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Tax Policy Branch
Department of Finance Canada
90 Elgin Street
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Via email GAAR-RGAE@fin.gc.ca

Dear Sir or Madam:

**Re: GAAR Consultation – Deloitte's Comments**

We are writing to provide our comments on proposals released in Budget 2023[1] to amend the General Anti-Avoidance Rule ("GAAR") in the Income Tax Act (the "Act"), and more specifically, the changes described under the heading "General Anti-Avoidance Rule" in Tax Measures: Supplementary Information and in the related legislative proposals ("GAAR Proposals"). These proposals build upon the consultation paper entitled "Modernizing and Strengthening the General-Anti-Avoidance Rule" ("GAAR Consultation Paper") released on August 9, 2022. We believe such an approach of iterative feedback helps foster a greater understanding of the issues being addressed and how taxpayers can adapt to the GAAR Proposals.

Deloitte and its affiliated entities constitute one of the largest professional services firms in Canada. We work with many taxpayers, ranging from individuals and private businesses to Canadian and global multinationals, to advise and support them in meeting their compliance obligations under the Act. We were pleased to provide comments on the GAAR Consultation Paper in our letter of September 30, 2022 ("September 2022 submission") and are equally pleased to provide feedback on the GAAR Proposals.

We provide our comments from the perspective of tax practitioners who regularly interact with and advise taxpayers on how to comply with the provisions of the Act. In our experience, we find that many taxpayers are motivated by tax certainty and predictability – particularly in relation to financial reporting obligations.

## General observations

The GAAR is and has been an important part of the Act since its introduction in 1988, and further development through jurisprudence over many decades. In our September 2022 submission regarding the GAAR Consultation Paper, we highlighted that, in our experience, the GAAR has been an effective deterrent and taxpayers seldom implement transactions if the GAAR is expected to successfully apply.

[1] The term Budget 2023 is used throughout the document and incorporates references to the Tax Measures: Supplementary Information.

## Preamble

Taxpayers are likely to interpret the preamble to the GAAR as formalizing a Parliamentary intent, which is consistent with the general views of taxpayers and advisors. However, formalizing the understanding through legislation may cause additional uncertainty, particularly as new terms are introduced in a legislative framework which have not been subject to interpretation by the judiciary.

*Tax benefits contemplated*

A portion of the proposed paragraph 245(0.1)(a) is intended to establish legislatively that tax benefits contemplated are not intended to be struck down by the GAAR ("while allowing taxpayers to obtain tax benefits contemplated by the relevant provisions"). However, we believe the reference to *tax benefits contemplated* is too narrow in light of the potentially wide array of tax benefits taxpayers avail themselves of that may not be explicitly contemplated by the provisions. Instead, we recommend the following wording (our suggestions in italics):

> 245(0.1) This section of the Act contains the general anti-avoidance rule, which
>
> (a) applies to deny the tax benefit of avoidance transactions that result directly or indirectly either in a misuse of provisions of the Act […] or an abuse having regard to those provisions read as a whole, while allowing taxpayers to obtain tax benefits contemplated by the relevant provisions *or not otherwise resulting in a misuse or abuse*; […]

We believe this wording captures the purpose of the GAAR, recognizes the complex and often rule oriented and prescriptive nature of tax legislation, and more effectively preserves the reasonably well-functioning abusive tax avoidance framework established by the courts.

*Foreseeing tax strategies*

The preamble specifies that the GAAR can apply "regardless of whether a tax strategy is foreseen" but does not further define this concept. First, the concept of a "tax strategy" is not defined in the Act,[2] and was not discussed in the GAAR Consultation Paper in any detail.[3] Clearly articulating what a "tax strategy" is intended to be (perhaps through explanatory notes) is important, as it seems to suggest a concept with clear and direct intent that the results from a "series of transactions" to achieve an overall aim.

The second concept stems from the GAAR Consultation Paper highlighted concerns with comments from the Supreme Court of Canada in *Alta* stating that the GAAR "was enacted to catch unforeseen tax strategies"[4] and a potential reading of that statement as a "restricted application of the GAAR [that] does not recognize the complex interaction of the GAAR with specific anti-avoidance rules."[5] The Supreme Court of Canada has now confirmed in *Deans Knight* that "the GAAR is not limited to unforeseen situations,"[6] which should eliminate the need for proposed subsection 245(0.1)(c) to be included in legislation.

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[2] Bill C-47, which, in part, introduces reporting requirements for notifiable transactions under proposed section 237.4 uses the term "tax strategy" but does not define the term.

[3] While the language is aligned with commentary from the Supreme Court of Canada in *Canada v. Alta Energy Luxembourg S.A.R.L.*, 2021 SCC 49 (herein referred to as "*Alta*"), the underlying concepts of a "tax strategy" were not discussed in that case.

[4] Ibid., at para. 80.

[5] GAAR Consultation Paper, at page 16.

[6] *Deans Knight Income Corp. v. Canada*, 2023 SCC 16, at para. 45.

## Avoidance transaction

We anticipate that reducing the threshold from "primary purpose" to "one of the main purposes" test will not change the approach that taxpayers take in preparing a fulsome GAAR analysis. As noted in our September 2022 submission, in our experience, most of the focus in an analysis as to the applicability of the GAAR is with respect to potential misuse or abuse and trying to determine the object, spirit and purpose of the relevant provisions relied upon.

Care should be taken to consider the follow-on effect on definitions for other purposes in the Act. While the draft legislation would align terminology with the proposed amendments to the reportable transaction rules in section 237.3 of the Act, the "avoidance transaction" term is used selectively elsewhere in the Act, notably in subsection 5907(2.02) of the Income Tax Regulations. It should be noted that the rule in subsection 5907(2.02) does not include a misuse or abuse threshold, as does the GAAR itself, and thus, the lowering of the avoidance transaction threshold to a "one of the main purposes" test in this context may render the provision overly broad.

Consider a Canadian-parented multinational group with an existing group of US resident subsidiaries carrying on an active business. Suppose the group is considering entering into a joint venture type arrangement with a third party under the terms of which both the taxpayer and the third party will contribute assets to a newly formed US entity in exchange for equity. Suppose further that the new entity will be controlled by the taxpayer group such that it will be considered a designated person or partnership in respect of the taxpayer, within the meaning of subsection 5907(1). The assets to be transferred by the taxpayer's existing US subsidiary are excluded property within the meaning of subsection 95(1), and accordingly, their disposition should give rise to exempt surplus. Suppose further that, within two years, the taxpayer has a need for additional cash in Canada and relies on the exempt surplus generated on the aforementioned asset transfer to repatriate the required funds on a tax-free basis.

The primary purpose for the asset transfer is to expand the taxpayer's global business through a strategic joint venture with a third party. However, it may be very difficult, from a practical perspective, for the taxpayer to successfully argue that the generation of surplus was not "one of the main purposes" underlying the transfer, particularly given the subsequent cash repatriation transaction, regardless of whether such subsequent transaction was contemplated at the time the surplus was generated. Put simply, it can be very difficult to prove a negative.

In summary, caution should be given to reducing the threshold for what constitutes an avoidance transaction, without considering and making corresponding adjustments to the other provisions which cross-reference this definition.

It is also unclear if other legislation, such as the Underused Housing Tax Act[7] or the Select Luxury Items Tax Act[8] would expect similar legislative amendments to align with the standard of an avoidance transaction. We would be supportive of a harmonized definition, to the extent possible, in all tax legislation, to ensure a common standard in the application of general anti-avoidance rules which have a common objective and framework.

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[7] Section 12 of the Underused Housing Tax Act, S.C. 2022, c. 5, contains a general anti-avoidance provision which uses similar language to that found in the Act.

[8] Section 68 of the Select Luxury Items Tax Act, S.C. 2022, c. 10, contains a general anti-avoidance provision which uses similar language to that found in the Act.

## Economic substance

The GAAR Proposals include a proposal to consider economic substance, which is considered in the context of meeting the "initial objective (of the GAAR)" as outlined in Budget 2023. Specifically, the proposals introduce a three-part test in proposed section 245(4.1) to establish if a transaction is significantly lacking in economic substance. If a transaction is found to be significantly lacking in economic substance, that "tends to indicate" that the transaction results in a misuse or abuse of the Act.

In this regard, the GAAR Proposals appear to address the three main issues that were highlighted in the GAAR Consultation Paper as necessary, with the addition of an explicit economic substance rule:

1. Define economic substance so that it is possible to determine when it is lacking;
2. Integrate the economic substance rule into the GAAR analysis; and
3. Determine the appropriate consequences of a lack of economic substance.

While the definition of economic substance and the integration of the economic substance rule in the GAAR analysis appear clear, the appropriate consequences when there is a lack of economic substance require additional explanation.

*Consequence of "tends to indicate"*

A crucial question is the consequence of a transaction lacking economic substance, and specifically, whether the burden of proof changes in establishing whether there is a misuse or abuse of the Act. The GAAR Consultation Paper contemplated this approach while identifying associated challenges.

The use of the language "tends to indicate" appears most closely aligned with the GAAR Consultation Paper's suggestion to introduce a "more stringent misuse or abuse test." While Budget 2023 notes that "it would still be necessary to determine the object, spirit and purpose of the provisions or schemes relied upon, in line with existing GAAR jurisprudence," the documents go on to say that "[to] the extent that a transaction lacks economic substance ***the new rule would apply***; otherwise, the existing misuse or abuse jurisprudence would continue to be relevant (emphasis added)."

It is not clear from the Budget 2023 text what "the new rule" is, particularly when this is contrasted with the "existing misuse or abuse jurisprudence," which places the onus on the Crown to establish the misuse or abuse of the provisions relied upon. To the extent there is a "new rule" and not simply an indication of what characteristics "tend to" mean, this should be clearly articulated.

In summary, the consequence of a transaction lacking economic substance, while it may "tend to indicate" a misuse or abuse of the Act, should not shift the burden of proof in establishing the misuse or abuse. We would reiterate our comments from our September 2022 submission regarding the difficulties of shifting the burden of proof to the taxpayer. These difficulties are exacerbated if the proposed preamble, particularly in relation to "tax benefits contemplated by the relevant provisions," is not modified as discussed above.

*The need for examples*

Budget 2023 includes a single example – the transfer of funds by an individual from a taxable account to a tax-free-savings account ("TFSA") – to suggest that there is clearly no misuse or abuse of the provisions of the Act.

Similarly, simple transactions could be highlighted where there is a less clear policy intent behind certain provisions relied upon. Examples may be provided through the explanatory notes, or through additional administrative guidance (described below). The GAAR Consultation Paper recognized this, stating

> 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.

The draft legislation includes an overall objective – that all or substantially all of the opportunity for gain or profit and risk of loss of the taxpayer (taken together with those of all non-arm's length taxpayers) remains unchanged – along with specific examples about how that overall objective may be realized through several mechanisms, as articulated in proposed section 245(4.1)(a) of the Act.

*Example: Loss consolidation transactions and other acceptable tax planning*

Due to Canada's system of taxation, which involves a determination of tax obligations for individual persons, including corporations that are under common control, the inclusion of the non-arm's length taxpayers may give rise to concerns around the permissibility of ordinary transactions which seek to utilize tax attributes within affiliated parties.

For example, consider a situation where a corporation has started a business in a separate wholly owned subsidiary ("LossCo") which was ultimately unsuccessful and has generated non-capital losses, which were funded through a note payable. The corporation also holds real estate with an inherent gain. The corporation transfers the real estate to LossCo pursuant to subsection 85(1) of the Act in exchange for share consideration and proceeds to sell the real estate back to the main corporation in exchange for an offsetting note.

Similar loss consolidation transactions may be routinely undertaken to optimize the use of tax attributes, including within the parameters of published rulings by the CRA.[9]

*Example: Individual gifts to a parent*

For example, consider an individual who intends to provide financial support for a parent. The individual chooses to make a monetary gift to a parent, who happens to have no other material sources of income. The parent earns investment income on the funds and pays less tax on the proceeds than would have been incurred had the individual maintained control of the funds, given their other sources of income. While the individual has been impoverished by virtue of the gift with a non-economic return, by virtue of the non-arm's length relationship between the individual and their parent, the transaction arguably lacks economic substance under the definition. Furthermore, this outcome can be contrasted with the TFSA example given that there is no clear policy intention to enable gifts to non-arm's length persons.[10]

These are two simple examples and emphasize the need for additional guidance, as discussed below as part of the coming into force process.

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[9] For readability, the term "CRA" will be used throughout, notwithstanding the various name changes over the years.

[10] The attribution provisions arguably provide a framework and could be interpreted as a policy intent, but when read with the proposed preamble, this is not clear.

## Financial penalty and reassessment period

The GAAR Proposals include a penalty equal to 25% of the amount of the tax benefit, with the tax benefit being deemed to be nil where the tax benefit involves a tax attribute that has not yet been used to reduce tax. While we believe that the GAAR has served as an effective deterrent without financial penalties, the role of penalties will likely enhance disclosure, which in turn, can help inform the government's views of necessary changes.[11]

We believe the financial penalty and the extension to the normal reassessment period will be effective at encouraging additional reporting under the enhanced mandatory disclosure rules, which are currently before Parliament in the form of Bill C-47. In our experience, the majority of taxpayers value tax certainty, and the potential extension of normal reassessment periods and financial penalties will be sought to be avoided. We are supportive of penalties to the extent they indirectly enhance the ability of the CRA to fulfil its administrative functions and provide taxpayers with the ability to achieve certainty in their tax compliance obligations in an expedited manner.

Consideration should be given to the administrative burden of the additional disclosures and the potential additional cost for taxpayers and tax administrators, particularly with what is expected to be revised reporting requirements under section 237.3 of the Act. Care should be taken in achieving the objective of the disclosures – that is, to provide notice to the CRA to enable timely administration of the Act of potential areas of disagreement. For example, where a disclosure is being made voluntarily under section 237.3 and perhaps requiring a reduced amount of information may be helpful.[12]

## Coming into force provisions

When the GAAR was enacted in 1988, it was accompanied by coming into force provisions which provided lead time through the enabling legislation, Bill C-139,[13] for transactions that were part of a series of transactions. Specifically, GAAR was not applicable for transactions that were part of a series of transactions that commenced before the day of Royal Assent, provided they were completed before 1989. A narrowing of a "series of transactions" was used for these purposes to provide a reasonable timeframe for the completion of certain transactions within a series of transactions. As we transition into the new GAAR, similar coming into force provisions should be applicable, particularly given the broad interpretation of a series of transactions in subsection 248(10) of the Act.

The CRA issued an Information Circular (IC 88-2) on October 21, 1988, which provided 28 specific examples and the CRA's views. The published circular was further assisted with comments from CRA officials to provide interpretative issues on common transactions.[14] We would strongly suggest similar detailed guidance, ideally jointly from the CRA and the Department of Finance, on a similar timeline (i.e., concurrent with the enactment of legislation in Parliament) regarding acceptable transactions.

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[11] Changes may be made legislatively or through more formal notification of areas of concern, such as through the notifiable transactions regime contained within Bill C-47.

[12] The volume of information may be of particular concern if taxpayers are asked to fully describe a "series of transactions" which can be subject to interpretation, while ensuring there is a complete disclosure being made.

[13] S.C. 1988, c. 55.

[14] The 1988 Round Table included commentary regarding "purification" transactions undertaken to ensure the shares meet a definition of a qualified small business corporation. This is an example of a common series of transactions undertaken by many taxpayers in the context of the sale of shares which would have broad application.

While some provinces rely on the Act's definition of GAAR for their provincial purposes, other provinces and territories have standalone legislation which aligns, but does not automatically refer back, to the Act. We would strongly encourage harmonization between the federal government and provincial governments, including with effective dates and coming into force provisions, to allow for harmonization in tax administration for taxpayers that have tax compliance obligations in multiple provinces and territories.

## Conclusion

The proposed modernization of the GAAR further refines concepts which were largely contemplated with the implementation of the GAAR in 1988 and represents a reasonable evolution. The introduction of penalties will likely encourage additional disclosure by taxpayers, which will enable the CRA to fulfil its administrative functions and responsibilities within the framework of the Act. To the extent changes are made, we would strongly recommend reliance on clearer and more predictable concepts and language, and that these concepts and language be harmonized throughout other Canadian tax legislations which have similar general anti-avoidance rules, so as to provide consistency for taxpayers that have compliance obligations under a variety of tax laws.

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We hope that our specific comments are helpful in your consideration of the GAAR Proposals. We would be pleased to meet with you or other officials to discuss our submission as Deloitte is committed to making a significant contribution to help shape Canada's tax policy and its application to the future of our country.

We consent to the disclosure of our comments under the *Access to Information Act* and have made a copy of our submission available on our website at www.deloitte.ca.

Yours very truly,

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