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**SENT BY ELECTRONIC MAIL** (GAAR-RGAE@fin.gc.ca)

Department of Finance Canada
Tax Policy Branch
90 Elgin Street
Ottawa, ON K1A 0G5

**RE: General Anti-Avoidance Rule ("GAAR") Proposal**

## 1. Introduction

These submissions are in response to the draft amendments (the "**Draft Amendments**") to the GAAR included in the Notice of Ways and Means Motion (the "**Budget NWMM**") that accompanied the 2023 Federal Budget released on March 28, 2023 ("**Budget 2023**").

First, we acknowledge and appreciate that, having reviewed the submissions made in response to the consultation paper released on August 9, 2022 (the "**Consultation Paper**"), the Government has made a deliberate choice not to proceed with some of the potential reforms that were initially posited in the Consultation Paper. In particular, consistent with our comments in our prior submission of September 30, 2022, we agree with the conclusions reflected in the Draft Amendments that, for both policy and practical reasons:

- It is appropriate for the Crown to maintain the onus under the misuse or abuse test in the final leg of the GAAR analysis to establish that the transactions in issue have offended the object, spirit and purpose of the provisions, or scheme, of the *Income Tax Act*, that the Crown alleges has been misused or abused.[1] This is consistent with the fundamental principle that the party with better knowledge of the matter in issue should bear a greater burden of proof.

- It is appropriate to maintain the current definition of "transaction", which does not impugn a taxpayer's choice to pursue the more tax-efficient route to achieve its commercial objectives. This conclusion is consistent with the reaffirmation by the Supreme Court of Canada, as recently as last week, that "[t]he GAAR must also be understood in light of its relationship to the *Duke of Westminster* principle. … The principle that taxpayers can order their affairs to minimize the amount of tax payable has been affirmed by this Court on numerous occasions. … The GAAR does not displace *the Duke of Westminster* principle for legitimate tax planning. Rather, it recognizes a difference between legitimate tax planning — which represents the vast majority of transactions and remains unaffected, consistent with

[1] *Deans Knight Income Corp. v Canada*, 2023 SCC 16 [*Deans Knight*] at para 52.

> the *Duke of Westminster* principle — and tax planning that operates to abuse the rules of the tax system — in which case the integrity of the tax system is preserved by denying the tax benefit, notwithstanding the transactions' compliance with the provisions relied upon."[2]

The well-defined test for applying the GAAR that has been developed by the courts in decades of jurisprudence is operational in respect of the wide range of provisions found in the *Income Tax Act* and other legislative instruments. This test reflects the courts' effort to respect Parliament's intention that the GAAR strike an appropriate balance between curtailing abusive tax avoidance and the need for certainty in the application of tax laws.[3] We remain concerned that, if enacted as proposed, the Draft Amendments risk upsetting this careful balance struck by the courts, including six decisions of the Supreme Court of Canada.

Our submission addresses certain key concerns in relation to aspects of the Draft Amendments that risk undermining the continued efforts of the courts to ensure that the application of the GAAR remain rigorous and principled and not devolve into a purely discretionary exercise of the Minister of National Revenue's power.

## 2. Role of Fairness Incompatible with Prior Jurisprudence

The Supreme Court has repeatedly instructed that certainty, predictability and fairness are key principles of the Canadian tax system. In *Canada Trustco*, the Court explained that "[t]he provisions of the *Income Tax Act* must be interpreted in order to achieve consistency, predictability and fairness so that taxpayers may manage their affairs intelligently."[4]

The concept of fairness that the Supreme Court has consistently sought to protect is one that allows *taxpayers to know what the law is and how they can follow it* — in other words, fairness for the taxpayer who is subject to the exercise of state power reflected in tax legislation, not fairness in, or for, the tax system itself. That judicial conception of fairness — in its most basic form — is an expression of the principle of the rule of law and was recently reiterated in the first Supreme Court decision regarding the application of the GAAR to a tax treaty.[5]

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2 *Deans Knight* at paras 46-47.

3 See, *inter alia*, *Deans Knight* at para 48.

4 *Canada Trustco Mortgage Co. v Canada*, 2005 SCC 54 [*Canada Trustco*] at para 12 (emphasis added).

5 *Canada v Alta Energy Luxembourg S.A.R.L.*, 2021 SCC 49 [*Alta Energy*] at para 1.

The Draft Amendments introduce an entirely distinct concept of "fairness" that is divorced from the principles of predictability and certainty. Instead of the three principles being tied to one another as the Supreme Court intended, the proposed Preamble alludes to balancing taxpayer certainty with "fairness of the tax system" — an undefined concept that seems intended to be synonymous with "protecting the tax base". Doing so fundamentally changes the concept of "fairness", which the Supreme Court affirmed in *Deans Knight* as being fully integrated with certainty and predictability.

As the Court observed in *Deans Knight*:

> [A] proper application of the GAAR methodology serves to ensure reasonable certainty in tax planning.[6] … The GAAR is not a tool to sanction conduct that courts find immoral (*Copthorne*, at para. 65; *Alta Energy*, at para. 48). Rather, courts must conduct an 'objective, thorough and step-by-step analysis' (*Copthorne*, at para. 68). Within this analysis, the principles of certainty, predictability and fairness do not play an independent role; rather, they are reflected in the carefully calibrated test that Parliament crafted in s. 245 of the Act and in its interpretation by this Court.[7]

We believe that any reference to fairness in the context of the GAAR should be limited to the well-understood meaning of this concept, as reflected in the jurisprudence.

### 3. Economic Substance Test Should be Revisited

The Draft Amendments introduce an "economic substance" test that is to be inserted at the misuse and abuse stage of the GAAR analysis. As confirmed by the Department of Finance at the 2023 International Fiscal Association Roundtable (the "**IFA 2023 Finance Roundtable**"), the task of incorporating "economic substance" into the GAAR was undertaken in response to the Mandate Letter dated December 16, 2021 to the Deputy Prime Minister and Minister of Finance, which called for the Government to modernize the GAAR and "focus on economic substance".

As acknowledged in the Consultation Paper, the concept of "economic substance" is capable of various interpretations. One such interpretation would be to have regard to the economic substance of the transactions to which the provisions of the *Income Tax Act* are to be applied, including consideration of the accounting treatment applicable to the transactions, similar to the approach applied in other jurisdictions like the United States. A very different approach to this concept, which has been adopted in the Draft Amendments,

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6 Citing P. Samtani and J. Kutyan, "GAAR Revisited: From Instinctive Reaction to Intellectual Rigour" (2014), 62 Can. Tax J. 401, at p. 403).

7 *Deans Knight* at para 50.

is to approach economic substance in a binary fashion. We have serious concerns with this approach as detailed below.

As it has been judicially interpreted to date, the GAAR respects the foundational Canadian tax principle that transactions are to be tested according to their legal *substance* — the substantive rights and obligations actually created between parties — and requires that the analysis of whether those transactions are abusive be firmly grounded in the text, context and purpose of the relevant provisions of the *Income Tax Act*. The proposed "economic substance" test: (i) is incorrectly situated at the wrong stage of the GAAR analysis, (ii) is inappropriately measured on a transaction-by-transaction basis, and (iii) risks creating unnecessary uncertainty with respect to legitimate, tax-efficient transactions within related groups.

First, situating the economic substance test at the misuse and abuse stage of the GAAR analysis is confusing, given that such a test is disconnected from the rigorous analysis required under this stage of the GAAR. As the Supreme Court cautioned in *Deans Knight*, the misuse and abuse analysis is founded on the text, context and purpose of the provisions involved, lest the analysis "turn into 'a value judgment of what is right or wrong [or] … what tax law ought to be or ought to do'."[8] The jurisprudence of the Supreme Court also confirms that the misuse and abuse analysis is robust and encapsulates various circumstances in which abusive tax avoidance may be found:[9]

> This Court's jurisprudence sheds light on the types of circumstances that rise to the level of abuse. For example, if the rationale underlying the provision is to encourage particular relationships or activities, abusive tax avoidance may be found where the relationships and transactions are "wholly dissimilar to the relationships or transactions that are contemplated by the provisions", as was the case in *Mathew* (para. 57, citing *Trustco*, at para. 60). Similarly, where a specific anti-avoidance rule is flipped on its head to enable tax avoidance, there is likely to be a finding of abuse, as was the case in *Lipson* (para. 42; see also *Fiducie Financière Satoma v. The Queen*, 2018 FCA 74, 2018 D.T.C. 5052, at para. 52). An abuse may also be found in certain circumstances where a series of transactions "achieved a result the section was intended to prevent" while narrowly avoiding application of the provision, as in *Copthorne* (paras. 124-27). These examples are not exhaustive, but provide useful guidance on how the object, spirit and purpose of different types of tax provisions can be frustrated.

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8 *Deans Knight* at para 63, citing *Copthorne* at para 70.

9 *Deans Knight* at para 70.

The inclusion of the proposed economic substance test improperly departs from the specific objectives of the misuse and abuse test, and risks collapsing two distinct steps of the GAAR analysis developed by the courts over the past two decades: the avoidance transaction step and the misuse and abuse step. Specifically, the factors set out in the Draft Amendments that "tend to indicate" a lack of economic substance all focus on the relative weighting of tax considerations (including those unrelated to the Canadian tax system) to the economic benefits of the transactions in issue. As currently defined, this test manifestly overlaps with the factors that are necessarily considered at the avoidance transaction stage of the analysis.

For a transaction to be an "avoidance transaction" as defined, it must be tax-driven as opposed to being commercially-driven. The explicit weighing of tax consequences against economic consequences under the proposed economic substance test could be a logical addition to the factors relevant to the existence of an avoidance transaction. The avoidance transaction element of the GAAR analysis already considers the taxpayer's purpose and is better aligned with a test that speaks to a presence or lack of substance. Resituating the economic substance test would accomplish the objective set out in the Mandate Letter without unduly upsetting the careful balance established by the jurisprudence.

The proposal clearly contemplates that a transaction, or series, may be significantly lacking in economic substance without being abusive, and that the GAAR is unlikely to apply to transactions and series that have economic substance. However, it is unclear how the proposed economic substance test would interact with the examination of the object, spirit and purpose of the relevant provisions, so that courts might determine whether there has been a misuse or abuse in a manner that adheres to the jurisprudence.

This concern is exacerbated with respect to tax results obtained outside Canada, which, as the proposed addition is currently drafted, may weigh against economic substance even if those results are entirely appropriate and consistent with good tax policy (such as, for example, satisfying the requirements for a tax-deferred transaction under foreign law). Regardless of where the economic substance test is placed, foreign tax benefits should not derogate from economic substance to the extent that they are not abusive under the relevant foreign tax law.

We understand that the Government's concern about the application of the GAAR to transactions that lack "substance" may in part be animated by comments made by the Court in *Canada Trustco*. In that appeal, the Supreme Court accepted the unchallenged factual finding by the trial court that the transactions at issue involved a profitable commercial investment and the parties' agreement that a standard sale-leaseback transaction would be consistent with the object, spirit or purpose of the capital cost allowance ("**CCA**") provisions.

In that specific context, the Court rejected the Crown's argument that the transactions suffered from a "lack of substance" because that argument amounted to "a narrow consideration of the 'economic substance' of the transaction, viewed in isolation from a textual, contextual and purposive interpretation of the CCA provisions. It did not focus on the purpose of the CCA provisions read in the context of the Act as a whole, to determine whether the tax benefit fell outside the object, spirit or purpose of the relevant provisions."[10]

As to the relationship between "lack of substance" and abuse, the Court said:

> A transaction may be considered to be "artificial" or to "lack substance" *with respect to specific provisions* of the *Income Tax Act*, if allowing a tax benefit would not be consistent with the object, spirit or purpose of those provisions. We should reject any analysis under s. 245(4) that depends entirely on "substance" viewed in isolation from the proper interpretation of specific provisions of the *Income Tax Act* or the relevant factual context of a case.[11]

These comments in *Canada Trustco* were predicated on the Court's careful analysis of how to approach the GAAR so that "the wording of the provisions of the *Income Tax Act* together with the relevant factual context of a given case achieve balance between the need to address abusive tax avoidance while preserving certainty, predictability and fairness in tax law so that taxpayers may manage their affairs accordingly."[12] In those circumstances where it is appropriate to consider economic substance in light underlying rationale of the relevant provisions, the courts have done so under the GAAR as currently enacted, in line with the *Canada Trustco* guidance. An example of this is the *Triad Gestco* trilogy of cases, wherein the Federal Court of Appeal conducted an analysis of the policy underlying the loss provisions and determined that a "paper loss" would be inconsistent with the rationale of those rules.[13] With respect, in doing precisely what the Court warned against in *Canada Trustco* — considering economic substance "in isolation from the proper interpretation of specific provisions of the Act"[14] — the Draft Amendments risk disturbing this carefully struck balance.

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10 *Canada Trustco* at para 76.

11 *Canada Trustco* at para 60 (emphasis in original).

12 *Canada Trustco* at para 61.

13 *Triad Gestco Ltd. v Canada*, 2012 FCA 258; *1207192 Ontario Limited v Canada*, 2012 FCA 259; and *Canada v Global Equity Fund Ltd.*, 2012 FCA 272.

14 *Canada Trustco* at para 76.

Second, the proposed economic substance test focuses on a single transaction instead of the entire series. By its nature, economic substance requires a holistic perspective of the entire series of transactions undertaken by a taxpayer. Any attempt to focus narrowly on just a single transaction or step, or to deny the legal effect of separate substantive steps simply because they may economically offset each other, is arbitrary and misleading. For example, the fact that one transaction step out of an entire series does not result in a change to the economic position of a taxpayer should not "tend to indicate" a lack of economic substance or that the series results in a misuse or abuse. Similarly, where the individual steps in a series of transactions have independent economic substance, the fact that some steps may be intended to alleviate, or offset, the economic risks attendant in other steps in the series should not "tend to indicate" a lack of economic substance or that the series results in a misuse or abuse. Protecting against economic or commercial risk is, fundamentally, an exercise with substance.

Third, the proposed test captures transactions within related groups. Many legitimate corporate objectives from a tax policy perspective — such as plain-vanilla rollover transactions, tax-deferred divisive corporate reorganizations, and intra-group corporate loss consolidation transactions — necessarily involve transactional steps that do not have economic substance (as defined in the Draft Amendments) but rather are necessary in light of, amongst other valid policy considerations, the fact that Canada does not have a system of consolidated group taxation.

In this regard it is notable that historically the lack of change in the net economic position of a taxpayer, or related group, has been precisely the circumstance in which Parliament has legislated to prevent a taxable event. The numerous tax-deferred “rollover” provisions in the Act are predicated on the proposition that it would be inappropriate to impose tax where there has been no economic recognition of a “paper gain” that would otherwise technically arise under the provisions of the *Income Tax Act* in the absence of a rollover. Many such related-party transactions would appear to meet at least one (if not all) of the three factors itemized in the proposal as “tending to indicate” a lack of economic substance, including whether:

- there is the potential for pre-tax profit;
- the transaction has resulted in a change of economic position; and
- it is reasonable to conclude that the entire, or "almost entire," purpose for undertaking or arranging the transaction or series was to obtain the tax benefit.

As drafted, the proposed test captures commonly accepted transactions that may be lacking in economic substance and, as result, could inappropriately be treated as indicating that a transaction or series is abusive. The IFA 2023 Finance Roundtable comments suggest that

the Preamble, which acknowledges that taxpayers should be entitled to obtain the tax benefits "contemplated" by the provisions of the *Income Tax Act*, is considered by the Department to be sufficient to protect related party transactions from being subject to the GAAR. However, in our respectful submission, this should be made explicit, and should be expressly tied to the proposed economic substance test to provide certainty for taxpayers.

### 4. Due Diligence Defence Required for Penalty and Extension of Limitation Period

Budget 2023 proposed that a 25 percent penalty be introduced for transactions subject to the GAAR, and that the normal reassessment period under the *Income Tax Act* be extended by three years for GAAR assessments. Both the penalty and the extended reassessment period can be avoided if the taxpayer voluntarily discloses the transaction to the CRA under the reportable transactions rules in section 237.3. This is a significant shift in the operation of the GAAR, as the courts have explicitly held that the GAAR is not a penal provision,[15] and that taxpayers cannot self-assess under the GAAR.

Given this transformational change to the consequences under the GAAR, it is imperative that these measures include an adequate due diligence defence. Such a defence would recognize the exceptional nature of penalties and extended reassessment periods in the scheme of the *Income Tax Act* and particularly in the context of the GAAR — a provision that necessarily applies only where a taxpayer has complied with the express provisions of the legislation. As the Supreme Court has noted in the context of another penalty in the *Income Tax Act*, it is "meant to capture serious conduct, not ordinary negligence or simple mistakes."[16]

Further, the existing assessment periods serve important policy goals: "Consistency and predictability are achieved by a taxpayer knowing that the issue of its tax burden will have been settled and concluded after the three-year period except for in certain limited circumstances."[17] Consistent with these considerations, many existing penalties in the *Income Tax Act* (such as in subsection 163(2)) require "gross negligence" to apply, and one of the key exceptions to the limitation period applies only when there is a "misrepresentation … attributable to neglect, carelessness or wilful default" or "fraud."[18]

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15 *Lipson v Canada*, 2009 SCC 1 at para 52.

16 *Guindon v Canada*, 2015 SCC 41 at para 61.

17 *Inwest Investments Ltd. v Canada (National Revenue)*, 2015 BCSC 1375 at para 84.

18 See paragraph 152(4)(a).

Moreover, the situations in which penalties are applied in the *Income Tax Act* typically involve objective facts and actions that are wholly within the taxpayer's control. By contrast, at the heart of the GAAR exercise is a debate about the underlying rationale of complex schemes in the *Income Tax Act*. As the Consultation Paper recognizes, the Crown itself has struggled to clearly establish the "object, spirit and purpose" of the relevant provisions in many instances. This is an exercise in which thinking minds can differ on the outcome, and one that clearly warrants a due diligence exception where the exercise itself has been undertaken seriously.

Thus, just as the reportable transaction rules include a due diligence defence in subsection 237.3(11), the application of the proposed penalty and extended limitation period under the GAAR must have a similar due diligence defence.[19] In other words, if a person has exercised the degree of care, diligence and skill to determine whether the GAAR might apply that a reasonably prudent person would have exercised in comparable circumstances, and concluded that the GAAR did not apply, the extended reassessment period and penalty should not apply.

We acknowledge the proposal that the GAAR penalty and extended reassessment period can be avoided if a taxpayer voluntarily reports the impugned transactions to the Minister. In our respectful submission, this measure is insufficient to protect taxpayers who have otherwise made diligent efforts to comply with the provisions of the *Income Tax Act*. As it stands, taxpayers would effectively be coerced into reporting legitimate transactions that they have prudently determined not to be abusive, for fear of being subject to the GAAR penalty or extended limitation period, based on the uncertainties introduced by the Draft Amendments (including by the proposed introduction of an economic substance test).

Although the revised Form RC312 has yet to be publicly released, we understand and have serious concerns that it may require taxpayers to "self-audit" and appears designed to supply the Minister with reasons to apply the GAAR. For example, it would be problematic if the Form were to presuppose, and request a list of, provisions avoided by the taxpayer, or require the taxpayer to identify concepts such as a "tax benefit" or a "series of transactions". Doing so would place taxpayers in the untenable position of having to explain how parts of the GAAR apply, notwithstanding that they have determined, with prudence and diligence, that the GAAR does not apply. This runs contrary to the basic principle of fairness articulated by the Federal Court of Appeal that "stands against any

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[19] It is well-accepted that there is a rebuttable presumption of a due diligence defence for administrative penalties and that even strict penalties should not be applied if a taxpayer has taken all reasonable measures to comply with the legislation. *Canada (Attorney General) v Consolidated Canadian Contractors Inc. (C.A.)*, 1998 CanLII 9092 (FCA), [1999] 1 FC 209 and *Home Depot of Canada Inc. v The Queen*, 2009 TCC 281.

construction of the Act that would allow the Minister to compel a taxpayer to self-audit on an ongoing basis."[20]

While subsection 237.3(12) provides that the filing of an information return under section 237.3 is not an admission by the taxpayer that the GAAR applies or that any transaction is a part of the series, it is silent on the impact of the apparently forced admissions regarding tax benefit, tax avoidance and relevant provisions. Furthermore, although section 237.3 provides that the filing of the form is not an admission, it does not provide adequate protection against using the information in these forms as evidence that any element of the GAAR test has been satisfied. We would urge that greater protections be enshrined in Form RC312, as well as in the *Income Tax Act* itself, clarifying that the information supplied in these forms cannot be relied upon directly or indirectly as evidence in support of the application of the GAAR.

## 5. Draft Amendments should be Clearly Prospective

There has been a lamentable trend recently toward retroactive tax legislation, including in Budget 2023 with which the Draft Amendments were released. Budget 2023 included a proposal to impose GST/HST on services provided by payment card network operators — purportedly effective from the inception of the GST. These changes were inconsistent with the Department of Finance's own guidelines on retroactive legislation. Those guidelines provide that retroactive *clarifying* tax legislation, though generally a serious violation of the rule of law, may be appropriate on an exceptional basis where the amendments reflect a long-standing and well-known interpretation of the law by the CRA.[21] In the case of the GST/HST amendment proposed by Budget 2023, the amendment did not reflect any such long-standing, well-known interpretation, as the amendment followed years of litigation, relating to periods as early as 2003, and a Federal Court of Appeal decision that reached a concluded view on the interpretation that is precisely contrary to the Budget 2023 changes.

We acknowledge that there has not been any suggestion to date that the Draft Amendments would be effective prior to Royal Assent and, in fact, it was confirmed at the IFA 2023 Finance Roundtable that they were not intended to be retroactive. This is appropriate given that aspects of the Draft Amendments, including the separate consideration of economic substance and the introduction of a penalty, reflect substantial changes in policy (as acknowledged in the Consultation Paper).

However, given that the GAAR can apply to a "series of transactions", the effective date alone provides insufficient comfort that the Draft Amendments will not be applied by the

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[20] *BP Canada Energy Company v Canada (National Revenue)*, 2017 FCA 61 at para 83.

[21] Comprehensive Response of the Government of Canada to the Seventh Report of the Standing Committee on Public Accounts (September 1995).

Minister with retroactive effect to previously completed transactions, or to series of transactions. We urge the Government to provide that any changes to the GAAR shall only apply to transactions or series of transactions commenced after Royal Assent. This is particularly pressing given the proposed penalties and the extension of the limitation period, as taxpayers obviously cannot be expected to have been duly diligent in complying with the new rules, or with any new reporting requirements, prior to their announcement or enactment.

## 6. Concluding Comments

As we noted in our earlier submission, an inordinate amount of time is currently spent on tax disputes in Canada (including at audit, appeals, and at all levels of Court). The Draft Amendments, if enacted as proposed, have the potential to compound the uncertainties associated with the GAAR, augment the already significant burden on Canadian taxpayers in the form of compliance and dispute costs, and harm Canada's competitiveness in an increasingly global economy. We strongly urge the Department to propose appropriate revisions, having regard to the concerns described in this submission.

We would be happy to discuss any aspect of this submission further, or to comment on any further revisions to the Draft Amendments.

Yours very truly,

**Osler, Hoskin & Harcourt LLP**