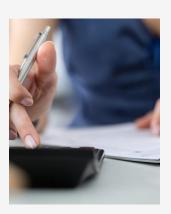


Tax avoidance in Canada and the future of the GAAR

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The Canadian *Income Tax Act* (Tax Act) contains a general anti-avoidance rule (GAAR) which can negate tax benefits arising from "abusive" tax avoidance transactions. These are transactions that satisfy the requirements of the law, but are found to be contrary to the spirit or underlying policy of the legislation or its specific provisions.

In the <u>2020 Fall Economic Statement</u>, the federal government announced its intention to undertake a public consultation on modernizing Canada's anti-avoidance rules, including the GAAR. In <u>Budget 2022</u>, the federal government maintained its intention to "strengthen" the GAAR, but acknowledged that the GAAR should not interfere with legitimate commercial and family arrangements.

In August 2022, the government released a <u>consultation paper</u> that describes potential sweeping changes to the GAAR (the Consultation Paper). Many of the revisions suggested in the Consultation Paper are likely to affect routine tax planning and undermine the long-established principle, recently upheld by the Supreme Court of Canada in <u>Loblaw Financial Holdings</u>, that taxpayers are entitled to order their affairs to minimize tax. Any revisions will also have to be considered in the context of a GAAR decision expected from the Supreme Court of Canada in 2023 in <u>Deans Knight Corporation</u>.

The Consultation Paper

The application of the GAAR is premised on three requirements: there has to be both a "tax benefit" and an "avoidance transaction," which is generally a transaction that is undertaken primarily for tax purposes, and it must be demonstrated that the avoidance transaction, or the series of transactions of which it is a part, results in a misuse or abuse of particular provisions of the Tax Act or of the legislation as a whole.

The Consultation Paper identifies ways to expand the GAAR, but does not articulate why the government believes the current law falls short of meeting the objective of preventing abusive tax avoidance. Nor does it explain why the GAAR must be amended to broadly address potential future disputes, rather than addressing specific issues to the extent necessary through targeted legislative amendments to particular provisions.

The Consultation Paper identifies 24 GAAR cases that the tax authority has lost (while



observing that the application of GAAR has been raised by the tax authority in more than 1,300 instances) and suggests a menu of revisions intended to reverse the outcomes of those 24 cases. The Consultation Paper implies that anything less than universal success by the government in all cases in which it seeks to apply the GAAR is unacceptable. The Consultation Paper also suggests, among other broad changes, that taxpayers ought to bear the burden of both establishing the clear policy of the relevant provisions or statutory scheme at issue and demonstrating that there has not been any misuse or abuse of those provisions or scheme.

Amendments to a provision such as the GAAR should not be driven by taxpayer success in a handful of cases. The Canadian tax authority has been unsuccessful principally in cases where it was unable to establish that the policy of the relevant provisions was what the tax authority alleged it to be. Moreover, the proposal to change the burden of proof in GAAR cases is inconsistent with the theme in Canadian tax jurisprudence that the party with better knowledge of the matter in issue should bear a greater burden of proof. The tax authority is in a better position to establish the policy of the provisions or schemes of the Tax Act than any taxpayer. If the tax authority is finding it challenging to discharge this burden, the solution is for Parliament to more clearly articulate the policy of the legislation it is enacting — ideally at the time of enactment.

The Consultation Paper also indicates that the government is contemplating adding an explicit rule that integrates "economic substance" into the GAAR analysis. As a threshold matter, there is a lack of clarity as to what is meant by "economic substance" in this context, or how such a rule would operate. In any event, such a change would mark a fundamental shift in tax policy. Canadian courts have explicitly and repeatedly held that, absent a specific rule to the contrary, taxpayers should be taxed based on the legal and contractual relationships actually established.

In our <u>submission</u> on the Consultation Paper, Osler stated to the Department of Finance that the suggested changes to the GAAR were disproportionate to the concerns identified by the government. The suggested measures would significantly narrow taxpayers' ability to plan commercial transactions in a tax-efficient manner. The measures are, therefore, contrary to the government's stated intention, both at the time of the introduction of the GAAR and in the Consultation Paper, to leave legitimate tax minimization undisturbed. If implemented, the changes would also undercut longstanding GAAR case law and undermine the very principles of certainty and predictability that the government seeks to preserve.

Deans Knight Income Corporation

On November 2, 2022, the Supreme Court of Canada heard an appeal from the decision of the Federal Court of Appeal in <u>Canada v. Deans Knight Income Corporation</u>. This case concerned the application of the GAAR to a recapitalization arrangement. At the Court of Appeal, the Crown persuaded the Court to depart from the established legal standard for corporate control (being *de jure* or voting control) and use a novel standard of "actual control" to decide that the arrangement in issue had abused the tax rules governing the availability and use of tax losses.

The Tax Executives Institute (TEI) and the Canadian Chamber of Commerce intervened to make <u>submissions</u> to the Supreme Court regarding the scope of the GAAR. As TEI's representative, Osler argued that the proper function of the GAAR is to determine whether transactions are abusive based on the legislative scheme set out in the statute. It is not to rewrite legislative schemes that rely on established legal concepts and allow for predictable tax outcomes simply because a taxpayer has undertaken a primarily tax motivated transaction. TEI argued that the approach advocated by the Crown — where the courts interpret and apply generally understood legal concepts differently based on tax motivation



— is not workable as many ordinary commercial transactions are structured to minimize taxes.

Hopefully the Supreme Court will provide further direction on how to ascertain the purpose of relevant tax provisions, the type of extrinsic evidence that may be used to establish such purpose and the threshold of proof to be satisfied in establishing abusive tax avoidance.

Concluding observations

A decision in *Deans Knight* is likely to be rendered in 2023. As such, guidance will be forthcoming from our highest court on the interpretation and application of the GAAR. At the same time, the government is contemplating fundamental changes to the GAAR itself. Both developments portend significant implications for future tax planning — and ultimately tax disputes.