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Summary of Comments and Recommendations Provided to the Department of Finance on the General Anti-Avoidance Rule Proposals Released on March 28, 2023

June 7, 2023

This summary sets out the Committee's comments and recommendations on the proposed amendments to the General Anti-Avoidance Rule ("GAAR") released as part of the Notice of Ways and Means Motion ("NWMM") to introduce an Act to implement certain provisions of the budget tabled in Parliament on March 28, 2023. Unless otherwise noted, all references are in respect of the *Income Tax Act* (Canada) (the "Act").

The information in this summary was discussed in greater detail with the Department of Finance ("Finance") in May 2023.

Introduction

In the 2023 Federal Budget, proposed changes were introduced which can be divided into the following themes:

- The addition of a preamble to Section 245
- Revision to the avoidance transaction definition
- Addition of a specific economic substance test
- Extending the normal reassessment period for GAAR reassessments
- Proposed penalty rule where the GAAR applies

One issue that was not addressed in the NWMM but will be critically important is the coming into force rules for the proposed changes.

During the discussions with Finance, the Committee focused on issues related to the effective date, the addition of the economic substance test and the proposed penalty that would apply to GAAR assessments, if enacted.

Effective Date

The Committee discussed the importance that the revisions to the GAAR apply on a prospective basis. The changes that have been proposed are significant, and in particular, a penalty will now apply on GAAR assessments (subject to disclosure exceptions) if the proposed change is enacted. The proposals will also have an impact on the application of GAAR more generally.

As the GAAR can apply to either a specific transaction or a series of transactions, this was a focus of the discussion with respect to the coming into force rules, and the main issue identified dealt with scenarios where a series of transactions straddles the effective date. Again, it was the committee's general view that the proposed changes to the GAAR rules should apply prospectively in the context of a series of transactions. That is, if the series of transactions commenced before the effective date of the proposed changes, then the series and transactions contained within the series should generally not be subject to the proposed GAAR rules.

Recommendation

Since the GAAR proposals include significant changes and in particular a penalty, it is recommended that the proposals apply prospectively. For a series of transactions, the proposed rules should apply to a series of transactions that commences after the effective date.

Economic Substance

A number of issues were discussed regarding the economic substance rule in proposed subsection 245(4.1). The most significant concern is the integration of this subsection with the application of the GAAR. Based on the Committee's understanding, the goal of the proposed subsection is to ensure that economic substance factors are considered as part of process to determine if the GAAR applies. However, based on feedback from members of the tax community, how economic substance should be considered from a practical perspective is not well understood. In particular, the weight that should be placed on economic substance factors is unclear and the views of members of the tax community seem to vary significantly.

As a penalty is part of the proposed changes, it is important that the government's intentions on the application of an economic substance test is communicated as clearly as possible. Although using the reference "factors that tend—depending on the particular circumstances—to establish" is presumably designed to provide flexibility, it is also causing significant uncertainty.

The Committee also believes that uncertainty is arising in part because practical examples on how to apply an economic substance analysis have not yet been released. The budget papers referred to Tax-Free Savings Account contributions as an example of a transaction lacking economic substance, but more comprehensive examples should be provided since a specific transaction or series will more than likely involve several different areas of the Act. Examples discussed during the meeting included loss consolidation transactions and post-mortem planning, both of which have been the topic of numerous favourable CRA rulings. Generally speaking, these examples are focused on dealing with specific tax issues and will not have a high level of economic substance.

Recommendation

The Committee recommended that more specific and substantive examples are provided on how the government believes that economic substance considerations should be integrated into the determination of whether the GAAR applies. This will help deal with the high level of uncertainty related to the proposed changes.

Specific issues related to subsection 245(4.1) raised by the Committee include:

- *Reference to "expected value of the tax benefit" and "expected non-tax economic return"* – The Committee pointed out that the wording used seems to imply that tax and economic factors must be measured in terms of specific dollar amounts which would create practical issues. For example, if a business is incorporated, the availability of limited liability protection is a significant economic factor but cannot be measured as a specific dollar amount and compared to the tax benefit value.

- *Application to a series* – References in proposed subsection 245(4.1) refer to a transaction but not always to a series. Consistent references should be used in the same manner as section 245 generally.

- *Level of detail of proposed paragraphs 245(4.1)(a) and (b)* – As the list refers to factors that tend to establish a lack of economic substance, should the list also reflect the subjective nature of the factors as opposed to using very specific references in paragraphs (a) and (b)? In addition to the concern above on paragraph (b), paragraph (a) provides for an "all or substantially all" test which CRA interprets as 90%. With this in mind, would it be more practical to list a more general series of factors which tend to establish a lack of economic substance?

Application of Penalties

General concerns on mandatory application

It is clear from the budget papers and the NWMM that the intention is that a penalty of 25% should apply to the amount of tax benefit at stake in a GAAR assessment if a disclosure is not made. It is recognized that providing the CRA with a power to apply a discretionary decision on a penalty (or not) on each GAAR assessment would create a significant amount of uncertainty. However, we also believe that there will be scenarios where the application of a penalty would be inappropriate.

One key concern is that the relevant considerations for the application of the GAAR will change over the course of time, and although there is an ability to self-report to avoid a penalty under proposed subsection 237.3(12.1), such reporting has a tight deadline. As examples, the Committee identified scenarios where taxpayers may initially believe that making a disclosure is not needed but the decision factors can change over time. These include:

- *Subsequent court cases* – Situations where a taxpayer's fact pattern is similar to a court case where it was ruled that the GAAR did not apply and this conclusion is reversed in a subsequent ruling. This could be due to an appeal of the same case or a ruling in a different case with similar facts.

- *CRA rulings* – Although a ruling provided to a specific taxpayer should prevent the application of the GAAR in most circumstances for that taxpayer if CRA states that the GAAR doesn't apply, these rulings are not binding for other taxpayers. For those that use rulings as a barometer for the application of the GAAR, subsequent events could have a significant impact.

- *New CRA positions* – Although new CRA assessing practices will often not involve the GAAR, the CRA has been known to announce new assessing practices related to filing and tax positions that taxpayers have commonly used for many years. Similar to the other examples, CRA announcements on a new position on the GAAR related to common tax practices may impact taxpayers who did not believe that a GAAR disclosure was needed. These announcements could

arise in various ways, such as practitioner communiques, tax roundtables and other communication channels.

Another issue of concern is related to the impact of the GAAR penalty in situations where the parties want to reach a settlement. Depending on the scenario, the CRA may be pursuing the same relative amount of tax under a GAAR assessment and an assessment under other specific technical rules. It is conceivable that there could be situations where a settlement could be more easily reached if both potential reassessments do not involve a penalty. In such situations, the CRA should have the ability to waive the penalty to reach a fair and equitable settlement that is in the public interest. Although subsection 220(3.1) may technically give the CRA the ability to waive the proposed GAAR penalty, including a specific rule in section 245 would provide greater certainty. Another possibility would a specific rule to enable a taxpayer to file a disclosure after the deadline using a process similar to the current voluntary disclosure process. The Committee also believes that the CRA and Finance should work on policies to provide guidance on situations where a waiver of the penalty may be considered.

Recommendation

The Committee believes that there should be some recourse for taxpayers who are assessed under the GAAR in a scenario where there have been developments on the application of the GAAR after the time that the ability to report a transaction or series under proposed subsection 237.3(12.1) has passed. Such recourse could be in the form of the ability to file a late disclosure or allowing a waiver of the penalty for a taxpayer under relevant conditions, as explained above.

The Committee also recommended that the CRA should have the ability to waive penalties or accept a late disclosure in circumstances where such action is fair and equitable.

Measurement of the tax benefit

Under proposed subsection 245(5.1), the penalty is "equal to 25% of the amount of the tax benefit that would, but for that subsection, result directly or indirectly from the transaction or series of transaction that includes the transaction." The Committee identified specific technical concerns on this, which include:

- *Scope of calculation* – Especially in the case of a series, there may be many transactions involved, and they may be in respect of multiple taxpayers. If multiple taxpayers are involved, it is conceivable that although there was an overall benefit, the impact of the application of the GAAR may vary for each taxpayer.

- *Timing of benefits* – Ignoring timing differences related to tax attributes, it is possible that the timing of how a series of transactions is taxed could vary under the GAAR. In particular, a series of transactions may create a tax deferral benefit rather than an absolute tax reduction and a GAAR assessment may result in an acceleration of the tax that would have otherwise arisen in a future year. It is unclear how (or if) such an outcome should (or can) be incorporated in the calculation of the penalty. It is also not entirely clear whether the penalty would be assessed in respect of additional taxes payable for each year reassessed, in which case, it's not clear how years with tax reductions arising from the "recharacterization" under the GAAR would be handled (that is, to avoid an "excessive" penalty overall). Alternatively, the penalty could be assessed based on the overall (net) tax benefit that is denied, perhaps allocated entirely to the most recent year reassessed.

Recommendation

Guidance should be provided on how penalties will be calculated in situations where calculating the exact amount of the tax benefit is uncertain.

Subsection 245(12.1)

The Committee believes that disclosures under subsection 245(12.1) could become common to provide protection even if the taxpayer believes the risk of application of the GAAR is low. The volume of disclosures filed will depend on the amount of information required to be disclosed and the cost to do it.

Although the proposed penalty/disclosure regime should act as a deterrent for aggressive tax planning where application of the GAAR has a high probability of a successful assessment by the CRA, there will be other situations where the taxpayer believes that the probability that the GAAR applies is low or the taxpayer enters into the transaction/series for non-tax reasons. In such situations, it would be appropriate to provide assurances to the taxpayer that the fact a disclosure was made cannot be taken into account when determining whether the taxpayer is subject to the GAAR.

Recommendation

The Committee recommended that a rule should be added to section 245 stating that a disclosure filed under proposed subsection 237.3(12.1) cannot be used as a factor in any way when determining whether the GAAR applies.