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March 27, 2024

Attn: General Memo

Re: Tax Anti-Avoidance rule changes on the horizon

The General Anti-Avoidance Rule (GAAR) allows the Canada Revenue Agency (CRA) to assess tax where a taxpayer follows the letter of the law but not its object, spirit, and purpose causing a misuse or abuse of the Income Tax Act (Act). After years of the GAAR provisions remaining mostly unchanged, in the 2023 Budget, the federal government proposed some substantial changes in response to recent jurisprudence and the government's concern that tax planning was increasingly circumventing the current GAAR.

The amendments, which would broaden the scope of the GAAR, are currently before the House of Commons as part of Bill C-59. Once enacted, the expanded GAAR will apply retroactively to transactions occurring on or after Jan. 1, 2024, except for the penalty which will apply to transactions occurring on or after Royal Assent.

The proposed expanded GAAR appears to reflect Canadian and global tax policy trends around addressing and preventing strategies that exploit perceived loopholes.

Summary of amendments

Preamble – The government proposes to add a preamble to guide the interpretation of the GAAR. It also seeks to clarify that the GAAR is meant to strike a reasonable balance between protecting the tax base, i.e., limiting aggressive tax planning, and taxpayers' need for certainty in planning their affairs.

Avoidance transaction – For the GAAR to apply, there must be an avoidance transaction. As part of the amendments, the government proposes to capture additional transactions by lowering the threshold to qualify from the "primary purpose" test to "one of the main purposes" test. This lowered threshold now means that if one of the main purposes of the transaction was to obtain a tax benefit and the transaction (or series of transactions of which the transaction is part of) results directly or indirectly in a tax benefit, then it would be an avoidance transaction.

Economic substance – Under the amended rules in Bill C-59, an avoidance transaction that significantly lacks economic substance is an important consideration when determining whether there was a misuse or abuse of the Act.

The factors that may establish that a transaction lacks economic substance are:

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- no substantial change in the opportunity for gain or profit and risk of loss of the taxpayer and non-arm's length persons,
- the expected value of the tax benefit exceeds the expected value of the non-tax economic return, and
- the entire, or almost entire, purpose for undertaking or arranging the transaction or series was to obtain a tax benefit

This list is non-exhaustive, and the government confirmed that these factors are to be read disjunctively – meaning that not all factors would need to be present to indicate a lack of economic substance. However, if the rationale underlying a provision is to encourage a particular policy, then it could result in a finding that there is no misuse or abuse in appropriate circumstances, for example, utilizing a tax-free savings account.

The economic substance requirement arguably already exists within the current GAAR case law, so it is debatable how much of an impact codifying this rule will have.

Penalty – The government opines that the current GAAR is not a sufficient deterrent to misuse or abuse of the Act as a taxpayer is simply denied the tax benefit. The amendments propose to introduce a penalty of 25% of the tax benefit obtained when the GAAR is found to apply, less any gross negligence penalties. The penalty can be avoided if the taxpayer can demonstrate that at the time the transaction was entered into, they relied on published administrative guidance or court decisions regarding an 'identical or almost identical' transaction such that it was reasonable to conclude the GAAR would not apply. This is called the 'due diligence defence' and as the CRA notes, it is a very high threshold. The penalty could also be avoided if the transaction was disclosed to the CRA under the mandatory disclosure rules (MDR) either voluntarily, or as required by legislation.

Reassessment period - The CRA normally has three or four years from the date of reassessment to reassess a taxpayer. The GAAR amendments propose a three-year extension to the normal reassessment period for GAAR assessments unless the transaction was disclosed under the MDR.

Sincerely,
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