sought would be denied by a determination of the reasonable tax consequences in the circumstances in the usual manner.

There is a risk, however, that such a test would result in the GAAR applying to transactions that are not objectionable on policy grounds. The Act contains a number of tax incentives that are designed to encourage taxpayers to enter into transactions that they might otherwise not pursue. These include common transactions like contributing funds to an RRSP to purchase investments, rather than using the funds to purchase the investments outside an RRSP. It would be inappropriate for the GAAR to apply to deny a tax benefit that was specifically intended to be provided in the relevant circumstances by the provisions relied upon by a taxpayer to obtain the benefit.

Loss consolidation transactions within an affiliated group illustrate another issue with automatically applying the GAAR to transactions lacking in economic substance. While the transfer of tax losses and other attributes within a corporate group is generally considered acceptable, these transactions are often carried out in a manner that may be considered lacking in economic substance. It would be inappropriate in policy terms to deem such transactions to be abusive and determine tax results based on economic substance (perhaps disregarding the transactions giving rise to the tax benefits). Thus, an exception or accommodation of some sort would be required.

While not necessarily fatal, these issues illustrate that a finely tuned economic substance test that filters out acceptable tax planning may be required for this consequence to be appropriate. It is unclear at this point whether such an economic substance test is feasible. Another way to solve this issue may be to provide a list of approved categories of transactions that are to be considered non-abusive despite lacking economic substance. However, such a list would need to be continuously updated and the items on the list would need to apply to a broad range of situations, many of which might be unanticipated at the time the list is created.

- *reversing the misuse or abuse burden*

As noted above, some transactions (such as RRSP contributions and intra-group loss transfers) might be found to lack economic substance but be within the policy underlying the provisions relied upon. It would be important to ensure that the GAAR does not apply to such transactions.

As such, if it is considered undesirable to reverse the burden of establishing abuse in the context of the general application of the misuse or abuse test, as discussed in the previous section of this paper, such an approach could instead be applied more narrowly to transactions that lack economic substance.

- *introducing a more stringent misuse or abuse test*

If transactions are found to lack economic substance, another approach would be to introduce a more stringent misuse or abuse test. This would place the burden of establishing that there was no misuse or abuse on the taxpayer, as with the previous approach.

This could be done by providing that the misuse or abuse exception would apply only where the taxpayer clearly demonstrates that the use made by the taxpayer of the provisions relied upon to obtain the tax benefit was specifically contemplated and intended by Parliament when it enacted the provisions.⁵⁰ For example, where the purpose of a relied-upon provision is to provide a tax incentive, the taxpayer would be required to demonstrate that the transaction(s) undertaken was specifically intended to be incentivized when the provisions were enacted. In the case where a specific anti-avoidance rule is avoided, the taxpayer would be required to establish that it was not intended to apply.

- *adjusting the “reasonable consequences” rules in subsection 245(5)*

If the GAAR applies in circumstances where a transaction is found to lack economic substance, this may be relevant to the determination of the reasonable tax consequences as determined under subsection 245(5).

It is arguable that the current test for reasonable consequences gives sufficient leeway for reasonable re-determinations based on the GAAR applying due to a lack of economic substance. However, it may add certainty to specifically provide that in circumstances where the new economic substance test is failed, the reasonable tax consequences are to be determined taking into consideration that lack of economic substance.

- Do respondents have suggestions as to how economic substance should be defined for the purposes of a GAAR analysis?
- Do respondents have views on what should be the appropriate consequences when a transaction is found to be lacking in economic substance?

⁵⁰ Possibly similar to the first of two steps in the ‘Parliamentary contemplation test’ established by the New Zealand Supreme Court in *Ben Nevis Forestry Ventures Ltd v Commissioner of Inland Revenue* [2008] NZSC 15, [2009] 2 NZLR 289.

- Do respondents have views on how best to integrate an economic substance test into the GAAR?
- If an economic substance test is integrated into the misuse or abuse analysis, do respondents have views on how best to accommodate transition and minimize disruption with respect to existing jurisprudence?

5. Penalties and other deterrents

Statement of Issue

The GAAR does not have a sufficient deterrent effect on abusive tax planning.

Background

If a transaction's potentially abusive nature is not detected, the taxpayer enjoys the tax benefit. However, as noted in the previous section of this paper, even when the GAAR does apply, it only seeks to apply the "reasonable" tax consequences to a taxpayer in order to deny the tax benefit sought. In most situations, this would put the taxpayer back in the position they would have been in if they had not carried out the tax planning arrangement. Thus, it would appear that, under the current GAAR, the economic downside to taxpayers may be limited to the professional fees incurred for implementing the transactions plus the non-deductible interest on the taxes owing. In contrast, the upside can be significant.

While the application of existing penalty provisions should be considered in the context of GAAR assessments, including the potential application of the gross negligence penalty (particularly in cases where the taxpayer has undertaken a transaction similar to one in which the courts have found the GAAR to apply or where the taxpayer has a history of undertaking transactions that have been found to be subject to the GAAR), there appears to be some judicial reticence to impose a penalty in the context of a rule that only the Minister can apply.⁵¹

Taxpayers have different risk tolerances and attitudes towards abusive tax planning. Some taxpayers who might otherwise undertake a transaction are undoubtedly deterred by professional advice that the GAAR will likely apply, or similar statements by the CRA. Nevertheless, it is clear that the GAAR does not deter abusive tax planning for some other taxpayers.

Recent investments in the CRA's audit capacity have had the effect of reducing the chances of non-detection of abusive tax planning. However, given the scale of potential tax savings relative to the probable costs, the current GAAR is unlikely to have a

⁵¹ *Copthorne Holdings Ltd. v. The Queen*, 2007 TCC 481 at paragraph 77. The Tax Court of Canada did not uphold the application of a penalty pursuant to subsection 227(8). Neither the Federal Court of Appeal nor the Supreme Court of Canada modified this aspect of the decision.

significant deterrent effect for the relatively more risk-tolerant segment of the population of taxpayers.

Tax avoidance files involving the application of the GAAR are highly complex and technical in nature. It is time consuming to discover and analyze complex tax avoidance transactions. For example, the determination of the primary purpose of a transaction as well as the object, spirit and purpose of applicable provisions can be a burdensome undertaking for the CRA and taxpayers. The CRA's process of auditing complex transactions, requesting and obtaining additional information, and otherwise exchanging correspondence with taxpayers (and their advisors and counsel) on facts and positions often spans years. As such, the CRA might not have enough time to reassess a return of income for the relevant tax year with respect to these transactions before the return becomes statute-barred.⁵².

The CRA's Perspective: Is the GAAR an Effective Deterrent?

Taxpayers have various risk tolerances in conducting their tax affairs. Some seek to avoid controversy and take steps to ensure their filings are correct; they do not undertake planning they think might attract the application of the GAAR. Other taxpayers perceive tax as an unnecessary and potentially avoidable cost impacting their bottom line. They take all possible steps, and in some cases enter into abusive arrangements, in an attempt to minimize their tax liability. The former are already deterred by the GAAR while the latter group is not. Many taxpayers fall between these two approaches and assess the costs, benefits and risks of any given tax plan based on their particular circumstances and perspective.

The CRA continues to identify tax avoidance arrangements that achieve the same results as in cases where the courts have applied the GAAR. In these situations, the taxpayers know that the CRA will apply the GAAR if their planning is detected but they undertake the transactions nonetheless. These taxpayers assess the costs, benefits and risks of the tax plan knowing that:

- when the GAAR is applied, the CRA can generally only deny the tax benefits sought without any additional consequences beyond interest charges; and
- the CRA cannot realistically audit, detect, reassess and prevail through litigation in 100% of abusive tax planning arrangements.

The CRA further observes that some taxpayers repeatedly engage in abusive tax planning. As such, the CRA is of the view that the current formulation of the GAAR does not provide a sufficient deterrent to abusive tax planning.

⁵² The CRA can reassess tax returns for individuals, trusts and Canadian-controlled private corporations within 3 years from the original notice of assessment date (4 years for other corporations), beyond which the CRA is generally precluded from reassessing the taxpayer. The reassessment period is extended in certain situations.

Addressing the Issue

The government is considering the following possible solutions to this issue:

- introducing a penalty based on a percentage of the tax benefit;
- increasing the interest rate on taxes in dispute under a GAAR assessment; and
- extending the reassessment period for GAAR assessments.

Penalty

One option is to have an automatic penalty, based on a fixed percentage of the amount of the tax benefit, in every case where the GAAR is found to apply. It would be important to strike a balance between meaningfully deterring abusive tax planning and not providing an excessive penalty. For example, a 10% penalty may be too low to meaningfully deter abusive tax planning and a 100% penalty may be too high, resulting in a reluctance to apply the GAAR⁵³.

There would still be an element of discretion for the CRA to the extent GAAR is assessed as a secondary position. In such a case, taxpayers would have an incentive to settle on the basis of the primary technical position, if the primary position does not come with a penalty, and the CRA would presumably have the discretion to accept that approach. However, in order to level the playing field, consideration could also be given to introducing similarly structured penalties for many of the Act's other anti-avoidance rules.

Another option is to have a penalty that applies only in certain circumstances. While the penalty may be assessed by the CRA, it could be reversed by the courts if they find the conditions for applying the penalty have not been met. This could be a standalone penalty or it could be applied in addition to an automatic penalty. As a standalone penalty may not have the necessary deterrent effect, a combination approach would seem more effective. However, the combined percentage of the two penalties would, again, have to be set with a view to ensuring its deterrent effect while not being excessive so that there is a reluctance to apply the GAAR.

The primary challenge with a circumstantial penalty is setting the conditions for it to apply. For example, it could apply where:

- it was reasonable to expect that the GAAR would apply to the transactions at the time they were implemented;
- the CRA has published a position stating that the transactions are subject to the GAAR; or

⁵³ For example, prior to the enactment of Budget 2004 measures, the only sanction against a registered charity that did not comply with its requirements under the Act was the revocation of its status as a registered charity. Because of its harshness, revocation was seldom imposed for minor infractions. To rectify this, Budget 2004 announced sanctions that are more commensurate with the severity of the infraction in question.

- the same or a related taxpayer previously implemented a similar transaction that was found to be subject to the GAAR (in situations where the gross negligence penalty was found not to be applicable).

A purely discretionary penalty is not under consideration.

Consideration could also be given to whether it would be appropriate to have a special rule for determining the penalty where the tax benefit involves unutilized tax attributes. For example, a lesser percentage might be applied to take into account the time value of the tax benefit or, as with capital losses, for example, the likelihood of it ever being realized. Where a taxpayer believes that the GAAR does not apply in respect of a tax attribute, it might also incentivize earlier determinations. On the other hand, applying the full penalty to the maximum possible benefit would be easier to administer and could serve as an effective deterrent. It would also reduce any incentive for a taxpayer to enter into two-step transactions where a tax attribute is created first and then used in a later transaction, so that if the GAAR is applied it would apply to the first transaction, which would attract a lesser penalty.

Finally, there could be some mechanism that provides taxpayers with a way to protect themselves from the application of a penalty. Many penalties provide a due diligence defence. An exclusion could also be provided where a taxpayer has proactively disclosed sufficient information about the avoidance transaction to the CRA – similar to the approach adopted in Quebec. In this regard, the proposed regime for Mandatory Disclosure Rules announced in the 2021 Federal Budget⁵⁴ is closely related to this consultation.

Special interest rate

A higher rate of interest could apply to taxes payable that are in dispute under a GAAR assessment than would generally apply to other types of assessments. This could significantly change the economic calculus of abusive tax planning and create an incentive to resolve GAAR disputes earlier in the process.

The impact of such a rule would be greater or lesser, depending on the rate chosen. However, it would serve as less of a deterrent in circumstances where an abusive tax plan is implemented in the hopes of non-detection and then immediately settled once assessed. In addition, consideration would have to be given to how it could be adapted to tax planning involving unused tax attributes.

Extending the reassessment period for GAAR assessments

⁵⁴ Draft legislative proposals were released for public comment on February 4, 2022.

Consideration could be given to extending the reassessment period for an additional three years for GAAR assessments, similar to the additional time allowed to the CRA to properly examine activities in respect of foreign affiliates of a taxpayer that are relevant to the Canadian tax base.

While the proposed Mandatory Disclosure Rules would enhance reporting in respect of certain transactions, and provide an extended reassessment period where these reporting obligations are not met, reporting is not required under these rules in all circumstances where the GAAR could apply.

An extended reassessment period would provide the CRA with more time to detect and assess transactions to which the GAAR should apply, reducing the odds of non-detection and increasing the deterrent effect of the GAAR. It would also reflect the complexity of many tax avoidance structures and the difficulty of detecting avoidance transactions within a complicated series of transactions.

- Do respondents have views on the optimal design of a penalty or other rules intended to provide a sufficient deterrent to abusive tax planning?

D. Conclusion

The government is considering measures to respond to the issues described above and welcomes feedback on the questions posed above after each section. The government is also interested in hearing about other issues with the GAAR that respondents believe have led to inappropriate outcomes. Interested parties are invited to send written representations by September 30, 2022 to the Department of Finance Canada, Tax Policy Branch at GAAR-RGAE@fin.gc.ca on the relative merits of the various approaches to dealing with the issues.

- Has the application of the GAAR led to any other issues that have produced inappropriate outcomes?
- Do respondents have any other comments or suggestions on ways to modernize the GAAR?

ANNEX A

Subsequent to the establishment of the framework of a GAAR analysis articulated in the first Supreme Court of Canada decision on the GAAR (*Canada Trustco*), GAAR assessments issued by the CRA have been overturned by the courts 24 times. The following table shows these 24 court cases where the GAAR was held not to apply, organized by issue.

Tax Benefit	Avoidance Transaction	Misuse or Abuse
Univar Canada Ltd. (2005 TCC 723)	Evans (2005 TCC 684)	Canada Trustco (2005 SCC 54)
Fundy Settlement (2012 SCC 14) ⁵⁵	Overs (2006 TCC 26)	MIL Investments (2007 FCA 236)
Wild (2018 FCA 114)	McMullen (2007 TCC 16)	Landrus (2009 FCA 113)
Rogers Enterprises (2020 TCC 92)	McClarty (2012 TCC 80)	Remai (2009 FCA 340)
Bank of Montreal (2020 FCA 82)	Swirsky (2013 TCC 73) ⁵⁶	Lehigh (2010 FCA 124)
Damis Properties (2021 TCC 24) ⁵⁷	Spruce Credit (2014 FCA 143)	Collins & Aikman (2010 FCA 251)
	Loblaw (2018 TCC 182) ⁵⁸	Gwartz (2013 TCC 86)
		MacDonald (2012 TCC 123) ⁵⁹
		Univar (2017 FCA 207)
		MMV (2020 TCC 82) ⁶⁰
		Alta (2021 SCC 49)

⁵⁵ The Crown was successful in the case on the technical issue of residency and the comments on the GAAR were *in obiter*. The existence of a tax benefit was not the only contentious issue.

⁵⁶ The Crown was successful in arguing a technical position, and this decision was upheld by the Federal Court of Appeal. The GAAR was not discussed in detail at the Federal Court of Appeal.

⁵⁷ The TCC did conclude that there was at least one tax benefit but not the one identified by the Crown. The Crown has appealed the decision to the Federal Court of Appeal. The existence of a tax benefit was not the only contentious issue.

⁵⁸ The Crown was successful in arguing a technical position, but this decision was reversed by the FCA. The GAAR was not discussed at the Federal Court of Appeal or the Supreme Court of Canada.

⁵⁹ The TCC decision (Crown loss) was reversed by the FCA by applying a technical position. The GAAR was not discussed at the Federal Court of Appeal.

⁶⁰ The Crown has appealed the decision to the Federal Court of Appeal.

ANNEX B

Examples

The following examples illustrate how, in a general way, the proposed tests for ascertaining the existence, or lack, of economic substance might apply in certain fact patterns. While these examples are based on actual fact patterns to which the Crown has sought, or may seek, to apply the GAAR, they are intended simply to illustrate how the various tests might be applied and should not be taken as suggesting that the current GAAR should or should not apply in any particular circumstances.

The examples focus on the analysis of a transaction in each fact pattern to determine if it lacks economic substance, but other transactions, or the series of transactions as a whole, would need to be analyzed in actual cases.

Canada Trustco Decision

This example is based upon the fact pattern in *Canada Trustco Mortgage Co. v. Canada*, 2005 SCC 54 (Canada Trustco).

Background

Economically, a financing lease and a secured loan are highly substitutable. The main difference between the two is the fact that they result in title to the asset being in different hands: in the case of a lease, the financial institution holds the title, while in the case of a secured loan the borrower holds this title.

Because the income tax law looks at ownership to determine who may claim capital cost allowance, leases have been used to transfer capital cost allowance deductions from the user of an asset to the person financing its acquisition. To seek to neutralize the tax consequences of substituting a lease for a loan, the specified leasing property rules in the *Income Tax Regulations* effectively recharacterize such a lease from the lessor's perspective to be a loan and provide restrictions on the amount of capital cost allowance that the lessor can claim. During the taxation years in question, the specified leasing property rules contained an exception for long-haul trailers, which was central to the tax planning in *Canada Trustco*.

Transactions

The facts of the case were described in the decision of the Tax Court of Canada and summarized in the Appendix of the Supreme Court of Canada decision and therefore have not been reproduced here.

Economic Substance Analysis

Sole or dominant purpose test

As with the current primary purpose test, this test would depend on the facts of the case. If a taxpayer has no *bona fide* commercial purpose (or almost no such purpose)

for entering into a transaction or series of transactions, then the relevant transactions would be considered to lack economic substance.

In *Canada Trustco*, the Tax Court found that the primary purpose of the series of transactions was the obtaining of a tax benefit. However, the court also found that tax was not the only purpose for the transactions.⁶¹ Based on that finding, a sole purpose test would not result in the *Canada Trustco* fact pattern being found to lack economic substance.

Under the proposed test, a transaction could be found to lack economic substance where it is almost entirely tax motivated or, put differently, its dominant purpose is to obtain a tax benefit. While this is an inherently factual determination, it seems reasonable to conclude that the leasing transactions in *Canada Trustco* were almost entirely tax motivated. Indeed, testimony mentioned in the Tax Court decision suggested that the capital cost allowance deductions were providing the very attractive returns and the decision itself referred to “the dominance of the tax benefit purpose”⁶² (however, as the dominant purpose was not at issue, this should not be taken as dispositive).

Potential for pre-tax profit

The facts in *Canada Trustco* illustrate a challenge with the design of a pre-tax profit test. The Appendix to the Supreme Court of Canada's decision states that Canada Trustco Mortgage Company “would realize a before-tax return of approximately \$8.5 million from the transactions.” However, this return was derived indirectly from the purchase of a Government of Ontario bond and not the actual purchase and leasing transactions which gave rise to the tax benefit.

If the pre-tax profit test simply involved looking at whether the series of transactions as a whole had the potential for pre-tax profit, the facts in *Canada Trustco* could lead to the conclusion that there was a potential for pre-tax profit. Likewise, in such a test, a comparison of the potential for pre-tax profit to the expected tax savings may or may not result in a finding of economic substance, depending on the multiple used.

On the other hand, a consideration of the purchase of the trailers within the context of the leasing and financing arrangements suggests that it carried no potential for pre-tax profit due to the circular flow of funds and the nearly \$6 million in costs (i.e., \$2.34 million of transaction costs and the \$3.6 million that went to Transamerica Leasing Inc. –the subleasee corporation located in the United States). This underscores an issue to be addressed in the specific design of the test: that an element could be added to a purely tax-driven series of transactions, which ostensibly provides the potential for pre-tax profit despite being ancillary to the transactions giving rise to the tax benefit.

Change in economic position

⁶¹ *Canada Trustco* at paragraph 54.

⁶² *Canada Trustco* at paragraph 56.

As discussed above, the funds contributed by Canada Trustco Mortgage Company were indirectly used to purchase a Government of Ontario bond. Beyond that, and any transaction costs, the economic positions of the parties remained largely unchanged vis-à-vis the trailers and leasing transactions which gave rise to the tax benefit. Canada Trustco Mortgage Company had no material opportunity for gain or profit or risk of loss in respect of the leased property as a result of the series of transactions. Thus, under this test, the transactions in *Canada Trustco* might reasonably have been found to lack economic substance.

Legal form vs accounting treatment

As there was no discussion of the accounting treatment accorded these transactions by any of the parties in the case, it is impractical to comment on how this factor may have been applied.

Captive Insurance Planning

This example is based upon planning in respect of which a measure was announced in Budget 2014. It involves the tax rules as they were before these amendments.

Background

The Canadian tax system contains rules that protect the tax base by preventing taxpayers from shifting certain Canadian-source income to no- or low-tax jurisdictions. Under these rules, such income earned by a controlled foreign affiliate of a taxpayer resident in Canada is considered foreign accrual property income (FAPI) and is taxable in the hands of the Canadian taxpayer on an accrual basis.

A specific anti-avoidance rule in the FAPI regime is intended to prevent Canadian taxpayers, including financial institutions, from shifting income from the insurance of Canadian risks (i.e., risks in respect of persons resident in Canada the premium income from which has its source in Canada) offshore. This rule provides that income from the insurance of Canadian risks is FAPI where 10 per cent or more of the gross premium income (net of reinsurance ceded) of a foreign affiliate of the Canadian taxpayer in respect of all risks insured by the affiliate is premium income from Canadian risks.

Transactions

A taxpayer transfers a pool of Canadian risks, originally insured in Canada, to a wholly owned foreign affiliate of the taxpayer.

The Canadian risks are then exchanged with a third party for foreign risks that were originally insured outside of Canada, while at the same time ensuring that the affiliate's overall risk profile and economic returns are essentially the same as they would have been had the affiliate not entered into the exchange. This can be accomplished through make-whole agreements which obligate the parties to make compensatory payments to one another to the extent the returns on their respective portfolios differ.

Economic Substance Analysis

Sole or dominant purpose test

As with the current primary purpose test, this test would depend on the facts of the case. If a taxpayer has no *bona fide* commercial purpose (or almost no such purpose) for entering into a transaction or series of transactions, then the relevant transactions would be considered to lack economic substance.

In this case, the exchange with the third party would be found to lack economic substance if it was entirely tax motivated or, at the most, any non-tax considerations were inconsequential in the context of the transaction.

Potential for pre-tax profit

If the transaction costs of implementing the exchange exceed the potential for pre-tax profit or are immaterial in the context of the transaction, then the transaction would be found to lack economic substance.

The facts suggest that the economic returns on the exchanged Canadian portfolio and foreign portfolio are essentially the same. If they are exactly the same, such that there cannot be an incremental increase in profits, then the economic substance test would be failed. Likewise, if the returns were sufficiently different that there was some potential for an increase in pre-tax revenues, the transaction would be found to lack economic substance if the transaction costs exceeded that expected increase.

If the test were to involve a comparison of the tax benefit to the potential for pre-tax profit, then the amount of FAPI that the transaction aims to avoid would be compared to the anticipated pre-tax profit. If there is no potential for pre-tax profit, then the amount of the tax benefit would necessarily be more than 10 times the reasonably anticipated pre-tax profit.

Change in economic position

This series of transactions is designed to ensure that the taxpayer's economic returns are essentially unchanged as a result of the transaction. As such, its opportunity for gain or profit and risk of loss are not materially effected. While there may be some additional counterparty risk as a result of the exchange, it would be a factual question as to whether that results in a material change in economic position.

Legal form vs accounting treatment

If the accounting treatment for this series of transactions is similar to what it would have been (but for the tax benefits) had the Canadian risks not been transferred to the foreign affiliate and exchanged for foreign risks with the third party, that would indicate that the transactions may be lacking in economic substance.

Straddle Planning

This example is based upon planning in respect of which a measure was announced in Budget 2017. It involves the tax rules as they were before these amendments.

Background

Derivatives are financial instruments whose value is derived from changes in the value of an underlying interest. Prior to the amendments arising from the Budget 2017 announcement, there were no specific rules in the *Income Tax Act* that governed the timing of the recognition of gains and losses on derivatives held on income account. As a result, some taxpayers implemented strategies to selectively realize gains and losses on derivatives through, for example, straddle transactions in order to defer tax.

Transactions

A taxpayer concurrently enters into two derivative positions that are expected to generate equal and offsetting gains and losses.

Shortly before its taxation year-end, the taxpayer disposes of the position with the accrued loss (the losing leg) and realizes the loss. Shortly after the beginning of the following taxation year, the taxpayer disposes of the offsetting position with the accrued gain (the winning leg) and realizes the gain. The timing between closing out the two legs is kept as short as possible, in order to minimize any potential for economic exposure to fluctuations in the value of the underlying reference assets.

The taxpayer claims a deduction in respect of the realized loss against other income in the initial taxation year and defers the recognition of the offsetting gain until the following taxation year. The taxpayer claims the benefit of the deferral although economically the two positions are offsetting.

These transactions are continued year after year, with the taxpayer seeking to indefinitely defer the recognition of the gain on the winning leg by entering into successive straddle transactions.

Economic Substance Analysis

Sole or dominant purpose test

As with the current primary purpose test, this test would depend on the facts of the case. There are certainly circumstances where offsetting short-long positions can be entered into for commercial purposes, such as in the context of arbitrage trading strategies that, for example, seek to exploit pricing discrepancies between different but similar securities for profit.

In this case, it seems reasonable to conclude that the series of transactions is entirely tax motivated. Of particular relevance are the steps taken to ensure that there are no non-tax economic consequences related to the transactions. As a consequence, under this test the series of transactions would be found to lack economic substance.

Potential for pre-tax profit

To the extent possible, the transactions are structured to avoid any potential for economic gains or losses. As such, the potential for pre-tax profit appears to be nil or negligible and would likely be less than any transaction fees, indicating that the transactions lack economic substance.

A comparison of the expected tax benefit to the potential pre-tax profit would likewise result in a determination that the series of transactions lacks economic substance.

Change in economic position

In this case, the two positions are intended to be as close to perfectly offsetting as possible and steps are taken to minimize any potential economic exposure. While there is a short period in which one leg is closed and the other is open, this is minimized such that all or substantially all of the taxpayer's opportunity for profit and risk of loss in respect of the series is eliminated.

Legal form vs accounting treatment

If the accounting treatment for this series of transactions – either the balance sheet presentation or reported income in the income statement – did not differ significantly from what it would have been absent the transactions, that could indicate a lack of economic substance. It is recognized that not all taxpayers prepare financial statements in accordance with generally accepted accounting principles. In some of these cases, it may be impractical to apply this factor.

ANNEX C

Summary of Consultation Questions

Tax Benefit

1. Are there any changes to the wording of the “tax benefit” definition required in order to ensure that it applies appropriately?

Avoidance transaction: mixed purpose transactions

2. Should the definition of “transaction” be extended to include certain choices and if so, which choices ought to be included?
3. Which, or which combination, of the alternatives discussed above is most appropriate for ensuring that the GAAR is effective in preventing abusive tax avoidance?
4. Are there other alternatives for achieving this objective?

Misuse or abuse: determining object, spirit and purpose and general schemes

5. Do respondents have comments or suggestions on ways to clarify the object, spirit and purpose of provisions of the Act?
6. Do respondents have comments or suggestions on ways to improve the interpretive process under subsection 245(4) by, for example, adding targeted interpretive rules or changing the burdens and standards of clarity established by the courts?
7. With respect to potentially changing the burdens and standards of clarity established by the courts, in which circumstances would it be appropriate to change them and how might the current clarity standard be modified, recognizing the complexity of the Act?
8. Regarding the objectives of certainty, predictability and fairness (including the broader notion of fairness), do respondents have comments or suggestions on how best to maintain an appropriate level of, and balance among, certainty, predictability and fairness?

Economic substance

9. Do respondents have suggestions as to how economic substance should be defined for the purposes of a GAAR analysis?
10. Do respondents have views on what should be the appropriate consequences when a transaction is found to be lacking in economic substance?
11. Do respondents have views on how best to integrate an economic substance test into the GAAR?
12. If an economic substance test is integrated into the misuse or abuse analysis, do respondents have views on how best to accommodate transition and minimize disruption with respect to existing jurisprudence?

Penalties and other deterrents

13. Do respondents have views on the optimal design of a penalty or other rules intended to provide a sufficient deterrent to abusive tax planning?

Conclusion

14. Has the application of the GAAR lead to any other issues that have produced inappropriate outcomes?

15. Do respondents have any other comments or suggestions on ways to modernize the GAAR?