PERSPECTIVES ON TAX LAW & POLICY

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GAAR in 2024 and Beyond

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Tax avoidance is acceptable unless abusive. What constitutes abusive tax avoidance in 2024 and beyond, and what is legitimate tax minimization? How should the abusive be distinguished from the legitimate? Does the distinction constitute a rigorous legal standard?

In this article, in order to provide context for the other contributions to this issue of *Perspectives*, I will briefly review the original general anti-avoidance rule (GAAR), its roots and growth since the 1980s, and some recent changes to the rule, and I will offer some comments about its future.

GAAR: What Technical Provisions Say Is Not Necessarily What They Mean

GAAR is a provision of last resort. It applies to negate, on the grounds of abusive tax avoidance, tax benefits that taxpayers would otherwise enjoy under a textual, contextual, and purposive statutory interpretation of the ITA's provisions. It is a quintessential dispute provision. The CRA raises GAAR first, by determining that a transaction is abusive even though it complies with the technical provisions of the ITA.

As originally enacted, GAAR applies only if, in general,

- a taxpayer reduced, avoided, or deferred tax (the "tax benefit" test);
- it cannot reasonably be considered that the taxpayer carried out the transaction, or series of transactions, for bona fide purposes other than to obtain a tax benefit (the "avoidance transaction" test); and
- granting the tax benefit would defeat, rather than foster, the object, spirit, and purpose (OSP) of provisions giving rise to the tax benefit (the "misuse or abuse" test).

How It Started

With the enactment of the original GAAR, Parliament essentially codified contemporaneous judicial views of abusive tax avoidance. The well-known origin story of GAAR starts in England, with the 1930s-era saga of the Duke of Westminster. The duke had found a clever way to pay a gardener to avoid a surtax. The House of Lords approved this tax avoidance, stating:

> Every man is entitled if he can to arrange his affairs so that the tax attaching under the appropriate Acts is less than it otherwise would be. If he succeeds in ordering them so as to secure that result, then, however unappreciative the Commissioners of Inland Revenue or his fellow taxpayers may be of his ingenuity, he cannot be compelled to pay an increased tax. (*Inland Revenue Commissioners v. Westminster (Duke of)*, [1936] AC 1 (HL), at 19.)

The principle underlying this decision, which became known as the "*Duke of Westminster* principle," was referred to as foundational in the recent SCC decision in *Canada v. Alta Energy Luxembourg SARL* (2021 SCC 49); see this recent summary of the case. The reference, in *Duke of Westminster*, to "tax . . . less than it otherwise would be" corresponds to the "tax benefit" test in the original GAAR.

Next came a development in the UK common law. In the early 1980s, the House of Lords considered a number of cases in which a taxpayer had carried out a taxable transaction and combined it with a tax-avoidance transaction that had no business purpose apart from saving tax. The House of Lords concluded that the two transactions together constituted a scheme, and that this scheme was ineffective to save the tax (*W.T. Ramsay Ltd. v. Inland Revenue Commissioners*, [1982] AC 300; *Inland Revenue Commissioners v. Burmah Oil Co. Ltd.*, [1982] STC 30 (HL)). The approach in these cases became known as the "*Ramsay* principle," which itself evolved in the UK jurisprudence (see this recent article). These decisions are sometimes

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considered when it comes to applying the "series of transactions" concept in GAAR.

In the next part of the GAAR story, we cross the pond to Canada, and to the SCC decision in *Stubart Investments Ltd. v. The Queen* ([1984] 1 SCR 536). The Crown essentially argued in this case that a transaction should be disregarded for tax purposes if it lacks an independent or bona fide business purpose. The SCC rejected that view and made two important points about Canadian tax law that became foundations of the original GAAR.

First, the court observed that taxpayers carry out transactions for a host of bona fide reasons, unrelated to tax or even business considerations. Transactions carried out for legitimate reasons should be respected for tax purposes. This branch of the court's reasoning inspired the "avoidance transaction" definition in subsection 245(3) of the ITA.

Second, the court in *Stubart* explained that tax legislation reflects a mix of fiscal and economic policy, including social policy goals. Parliament may extend a tax benefit to induce taxpayers to act in a particular way. If a taxpayer undertakes an action that Parliament sought to encourage through tax legislation, the taxpayer should get the tax benefit. Put another way, the tax benefit should not be negated solely because it prompted the taxpayer to act, and the taxpayer intended to enjoy the benefit.

Assuming that a taxpayer is primarily tax-motivated, the court in *Stubart* distinguished legitimate tax minimization from abusive tax avoidance by reference to the "object and spirit" of relevant statutory provisions:

> It seems more appropriate to turn to an interpretation test which would provide a means of applying the Act so as to affect only the conduct of a taxpayer which has the designed effect of defeating the expressed intention of Parliament. In short, the tax statute, by this interpretative technique, is extended to reach conduct of the taxpayer which clearly falls within "the object and spirit" of the taxing provisions. Such an approach would promote rather than interfere with the administration of the *Income Tax Act*, *supra*, in both its aspects without interference with the granting and withdrawal, according to the economic climate, of tax incentives. The desired objective is a simple rule which will provide uniformity of application of the Act across the community, and at the same time, reduce the attraction of elaborate and intricate tax avoidance plans, and reduce the rewards to those best able to afford the services of the tax technicians.

This branch of the court's reasoning inspired the misuse or abuse test in subsection 245(4) of the ITA, including the OSP analysis developed in the case law.

How It's Going

It's not unusual for Parliament, before reviewing and significantly amending a new legislative regime, to give the courts some time to interpret the regime. GAAR has just arrived at that point.

Following GAAR's enactment in the late 1980s, it took several years for the first GAAR cases to be decided, and over 15 years passed before the first SCC GAAR case (*Canada Trustco Mortgage Co. v. Canada*, 2005 SCC 54). To date, almost 500 judicial decisions have considered GAAR, including six SCC decisions that have pronounced on it. Although the Crown won about half of these cases (including more than half of the SCC cases), the government expressed concern in its 2022 consultation paper (Modernizing and Strengthening the General Anti-Avoidance Rule) that GAAR required changes "so that it better meets its objective of preventing abusive tax avoidance."

GAAR's broader context has changed in the past 35 years. Much has happened to make taxpayers' bona fide non-tax purposes more diverse and sophisticated: for example, globalization, information technology, the Internet, e-commerce, enhanced transparency, and regulatory responses to financial crises and corporate scandals around the world.

As for determining the OSP of a statutory provision, domestic tax laws are constantly changing, sometimes without much plain-language explanation of the underlying reasons for the change. Corporate tax policy has gone global and continues to evolve in response to, among other developments, the base erosion and profit shifting initiatives of the Organisation for Economic Co-operation and Development. The OSP analysis has become only more complex.

The landscape for reputational risk has also changed. Public awareness of corporate tax issues has increased. Media coverage of tax-avoidance issues was at one time non-existent but has become common. For public companies, the reputational risk posed by a mere allegation of abusive tax avoidance in a TCC pleading is significantly greater than it was 35 years ago.

The legislative changes to GAAR began in 2022. First, the Department of Finance amended the definition of "tax benefit" to effectively overrule the FCA's decision in *1245989 Alberta Ltd. v. Canada (Attorney General)* (2018 FCA 114) (see details below). Second, the Department of Finance released the consultation paper linked above, and, after receiving several submissions, it released legislative proposals in the 2023 federal budget. These were modified in the August 4, 2023 legislative proposals, and further modified in the Fall Economic Statement Implementation Act, 2023 (Bill C-59). Bill C-59 was released on November 30, 2023 and, at the time of writing, is in second reading in the House of Commons.

The changes in Bill C-59 represent less a tearing down of GAAR than a renovation of and addition to it. Although some changes are worthy of consideration, the rule's core provisions have been left largely untouched.

The Renovations

The amendments modify the three-part GAAR test.

Expanding the Tax Benefit Test

Courts have generally applied a low threshold to the "tax benefit" test while holding that tax attributes do not constitute tax benefits until used to reduce, avoid, or defer tax.

The 2022 amendment changed the "tax benefit" definition to include the mere creation of a tax attribute, such as paid-up capital. A tax benefit now includes "a reduction, increase or preservation of an amount that could at a subsequent time . . . be relevant for the purpose of computing" tax payable or refunded. This amendment expands GAAR beyond the *Duke of Westminster* case, which focused on actual tax avoidance, not potential tax avoidance. A tax attribute may or may not ultimately be used to reduce, avoid, or defer tax, but it is nonetheless now included in the tax benefit definition.

This amendment may give rise to enhanced administrative burdens. Subsection 152(1.11) of the ITA was amended simultaneously to provide that a notice of determination could be issued with respect to a transaction to determine amounts that could, at a subsequent time, be relevant to the computation of tax; such amounts may include loss carryforwards, the paid-up capital of a share, exempt surplus, undepreciated capital cost, and the adjusted cost base of a property. Notices of determination generally give rise to the same dispute rights and obligations as notices of assessment. Before these amendments, a taxpayer would receive a GAAR reassessment and take steps to dispute it; now, a GAAR dispute could have two parts—one focused solely on the tax benefit, and another on the other branches of the GAAR test.

This change also relates to the new notifiable and reportable transaction regimes under the mandatory disclosure rules (MDRs) in the ITA (measures that were canvassed in the September 2023 issue of *Perspectives*). The net effect of the change will be to significantly move up the date of a notice of determination of a tax benefit, potentially to a date before the tax return for the year is filed, and far in advance of any audit.

Lowering the Avoidance Transaction Threshold

Under the original GAAR, the avoidance transaction test focuses on whether the transaction or series was undertaken or arranged primarily for bona fide purposes other than to obtain a tax benefit.

Under the Bill C-59 amendments, the avoidance transaction test generally asks whether obtaining the tax benefit was *not* "one of the main purposes" for undertaking or arranging a transaction. This change departs from the reasoning in *Stubart*, which posited that abusive tax avoidance is limited to transactions undertaken primarily to avoid tax.

It remains to be seen how courts will interpret this new test. Consider, for example, a taxpayer required to act—to dispose of an asset, for example—by a non-tax regulatory regime. Does an avoidance transaction exist if the taxpayer chooses the most tax-efficient way to effect the disposition?

The Department of Finance abandoned certain other proposals that were originally being considered as part of the "modernization" process. One proposal was that Finance identify purposes that are not considered bona fide. Another proposal was to extend the definition of "transaction" to include a mere choice. These abandoned proposals would have further expanded the concept of an "avoidance transaction" beyond its origins in the UK common law and its conception in *Stubart*.

Supplementing the Misuse or Abuse Test

The misuse or abuse test is the heart and soul of GAAR. Courts have interpreted this test as requiring a determination of the OSP of relevant provisions, and of whether the avoidance transaction at issue fosters or undermines the OSP. Courts emphasize that the analysis is neither a value judgment nor a search for an overriding policy of the Act; it is an analysis grounded in statutory interpretation (*Deans Knight Income Corp. v. Canada*, 2023 SCC 16, at paragraph 63).

Bill C-59 does not change the core misuse or abuse test. Rather, the amendments in the bill provide that if an avoidance transaction (or series of transactions) is "significantly lacking in economic substance," this is an "important consideration that tends to indicate" a misuse or abuse. A non-exhaustive list of factors relating to economic substance is provided. The Department of Finance released detailed explanatory notes (ENs) to Bill C-59, which comment on the intended approach to economic substance.

These amendments erode the SCC's holding in *Canada Trustco* that, "[a]lthough the Explanatory Notes make reference to the expression 'economic substance,' s. 245(4) [of the ITA] does not consider a transaction to result in abusive tax avoidance merely because an economic or commercial purpose is not evident." This erosion appears intentional. The amendments also seem inconsistent with the primacy of legal form over economic substance in Canadian tax law generally, and with the view, well established since *Canada Trustco*, that a GAAR analysis is not focused on overriding policies (such as an overriding policy relating to economic substance).

The misuse or abuse test is sometimes criticized for lacking in rigour or for leading to unpredictable or overly subjective outcomes. The 2022 consultation paper acknowledged this uncertainty and suggested several amendment options. One option was generally to give the government, rather than taxpayers, the benefit of the doubt when the OSP of relevant provisions is unclear. None of these options was included in Bill C-59.

The Additions

A New Preamble

Under Bill C-59, section 245 will include a new preamble. The preamble essentially summarizes the GAAR test and says that GAAR "strikes a balance" between, on one hand, "the Government of Canada's responsibility to protect the tax base and the fairness of the tax system" and, on the other hand, "taxpayers' need for certainty in planning their affairs."

It remains to be seen how courts will incorporate the preamble in interpreting GAAR. Courts have often recognized taxpayers' need for certainty in GAAR cases. The preamble seems

designed to offer a counterbalancing consideration. However, the constitution and division of powers may constrain judicial consideration of these matters. As the SCC remarked in *Canada v. McLarty* (2008 SCC 26, at paragraph 75):

> In reassessment cases, the role of the court is solely to adjudicate disputes between the Minister and the taxpayer. It is not a protector of government revenue. The court must decide only whether the Minister, on the basis on which he chooses to assess, is right or wrong.

A New GAAR Penalty

The changes also add a GAAR penalty that is generally equal to 25 percent of the avoided tax. This penalty applies if, among other requirements, GAAR applies and no disclosure was made under either the MDRs or new rules permitting similar voluntary disclosures. Limited exceptions are set out in the legislation.

The Department of Finance views the new penalty as a deterrent, because it effectively amplifies the downside to a taxpayer of losing under GAAR. However, the design of the new penalty is problematic. It applies notwithstanding the acknowledged uncertainty about GAAR's application, particularly with respect to the misuse or abuse analysis, and it contains no fault requirement, such as gross negligence. No distinction is made between cases that are close to the line (including cases in which different judges may disagree on whether abuse is present) and cases that are clearly abusive. In any event, other deterrents for taxpayers already exist, including the reputational risk posed by media coverage of GAAR litigation.

An Extended Reassessment Period

If a taxpayer fails to disclose voluntarily (or where required) under the MDRs, the amendments give the minister an additional three years beyond the normal reassessment period to reassess under GAAR. The Department of Finance claims that this additional time is a further deterrent.

What's Next?

Assuming that Bill C-59 passes, life under the new, amended GAAR has already begun. Most of the amendments apply to transactions occurring on or after January 1, 2024. The penalty applies only on royal assent.

GAAR appears to have broadened beyond its original focus on transactions undertaken primarily to avoid tax. A new cycle now begins, of GAAR reassessments, tax appeals, and courts interpreting the new legislative regime before material amendments are proposed again. A rise in GAAR reassessments and disputes is quite likely. ■

GAAR Two Years Later

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In one sense, much has happened since mid-2022, when an earlier issue of this newsletter examined various aspects of tax avoidance and considered whether GAAR was operating as intended. In a more substantive sense, however, relatively little has changed.

Recent Case Law on Loss Trading

The SCC's 2023 decision in *Deans Knight* (2023 SCC 16) established the unsurprising principle that when the courts are faced with the "functional equivalent" of the mischief that a statute seeks to address (the mischief, in that case, of using a corporation's historical tax losses after a de jure acquisition of control by an unrelated party), they will apply GAAR if they view the overall result as offensive, having regard to Parliament's aims in enacting the statute.

This principle was reiterated in the subsequent FCA decision in *MMV Capital Partners* (2023 FCA 234). In that case, too—in which an arm's-length party had acquired over 99 percent of the equity of (and was the sole source of funding to) a corporation whose only asset was its tax losses—the fact that the transactions stopped just short of a de jure acquisition of control did not prevent the object, spirit, and purpose (OSP) of subsection 111(5) from being engaged. A similar conclusion, on somewhat comparable facts, was drawn in *Madison Pacific Properties Inc.* (2023 TCC 180), where the TCC concluded (at paragraph 184) that the relevant intermediaries "could control the Appellant as if they had *de jure* control without actually taking that control," and that, accordingly, GAAR applied in a situation where the result, on the facts (including their economic substance), was one to which the loss-trading rules were intended to apply.

The ratio of all of these decisions remained tethered to the "control" concept found in the text of subsection 111(5) and was much narrower than the Crown's assertion (at paragraph 105 of its factum in *Deans Knight*) that "ultimately, loss restrictions are intended to apply when there are fundamental changes in share ownership." GAAR was applied in all three of these cases on the explicit basis that the functional equivalent of what the text established as the threshold for invoking loss restrictions had been met, and ultimately none of them breaks significant new legal ground.

In fact, these cases demonstrate the robust effectiveness of GAAR in its current form, such that its reach will not be significantly expanded by Parliament's "modernization" of it. Lowering the threshold for an "avoidance transaction" (rarely an impediment to the application of GAAR) will have little practical significance, and the interpretive verbiage in the new preamble simply replicates the existing case law. Of modestly greater interest are the new provisions requiring economic

substance to be considered in a "misuse or abuse" analysis and dictating that a "significant lack" of such substance "tends to indicate" an abuse or misuse. One wonders whether the Crown ought to concede the reverse—that is, a presumption that *no* misuse or abuse exists where economic substance is present. In any case, the GAAR jurisprudence (including *Deans Knight*) is already replete with examples of the courts considering economic substance at both stages of the misuse or abuse analysis. This was pointed out to Finance in, for example, the May 3, 2023 submission from the Canadian Chamber of Commerce (at 39-47) (a submission of which I was the author).

Amendments Do Little More Than Codify Existing Jurisprudence

In any case, it would be astonishing to see the courts interpret the GAAR amendments in Bill C-59 as doing anything more than codifying the existing GAAR jurisprudence. As the government itself observed in its 2022 consultation paper, "Any effort to improve the GAAR must be cognizant of any uncertainty that would be created, inadvertently or otherwise, to the extent the precedential value of existing jurisprudence on misuse or abuse is eroded or rendered irrelevant." The Canadian Chamber of Commerce repeatedly encouraged Finance—in submissions made in September 2022, May 2023, and September 2023—to articulate which GAAR decisions it disagreed with, and which ones would be decided differently under the proposed amendments. Finance did not do so, however, apart from a modest reference to *Canada Trustco* (2005 SCC 54) in the Bill C-59 explanatory notes. (This reference addressed one element of what constitutes a lack of economic substance but offered no conclusion on the misuse or abuse question.) With its September 2023 submission, the Chamber certainly advised the government that, unless it made a clear statement otherwise, the business community would interpret the GAAR amendments as codifying the existing jurisprudence. All this being so, there seems little basis or rationale for jettisoning the guidance provided by 30 years of GAAR jurisprudence, and on this premise Finance can fairly say that the Bill C-59 GAAR amendments fulfill the minister's mandate regarding economic substance without needlessly creating chaos: in other words, a job well done.

Impact of the GAAR Penalty

One legislative change to GAAR will have a substantive impact: the new 25 percent penalty, imposed whenever GAAR applies. A deterrence penalty of this kind was proposed and then withdrawn when GAAR was first enacted in 1988. The government has not explained what has changed since that earlier decision against a GAAR-specific penalty, nor why existing penalty provisions are insufficient. There seem to have been few, if any, GAAR cases in which the courts have refused to apply subsection 163(2) gross negligence penalties assessed by the CRA.

It will be interesting to see how often taxpayers respond to the new penalty by disclosing transactions as a preventive measure, to eliminate potential liability, and whether the CRA will treat such disclosures as some form of admission. Conceivably, the harshness of the penalty could backfire by making courts reluctant to find that GAAR applies. Unless the CRA develops detailed administrative policies on when it will seek to impose the new penalty that take factors such as these into account, it will have undue discretionary leverage over taxpayers that face significant cost and risk when considering whether to contest a tax dispute in which GAAR may be threatened. It would be in everyone's interest for the government to refine the legislation to make the penalty dependent on the reasonableness of the taxpayer's conduct in the circumstances. This refinement could involve the incorporation of basic considerations of fairness, such as whether legitimate interpretive uncertainty exists and whether the taxpayer sought professional advice.

The business community shares the government's objective of a robust GAAR that prevents a tiny minority from gaming the system. The vast majority of taxpayers are content to paint within the lines and want only for those lines to be reasonably clear. GAAR will always carry some degree of uncertainty, but taxpayers justifiably expect the government to do what it reasonably can to articulate Parliament's intentions and administer the rules accordingly.

The standard is not perfection but rather, as David Dodge stated in 1988, "'reasonably predictable result[s]' so that taxpayers can comply with the rule, and the administration and the courts can easily apply it" (see David A. Dodge, "A New and More Coherent Approach to Tax Avoidance" (1988) 36:1 *Canadian Tax Journal* 1-22, at 22). Taxes are a cost of doing business, and a country suffering as severely as Canada from capital underinvestment should be doing all that it can to reduce the cost-certainty risks that its business community faces when planning major capital expenditures. The government can help considerably by making a greater effort to articulate the legislative rationale of specific provisions; in the case of GAAR, this is especially important now that taxpayers face a 25 percent penalty if they get the rationale wrong.

Better Articulation of Legislative Rationale

In my view, one need not make a false choice between "certainty" and "fairness" in this context. As the Canadian Chamber of Commerce stated in its May 2023 submission, "Certainty need not be sacrificed in pursuit of other objectives and is in fact enhanced along *with* fairness if it is achieved by better articulating legislative rationale." By far the most cost-efficient solution is the one the government itself noted in its 2022 consultation paper: better and more detailed explanation of the government's intentions at the time legislation is enacted. By simply telling us more about what is and is not permissible, the government can (1) make it easier for the compliant majority to

follow the rules, and (2) leave less interpretive underbrush for the small subset of aggressive taxpayers to hide in.

An enormous amount of time and money has been spent on litigating the loss-trading cases, merely in order to answer the question: What constitutes "loss trading" when the loss remains within the same entity? Most if not all of this expense could have been spared with the addition of a single sentence in the subsection 111(5) explanatory notes, something to the effect of the following:

> While subsection 111(5) applies upon an acquisition of de jure control, the tax policy underlying these rules applies where de jure control as normally defined has been effectively nullified and an unrelated person or group of persons has acquired the "functional equivalent" (whether through share voting rights or otherwise).

If Finance devoted more resources to crafting more detailed explanatory notes, the result would be vastly superior to the current system, in which litigants are forced—years or sometimes decades after relevant legislation has passed—to undertake research and persuade the courts regarding Parliament's legislative rationale. The case-by-case determination of legislative rationale is extremely cost-inefficient and untimely. It also leaves the taxpayer at an enormous financial and informational disadvantage relative to the Crown (which has greater resources and can spread the cost over many cases dealing with the same legal issue) and can be muddied by the taxpayer's particular circumstances.

It would be a wise and cost-efficient investment to give Finance whatever resources it needs in order to produce better contemporaneous legislative documentation. The resources required for this would cost the government less than what it spends in litigating just one or two GAAR cases to the appellate stage. The reallocation of resources away from resolving disputes and toward preventing them will more than pay for itself. Notwithstanding the inherent danger of such documentation being "self-serving" in some circumstances (as noted in *Oxford Properties*, 2018 FCA 30, at paragraph 93), it remains by far the simplest and most cost-efficient way for legislative rationale to be expressed, creating a fairer and more predictable tax system.

Improving the Administration of GAAR

The cost of resolving disputes could be greatly reduced through the improved administration of GAAR. The Canadian Chamber of Commerce, in its May 3, 2023 submission, made a number of specific suggestions for resolving GAAR disputes more quickly, cost-efficiently, and consistently. These suggestions included

- overhauling the composition and functioning of the GAAR Committee;
- requiring the Crown to formulate and articulate, early in the dispute process, its view on the relevant legislative rationale, and then to adhere to it; and
- facilitating the participation of intervenors in establishing OSP in GAAR cases.

The reality is that, because GAAR cases involve a unique interpretive analysis (that is, the establishing of legislative rationale), they are different from "normal" tax controversies and should be handled differently.

Conclusion

The developments of the past two years will have a positive impact on the way in which future GAAR cases are litigated. The GAAR amendments require litigants to expressly consider and address economic substance (including the factors listed in new subsection 245(4.2)) as part of their misuse or abuse analysis. Post-*Deans Knight*, we should also expect to see the parties describe why the outcome achieved by the taxpayer is or is not the "functional equivalent" of what the relevant provisions are targeting.

Both of these developments are constructive, in that the resolution of GAAR cases will be faster and more efficient. Greater "clarity and consistency" regarding economic substance (to quote the Bill C-59 explanatory notes on new subsections 245(4.1) and (4.2)), along with greater rigour in determining how GAAR cases should be resolved and what the courts should expect to see, will sharpen the distinctions between the parties' positions earlier in the process. Looking forward, the business community would also welcome further clarity from the courts or government on how best to establish legislative rationale, including the role of subsequent amendments, CRA administrative statements, and other extrinsic materials. ■

Policy on the Front Lines

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There are many differing views about the new general anti-avoidance rule (GAAR), and if the old GAAR's early years are any indication, we'll be weighing in on these views for quite some time.

In coming years, courtrooms will ring with arguments over just how low the "one of the main purposes" bar should be (in the amended "avoidance transaction" definition), or how "almost" you'll need to get in order to trip over the "entire" or "identical" lines (in new paragraph 245(4.2)(c) and new subsection 245(5.2), respectively). We'll chew over how much "lacking" it will take to "significantly lack" economic substance, and just what this, that, or the other "tends to indicate" (both from the new subsection 245(4.1)).

But the front lines of this great debate won't be in our courtrooms anytime soon. After all, it took more than 15 years for the SCC to decide its first GAAR case (*Canada Trustco Mortgage Co. v. Canada*, 2005 SCC 54). In the short term, these interpretive front lines will be on the desks of CRA auditors across the country, as they apply the policies that exist between the lines

of audit manual checklists and behind the closed doors of the CRA's GAAR Committee.

Don't get me wrong; I think it's essential for us to figure out *what* the new GAAR says, and I'm just as curious as the next tax nerd to see all of the creative and persuasive submissions from both sides, justifying one interpretation over another. But I believe that the future battlefield will be shaped far more by *how* the CRA actually applies the new GAAR. What we really should be asking ourselves, then, is whether the CRA's current policies, first implemented in 1988, are ready for the challenges that a 2024 reset will bring.

How Does It Work Now?

Under the CRA's current policies (which are oversimplified here, in the interests of brevity), an auditor that wants to apply GAAR must first obtain approval by referring the matter to the CRA's GAAR Committee. The auditor prepares a report, and—depending on the report's route to the GAAR Committee—other CRA technical specialists may also chime in, in support of the referral.

The GAAR Committee, made up of a large, revolving cast, includes representatives from various departments of the CRA, the Department of Finance, and the Department of Justice. They review the materials and then meet on an ad hoc basis to discuss and provide a recommendation. The GAAR Committee considers the relevant facts and provisions, but it may also take into account other factors, including the risks involved in taking certain positions, and whether competing policy decisions may be relevant.

Taxpayers may make written but not oral representations to the GAAR Committee, and they may not participate in the committee's deliberations in any way. The taxpayer is notified of the committee's decision by the auditor and may obtain only limited disclosure of the reasons supporting that decision.

So What's the Problem?

Well, the problem is that the GAAR Committee is about to get very, very busy. Today, a GAAR referral requires analysis of whether there is a tax benefit, an avoidance transaction, and a misuse or abuse. Under the new GAAR, the committee's to-do list will get a whole lot longer.

For starters, the avoidance transaction threshold will drop from a "primary purpose" exclusion to a "one of the main purposes" inclusion, and so the number of referrals is sure to grow. In addition, members of the GAAR Committee will now have more to consider. For instance, they will have to determine whether the extended reassessment period under new subparagraph 152(4)(b)(viii) applies. The committee's oversight on this issue is important in order to ensure that auditors facing statutory deadlines are not inappropriately applying the new GAAR merely to get extra time to conduct their audits, especially if the technical rules don't clearly apply. (See Dominic Bédard-Lapointe and Anu Koshal, "How Will the New GAAR Penalty (Not) Apply to You?" presented at the Canadian Tax Foundation's 2023 annual conference.) Committee members will also have to consider, for the first time, the imposition of GAAR penalties, and whether the exception in new subsection 245(5.2)—applicable if a transaction was "identical or almost identical" to one considered in published guidance or court decisions—or any common-law defences may be available.

But the biggest impact on the GAAR Committee's workload will come from its members now having to consider whether transactions are "significantly lacking in economic substance" (SLES). Under the amended legislation, identifying a transaction or series as SLES will be "an important consideration that tends to indicate" abuse. The new rules list factors that may establish that transactions are SLES, but the list is not exhaustive. Until we have case law to guide us on what these new rules mean, the GAAR Committee will need to spend considerable time sorting out that question. And even though the explanatory notes published by the Department of Finance suggest (at 329) that when a transaction is SLES, "the starting point would be that there is a misuse or abuse," there is no rebuttable presumption (as there was in the August 4, 2023 version of the proposals), and therefore the GAAR Committee will still need to complete that review as well.

Yet it doesn't end there. If we have more reassessments approved by the GAAR Committee, we will also inevitably end up with the filing of more objections. In the post-COVID era—with shutdowns, early retirements, and the after-effects of staff shifting to essential services during the pandemic—the CRA is still struggling to meet its basic service standards for objections. The agency is taking action, through recruitment efforts, to try to catch up, but it acknowledges the risk that staffing requirements still may not be met. The added volume of potentially complex objections resulting from the GAAR amendments will pose a further challenge in this regard, so here's hoping that at least some of the new hires will flow into the CRA Appeals Division.

Even if the CRA manages to keep the cases moving, the next stop is the TCC, which has its own backlogs, compounded by a shortage of judges across the country. Although some creative thinking may help fill current vacancies (for example, several sections of the Canadian Bar Association advocated for a resolution, adopted at the 2024 annual general meeting, to eliminate the residence requirement for Federal Court and TCC judges in order to attract more applicants), Chief Justice Rossiter warned at the 2023 CTF annual conference that more judges are needed and that, with retirements looming over the next few years, things will only get worse.

An influx of new, complicated reassessments, hot on the heels of an unprecedented pandemic—all of this occurring while an aging workforce continues to hit retirement age in droves—will surely clog all of these processes and affect the dispute resolution process for all taxpayers, not just those reassessed under the new GAAR. In circumstances like these,

we'll be lucky to have authoritative guidance from the SCC within 15 years.

What Can We Do?

The CRA says that it will review the administrative guidance in *Information Circular* IC88-2 (October 21, 1988), and that's a great start. But a new GAAR rollout needs more than just an update. We need to reimagine the way the GAAR referral process works as a whole.

In my view, the necessary renovation should start with the creation of a *standing* GAAR Committee as soon as possible; the ad hoc days for this committee are clearly over. A dedicated committee, with permanent members, will be vital for the CRA to keep up with the pace. Moreover, an early investment of time and resources, together with a clear mandate to manage the long-term impact of the new GAAR, will ensure that the CRA's interpretive positions can be applied consistently from now on.

I also strongly believe that it is time to allow taxpayers to make oral representations directly to the GAAR Committee. I know that this idea has been brought up before, and that people have rightly criticized the notion of including taxpayers in the GAAR Committee's deliberative process. I agree that GAAR Committee members should be able, as part of their decision making, to speak freely among themselves and consider issues that have nothing to do with taxpayers, and that they cannot do this if taxpayers are present. But, at the same time, I believe that these committee members would benefit greatly from an oral presentation by the taxpayer *before* they begin their discussions behind closed doors. This will take more time, of course, but I believe that creating the space—in a permanent, dedicated forum—for more effective input from taxpayers will ensure that the GAAR Committee has access to the very best information that it needs to make its decisions. Not to mention the fact that such a change would squarely align with the CRA's mandate that government be made more accessible and transparent.

Perhaps more importantly, though, I am confident that more effective input from taxpayers will also lead to better outcomes. In my practice, I often present a summary of a taxpayer's facts and legal positions at the beginning of a dispute. This gives the appeals officer or opposing counsel the opportunity to ask questions in the moment, so as to ensure that they fully understand the context and basis for the taxpayer's position. I have found that such direct communication, even when identical representations are included in written submissions, improves our chances of working together to find a reasonable resolution to the dispute. I believe that the GAAR Committee would likewise benefit from such a collaborative approach. And since it is often difficult to sway an appeals officer once the GAAR Committee has ruled, it will also ensure that taxpayers have a meaningful opportunity to challenge the CRA's position before having to take the matter to court.

These aren't new ideas, but the context in which we're considering them is entirely unique. We've never made such a substantial legislative change to such an important, wide-reaching rule, just after a global crisis virtually ground us to a halt, at a time when we continue to lose talent at an alarming rate. I'd say that, in such circumstances, these ideas are worth a serious second look. The new GAAR is clearly marching forward, but if we can find a way to work together, and to think creatively, we may just be able to make some kind of peace, with good policy in place on the front lines. ■

All's Fair in Love and Taxes: "Fairness" in the New Preamble to GAAR

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In this article, we consider the impact of the new preamble to the general anti-avoidance rule (GAAR) in Bill C-59.

Through the preamble, the federal government proposes to shape the way that taxpayers, their advisers, and the judiciary interpret GAAR. It should be clear to everyone that GAAR is intended to do what the preamble asserts—namely, to strike a balance between (1) the government's "responsibility to protect the tax base and the fairness of the tax system" and (2) "taxpayers' need for certainty in planning their affairs." The explanatory notes (ENs) accompanying the bill, which were published in November 2023, state that the "notion of fairness" in the preamble "is intended to be broad, referring to the unfair distributional effects of tax avoidance as it shifts the tax burden from those willing and able to avoid taxes to those who are not." Under this framework, fairness is defined by reference to its negation (unfairness), which itself is defined by reference only to tax avoidance.

But who is to say what is fair? Do judges know what is fair? And is that notion of fairness different from what taxpayers, their advisers, or the general public thinks is fair? How are taxpayers and tax administrators supposed to interpret the concept of fairness in a practical and useful manner?

Fairness Is Inherently Subjective

The SCC noted, in its unanimous 2011 decision in *Copthorne* (2011 SCC 63), that it would be inappropriate to consider the terms "abuse" or "misuse" as implying "moral opprobrium" regarding the actions of taxpayers who creatively minimize their tax liability. Two years later, speaking at the judges' panel at the Canadian Tax Foundation's 2013 annual conference, the author of that decision, Rothstein J, opined on the concept of "fairness":

> I don't even understand what fairness means in the tax context. Conceivably, when a judge has discretion to make decisions (for example, to impose a heavier or a lighter sentence in the

> criminal context), perhaps there is an element of fairness there. But to me fairness is just a matter of what is in the eyes of the beholder. I read last week a series in the *Globe and Mail* about how middle-class income was not keeping up with the top 1 or 10 percent. Earlier, I had read a piece in the *National Post* saying that the top 1 percent pay 21 percent of the tax, and the top 10 percent pay 55 percent of the tax, personal tax. And so to me that's just a question of looking at it from one's own pigeonhole. I don't see how that comes into judging at all.

We share Rothstein J's view that subjective notions of fairness should not play a role in the interpretation of Canada's income tax legislation. We would argue that, although the new preamble was introduced as an interpretive rule in earlier drafts of the proposed GAAR amendments, the intervening release of the SCC's judgment in *Deans Knight* (2023 SCC 16) severely impairs the preamble's use as such. This may be for the best. The notion of fairness underlying the preamble introduces a level of subjectivity that could make it hard to interpret in a practical and useful way.

The ENs posit a notion of fairness, but they shed little light on its proper interpretation. The "unfair distributional effects of tax avoidance" were first remarked on in Finance's GAAR consultation paper, released on August 9, 2022. The consultation paper notes that

> [i]f tax avoidance is perceived to be a significant problem in society, it can undermine attitudes toward tax compliance and more generally the rule of law itself. Viewed this way, a broader notion of fairness is key to maintaining the confidence of all taxpayers in the effective functioning of the tax system.

This statement provides little clarity about the meaning of fairness. Instead, it suggests that actions or results that make citizens feel that the tax system is unfair are themselves unfair.

This notion is echoed by the consultation paper's reference to the 1960s-era Carter report, which identified among the evils of tax avoidance "the sense of injustice and inequality felt by those who do not benefit from tax avoidance" and "the unfair shifting of the tax avoider's tax burden to other taxpayers" (see Canada, *Report of the Royal Commission on Taxation*, vol. 3 (Ottawa: Queen's Printer, 1966), at 541-42). Again, fairness is defined with reference both to public perception (something that cannot easily be ascertained by a taxpayer or a court) and to an activity (tax avoidance) identified as unfair without further justification.

Fairness in the GAAR Jurisprudence

The concept of fairness discussed above is dramatically different from the concept as historically contemplated in GAAR judicial decisions. Canada's courts have generally cited fairness, in combination with certainty and predictability, as a basis for justifying taxpayers' tax strategies, not for impugning them. For example, in the SCC's first GAAR decision, *Canada Trustco* (2005 SCC 54), the court noted that the "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." Similarly, in *Alta Energy* (2021 SCC 49), the majority of the SCC remarked, in finding for the taxpayer, that "[t]he principles of predictability, certainty, and fairness and respect for the right of taxpayers to legitimate tax minimization are the bedrock of tax law."

Admittedly, these cases do not help clarify the meaning of "fairness," and some scholars have noted the wide spectrum of available interpretation. On one hand, for example, Brian Arnold has referred to the expression "certainty, predictability and fairness" as a "meaningless mantra" (*Arnold Report* posting no. 244, October 24, 2022 (www.ctf.ca)). On the other hand, Fournier and Kutyan, referring to other SCC rulings, suggest that certainty, predictability, and fairness are "longstanding and fundamental rule of law principles that must be taken into account in any act of Parliament because they are elevated to supra-legislative, constitutional status" (Olivier Fournier and Justin Kutyan, "The General Anti-Avoidance Rule: Evolution Without Revolution," in the 2022 Conference Report, 22:1-38).

A New Concept of Fairness

In enacting the preamble, it is clear that Parliament wants to adopt a concept of fairness for the purposes of GAAR that differs from the concept of fairness in previous case law. The 2023 federal budget explained that the preamble was intended to "help address interpretive issues and ensure that the GAAR applies as intended." Similarly, the 2022 consultation paper suggested that the "broader notion of fairness" discussed above could be "assisted by including an interpretation rule in the GAAR that would help achieve a more appropriate balance with respect to the consideration of fairness." The consultation paper cited the decision in *Alta Energy*, contrasting the majority's linkage of certainty, predictability, and fairness with the minority's recognition that GAAR strikes a balance between certainty and fairness for the tax system as a whole. Thus, it would appear that the purpose of the preamble is to remove the concept of fairness as a complementary notion to certainty and to cast it, instead, as a counterweight.

A potential problem with this approach is the problem identified by Rothstein J, cited above. Empowering judges to employ a notion of fairness premised on the moral judgment expected from the public would be to burden them with a difficult task. Judges strive for impartiality, and asking them to ascertain public sentiment would likely introduce an undesirable amount of subjectivity into the judicial process. Such an approach would also put tax advisers and government officials in unenviable positions. It may be difficult for professionals—who spend their days advising businesspeople on the most appropriate way to manage their taxes—to determine when and how their suggested courses of action will undermine "the confidence of all taxpayers in the effective

functioning of the tax system." Government officials may also struggle to enforce GAAR by reference to a notion of fairness that treats all tax avoidance as fundamentally unfair.

Impact of Deans Knight

Fortunately, the tax community may never need to grapple with what "fairness" truly means in a GAAR analysis. The 2023 SCC decision in *Deans Knight* should effectively minimize the preamble's use as an interpretive rule. The SCC stated (at paragraph 50) that "the principles of certainty, predictability and fairness do not play an independent role [in the GAAR analysis]; rather, they are reflected in the carefully calibrated test that Parliament crafted in s. 245." In other words, a reasonable degree of certainty is achieved by the balance struck within the GAAR analysis itself, meaning that courts need only go through the traditional GAAR analysis to balance certainty and fairness.

Interestingly, the ENs (at 328) adopt precisely this language, albeit in the context of a very different understanding of fairness than the one before the court in *Deans Knight*. Surely Parliament cannot be suggesting, however, that GAAR "strikes a balance" between certainty and fairness but that certainty should be ignored and fairness separately taken into account—especially when "fairness" is defined by reference only to the unfairness of tax avoidance. The better view is that GAAR itself achieves not only a reasonable degree of certainty but also a reasonable degree of fairness. Not all tax avoidance is fundamentally unfair. Rather, tax avoidance is "unfair" only when it is found to result in an abuse or misuse under the carefully calibrated test that Parliament crafted, and the courts have fleshed out, in section 245. Therefore, taxpayers, their advisers, and the judiciary should not be required to consider fairness separately or subjectively. Instead, the ordinary analysis undertaken under the GAAR test should suffice. ■

Articulation of OSP in Deans Knight

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The SCC's decision in *Deans Knight* (2023 SCC 16) gives us an opportunity to reflect on the challenge and the utility of attempting to read the ITA's detailed provisions as part of a coherent scheme. The reasons given by the court in *Deans Knight*, and the majority's approach to finding and using the object, spirit, and purpose (OSP) of the provisions, have already been the subject of some debate and criticism (see, for example, Li et al., 2023). In this brief article, I discuss the majority's approach to articulating the OSP and offer a response to two criticisms of it.

The Approach in Deans Knight

At the core of the dispute in *Deans Knight* were the OSP of the provisions and the proper approach to finding and articulating the OSP. The majority found, after a relatively extensive consideration (at paragraphs 78-112) of the text, context, and purpose of subsection 111(5), that the OSP was

> to prevent corporations from being acquired by unrelated parties in order to deduct their unused losses against income from another business for the benefit of new shareholders. Parliament sought to ensure that a lack of continuity in a corporation's identity was accompanied by a corresponding break in its ability to carry over non-capital losses. (At paragraph 113.)

In the majority's view, both the appellant and the lower courts missed the mark by articulating the OSP as a legal test, "rather than summarizing the *rationale* of the provision" (at paragraph 115, emphasis in original). Put another way, courts ought to articulate the OSP in terms of "the *why*" rather than "the *how*."

Recent contributions to this publication (see Glicksman and Welch, 2022; Loomer, 2022) have suggested that drafters should write legislation that clearly articulates the purposes of the legislative scheme, a rigour that would ultimately result in more principles-based drafting. This would be a welcome development, but *Deans Knight*, meanwhile, shows some willingness on the court's part to do the difficult work of uncovering the underlying policies, principles, and systemic logic of the ITA, even in the absence of explicit legislative statements.

"How?" Versus "Why?" (But in Reality—"What?")

The majority in *Deans Knight* wrote that the OSP of a provision should be articulated in a way that prioritizes the "why" rather than the "how." It isn't clear, however, that the majority's own articulation gets all the way to the core of the "why" question. The majority helpfully identifies the policy goal underlying subsection 111(5), shifting the question from "*How* is the policy implemented?" to "*What* is the policy goal?" I suggest that the "why" question is slightly different. That question is, "*Why* is Parliament concerned about loss trading?" or "*Why* can some losses be deducted while others cannot?"

The majority, in its articulation of the OSP, comes close to answering the "why" questions but stops short of highlighting the answers. In quoting the Carter report (Canada, *Report of the Royal Commission on Taxation* (1966), vol. 4, at 261-62), Rowe J, writing for the majority (at paragraph 108), underlines the statement that the corporation should be regarded as an intermediary for the shareholders. He emphasizes (at paragraph 110), quoting from a paper by Strain, Dodge, and Peters in the CTF's 1988 Conference Report, that the rule targets situations in which the corporation should be treated as a new taxpayer because new shareholders are entitled to benefit from its success. This exploration of the literature comes close to answering the question of why Parliament wants to prohibit the deduction of some losses and not others.

The deduction of losses that are carried forward or carried back is sensible: the tax year is an arbitrary period, and the

accurate calculation of income needs to account for a variety of businesses that lose money in some years and earn a profit in others. The transfer of losses within a corporate group can be seen as acceptable because, in keeping with the view expressed in the Carter report, the group can be seen as one economic unit. However, permitting the sale of losses to a different economic unit—one that should be regarded as a new taxpayer, according to the 1988 paper quoted above—is undesirable because (1) it is inconsistent with the general rationale for allowing the deduction of losses from other years; and (2) it would effectively result in a government subsidy for the shareholders of corporations with failed businesses. The loss-streaming exception (what the majority terms "the business continuity exception") adds some nuance to the discussion but is consistent with it. When a failing business is rescued (or can reasonably be expected to be rescued), the original justification for carrying forward losses might be thought to apply. Alternatively, the availability of losses might be thought of as a subsidy—but one that is available only where the new owners have a reasonable expectation of turning the business around.

A New Legal Test?

The majority in *Deans Knight* aimed to avoid articulating the OSP in a way that formulates a new legal test, but it is questionable whether they were entirely successful in that attempt. Put another way, has "acquired by unrelated parties" replaced de jure control as the standard to be applied in GAAR cases where the OSP of subsection 111(5) is alleged to have been frustrated? The ITA defines "related persons" with considerable precision in subsection 251(2) and in related provisions. Accordingly, it is possible to imagine that future courts might be asked to rule on scenarios in which advisers have treated "acquired by unrelated parties" as the new legal test and structured transactions accordingly.

Such an approach would be out of step with the intentions of the majority and its reasons, read as a whole, but it remains to be seen how advisers and future courts will approach the reasons in *Deans Knight*. The FCA in *MMV Capital Partners* (2023 FCA 234) (decided shortly after *Deans Knight*) seems to have avoided taking a narrow formalistic approach in applying the SCC's guidance. *MMV* was the FCA's first opportunity to apply GAAR following *Deans Knight*. Monaghan J, in her reasons for concluding that the loss-utilization transaction at issue achieved outcomes that the provisions aim to prevent, made use of the OSP of subsection 111(5) as articulated in *Deans Knight*, but she also looked more holistically at the majority's reasoning.

Do GAAR Cases Undermine Certainty?

Certainty, a central and frequently raised concern about GAAR, was considered in *Deans Knight*. The majority accepted (at paragraphs 92-93) that Parliament chose de jure control as the test in subsection 111(5) and that de jure control offers more clarity and certainty for taxpayers. In dissent, Côté J also highlighted this concern. She noted (at paragraphs 168-69) that bright-line tests such as the test for de jure control can reduce litigation, promote predictability and certainty, and minimize costs.

However, both the idea that bright-line rules reduce cost and litigation and the idea that GAAR decisions create uncertainty can be contested, despite their intuitive appeal. In 1996, Rod Macdonald argued that bright-line rules often produce litigation, despite seeming to provide clear solutions. Bright-line rules are known to be under- or overinclusive (and often both), and, as Macdonald suggests, "[l]itigation over instances of under- and over-inclusion is rarely precluded" (at 49) simply because the rule prescribes a bright line. A bright-line rule is likely to structure disputes in particular ways. When parties cannot argue about the interpretation of the rule itself, they may argue about the facts, the targets of the rule, the purpose of the rule, or the fairness of enforcing the rule in particular circumstances. Thus, although the articulation of bright-line rules may have some beneficial effects in particular cases, it is not necessarily the case that a bright-line rule will produce fewer disputes than a more general standard.

Similarly, detailed statutory rules are enacted with the intention of producing certainty and predictability, which allow people to plan their affairs with the knowledge of what rules will apply. However, complex legal regimes often require further amendment and more detail, as can be seen in what Macdonald calls (at 49) the "thrust and parry of amendments to the *Income Tax Act* and the tax avoidance schemes conceived by sophisticated practitioners." The result is a set of rules that seem always in flux. Even if the rules could be said to be certain and predictable at any given point in time, a set of rules that becomes a moving target does not allow for the kind of long-term (or even medium-term) planning by taxpayers that certainty and predictability hope to facilitate.

Moreover, as Jinyan Li and Thaddeus Hwong have noted, GAAR decisions seem to be producing elements of certainty, even if GAAR itself creates uncertainty ((2013) 61:2 *Canadian Tax Journal* 321-66). The research of Li and Hwong has found, in particular (at 360), that GAAR has been "fairly consistently applied to loss utilization" schemes. At least since *OSFC* (2001 FCA 260), advisers in their planning have faced the risk that GAAR might apply to a loss-utilization transaction. Some taxpayers would understandably prefer the precision of the de jure control test, but *Deans Knight* may offer advisers reasonable certainty that a wide swath of proposed loss-utilization transactions will be found to be abusive and that avoiding the acquisition of de jure control will not be enough to save these plans from GAAR.

Two loss-utilization cases, *MMV Capital Partners* and *Madison Pacific Properties* (2023 TCC 180), may indicate that this certainty is crystallizing. Both involved loss-utilization transactions whose facts might be seen as distinguishing these

cases from *Deans Knight*. Nonetheless, abusive tax avoidance was found in both cases, and GAAR was applied.

Conclusions

It has been suggested that not every tax provision is part of a coherent scheme (see Li et al., 2023, at 1649). However, courts ought to seek out and strive for coherence in the law. In the GAAR context, in particular, courts are called on to attempt to put the provision in the context of a coherent scheme (*Deans Knight*, at paragraph 73) or a "plausible and coherent plan" (*Copthorne*, at paragraph 91). An important corollary, of course, is that the legislative drafter needs to ensure that a coherent scheme can be found.

In the case of the loss-utilization rules, the courts have been able to identify a coherent policy and scheme that can be used in the GAAR analysis, as opposed to having to articulate an alternative legal rule. It remains to be seen whether the same approach is possible in other cases. Will courts find a credible coherent scheme or policy in other potential areas of concern, such as surplus stripping, capital gains stripping, PUC manipulation, income splitting, and the FAPI rules? It may be difficult for them to do so, but coherence, certainty, and fairness can work together in the long run. ■

The New GAAR and the Slippery Slope to Substance Over Form

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Since its enactment in 1988, the general anti-avoidance rule (GAAR) has proved to be a reasonably effective tool in preventing abusive tax planning. The Department of Finance rightfully acknowledged, in its 2022 consultation paper, that GAAR has been successfully applied by the courts in a significant proportion of GAAR cases. Nonetheless, Finance has moved forward with its strategy to modernize and strengthen GAAR. These efforts culminated in various proposed amendments that were included in Bill C-59, currently at second reading in the House of Commons. The necessity (or, arguably, lack thereof) of the proposed amendments and their impact on the established GAAR jurisprudence (which includes six SCC decisions) have already been the subject of numerous articles and debates. Our position is that the proposed changes, as a whole, will add an unwarranted layer of uncertainty to the already complex application of GAAR. In this article, we focus on the potential effect of the new "economic substance" test at the "misuse or abuse" stage of the GAAR analysis. We warn against reopening the long-settled debate regarding substance over form and against questioning the status more generally, within Canadian tax jurisprudence, of our longstanding form-based approach. In that direction lies a slippery slope.

The Current Framework

The application of GAAR involves a well-known three-criteria test that, if ultimately met, denies the tax benefit resulting from an avoidance transaction, on the basis of the transaction's abusive nature. Specifically, the minister of national revenue can deny a tax benefit that results from an avoidance transaction (defined to include a transaction undertaken as part of a series of transactions) if the transaction may reasonably be considered to have resulted directly or indirectly in a misuse of the provisions of the ITA or in an abuse having regard to those provisions read as a whole. A transaction will not be considered an avoidance transaction if it is reasonably understood to have been undertaken or arranged primarily for bona fide purposes other than to obtain the tax benefit.

The misuse or abuse test has been the subject of much debate. In practice, most GAAR cases focus on the question of whether an impugned transaction is abusive. To make this determination, a court must determine whether the tax benefit arising from the avoidance transaction frustrates the object, spirit, and purpose (OSP) of the relevant tax provisions. In 2005, the SCC decided its first GAAR case (*Canada Trustco*, 2005 SCC 54), which established, among other things, the analytical framework for the third branch of the GAAR test (that is, a determination of whether the avoidance transactions were abusive). The SCC stated that such a determination must be based on (1) the OSP of the relevant provisions, and (2) whether the result of the transactions frustrated that OSP. More recently, in *Deans Knight* (2023 SCC 16)—almost 20 years after *Canada Trustco*—a majority of the SCC reaffirmed this same framework and clarified that the abuse determination must focus on *why* the impugned provision was enacted rather than on *how* it was drafted.

In light of the government's success in *Deans Knight*, we question why Finance is focused on adding a novel economic substance test rather than on clarifying Parliament's underlying rationale in enacting relevant tax provisions.

The New Economic Substance Test

Bill C-59 implements several amendments to GAAR. One change is a new preamble. The preamble appears to be a simple reiteration of the SCC analytical framework described above, along with a welcome confirmation that the new GAAR will not prevent taxpayers from obtaining tax benefits contemplated by Parliament. This may suggest that the *Duke of Westminster* principle is still alive and well (*IRC v. Westminster (Duke)*, [1936] AC 1 (HL)). Another bedrock tenet of our tax system—the need for certainty—has also, reassuringly, found its way into this new preamble. All of this is quite reassuring, until we go down the rabbit hole of "economic substance."

On December 16, 2021, Prime Minister Trudeau gave the minister of finance a specific mandate to modernize the GAAR

regime to focus on economic substance. The intention to fight abusive tax avoidance was clear in the mandate letter, but the rule-of-law values such as certainty, predictability, and sound judicial administration were, arguably, not given much weight. Under new subsection 245(4.1), the fact that an avoidance transaction is "significantly lacking in economic substance" (SLES) will be an "important consideration" that will "tend" to indicate abusive tax avoidance. Although the test has been modified from an earlier draft (which had elevated the effect of SLES to a rebuttable presumption), much less has been done to address the other concerns initially raised by the tax community, such as the (perhaps unintended) shift in focus from the OSP of ITA provisions to the taxpayer's intention. (See, for example, these articles by Jinyan Li and Fournier and Kutyan.)

The meaning of the expression "significantly lacking in economic substance" is outlined in new subsection 245(4.2), which provides a non-exhaustive list of factors that may establish (or tend to indicate) that a transaction is SLES. From a litigator's perspective, these new provisions will undoubtedly lead to debates, focusing on how to interpret the ambiguous term "significantly" or on the weight to be given to the factors themselves. For example, what would be the threshold for considering a lack of economic substance to be "significant"? Assuming that the legislator's language is intentional, what are the circumstance in which a lack of economic substance can be considered insignificant? How should the courts make this determination?

These are only a few of the interpretive questions that the courts (and practitioners) will have to face, and the explanatory notes (ENs) published in November 2023 do not provide clear answers. The ENs are extensive, but the underlying policies remain unclear. ENs are intended to be used as extrinsic aids for the determination of the provision's underlying rationale. They are intended to provide guidance. But the examples provided in the ENs to illustrate SLES raise more questions than they answer. Fortunately, the ENs provide some guidance on implementation. They specify, for example, that SLES, as a general matter, is to be evaluated on the basis of the overall series of transactions. In our view, however, the economic substance test and the corresponding ENs fail to provide sufficient certainty concerning the intended scope of these new measures, and they fall short of their larger objective. We would argue that Finance's goal of enhancing GAAR's effectiveness would have been better served if the significant qualifier and the list of factors had not been included in the ENs.

Arguably, only one thing is for certain: Finance has made economic substance explicitly *relevant* to the determination of the abusiveness of transactions. This raises a question, however: Given the extensive body of GAAR jurisprudence, did the GAAR framework require the addition of a specific consideration for economic substance? We would argue that it did not: courts have historically recognized, implicitly or explicitly, that the "vacuity and artificiality" of transactions confirm their abusive nature (see, for example, *Mathew*, 2005 SCC 55, at paragraph 62). The government's own explanatory notes (June 1988) to the original version of GAAR were abundantly clear: subsection 245(4) recognized that the provisions of the ITA were intended to apply to transactions with "real economic substance, not to transactions intended to exploit, misuse or frustrate the Act to avoid tax" (at 464). We question whether it was Finance's original intention that GAAR apply beyond the proverbial "rabbit out of the magician's hat" types of transactions, such as the basis-shifting transactions that were ruled abusive in *Global Equity* (2012 FCA 272).

Unfortunately, the ENs fall short of clarifying whether the new economic substance test is meant as a reiteration of the position set out in the jurisprudence or as something more. Finance did assert that, historically, too little weight had been given to economic substance and that the SCC had established a limited role for it. But where will this perspective lead us? Won't a new emphasis on economic substance encroach on our longstanding form-based approach to tax law?

The Slippery Slope

As the SCC mentioned in *Canada Trustco*, the term "economic substance" may be open to different interpretations. Without a clear definition of the term in Canadian law—and given the uncertainty regarding the intended scope and purpose of the amendments to the traditional GAAR framework—the courts and tax practitioners might be tempted to canvass how other jurisdictions have defined and interpreted the doctrine. Such an exercise is problematic, however, to say the least.

The "economic substance" doctrine in the United States, for example, generally applies only where the economic realities of a transaction are insignificant in relation to the transaction's tax benefits. In fact, the United States specifically codified its definition of "economic substance" back in 2010, under section 7701(o) of the Internal Revenue Code of 1986. That provision states that a transaction shall be treated as having economic substance only if it changes in a meaningful way the taxpayer's economic position and the taxpayer has a substantial purpose for entering into that transaction.

Another, more important consideration is that the US economic substance doctrine is known to borrow heavily from both the "business purpose" and "substance over form" doctrines. Bittker and Lokken go further in *Federal Taxation of Income, Estates and Gifts*, highlighting the fact that "the substance over form and business purpose concepts are closely related and have effectively coalesced in some cases, developing an economic substance doctrine." Nonetheless, these two doctrines have been interpreted, for the most part, as being distinct, and both (separately or together) can be raised in the United States (which has no statutory GAAR) to deny a tax benefit.

Under the business purpose doctrine, a transaction must have a bona fide non-tax business purpose in order to be respected for income tax purposes. So far so good. On the other hand, under the substance-over-form doctrine, the form or title given to a transaction by a taxpayer can be put aside in a determination of the resulting tax consequences. The substance-over-form doctrine thus allows US courts to look to the objective economic realities of a transaction rather than to the particular legal form that the parties employed (see *Lazarus*, 308 US 252 (1939), at 255; *TIFD III-E, Inc. v. US*, 459 F 3d 220 (2d Cir. 2006); and *Frank Lyon Co. v. US*, 435 US 561 (1978), at 573).

Even when a transaction is said to have economic substance, US courts may nonetheless reject a taxpayer's transactions under the substance-over-form tax doctrine (see *TIFD III-E, Inc.*). These particularities of the American economic substance test can only lead to a very slippery slope that will inevitably end with the substance-over-form doctrine being imported into Canada—a doctrine that has consistently been rejected in Canadian courts in such key SCC decisions as *Stubart* ([1984] 1 SCR 536) and *Shell* ([1999] 3 SCR 622). Once Canada, through the GAAR amendments, incorporates an unclear economic substance test into the ITA, it is inevitable, in our view, that Canadian courts will begin looking to US developments.

Although Finance stated, in the 2023 federal budget, that the new economic substance provisions "would not supplant the general approach under Canadian tax law, which focuses on the legal framework of an arrangement," no other formal reassurance has been provided to confirm the primacy of a transaction's legal substance—beyond the extensive body of established GAAR jurisprudence stating that the legal form of a transaction must not (in the absence of sham) be ignored in favour of its presumed economic substance. (See, for example, *Continental Bank*, [1995] 2 SCR 298.) Another noteworthy consideration is that the current state of the Canadian GAAR jurisprudence does not support the view that one may look at the beginning and the end of a series of transactions and ignore intervening transactions on the basis of a presumed doctrine of economic substance. Longstanding and inherent principles of the Canadian tax system should not be ignored or relinquished because a new legislative principle has been enacted. Our view is that, despite the ENs' lack of clarity and the ambiguity of the Bill C-59 changes, Finance's intention in modernizing and strengthening GAAR was not to dismantle 30 years of tax-related case law.

Accordingly, we urge that the new economic substance test be interpreted in light of the already established Canadian case law, where form matters (*Friedberg*, [1993] 4 SCR 285) and where substance is not synonymous with effect. ■

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