PERSPECTIVES ON TAX LAW & POLICY

Editor: Jeffrey Trossman

Volume 3, Number 2, June 2022

The Inevitability of Tax Avoidance

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This issue of *Perspectives* addresses the reform of Canada's anti-avoidance framework. The articles that follow present diverse perspectives on potential reforms to anti-avoidance provisions in the ITA, including the general anti-avoidance rule (GAAR) and specific anti-avoidance rules (SAARs).

In this introductory article, I comment briefly on the failure of GAAR to fulfill its originally intended purpose. As explained below, it is my view that modifications to the wording of GAAR (or, for that matter, to transfer-pricing rules or treaty anti-avoidance rules) are likely to have little effect on corporate tax avoidance in the Canadian domestic and transnational spheres. A more principles-based approach to drafting tax legislation would be preferable.

Legislative Background

Canada enacted GAAR (section 245 of the ITA) in 1988. A key moment in the tax reform discussions that preceded the introduction of GAAR was the shift away from judicial anti-avoidance doctrines, which were based mainly on business purpose, to a more sophisticated framework whereby transactions are excluded from the ambit of GAAR if they do not involve a "misuse" or "abuse" of the relevant provisions (subsection 245(4)). While the last 25 years have seen interesting disputes over the meaning of "tax benefit," "avoidance transaction," and "series of transactions," the greatest challenge has been and continues to be the interpretation of "misuse" and "abuse." Interpretive guidance has been provided by the SCC, most notably in *Canada Trustco* (2005 SCC 54) and *Copthorne* (2011 SCC 63). This guidance has, however, been notoriously difficult to apply to sophisticated tax-avoidance arrangements, including those involving Canadian corporations and multinational enterprises.

Recent Government Proposals

The 2022 federal budget sets out several important proposals to update GAAR and to address perceived inappropriate tax avoidance, focusing especially on large multinational enterprises. First, the 2022 budget proposes to expand the meaning of "tax benefit" and "tax consequences" in subsection 245(1) such that GAAR can apply to transactions affecting tax attributes that have not yet been realized in computing tax payable, overriding the decision of the FCA in *Wild*, sub nom. *1245989 Alberta Ltd.* (2018 FCA 114). This change was widely expected and is largely a matter of timing and efficiency in the audit, assessment, and appeal process.

Of greater interest is the statement, in the 2022 budget, that the government intends to release a broader consultation paper on "modernizing" GAAR, with a consultation period running through the summer and with legislative proposals to be announced by the end of 2022. The intention to modernize anti-avoidance rules was previously indicated both in the 2020 fall economic statement, which stated that updates were "essential to the integrity of the tax system" and must be sufficiently robust to address "sophisticated and aggressive tax planning," and in the 2021 federal budget, which stated that the government would take "next steps to strengthen and modernize" GAAR. The possible GAAR reforms—which could include, among other things, modification of the "avoidance transaction" purpose test in subsection 245(3), additional guidance on the "misuse" and "abuse" inquiry in subsection 245(4), or both—were considered at length in last year's CTF book on GAAR, edited by Brian Arnold, *The General Anti-Avoidance Rule: Past, Present, and Future*. Some of these potential reforms are addressed in the other articles in this issue.

In a related development, the 2022 budget also proposed international tax measures that would facilitate the imposition

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of a 15 percent global minimum tax on large multinational enterprises, in line with the OECD "pillar 2" proposals. These proposals should be read in conjunction with earlier concerns expressed in the 2020 fall economic statement regarding taxpayers "shifting profits offshore" and in the 2021 budget regarding perceived deficiencies in Canada's transfer-pricing rules. Although these proposals are related to the reform of anti-avoidance rules, they are outside the scope of this issue of *Perspectives*.

What the Government Sees as an Unsatisfactory Interpretive Approach

Early concerns expressed by some commentators about GAAR being overly broad have, for the most part, been assuaged by the restrictive stances taken by the courts in the last 25 years. Of course, those who expected a statutory GAAR to do more to counteract aggressive tax avoidance have been disappointed. It is clear from the budget proposals mentioned above that Finance believes there are deficiencies in GAAR, or in the way that it has been judicially applied, that go beyond the meaning of "tax benefit." At the same time, some taxpayers and advisers believe the "misuse or abuse" test frequently amounts to a "smell test," making it notoriously difficult to predict outcomes.

The long history of judicial approaches to GAAR is beyond the scope of this article; this history has been examined in detail by others, including David Duff (in chapter 16 of the CTF book on GAAR, cited above). It is worth summarizing how courts have said that they must approach the critical element of misuse and abuse in determining whether GAAR applies to an avoidance transaction.

In *Canada Trustco*, the SCC observed that the determination of the "object, spirit or purpose" of the provisions relied on must follow from a "unified textual, contextual and purposive" (TCP) analysis of those provisions, which appeared (at the time) to be equivalent to the interpretive approach applied in any statutory interpretation. In *Copthorne*, however, the SCC stressed that there is a difference between the TCP approach employed in ordinary statutory interpretation and what we might call an enhanced interpretive approach required by GAAR, whereby a court is required to determine the object, spirit, or purpose of the provisions relied on. The SCC in *Copthorne* stated (at paragraph 70) that, although the meaning of the text may be clear, the search in a GAAR analysis "is for the rationale that underlies the words that may not be captured by the bare meaning of the words themselves." What this seems to mean is that greater emphasis should be given to context and purpose in a GAAR analysis than in an analysis governed by the standard TCP approach, which gives greater emphasis to text. The difference is subtle but has been reiterated in *Alta Energy Luxembourg SARL* (2020 FCA 43; aff'd 2021 SCC 49) and *Loblaw Financial Holdings* (2020 FCA 79; aff'd 2021 SCC 51). This approach also seems to underlie the recent decision of the FCA in *Deans Knight Income Corporation* (2021 FCA 160; leave to appeal to the SCC granted March 10, 2022).

Although the distinction between the standard TCP approach and the enhanced approach under GAAR is sound, I question whether the greater emphasis on context and purpose is actually realized in most litigation involving GAAR, except, perhaps, in cases involving the manipulation of tax losses or other tax attributes (such as *Mathew*, 2005 SCC 55, *Deans Knight*, and *Copthorne*), where the courts have been more willing to accept that an underlying policy against loss or attribute trading exists. In other areas, including surplus stripping, debt dumping, and treaty shopping, the enhanced interpretive approach seemingly required by GAAR has tended to produce a largely textual interpretation.

The following statements made by Boyle J in *Collins & Aikman* (2009 TCC 299, at paragraph 59; aff'd 2010 FCA 251) regarding an alleged surplus-stripping arrangement—variations of which have frequently been challenged under GAAR—are illuminating:

> In essence, the most significant part of this analysis is the determination of what is the scheme of the *Act* applicable to corporate distributions. Is the scheme of the *Act*, as maintained by the Crown, that corporate distributions are to be included in income except where specific provisions of the *Act* provide otherwise in particular circumstances or to a particular extent? Or does the scheme of the *Act*, of which subsection 84(4) forms part, provide that (i) dividends distributed by corporations are included in income except in circumstances where, or to the extent that, the *Act* provides otherwise, and that (ii) distributions to shareholders by corporations other than by way of dividend are included in income to the extent only that they exceed the shareholders' paid-up capital in those shares, subject to specific rules which provide otherwise in certain circumstances or to a certain extent?

Boyle J rightly observed (at paragraph 60) that the "difference between these two competing schemes is that in the Crown's mind this scheme begins from an *unstated premise not vocalized in the language of the Act* that corporate distributions are income." (Emphasis added.) Referring to the direction from *Canada Trustco* that courts must employ a unified TCP interpretation of the relevant provisions, Boyle J stated that the taxpayer's interpretation of the statutory regime applicable to corporate distributions was to be preferred. The FCA agreed with this approach to interpreting subsection 84(4) and dismissed the Crown's further argument that there had been an abuse of section 84.1 or 212.1.

The essence of this view is that the relevant statutory provisions were drafted with great precision—they say what they say—and that, accordingly, they lack an identifiable policy foundation beyond what the text dictates. In particular, I do not see how one can read through the labyrinth of section 84.1—one of the key surplus-stripping rules in the ITA—and come to any other conclusion. If provisions are drafted this way,

then in my view it makes no difference whether one undertakes a standard TCP approach to interpreting legislation or undertakes an enhanced interpretive approach under GAAR; it does not matter whether the purpose of provisions is given less or more emphasis if no purpose can be discerned.

Adopting the passage from *Collins & Aikman* quoted above, one could tenably pose similar questions regarding the proper interpretation of other provisions of the ITA:

- In *Deans Knight*, for example, one could ask: Does the scheme of the Act begin from an *unstated premise* that a corporation's losses should not be accessible to arm's-length parties, except where specific provisions such as subsections 111(5) and 256(7) provide otherwise in particular circumstances? Or does the scheme of the Act, of which subsection 111(5) forms a part, provide that such losses are available in specific circumstances and are unavailable in other specific circumstances? (In the case of *Deans Knight*, I anticipate that the unstated premise will probably be accepted by the SCC.)
- In *Alta Energy*, one could ask: Does the scheme of the Canada-Luxembourg treaty begin from an *unstated premise* that tax treaties are intended to encourage investment from persons resident in the other contracting state, but that only persons who are substantially integrated in the economic life of a contracting state, and are not "conduit" entities, should be able to access treaty benefits, including the benefits provided under article 13? Or does the scheme of the treaty, of which article 13 forms a part, provide that certain treaty residents realizing certain capital gains qualify for exemption in specific circumstances and are subject to taxation in other specific circumstances? (In this case, the unstated premise was rejected by a majority of the SCC.)
- Finally, if *Loblaw Financial* had turned on GAAR, one could ask: Does the scheme of the Act begin from an *unstated premise* that the passive or base-eroding income of a controlled foreign affiliate should be taxed on an accrual basis, except where specific provisions such as paragraph 95(2)(a) provide otherwise? Or does the scheme of the Act, of which subsection 95(2) forms a part, provide that certain passive or base-eroding income qualifies for exemption in specific circumstances (such as where the foreign affiliate is a qualifying foreign bank) and is subject to accrual taxation in other specific circumstances? (Here again, although *Loblaw* was not a GAAR case, it seems that the unstated premise would probably not have been accepted by the SCC.)

The reader could, no doubt, imagine numerous other examples. In the absence of principles-based legislation providing guidance, it is easy to see why taxpayers, advisers, and judges will prefer the relative certainty and predictability of the latter interpretation in each case.

Are New Solutions Possible?

The SCC observed in *Canada Trustco* (at paragraph 13) that the ITA is "an instrument dominated by explicit provisions dictating specific consequences, inviting a largely textual interpretation," on which a rather different provision—GAAR—is imposed. Perhaps it is time for the government to consider an evolution toward more principles-based legislation in income tax, thus creating a bridge between excessively prescriptive legislation and nebulous anti-avoidance rules. This could include a new approach to legislative drafting that clearly spells out the object, spirit, and purpose of specific provisions.

Although this evolution might not obviate the need for a GAAR, it would mean that "unstated premises" become stated premises, providing a lens through which the specific provisions in a particular portion of the ITA should be viewed. For example, if *Deans Knight* is overturned by a majority of the SCC, would it not be better to reconsider and revise the loss-restriction rules to state, in principle, what they are trying to achieve, rather than tinkering with the wording of GAAR (or related loss-restriction provisions, such as section 256.1) to deem control of a corporation to be acquired in certain circumstances and to a certain extent?

The typical argument raised against principles-based legislation is that the approach is too vague, lacking the certainty and predictability that taxpayers and their advisers deserve. However, as John Avery Jones (1996) and others have argued, principles-based legislation, when properly designed, can provide *more* clarity rather than less to taxpayers, revenue authorities, and courts. One way of achieving this greater clarity is through better explanatory notes by Finance, which state clear principles and set out examples that follow from those principles. Adopting such principles in the legislation itself would be even better. Principles-based legislation forces government to think as cohesively and as neutrally as possible in setting out the relevant principles—a pressure that, one hopes, would lead to a better tax system.

Conclusions

Consultations on improvements to GAAR, as well as to Canada's transfer-pricing rules and international tax regime more generally, are welcome. While the OECD may push Canada toward a rationalization of our international tax rules for the largest multinational enterprises, improvements to the anti-avoidance frameworks that apply to most taxpayers will have to come from within Canada. A complete overhaul of the ITA to implement principles-based legislation is not going to happen. However, attempts at the rejuvenation of key portions

of the ITA to incorporate a principles-based approach are worth considering.

Indeed, some early signs of evolution in this direction can already be seen in recently enacted or proposed measures to implement OECD standards. Examples of this movement include subsection 270(2) of the ITA (requiring the "common reporting standard" provisions to be interpreted consistently with the OECD report) and the proposed "hybrid mismatch" rules (which similarly require that the technical provisions be interpreted consistently with the relevant OECD report).

Moving, even slowly, to a more principles-based approach would be preferable to our continuing paradigm of excessively detailed provisions overlaid with vague anti-avoidance rules. ■

SAARs: Help or Hindrance to GAAR?

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The role of specific anti-avoidance rules (SAARs) in relation to GAAR has long been a vexing question. Shawn Porter's chapter on the subject ("The Relationship Between the General Anti-Avoidance Rule and Specific Anti-Avoidance Rules," in *The General Anti-Avoidance Rule: Past, Present, and Future* (2021)) is an excellent exploration of the relevant considerations. Porter reviews extensive jurisprudence involving the interaction of GAAR with SAARs and concludes that they play complementary roles in constraining tax avoidance.

Following the publication of Porter's chapter, the SCC decided *Canada v. Alta Energy Luxembourg SARL* (2021 SCC 49), a case that addressed tax avoidance through treaty shopping. In the reasons of Côté J, writing for a majority of six justices, and those of Rowe and Martin JJ, writing for the three dissenting justices, we find quite different views of how the "abuse" test in GAAR should be interpreted in the presence or absence of a relevant SAAR. Because the case involved alleged abuse of the 1999 bilateral Canada-Luxembourg tax treaty, the court emphasizes the contractual nature of the treaty and the intentions of the two governments when they entered into the treaty.

In this article, we review the contrasting approaches in *Alta Energy* to the interaction of SAARs and GAAR, and comment on some implications for the drafting of SAARs going forward.

Alta Energy: Majority Reasons

In determining that GAAR did not apply, the majority states (at paragraph 2) that GAAR acts as a "legislative limit on tax certainty by barring abusive tax avoidance transactions, including those in which taxpayers seek to obtain treaty benefits that were never intended by the contracting states." This intention "is found by going behind the text of the provisions under which a tax benefit is claimed in order to determine their object, spirit, and purpose."

A key question is how far behind the text of a particular provision a court should go to determine the provision's object, spirit, and purpose. In *Alta Energy*, the inquiry focused on the treaty parties' intentions as to who should—and who should not—be entitled to rely on the treaty's capital gains article. The majority searched for a relevant SAAR in the treaty itself and noted the absence of any applicable one. The majority found (at paragraph 82) that the absence of a SAAR represents "an enlightening contextual and purposive element as it sheds light on the contracting states' intention." The majority inferred that, because there was a SAAR denying treaty benefits to certain defined Luxembourg holding companies but no SAAR denying treaty relief to conduit companies in general, it was intended by the treaty parties that other companies with limited economic ties to Luxembourg *could* claim treaty relief. The majority found that there was no abusive tax avoidance because the contracting states' intentions were consistent with the capital gains exemption being available to the taxpayer. As a result, GAAR did not apply.

The majority reached this conclusion even though Canada's domestic tax law included GAAR in 1999, when Canada and Luxembourg entered into the treaty. Furthermore, any doubt as to whether GAAR applied to treaties was addressed in 2005, when the rule was retroactively amended to expressly provide for this. This amendment suggests that GAAR's potential application was known to and understood by the parties.

The majority's reasons raise the question of whether GAAR can apply in the absence of a relevant SAAR. The majority acknowledges (at paragraph 82) that the absence of SAARs that would have prevented the situation is not necessarily determinative of the application of GAAR; if that were the standard, it would provide a full response in every case and gut GAAR. However, the majority found that, in this case, Canada and Luxembourg made a deliberate choice to guard some benefits against conduit corporations and to leave others, such as the business property exemption, unguarded.

The majority held (at paragraph 96) that "[t]he courts' role is limited to determining whether a transaction abuses the object, spirit, and purpose of the specific provisions relied on by the taxpayer. It is not to rewrite tax statutes and tax treaties to prevent treaty shopping when these instruments do not clearly do so."

To summarize, the majority seemed particularly concerned that well-known avoidance arrangements involving conduit Luxembourg companies held by residents of other countries were not specifically dealt with in the treaty. The absence of a SAAR that addressed the planning was considered instructive; presumably, the inclusion of a SAAR might have assisted the court in determining the underlying rationale of the relevant provisions. Less clear is how a SAAR would have informed context and purpose if the SAAR did not precisely address the planning at issue.

Alta Energy: Dissenting Reasons

The dissenting reasons present quite a different view on the relevance of the presence or absence of SAARs to the application of GAAR (at paragraph 141):

> Since not every tax avoidance strategy can be foreseen, the effectiveness of specific provisions is limited to Parliament's ability to anticipate such schemes. For this reason, those provisions cannot completely thwart inappropriate tax avoidance. . . . Before the inception of the GAAR, the increased use of complex tax avoidance schemes and matching responses to curb them left taxpayers with the expectation that purely tax-motivated transactions that were inconsistent with the rationale of the provisions relied upon were acceptable as long as they are not targeted by specific legislation.

GAAR was meant "to reduce the burden of having to perpetually address abusive schemes with specific legislation matching each newly marketed 'purely tax-motivated scheme' " (paragraph 142). The dissent refers to the Department of Finance's 1988 explanatory notes that accompanied the introduction of GAAR, which stated that it was to apply "as a provision of last resort *after the application of the other provisions of the Act, including specific anti-avoidance measures*." (Emphasis added by dissent.)

The dissenting opinion concludes that the minister was entitled to rely on GAAR, rather than negotiate a SAAR to include in the treaty. It rejects the view that if the contracting parties meant to include an anti-avoidance provision within the treaty, they would have done so expressly, noting (at paragraph 143) that "[t]his very reasoning was unanimously rejected by [the] Court in *Copthorne* [2011 SCC 63]."

The dissent states (at paragraph 150) that if this view were accepted, GAAR would be prevented from applying in any case of abuse not already specifically addressed through SAARs, which would be inconsistent with GAAR's role as an anti-avoidance rule of last resort:

> In our view, no inference can be drawn from the absence of an anti-avoidance rule designed to counter the particular scheme employed in this case. To do so would be inconsistent with the role of the GAAR relative to other anti-avoidance tools. It would also be patently contrary to this Court's repeated holding that the GAAR is a provision of last resort, and can only find application where no other provisions of the Act do. . . . Thus, the absence of [a] specific anti-avoidance rule in the relevant provisions of the Treaty sheds little light on their underlying rationale.

The dissent notes that GAAR itself is the legislative response to abusive avoidance planning. The presence of GAAR is precisely what makes it unnecessary to introduce SAARs each time an abusive tax-planning technique is uncovered. The attention of the courts in an anti-avoidance analysis should be firmly focused on whether there has been abusive tax avoidance. The court must determine the underlying rationale or legislative purpose of the relevant provisions and assess whether the transaction or arrangement under review frustrates, defeats, or circumvents that purpose. The rationale or legislative purpose of a provision or regime in the Act can be determined notwithstanding the presence or absence of a relevant SAAR. As the dissenting reasons noted, the mere absence of a SAAR "sheds little light" on the true underlying rationale of the relevant provisions.

Implications for Drafting SAARs

How could the majority opinion in *Alta Energy* inform the drafting of SAARs going forward? While the presence or absence of a SAAR may shed some light on the legislative intention of particular provisions, some SAARs are narrowly focused and do not fully explain the underlying rationale of the related provisions or of the SAAR itself. As a matter of statutory interpretation, courts should generally not need to look for SAARs to inform the GAAR analysis. This is consistent with the views expressed at the time of GAAR's introduction, to the effect that many SAARs would no longer be necessary and that there should be a limited role for SAARs in the future. Indeed, an important intended consequence of the enactment of GAAR was to relieve Parliament of the need to constantly identify developments in tax planning and the practice of "legislation by press release" that had developed.

That said, it has been noted by more than one commentator that notwithstanding the introduction of GAAR, the number of SAARs in Canadian tax legislation has continued to increase. Post-*Alta Energy*, it might be expected that drafters of tax legislation will take note and carefully consider adding SAARs whose terms articulate the purpose of the legislative scheme in which the SAARs reside, rather than (or in addition to) setting bright-line tests. Legislative language that conveys the underlying rationale of the SAAR may facilitate courts' analysis of whether that underlying rationale has been undermined.

Legislative drafters might consider developing SAARs that incorporate a combination of approaches. Consideration could be given not only to describing legislative purpose but also to incorporating objective tests, providing express interpretive guidelines, and requiring that a realistic view of the arrangements be taken. For example, recently released draft "hybrid mismatch" rules refer specifically to the relevant OECD action report as a guideline for the interpretation of these rules. This approach parallels similar references in the "common reporting standard" rules in subsection 270(2) of the Act. This type of SAAR may be less susceptible to being circumvented by arguments of "implied exclusion"; it may also provide a court with the "enlightening contextual and purposive element" by shedding light on the legislator's intention. SAARs of this

type may also offer taxpayers clearer guidance in planning their affairs.

A slightly different approach is found in the recently released draft legislation to implement limits on interest deductibility—the excessive interest and financing expenses limitation (EIFEL) rules—which provides similar interpretive guidance in the technical notes.

SAARs that adopt this broader approach may amount to what could be termed "specific general anti-avoidance rules" within particular regimes in the Act, albeit without the abusive avoidance saving provision found in subsection 245(4). A longstanding example of this approach can be found in subsection 103(1), which deals with the allocation of partnership income. In *594710 British Columbia Ltd.* (2018 FCA 166), the FCA noted that, on the facts, the minister may not have had to resort to GAAR because subsection 103(1) appeared to apply on its own. The draft hybrid mismatch rules similarly include a SAAR (proposed subsection 18.4(20)) designed to address planning where one of the main purposes of the planning is to avoid or limit the application of the rules. The introduction of "specific general anti-avoidance rules" may support GAAR in challenging abusive tax planning by reinforcing the underlying rationale of the operative provisions.

The debate over the role of SAARs in relation to GAAR undoubtedly will continue to develop. For example, the recent submission of the Joint Committee on Taxation of the Canadian Bar Association and Chartered Professional Accountants of Canada with respect to the EIFEL rules stated that "there is nothing unique or special about the EIFEL rules to suggest that a code of specific targeted measures is necessarily to be preferred over placing reliance on [GAAR] . . . to address abusive planning." This is an interesting comment, given the views of the majority in *Alta Energy*. One hopes that further light will be shed on the interaction of SAARs with GAAR in the upcoming consultation on GAAR reform. ■

What Will Deans Knight Tell Us About GAAR?

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When the government announced, in November 2020, its intention to launch a consultation on "modernizing" GAAR, the reaction of many in the tax community was surprise. The CRA wins roughly half of the reported GAAR cases decided by the courts, and this statistic understates the agency's success in applying section 245, given how few taxpayers have the financial resources and risk tolerance to litigate a GAAR reassessment, irrespective of the merits. For the most part, the Crown seems to be winning the significant GAAR cases that it should be winning, along with some that it probably should not. So the government's concern is not clear.

Key Issue in GAAR Cases

The key question in most GAAR cases is whether an abuse or misuse has occurred. Answering this question requires an analysis of whether the taxpayer's transactions are inconsistent with the "object, spirit and purpose" of the relevant ITA provisions (*Copthorne*, 2011 SCC 63, at paragraph 66). The Crown bears the burden of establishing the object, spirit, and purpose of the provisions it alleges to have been abused. This is entirely logical, given the Crown's seemingly limitless resources, its easy access to the relevant legislative history, and its ability to reuse its work product in subsequent cases.

There is nothing about any of this that is unfair to the Crown or that places an unreasonable burden on it, any more than it is unfair for a taxpayer who has achieved a result clearly contrary to the statute's object, spirit, and purpose to be reassessed under section 245. GAAR represents a tradeoff between two worthy objectives: (1) curbing abusive tax avoidance and (2) allowing a reasonable degree of predictability in interpreting the ITA (*Canada Trustco*, 2005 SCC 54, at paragraph 61).

If the government is displeased with how the courts are interpreting and applying GAAR (a reasonable inference to draw from the proposed consultation), it is perhaps asking the wrong question in proposing to change the rules. The GAAR cases where the Crown has been unsuccessful have been mainly those where it was unable to clearly establish that the object, spirit, and purpose of the relevant provisions was what the Crown alleged it to be.

The Right Result: Alta Energy

Evaluating the effectiveness of GAAR requires distinguishing between (1) what the "right" result is according to the existing law and related interpretive aids, and (2) what the "right" result might be if we were rewriting the law from a different starting point (that is, from a tax policy perspective). Courts can reasonably be expected to deal only with the former. The SCC's most recent GAAR decision in *Alta Energy* (2021 SCC 49) provides an excellent illustration of this principle.

In *Alta Energy*, the taxpayer was a Luxembourg fiscal resident that sought the benefit of an exemption from Canadian taxation under the Canada-Luxembourg tax treaty. A majority of the court found (at paragraph 67) that the object, spirit, and purpose of the relevant treaty provisions were essentially as they read: to allow Luxembourg fiscal residents to claim the exemption, without regard to an unstated further condition (advanced by the CRA and found nowhere in the treaty itself) that any such Luxembourg resident have "sufficient substantive economic connections" to Luxembourg in order to claim treaty benefits.

One can reasonably assert that the standard for claiming treaty benefits *should* be higher than mere fiscal residence without significant home-country economic connection, although tax authorities have no problem accepting this as an adequate

basis for levying tax. Clearly, however, that is not what the treaty says, nor what Luxembourg believes the treaty says, and the government could not produce any supporting context or interpretive aids to persuade the majority that the treaty's object, spirit, and purpose included such an unwritten precondition for claiming benefits. Having not negotiated a treaty that said clearly what the government invited the court to infer the treaty said, the government could have amended the Income Tax Conventions Interpretation Act to say so. Alternatively, it could have produced its own treaty commentary with guidance to the same effect, or it could have threatened to terminate the treaty unless the wording was changed.

The government did none of these things, and ultimately the court declined to do for the government what the government wasn't willing to do for itself, on the good and proper grounds that what the court was being asked to do, in being asked to apply GAAR without the object, spirit, and purpose to support doing so, was not to interpret the treaty but rather to amend it. No one disputes that GAAR *can* apply to deny abusive claims for treaty benefits, but the lesson that the government should be taking from *Alta Energy* is that if it wants the courts to actually apply GAAR in this way, it needs to give them a stronger object, spirit, and purpose basis to work with.

Articulation of the Object, Spirit, and Purpose: Deans Knight

This takes us to the pending SCC hearing in the *Deans Knight* case (2021 FCA 160), in which the taxpayer was granted leave in March 2022 to appeal from the FCA's reversal of the TCC's decision. *Deans Knight* will be the sixth SCC decision on GAAR, and it is a critically important case for the tax community.

Deans Knight involves a corporation that had incurred significant losses. The shareholder entered into transactions designed to preserve bona fide business losses in anticipation of an initial public offering that would put new funds into the corporation, thus creating a new source of income against which the losses could be applied. The transactions were carefully structured to allow the existing shareholder to obtain value for its subsidiary's losses without triggering an "acquisition of control" within the meaning of the loss-restriction rules in subsection 111(5). The litigants agreed that no acquisition of control for this purpose had in fact occurred.

In a unanimous ruling, the FCA concluded that GAAR applied. The court held that the object, spirit, and purpose of subsection 111(5) is "to restrict the use of specified losses, including non-capital losses, if a person or group of persons has acquired actual control over the corporation's actions, whether by way of *de jure* control or otherwise" (at paragraph 72). The standard implied by the term "actual control" was described by the FCA as being different from the de jure control standard that subsection 111(5) uses, and as "includ[ing] forms of *de jure* and *de facto* control" (at paragraph 83).

The FCA stated that its basis for determining the object, spirit, and purpose of subsection 111(5) consisted of two "clear statements" of government intent:

- a 1963 statement by the minister of finance indicating that the statutory predecessor to subsection 111(5) was aimed at curbing a "practice [that] has developed of trafficking in the shares of companies whose businesses have been discontinued, but which technically have certain tax loss carry forward entitlements"; and
- a 1988 *Canadian Tax Journal* article by David Dodge, then a senior Department of Finance official, which was characterized by the FCA as stating that "one of the objectives of the GAAR was to deal with an erosion of tax revenues, including a large shortfall in expected tax revenues that 'was considered to be caused largely by the unexpected application of loss carryforwards.' "

The immediate issue before the SCC will be to determine the object, spirit, and purpose of subsection 111(5) and to decide whether the FCA's "actual control" articulation of it is accurate and, if it is accurate, what "actual control" means. The very limited bases cited by the FCA for its determination of the subsection's object, spirit, and purpose are a matter of serious concern when it comes to applying what is intended to be "a provision of last resort" (*Canada Trustco*, at paragraph 21), particularly because "the Minister must clearly demonstrate that the transaction is an abuse of the Act, and the benefit of the doubt is given to the taxpayer" (*Copthorne*, at paragraph 72). Very little light is shed on the object, spirit, and purpose of subsection 111(5) by two very dated "statements of government intent" and a reference to the SCC's statement in *Mathew* (2005 SCC 55) that "the general policy of the *Income Tax Act* is to prohibit the transfer of losses between taxpayers, subject to specific exceptions" (a transfer that did not actually happen in *Deans Knight*, as it did in *Mathew*). The court's own analysis on this point will serve as a very helpful reference point for future analyses of object, spirit, and purpose.

Also of interest will be the guidance on what extrinsic aids are relevant in determining object, spirit, and purpose. It is unclear whether an article written by a Finance official (however senior) reflects government policy accurately enough to constitute a reliable basis for the analysis of object, spirit, and purpose. Indeed, the danger of relying on such semi-official authorities is shown by the fact that the article refers to an unexpected decline in tax revenues caused by loss carryforwards as a source of budgetary concern, but it does *not* state (as the FCA suggests) that abusive tax-loss transactions were either responsible for the revenue decline or a motivation behind GAAR.

It is hoped that the effect of subsequent amendments on the object, spirit, and purpose analysis will also be addressed. The Crown has advanced the argument that the object, spirit,

and purpose of subsection 111(5) includes a "continuity of shareholder interest" concept (*Deans Knight* [FCA], at paragraph 58). This seems hard to square with that provision's use of a de jure control standard (that is, votes irrespective of economics) that applies only when a new control person (or group) exists, as opposed to when the existing controller ceases to control. As the Crown itself acknowledged in its response to the taxpayer's leave application, the 2013 enactment of section 256.1 "renders 'high equity-low-vote' loss trading structures like the applicant's ineffective for transactions undertaken after March 20, 2013." It will be very interesting to see what inference the SCC draws from this subsequent legislative amendment when it considers the object, spirit, and purpose of subsection 111(5), because this appears to be new ground for the court in GAAR cases.

Recommendations for Reform

If the government believes that it's not winning the GAAR cases that it should, perhaps the answer for the government is not to amend GAAR but, rather, to do a better job of articulating the object, spirit, and purpose of the legislation it is drafting (and to do so, ideally, contemporaneously with that legislation). Given how many smart and dedicated people the government has working for it on the tax side, and given that the rest of us are simply looking to arrange our affairs with a reasonable degree of confidence (not necessarily absolute certainty) about what the rules are, this is not an unfair expectation. Finance could give greater insight into the rationale behind the words of a provision, and into how the pieces fit together into a scheme, by providing "extrinsic aids such as technical notes, writings, Hansard and enacting notes" (*OSFC Holdings*, 2001 FCA 260, at paragraph 63), along with model treaties and commentaries of the kind that the United States produces.

By doing so, Finance would give courts that are being asked to consider GAAR much more material to work with in undertaking an object, spirit, and purpose analysis—a prospect that should appeal to the government, given its onus of demonstrating the object, spirit, and purpose of the relevant provisions. Greater clarity regarding object, spirit, and purpose (1) makes it easier for the vast majority of taxpayers who want to stay on the right side of the line to do so, (2) makes abusive tax avoidance more difficult to sustain for those who do not, and (3) can only reduce the ever-growing time and expense spent on tax controversy. The return on investment from a greater effort on the government's part to articulate the object, spirit, and purpose of legislative enactments (including treaties) would be to everyone's benefit (including the government's own), and it would be a more productive exercise than amending a GAAR that already strikes a fair balance between those who collect tax and those who pay it. ■

Should Statutory Factors or Hallmarks Regarding Abuse Be Enacted?

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Few intellectual journeys are as precarious as navigating the vast, uncharted expanse that is GAAR. Countless advisers have pulled their hair out attempting to synthesize a workable analytical framework, and it is becoming increasingly difficult to provide clients with concrete guidance on how GAAR might apply to a given series of transactions.

This lack of certainty and predictability—"bedrocks" of tax law, according to the majority in *Alta Energy Luxembourg SARL* (2021 SCC 49)—invites the introduction of statutory factors or hallmarks (or both) into section 245 of the ITA. As one facing the prospect of practising tax law for another two-plus decades, I find a more rigorous analytical framework for GAAR to be attractive. There may be significant downsides to enacting such statutory criteria, however, including some that may be unexpected. In this article, I describe how the enactment of legislative factors or hallmarks might supplement GAAR, and suggest that, despite the potential shortcomings of such statutory criteria, a carefully selected list of factors would be a worthwhile addition.

Factors Versus Hallmarks

As an initial point, "factors" and "hallmarks" are fundamentally different. Factors encompass neutral characteristics relevant to a particular transaction or series—for example, the relationship between the parties, the duration of the arrangement, and its substantive or economic results. The criteria set out in *Happy Valley Farms Ltd.* (86 DTC 6421) for determining whether real estate gains are ordinary income or capital gains come to mind. No single factor demands a particular conclusion; rather, they collectively guide the analytical process.

Conversely, a hallmark connotes abuse (or, potentially, non-abuse). Examples include the presence or absence of artificiality, circularity of funds (commonly referred to, internationally, as "round trip financing"), and an accommodating or tax-indifferent party. The tripartite test adopted in *Peter Cundill & Associates Ltd.* (91 DTC 5543) for determining whether persons factually deal at arm's length serves as an example. The existence of any such hallmark indicates that the arrangement is abusive. Typically, however, the absence of such a hallmark does not positively indicate that abuse does not exist; that is, it's often a one-way street.

In essence, factors guide a court's analysis, while hallmarks direct a court's finding. Factors may increase consistency of analysis, but without promoting predictability of result. Conversely, hallmarks may increase certainty of outcome, but have little to no effect on the analytical process.

International Experience

Multiple jurisdictions have enacted a GAAR. Even non-governmental organizations (for example, the International Monetary Fund and the European Union) have promulgated draft GAARs for their members. Although not all GAARs include a misuse or abuse test, most still include statutory factors or hallmarks. Certain jurisdictions (such as Australia) have only factors, others (such as Poland) have only hallmarks, and others still (such as the United Kingdom) have both.

Critically, however, those other jurisdictions' tax regimes are fundamentally different from Canada's. Such differences arise from a multitude of factors, including the existence of foreign judicial doctrines, the prevalence of SAARs, and whether positions or views disseminated by the relevant tax authorities have any binding effect. Accordingly, the relevance of foreign GAARs and their portability into the Canadian landscape may be limited.

Nevertheless, provided that such differences are taken into account, the approaches and experiences of other countries may be instructive. One notable example is the United Kingdom. A relative newcomer (introduced only in 2013), the UK GAAR regime includes both factors (such as the existence of contrived or abnormal steps) and hallmarks (such as claiming a credit for foreign tax that is unlikely to be paid). The UK GAAR also focuses on instances of *abuse* rather than *avoidance*, hence its moniker as a "general anti-abuse rule." That subtle terminological shift arguably carries significant meaning, and reframing Canada's GAAR as an anti-abuse rule, so as to accurately reflect its purpose and intended target, may be beneficial. (The acronym wouldn't even need to change!)

For good or ill, economic substance—couched in phrases such as "commercial substance," "economic reality," or "substantive effects"—features heavily in international GAARs. Numerous jurisdictions mandate an examination of the dissonance, if any, between tax effects and economic consequences. The attractiveness of that test to revenue-raising authorities is clear, but it injects considerable uncertainty and imprecision into the analytical process. Drawing the line between acceptable and inappropriate deviations from economic substance (as, for example, Bill C-362 of the 42d Parliament, 1st session endeavoured to do) could prove exceedingly difficult, especially in the highly developed Canadian income tax regime. Consider, for example, tax-free intercorporate dividends and intergenerational farm/fishing property rollovers, both examples of carefully designed regimes which produce tax consequences that, by intention, deviate greatly from their economic effects.

Despite the abundance of foreign GAARs, their relevance is limited given Canada's distinct legislative, judicial, and administrative landscape. Nevertheless, incorporating the assistive aspects of those regimes into the Canadian landscape, without unduly fettering judicial discretion or fundamentally rewriting our GAAR, could be productive.

Purpose and Prudence

If statutory factors or hallmarks (or both) are to be adopted, delineating the purpose behind their enactment will be key. As discussed above, increasing analytical consistency may not go hand in hand with promoting certainty of result. Judges may desire factors that offer them an analytical road map without unduly limiting their discretion, whereas taxpayers and CRA personnel may simply want a better indicator of their chance of success.

In theory, legislative hallmarks that target transactions with certain key features, in order to expressly cast such transactions as abusive, are also possible. For example, section 245 could conceivably be amended to stipulate that the "manipulation of bankrupt status to reduce a forgiven amount" (to co-opt a recent "notifiable transaction") is prima facie abusive. In my view, however, that approach would be overly narrow, subject to backfiring (consider the possible application of the "implied exclusion" doctrine, or *expressio unius est exclusion alterius*), and capable, arguably, of upsetting the developed balance between the roles of the legislature and judiciary in the GAAR context.

The pros and cons of statutory criteria would also need to be carefully weighed. Greater consistency and predictability would be laudable and should permit advisers to provide their clients—whether taxpayers or the government—with more constructive advice. GAAR litigation would also likely be minimized or shortened. However, any legislatively enshrined factors or hallmarks could be unduly prioritized. Practitioners and jurists might focus excessively on the enacted factors while dismissing other relevant characteristics; similarly, the finding that a hallmark applies might be seen as determinative, which may not be the legislative intent (unless the hallmark has been elevated to a deeming rule). Uncodified factors or hallmarks could be cast aside as irrelevant, and a guidepost could be interpreted as a stop sign.

Statutory criteria might also have broader, unanticipated effects. Factors or hallmarks—which should, in principle, be relevant only to the second stage of the abuse analysis (that is, the determination of whether the "object, spirit, and purpose" of the relevant provision was frustrated)—might, in practice, inappropriately affect the object, spirit, and purpose determination in the first place. Statutory factors or hallmarks may become the lens through which object, spirit, and purpose are discerned. The two stages could thus blend together and become a self-fulfilling prophecy; courts could frame the object, spirit, and purpose analysis on the basis of whether or not the statutory criteria seem to be present, then rely on that conclusion to support a finding of abuse. One can envision factors or hallmarks also being inappropriately relied on in

the "tax benefit" and "avoidance transaction" analysis. Put simply, courts may find it difficult to resist elevating factors or hallmarks into convenient rules of thumb that dictate whether GAAR should apply.

In addition, certain factors or hallmarks may have an effect opposite to what is intended. "Economic substance," for example, means different things to different people. Instead of promoting efficiency and predictability, its inclusion as a criterion could lead to more time and energy being spent on divining its meaning, its relevant characteristics, and the competing factual indicia of its existence or non-existence.

Drafting Considerations

Apart from the general considerations outlined above, meticulous forethought would need to be given to the content of any specific statutory amendments. Otherwise neutral factors ("the parties' relationship") could be drafted in more directive tones ("whether the parties are under common control"). The criteria could be listed using language that is exhaustive (that is, "means") or inclusive (that is, "includes"), including in any subset lists (for example, "round trip financing means . . ."). Similarly, the object of focus—taxpayers (their actions or mindset) versus transactions (their purpose or effect) versus objective criteria (their existence or non-existence)—could result in materially different analyses and results. Deeming rules—either alone or as complements to broader factors or hallmarks—could also form a part of any amended statutory scheme, as could rebuttable presumptions.

Hallmarks or examples that illustrate what is *not* abusive could also be considered. Certain jurisdictions (such as South Africa) have financial de minimis thresholds; others (such as the United Kingdom) provide that transactions undertaken in accordance with published governmental guidance are not abusive. In Canada, the non-application of a SAAR (see Rothstein J's dissent in *Lipson*, 2009 SCC 1) or the presence of reasonable alternative transactions (as analyzed in *Univar Holdco Canada ULC*, 2017 FCA 207) could also be enshrined as indicators of non-abuse.

Implementation in Canada

In my view, factors should be incorporated into GAAR. As it stands, practitioners, government officials, and judges must navigate the windswept GAAR landscape with few guideposts—and even those shift with each new decision. Neither private taxpayers nor the minister should be disproportionately disadvantaged by the introduction of carefully drafted legislative factors. Even if perceived disadvantages arise, any negative effects would be ameliorated, at least in part, by an increase in certainty and predictability. A limited set of neutral factors would still leave the courts as ultimate arbiters—both in terms of the weight and meaning to ascribe to each factor, and whether they apply in any given case—but provide judges with greater support and guidance.

The enactment of hallmarks, on the other hand, would in my view be a step too far. No list could delineate all indicators of abuse, and the courts already create hallmarks judicially ad hoc (for example, using a SAAR for self-benefit, as in *Lipson*). Statutory hallmarks could usurp the role of judges and unduly fetter their discretion. In addition, overly broad hallmarks could negate legitimate tax planning and, separately, render the stage one abuse analysis meaningless.

In any event, the enactment of statutory factors or hallmarks (or both) deserves serious consideration in the current effort to "modernize" GAAR. ■

Reimagining the Determination of Abusive Tax Avoidance

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The application of GAAR turns on three issues: (1) whether a "tax benefit" results from the impugned transaction, (2) whether the transaction is an "avoidance transaction," and (3) whether the avoidance transaction is abusive.

In practice, most disputes focus only on the third issue: Is the transaction abusive? Despite the central importance of the "abuse" aspect of the GAAR analysis and the extensive case law that has considered GAAR since its enactment in 1988, the application of GAAR in many cases is still notoriously difficult to predict. In our view, this uncertainty is unacceptable and should be addressed through legislative reforms.

The Current Test for Abusive Tax Avoidance

In simple terms, the abuse test provides that GAAR will apply to a transaction only if "it may reasonably be considered" that the transaction would "result directly or indirectly" in a "misuse" of the provisions of the Act, the regulations, or a tax treaty, or in an "abuse" of those provisions, read as a whole. In a unanimous decision, the SCC held in *Canada Trustco* (2005 SCC 54) that the analysis of whether there has been misuse or abuse requires a two-stage process: first, one ascertains the "object, spirit and purpose" of the provisions relied on to obtain the tax benefit; second, one asks whether, on the facts of the particular case, the object, spirit, and purpose of those provisions was "defeated or frustrated."

In this analysis, the minister of national revenue has the burden of proving misuse or abuse; that burden is intended to be significant. As stated in *Canada Trustco,* the need for consistency and predictability in tax law means that GAAR should apply only when the "abusive nature of the transaction is clear." Although the court cited the (original) "double negative" language of subsection 245(4) to support these findings,

subsequent case law has shown that the (current) affirmative test in subsection 245(4) has not altered the judicial requirement that the minister establish a "clear" abuse. In two more recent SCC decisions (*Copthorne*, 2011 SCC 63, and *Alta Energy Luxembourg SARL*, 2021 SCC 49), the court reiterated that, in an analysis of abuse, "the benefit of the doubt is given to the taxpayer."

In practice, the abuse analysis is frequently won or lost at the first stage. Once the object, spirit, and purpose, or underlying rationale or policy, of the relevant provision is determined, it is usually readily apparent whether the transaction at issue defeats that rationale or policy. If the court agrees with the minister's perception of a provision's rationale, a finding of abusive tax avoidance generally follows. The outcome of most GAAR disputes therefore turns on proving the underlying rationale of the relevant provisions.

Does the Current Test Work?

The judicial directive that GAAR applies only when an abuse is "clear" seeks to balance the principles of certainty and predictability with the need to address abusive tax avoidance and ensure fairness in the tax system, which is already replete with SAARs. In *Copthorne*, a unanimous SCC cautioned that "determining the rationale of the relevant provisions of the Act should not be conflated with a value judgment of what is right or wrong nor with theories about what tax law ought to be or ought to do." This is an eloquent way of saying that a determination of whether abuse exists is a *legal* test, not a smell test.

The "clear abuse" standard should, in theory, limit GAAR's application to scenarios where any objectively reasonable taxpayer would conclude that its transactions were abusive. In practice, however, "clarity" has proven to be a subjective standard. In the absence of express statements of legislative intent (which are commonly absent), a taxpayer may view the object, spirit, and purpose of a provision completely differently than a tax auditor; courts are often left to determine the "clear" policy of particular provisions of the Act when two or more competing views of the policy may be supportable. In practice, the life of most GAAR disputes—from transaction to audit, to litigation, to court judgment—is dependent on the perceptions of individuals, including judges, rather than on objective legal standards. As Webb J stated in extrajudicial comments in 2018, "The problem is that clarity is often in the eye of the beholder. It is clear to each person writing a decision that what he or she is writing is the answer." (See "Judges' Panel," in the CTF's 2018 conference report.)

In practice, the "clear abuse" standard has not prevented judges from disagreeing with one another. Even at the highest levels of the Canadian judiciary, judges often have diverging views on the policy rationale of particular provisions and on whether there has been a "clear abuse." In *Alta Energy*, the SCC justices split 6-3 on whether there was a clear abuse of a policy of the Canada-Luxembourg tax treaty. In another SCC case (*Lipson*, 2009 SCC 1), seven justices provided three sets of conflicting reasons. Counterintuitively, a "clear abuse" may be found even where cogent judicial opinions are issued on opposite sides of the question.

Is Change Necessary or Desirable?

The application of GAAR requires a rigorous legal analysis, but an observer of GAAR cases could be forgiven for thinking that whether or not GAAR applies in a particular situation remains a judicial "smell test." It is our view that, while the "clear abuse" standard, in theory, strikes the appropriate balance, the practical application of this standard tilts the balance too far away from certainty.

Restraining abusive tax avoidance and preserving fairness in the tax system are important fiscal policies. However, these goals can be furthered through means that do not sacrifice certainty and predictability for taxpayers. Some contributors to a prior issue of *Perspectives* described how the lack of certainty in tax matters erodes trust between taxpayers and government, discourages business investment, and increases the burdens associated with tax litigation. This lack of certainty impairs the government's capacity to raise revenues. None of this is good for the broader economy. Businesses benefit from certainty and predictability, which enable them to accurately assess the tax implications of commercial transactions and to ensure that any tax-planning strategies they adopt are sustainable from a business perspective.

As confirmed in the 2022 federal budget, GAAR is intended to prevent abusive tax avoidance while not interfering with legitimate commercial and family transactions. It functions as a provision of last resort to prevent abusive tax avoidance not addressed by SAARs. In our view, these objectives can be met only if the tax authorities and taxpayers can reliably assess whether a particular transaction is "abusive" and therefore subject to GAAR. More certainty in this area would benefit taxpayers, government, and, ultimately, the Canadian economy as a whole.

A Proposal for Change

The SCC has repeatedly held that GAAR should apply only when it is clear that the object, spirit, and purpose of a provision has been frustrated. And yet GAAR has not really been limited to cases where a finding of abuse is beyond serious debate. In our view, legislative action is needed to codify the "clear abuse" standard. The statute should specify a more objective and predictable way of determining "clear abuse." This could be achieved if the legislation required a determination of whether the taxpayer's view of the underlying policy is objectively reasonable.

The statute should require an assessment of the reasonableness of the taxpayer's position regarding the relevant provisions'

policy rationale, rather than requiring a final legal determination from the court regarding the policy rationale of those provisions. The minister would still have the burden of pleading its theory as to the policy of the provisions alleged to have been abused, and of providing the evidentiary basis for that theory. However, the taxpayer would be permitted to argue that its transaction complied with a different view of the policy underlying the provisions relied on. So long as that different view is objectively reasonable, GAAR would not apply.

In assessing the reasonableness of the taxpayer's view of a provision's policy rationale, all evidence available to the taxpayer at the time of the transaction should be considered, including, for example, the explanatory notes accompanying the relevant legislation, and the contemporaneous commentary (academic and otherwise) on the legislation. As explained in *Copthorne*, the underlying rationale of a provision may in some cases be no broader than the text itself. In such cases, accordingly, a reasonable position of the taxpayer might be that the text of a provision is conclusive because the text reflects and fully explains the provision's policy rationale. Government and tax authorities would remain able to articulate clear purposes of legislation, and if such public announcements were available to the taxpayer at the time the transaction was implemented, courts could take such statements into account in assessing the reasonableness of the taxpayer's position.

An approach focused on the objective reasonableness of the taxpayer's view of the provision's policy would strike a more appropriate balance between supporting certainty and predictability on one hand, and, on the other hand, countering abusive avoidance so as to safeguard tax fairness. Taxpayers would be better placed to assess the potential for GAAR to apply to a transaction, and the court would uphold GAAR assessments only when the minister could show that the taxpayer's position is "unreasonable" and therefore "clearly" abusive. The approach proposed here is not intended to make it more difficult for GAAR to apply. Rather, a shift in focus to the reasonableness of the taxpayer's view of the provision's policy gives better effect to the judicial directive that GAAR apply only in the presence of a "clear abuse," determined through an objective lens. Although GAAR needs to be flexible in order to address unpredictable and aggressive tax avoidance, the goal of protecting the government's tax revenues is best served by a system where all parties can reasonably predict whether GAAR applies in a particular set of circumstances.

This approach reflects elements of the UK GAAR. The UK provision, styled as a general anti-abuse rule, includes a "double reasonableness" test: tax arrangements are "abusive" only if they are arrangements that "cannot reasonably be regarded as a reasonable course of action" in relation to the relevant tax provisions. The UK GAAR also includes a non-exhaustive list of legislatively enumerated criteria for the courts to consider in their determination of abusive tax avoidance. Some commentators have noted that under this safeguard (which has not yet been tested in the UK courts), the UK GAAR should not apply so long as the taxpayer has taken a reasonable course of action in relation to the relevant tax provisions. This suggests that the UK GAAR will apply only in the clearest of cases and thus will operate as a true provision of last resort (see Glen Loutzenhiser, "The United Kingdom's General Anti-Abuse Rule," in *The General Anti-Avoidance Rule: Past, Present, and Future* (2021)).

It is conceivable that a "reasonableness" approach of the kind we propose here could occur judicially, through the elucidation of the "clear abuse" standard already established by the SCC. But this is far from a certain occurrence. The government's recent announcement that it is proceeding with a consultation paper to "modernize" GAAR presents an excellent opportunity to codify the "clear abuse" standard through a reasonableness test. We acknowledge that the government's focus in the consultation is on strengthening GAAR so that it is sufficiently robust to address aggressive tax planning; however, a continuing ability to address the most abusive tax planning will also require, in our view, a focus on ensuring certainty and predictability for taxpayers.

Conclusions

Whatever changes may be made to GAAR, an undeniable need exists to balance the principles of certainty and predictability on one hand, and, on the other hand, the need to address abusive tax avoidance and ensure fairness in the tax system. Although the current judicial test requiring "clear abuse" should, in theory, strike the appropriate balance between these principles, it has proved to be a very difficult standard to apply in practice. Despite the courts' adherence to an objective legal test, value-based judgments may be unavoidable when Parliament's intent is not expressly stated.

The principles of certainty and predictability support the adoption of a modernized test for identifying abusive tax avoidance, in order to improve objectivity and lessen uncertainty. Under our proposed approach, courts would apply GAAR only when the taxpayer's position on a particular policy scheme in the Act is shown to be objectively unreasonable. Under our formulation, GAAR would truly function as a provision of last resort, applying only in the clearest of cases. Although GAAR must remain a flexible tool for the government to target tax abuse, greater legislative certainty about GAAR would increase taxpayer compliance, decrease litigation and its associated economic and administrative burdens, and, ultimately, contribute to a more collaborative relationship between legislators and taxpayers. ■

Designing a GAAR Penalty

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Since GAAR was introduced, there has been debate over whether it should be accompanied by a penalty. A penalty could enhance GAAR's deterrent effect by increasing the downside risk and changing taxpayers' cost-benefit analysis. At the same time, depending on how it is designed, a penalty could be unfair, owing to the inherent uncertainty regarding GAAR's application, particularly in the determination of whether a transaction is abusive.

Quebec introduced a GAAR penalty in 2009. Penalties are included in the general anti-avoidance regimes of other jurisdictions, too, including Australia, New Zealand, and the United Kingdom. The question of whether a GAAR penalty should be added to the ITA—and, if so, how it should be designed—will likely be canvassed in the government's upcoming GAAR consultation. In this article, we focus on the design of a potential GAAR penalty rather than on the question of whether such a penalty should be added in the first place. The latter question is considered in a recent chapter by Khashayar Haghgouyan ("Should the Application of the General Anti-Avoidance Rule Be Subject to a Penalty?" in *The General Anti-Avoidance Rule: Past, Present, and Future* (2021)).

When Should a GAAR Penalty Apply?

In general, penalties are imposed under the ITA when a taxpayer has engaged in unacceptable conduct, such as gross negligence. However, it is not inherently immoral for a taxpayer to engage in a transaction that complies with applicable technical provisions but is found to result in a misuse or abuse under GAAR. As noted by Rothstein J in *Copthorne* (2011 SCC 63, at paragraph 65), it would be inappropriate to regard "abuse" in this context as implying "moral opprobrium."

A penalty that applies automatically whenever GAAR applies seems inappropriate. Such "absolute liability" penalties typically apply to situations involving a failure to meet a clearly defined factual requirement, such as a failure to file a tax return by the date required. These conditions provide clear guidance on what conduct is acceptable, which justifies penalizing unacceptable conduct. The application of GAAR, in contrast, is often very uncertain, not only because the determination of "abuse" is inherently complex but also because of ambiguities in the existing legal landscape, and because of the potential shifts that may occur before a transaction is considered by the CRA or a court.

An automatic penalty would be unfair because taxpayers often have understandable difficulty determining whether a transaction that complies with the technical provisions of the ITA is considered to frustrate the underlying rationale of the relevant provisions. Such a penalty could also undermine the government's policy goals: if the application of GAAR automatically—without any judicial discretion—triggers a substantial penalty, courts might be more reluctant to apply the rule. Furthermore, if the CRA does not have any discretion to waive penalties, the settlement of disputes might be impeded.

An alternative approach would be to limit penalties to situations involving abusive tax avoidance that is particularly egregious. This approach would acknowledge the inherent uncertainty in the application of GAAR; taxpayers would be penalized only when their conduct is clearly unacceptable or egregious. Of course, the challenge then would be to draw a coherent line between acceptable and egregious.

The provision could specify certain factors or hallmarks of egregious conduct that would trigger the penalty. For example, the penalty could apply to filing positions that are similar to positions rejected by the courts in previous GAAR decisions. This kind of condition might have limited practical application, however, given the time needed to resolve a typical GAAR case. It would also be difficult to develop a comprehensive set of criteria that would trigger the penalty.

A better approach would be to establish a general standard for the application of the GAAR penalty that allows reasonable judicial (or CRA) discretion in the penalty's application to specific cases. A reasonableness standard could be used; for example, the penalty could apply where a taxpayer's filing position does not have a reasonable basis according to the state of the law at the time the filing position was taken. Many existing penalties have "due diligence" defences, which are typically based on the "reasonably prudent person" standard of care, and there is well-developed case law on the application of this test. A reasonableness standard for the GAAR penalty could serve an equivalent function, though the focus would be more on legal uncertainty than on factual matters.

Similar approaches have been taken elsewhere. Australia penalizes tax positions that are not reasonably arguable, and New Zealand imposes penalties for positions that are not "about as likely as not to be correct," as determined objectively at the time the position is taken—meaning that taxpayers must have a reasonable and credible argument supporting their position (see Craig Elliffe, "Policy Forum: New Zealand's General Anti-Avoidance Rule" (2014) 62:1 *Canadian Tax Journal* 147-64). Courts are well placed to evaluate the reasonableness of a taxpayer's filing position when they are determining whether GAAR applies. A reasonableness standard would reduce uncertainty by applying the penalty only when the application of GAAR is clear.

Another approach would be to apply the penalty when specified disclosure obligations are not met. This would be consistent with the goal of forcing better disclosure of aggressive tax-planning strategies, as illustrated by the legislative proposals relating to mandatory disclosure released on February 4, 2022. Quebec's GAAR penalty applies when GAAR

applies to a transaction, unless the transaction is reported under Quebec's mandatory disclosure rules, or the taxpayer has voluntarily reported the transaction.

The broad Quebec approach arguably requires disclosure of otherwise non-reportable transactions whenever there is any non-negligible potential for GAAR to apply. Since it is often unclear whether GAAR will apply to a transaction, it would be difficult for taxpayers to determine whether preventative disclosure is needed. This uncertainty seems unfair to taxpayers. It could also be counterproductive, because it may encourage the excessive preventative disclosure of large numbers of low-risk transactions. If the government is flooded with disclosures, the use of such disclosure as a risk-assessment tool may be hindered.

In our view, failure to disclose a transaction should not in itself trigger the GAAR penalty if the taxpayer was not otherwise required to make this disclosure. One promising approach would be to implement a penalty that combines a disclosure-based element with an element that targets egregious or unreasonable behaviour. For example, a penalty could be imposed when GAAR applies to a transaction and either

- the taxpayer failed to comply with a requirement to disclose the transaction under the mandatory disclosure rules, or
- the taxpayer did not have a reasonable basis for concluding GAAR was inapplicable.

GAAR depends on the treatment of a transaction under the applicable tax law, which taxpayers may not fully consider until they prepare their tax returns. The mandatory disclosure rules, however, generally apply on the basis of factual conditions that are known when a transaction is implemented. Accordingly, if a disclosure-based approach is adopted, it should be acceptable for the taxpayer to meet the disclosure requirement by making the requisite disclosure by its filing-due date for the relevant year, not the shorter deadline in the mandatory disclosure rules.

Finally, although Quebec may penalize advisers and promoters under its GAAR penalty, we believe that any federal GAAR penalty should apply only to the relevant taxpayer. The terms "advisor" and "promoter" are defined very broadly in the mandatory disclosure rules, and those rules should in any event be calibrated to provide sufficient deterrent effect.

How Much Should a GAAR Penalty Be?

The quantum of any GAAR penalty would likely be based, at least in part, on the amount of tax savings that would have been realized but for the application of GAAR. A similar approach was adopted in some foreign jurisdictions and in Quebec, where the penalty is 50 percent of the denied tax benefit. Governments may favour this approach because it provides a significant deterrent for large transactions without having an unduly punitive impact on smaller transactions.

It would be challenging to compute the penalty on the basis of the amount of the denied tax savings, because the quantification of these tax savings is not always obvious. The definition "tax benefit" includes any reduction, avoidance, or deferral of tax. Moreover, changes proposed in the 2022 federal budget would expand the definition to include the creation of valuable tax attributes. A $100 tax credit and a $100 paid-up capital increase are both tax benefits under this expanded definition, but the two obviously produce very different tax savings. A tax attribute might never be used, and even if it is used, the tax savings may be many years down the road. For these reasons, a GAAR penalty cannot simply be based on a percentage of the tax benefit; a more refined approach is needed.

Denied tax savings could be determined by comparing the tax consequences that are redetermined by GAAR "as is reasonable in the circumstances" with those that would arise if GAAR did not apply. In some cases, the denied tax savings will be clear and immediate. In other cases, it may be necessary to consider hypothetical transactions that the taxpayer might carry out in the future or might have carried out had GAAR not applied. For example, if the tax benefit is an increase in paid-up capital, the denied tax savings might be determined by comparing a future distribution of that paid-up capital with an alternative distribution that could not rely on that attribute, such as a deemed dividend, the tax treatment of which would depend on the tax profile of the shareholders at the relevant time. Even this could be unduly harsh, because a taxpayer might argue that it has not actually used the attribute and might never do so.

The distinction between current and future (or actual and hypothetical) tax savings should also be considered. Should a GAAR penalty apply to both types of denied tax savings on the same basis, without considering the time value of money? This could produce unfair results, particularly if the penalty is a large percentage of the denied tax savings and those savings could not have been realized for some time or, as a practical matter, might never have been fully realized. If future tax savings are discounted, determining the appropriate discount rate requires careful consideration, especially in inflationary times; prescribed rates used for other purposes are unhelpful, since these rates are not forward-looking. Similar timing issues arise where the tax benefit is a deferral of tax rather than a permanent tax saving.

There could also be a role for a fixed penalty. For example, the penalty might be equal to the greater (or lesser) of a fixed amount and an amount based on denied tax savings. The proposed amendments to the mandatory disclosure rules include a similar approach to computing the maximum penalties payable under those rules.

There is scope for overlap between any new GAAR penalty and the penalties provided under the mandatory disclosure rules. A GAAR penalty should focus on supplementing rather than duplicating the mandatory disclosure regime. Care should

be taken to integrate the penalty regimes under these rules in order to produce appropriate outcomes. In general, the same "fault" should not be penalized more than once.

Businesses penalized under Quebec's rules—in a marked departure from typical approaches to penalties under tax legislation—are disqualified from government contracts for a five-year period. This kind of blacklisting is inappropriate for a federal GAAR penalty. Blacklisting would be very random in its impact and unduly punitive. It improperly conflates misuse or abuse under GAAR with immoral conduct. Blacklisting could also deprive the public of the benefits obtained from full competition for government contracts.

Conclusion

The design of a GAAR penalty may be just as important as the decision whether to introduce a penalty in the first place. The core objective of any GAAR penalty should be to disincentivize abusive tax planning. A GAAR penalty may increase the "cost" of such planning and enhance the government's ability to detect it. It is important that any GAAR penalty not subject taxpayers to arbitrary or unfair punishment. A GAAR penalty that combines reasonableness and a disclosure exception could further the goals of deterring abusive tax planning and encouraging disclosure while providing a reasonable degree of certainty for taxpayers. Determining the appropriate quantum of the penalty is not straightforward. Challenges include determining the appropriate way to link the amount of denied tax savings to the amount of the penalty. In deciding whether to add a GAAR penalty, the government should be mindful of the design challenges associated with such a penalty. ■

A Series of Transactions: A Serious Question

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GAAR serves as an important mechanism to combat abusive tax avoidance. A key aspect of GAAR is the concept of a "series of transactions." Specifically, an "avoidance transaction" arises only where a "tax benefit" results from a "series of transactions." This reference serves to capture transactions that on their own may not be abusive but form part of a series that ultimately provides tax benefits that were unanticipated by Parliament.

What Is a "Series of Transactions"?

It is often difficult to determine whether a given transaction is part of a series of transactions. If a business owner carries out a tax-motivated reorganization in anticipation of an arm's-length sale, the reorganization and the sale likely form a series of transactions. But what if a business owner carries out tax planning that would provide certain tax benefits when that owner eventually exits the business, perhaps decades later? Should the tax planning executed today still be considered part of a series that includes the later exit? Such determinations are very difficult.

The expression "series of transactions" is not defined statutorily. A common-law series of transactions takes its meaning from case law that originated in the House of Lords case of *Furniss v. Dawson* ([1984] AC 474 (HL)). Referring to that line of authority, Rothstein JA, as he then was, held in *OSFC Holdings* (2001 FCA 260, at paragraph 24) that a common-law series arises where

> each transaction in the series [is] pre-ordained to produce a final result. Pre-ordination means that when the first transaction of the series is implemented, all essential features of the subsequent transaction or transactions are determined. . . . That is, there must be no practical likelihood that the subsequent transaction or transactions will not take place.

Because the common-law definition was considered overly narrow, subsection 248(10) was introduced in 1986. This provision states that "where there is a reference to a series of transactions or events, the series shall be deemed to include any related transactions or events completed in contemplation of the series." Subsection 248(10) applies not only to GAAR but also to the entire Act.

This somewhat cryptically worded definition has been interpreted broadly by the courts in the context of GAAR cases. In the SCC's first GAAR decision, *Canada Trustco* (2005 SCC 54), McLachlin CJ stated that "in contemplation of" is read not in the sense of actual knowledge but in the sense of "because of" or "in relation to" the series. She added that the phrase can be applied to events either before or after the basic avoidance transaction. This suggests that even a limited degree of connection between transactions or events can be sufficient to constitute a "series." Moreover, a transaction may be part of a series of transactions if there were earlier preordained steps, even years earlier, that have some kind of causal or other connection to one another.

Although the TCC's decision in *MIL (Investments)* (2006 TCC 460; aff'd in a brief judgment 2007 FCA 236) suggested that a "strong nexus" is needed for transactions to be included in a series of transactions under subsection 248(10), the "strong nexus" concept was rejected by the SCC in *Copthorne* (2011 SCC 63). Instead (according to the court), for an event to satisfy the "in contemplation of" test, it is required only that there be more than a "mere possibility" or a connection with an "extreme degree of remoteness."

The "knew of," "because of," "in relation to," and "more than a mere possibility" tests and the retrospective application of "in contemplation of" are ambiguous and do not provide clear and precise rules to guide taxpayers. The inclusion of retrospectivity, in particular, broadens the scope of a series, because most subsequent transactions have the benefit of

hindsight, and therefore taxpayers will almost inevitably consider or contemplate prior transactions.

In practice, these verbal formulas do little to advance the cause of certainty and predictability. Forests have been killed by commentators writing about the scope of the "in contemplation of" test—more specifically, about the determination of whether a "related transaction" is or is not completed in contemplation of a common-law series of preordained steps. Although the literature is helpful, it offers taxpayers little help in organizing their affairs in a way that produces reasonably predictable results. In our view, the expansive meaning of "series of transactions" creates too much uncertainty. Furthermore, given that subsection 248(10) applies to the entire Act, the expansive interpretation of "series of transactions" creates significant uncertainty for commercial transactions not only under various SAARs but also under GAAR. We believe that Parliament can and should promote the competitiveness of Canadian markets by limiting this uncertainty. Our specific recommendations for reform appear below.

Recommendations for Reform

Our recommendations are rooted in our view that amendments are appropriate to promote a higher degree of predictability, certainty, and fairness. It costs taxpayers and tax administrations alike more time, effort, and financial resources to understand and comply with unpredictable and uncertain tax rules. Furthermore, legislation that is more predictable and reasonably certain fosters a more consistent application of tax rules, making it easier for the government to administer the rules and reducing the backlog of litigation. A line must be drawn between abusive tax avoidance and legitimate tax planning. This clarity can be achieved through some type of bright-line test or safe harbour and a more flexible standard. Below are some ideas for potential reform.

- *Amend the definition of "series of transactions" to exclude subsequent related transactions.* The retrospective application of subsection 248(10) is fatal to many commercial transactions because the tax effects of past transactions are undone by a subsequent transaction that the taxpayer had no intention of carrying out at the time of the past transactions. To strike a better balance than the current open-ended approach, the definition of "series of transactions" should be amended to exclude subsequent related transactions that follow a common-law series of transactions in circumstances to be specified.
- *Introduce a time limit to the definition of "series of transactions."* Subsection 248(10) could be amended to deem transactions that take place more than five years after the common-law series to not be part of the series, at least in the context of certain SAARs. Bright-line time limits are often used in similar circumstances—for example, the SAAR in subsection 69(11) that permits taxpayers to access a tax-deferred rollover if a disposition occurs at least three years after the initial rollover transaction. It is understandable that subsection 248(10) needs to be interpreted broadly in the context of GAAR. A bright-line time limit could encourage abusive planning whereby taxpayers generate tax attributes and choose to simply wait out the limit. However, this concern was addressed by the 2022 federal budget's proposed expansion of the "tax benefit" definition to capture tax attributes, even when those attributes have not yet been used to reduce, avoid, or defer tax. In the context of SAARs, the addition of a time limit would allow taxpayers to avoid negative and unanticipated consequences for commercial transactions while preventing abusive tax avoidance.
- *Introduce an "arm's-length person" exception.* The definition of "series of transactions" should exclude certain transactions undertaken by a person after the common-law series if that person deals at arm's length with the taxpayer who carried out the common-law series and had no involvement in the initial planning. Of course, it is true that any prudent purchaser of a business would conduct due diligence and would therefore know about previously completed transactions. But this should not be a sufficient basis for including any subsequent step undertaken by the arm's-length person in a single series of transactions with the initial common-law series.
- *Introduce an exception for bona fide commercial transactions.* Certain types of arm's-length transactions undertaken for the principal purpose of addressing identifiable business objectives should not be included in the same series of transactions as steps undertaken by an arm's-length person before the arm's-length transaction. Where the business purpose of a transaction is sufficiently predominant, the transaction should not be considered to be part of a series.
- *Introduce a safe harbour for certain events.* One circumstance that should be excepted from the extended meaning of a series of transactions in subsection 248(10) is death. Simply put, an individual's death should be sufficient to break a series. Widely accepted estate-planning techniques should not be subject to challenge simply because an overzealous auditor chooses to treat post mortem steps as part of the same series of transactions as the estate plan.
- *Introduce interpretive rules to better codify the meaning of subsection 248(10).* Uncertainty would be mitigated by the addition of statutory guidance on when a transaction should not be considered part of a series. One possible inspiration for such guidance could be the

US federal income tax rules on certain types of corporate spinoffs in section 355(e) of the Internal Revenue Code. This provision sets out more prescriptive rules for determining whether an otherwise tax-free spinoff is tainted by a subsequent sale transaction.

Conclusion

The "series of transactions" concept underpins not only GAAR but also many SAARs in the Act. Current law in this area is both vague and uncertain. In our view, any reform of anti-avoidance rules in Canadian tax law should include measures, including those discussed in this article, to better clarify the meaning of "series of transactions." ■

The editor of *Perspectives on Tax Law & Policy* welcomes submissions of ideas or of written material that has not been published or submitted elsewhere. Please write to Jeffrey Trossman at jeffrey.trossman@blakes.com. Published quarterly.

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