Consultation on GAAR Proposals

KPMG Submission to Canada's Department of Finance

KPMG LLP

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1 Introduction

The following comments are provided by KPMG LLP Canada ("**KPMG**", "**we**", or "**us**") in response to the legislative proposals released with the March 28, 2023 federal budget concerning proposed changes to the General Anti-Avoidance Rule ("**GAAR**") in section 245 of the *Income Tax Act* (Canada) (the "**Act**"). We appreciate the opportunity to provide input on this important topic.

2 General Comments

It goes without saying that the GAAR has become a fundamental rule in the application of the Act, and any proposed changes to its operation or scope merit careful analysis and debate. We commend the Department of Finance for having shared with the tax and business community last summer a consultation paper (the "**2022 Paper**") considering the various components of the GAAR, and discussing potential issues for the government in the GAAR's current operation and scope.

A decision that the current GAAR was deficient appears to have been reached by the government well before the consultation was launched,[1] [2] thus effectively pre-ordaining the conclusion that change was necessary. We question this premise, and suggest that the GAAR has, by the government's own report, been effective in challenging a wide range of aggressive tax planning – with no apparent loss in effectiveness over the course of more than 30 years. As the 2022 Paper notes, "the Crown has been successful in the courts in a significant proportion of GAAR cases and... many aggressive tax plans do not go forward due to the likelihood that the GAAR would apply". We also note that the analysis in the 2022 Paper of the court decisions involving GAAR did not take into account the impact of GAAR on tax planning that was identified by the Canada Revenue Agency ("**CRA**") on audit and resolved in the government's favour without going to court.

We submit that the current GAAR is fulfilling the (appropriate) goal set out in the accompanying explanatory notes when the rule was initially enacted, "to distinguish between legitimate tax planning and abusive tax avoidance and to establish a reasonable balance between the protection of the tax base and the need for certainty for taxpayers in planning their affairs." Following from this view, we suggest that the proposed changes to impose a "tougher" GAAR have the potential to:

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[1] 2021 Liberal Party Election Platform: "A re-elected Liberal government will: Modernize the general anti-avoidance rule regime in order to focus on economic substance…"

[2] 2020 Fall Economic Update: "For too long, certain individuals and businesses have been able to create increasingly complex structures in order to artificially lower their tax obligations in a manner that does not serve an economic purpose, including by shifting profits offshore and creating artificial tax deductions. To address this, the government will launch consultations in the coming months on the modernization of Canada's anti-avoidance rules, in particular the General Anti-Avoidance Rule. It is essential to the integrity of the tax system that our anti-avoidance rules be updated so they are sufficiently robust for tax authorities and courts to address this sophisticated and aggressive tax planning."

- negatively disrupt the current balance that GAAR is intended to strike,
- introduce additional, unwarranted uncertainty in the application of GAAR, impeding legitimate transactions that, as almost all do, include a tax component,
- undo some of the instructive and well-settled GAAR jurisprudence from the past 35 years, and
- undermine the government's stated objective of enacting a more effective GAAR.

We also note that the Supreme Court has very recently released its decision in a case centering on the application of the GAAR. Given the timing of the decision in *Deans Knight Income Corporation v. His Majesty the King* (2023 SCC 16), and the closing date for these consultations, we have not attempted to include in these comments any assessment of the *Deans Knight* decision in relation to the proposed changes to the GAAR. However, the proposed changes to GAAR should be analyzed in conjunction with that decision and we consider it reasonable to suggest that the outcome of that decision makes tightening changes in this area even less compelling.

Having set out our view that the GAAR is already achieving its purpose, and that sufficient justification for changes to the GAAR has not been made out, we will seek in the following comments to focus on the specific changes that we believe are problematic or raise particular concerns.

3 Preamble

3.1 Paragraph 245(0.1(a)

In paragraph 245(0.1)(a), the first part of the paragraph appears to be a summary of the current GAAR. The latter part of the paragraph – that the GAAR "allow[s] taxpayers to obtain tax benefits contemplated by the relevant provisions" – seems at first blush largely innocuous; however, on closer examination it appears capable of being read as making a fundamental change to the application of the GAAR.

Reduced to its simplest terms, the GAAR is designed to apply to transactions that result in a misuse or abuse. The determination of whether a transaction results in a misuse or abuse is based on an analysis of relevant provisions – i.e., one attempts to determine whether the transaction would be at odds with the scheme of the Act. Whether the provisions "contemplated" the particular tax benefit seems off-point: even if the tax benefits were not specifically contemplated it remains an issue of appropriately analyzing whether those benefits would result in a misuse or abuse.

An analysis of the preamble is made more challenging by the variety of terminology that the GAAR consultation employs. For example, while the draft legislative proposals use the term "contemplated", the discussion of the preamble in the budget's supplementary

information ("**BSI**") may be referring to this part of the preamble when it states that taxpayers "*cannot misuse or abuse the tax rules to obtain unintended benefits."* And the use later in paragraph (c) of the preamble of the term "foreseen" would seem to invite debate as to the overlap and differences between the terms "contemplated" and "foreseen". In any case, the fundamental point we wish to convey is that the proper test for applying GAAR is not whether a particular tax benefit was contemplated, uncontemplated, foreseen or unforeseen, but whether allowing the benefit would constitute a misuse or abuse.

3.2 Paragraph 245(0.1(b)

Our understanding of the objective of the second paragraph of the preamble is to confirm that, while taxpayers retain the right to pay only the amount of income tax for which they are legally liable, the determination of their tax liability is not determined solely by the technical provisions of the Act but also by the GAAR. (From the BSI: *"[GAAR] in effect draws a line: while taxpayers are free to arrange their affairs so as to obtain tax benefits intended by Parliament, they cannot misuse or abuse the tax rules to obtain unintended benefits.")*

It can be argued that this point is already well-recognized. For example, in its recent decision on section 245, the Supreme Court stated:

> [W]here tax provisions are drafted with "particularity and detail", a largely textual interpretation is appropriate in light of the well-accepted Duke of Westminster principle that "taxpayers are entitled to arrange their affairs to minimize the amount of tax payable"… This principle, derived from the rule of law, has been deemed the "foundation stone of Canadian law on tax avoidance".

And,

> This established principle was affected by the enactment of s. 245 of the Act, also known as the GAAR, which "superimposed a prohibition on abusive tax avoidance, with the effect that the literal application of provisions of the Act may be seen as abusive in light of their context and purpose" (Canada Trustco, at para. 1). Thus, if the Minister can establish abusive tax avoidance under the GAAR, s. 245 of the Act will apply to deny the tax benefit even where the tax arrangements are consistent with a literal interpretation of the relevant provisions.[3]

To the extent that the government seeks to make explicit in a preamble to section 245 what we (and the Courts) see as its current operative effect, we identify no concerns with that objective.

[3] Canada v. Alta Energy Luxembourg S.A.R.L. 2021 SCC 49

Paragraph (b) goes further than this, of course, by emphasizing that a balance is to be struck between taxpayers' need for certainty, on the one hand, and the government's responsibility to protect the tax base and *the fairness of* the tax system, on the other.

The BSI states that, "'*Fairness' in this sense is used broadly, reflecting 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."* We presume this commentary is intended to distinguish between those who are willing, or not, to undertake what is ultimately determined to be abusive tax planning. However, based on the description, it is not clear to us exactly how or to what extent this sentiment of "fairness" is intended to influence the actual analysis and application of the GAAR. Our concern is that the reference to fairness may invite the CRA or the courts to engage in some form of subjective analysis or interpretation as to what is "fair". In our view, any such approach would be inappropriate and lead to significant uncertainty and inconsistency. Furthermore, neither the CRA nor the courts should take on such a public policy role that should be left to Parliament. If the reference to, or concept of, "fairness" is maintained, it should be made clear that any notion of "fairness" must be based on a proper textual, context and purposive analysis of the relevant provisions of the Act and Parliament's intent in enacting such provisions based on appropriate extrinsic evidence.

3.3 Paragraph 245(0.1(c)

Paragraph 245(0.1)(c) provides that the GAAR "can apply regardless of whether a tax strategy is foreseen." While the draft proposals do not specify by whom the strategy must be foreseen, we presume that the intended 'seer' is Parliament – and we suggest that this be confirmed. Also as a drafting matter, we are not sure why the new concept of "tax strategy" is employed, as opposed to more established terms such as "tax benefit", or tax benefit resulting from an "avoidance transaction".

4 Avoidance Transaction

The 2022 Paper identified different ways in which the current avoidance transaction test in section 245 could be modified. In discussing the proposal for change, the 2022 Paper listed a number of benefits associated with "lowering the threshold under the purpose test". Neither the 2022 Paper nor the BSI discusses a primary counter-argument to a lower avoidance standard, i.e., that far more commercially-motivated transactions will be swept into the scope of GAAR.

At the limit, it can be argued that no transaction that misuses or abuses provisions of the Act should be tolerated. However, operationalization of that viewpoint would mean that any tax benefit, even if immaterial to a particular transaction or structure, would be subject to challenge – with a profound impact on business and commerce and the cost of administering the Act. The decision taken in 1987 was to exclude from potential GAAR examination transactions undertaken primarily for non-tax purposes, and that dividing line was justified as having struck an appropriate balance. Such primarily non-tax-motivated transactions would, under the proposals, be exposed to examination under the GAAR if any of the main purposes was to obtain a tax benefit – with justification for the proposed change being based on the assertion that this weaker test (now) *"strikes a reasonable balance, as it would apply to transactions with a significant tax avoidance purpose but not to transactions where tax was simply a consideration."*

The simple point we wish to make is that the function of the avoidance transaction test as "gatekeeper" to the GAAR will be significantly suppressed with this change. The effect of materially expanding the potential ambit of GAAR will require much more engagement of the tax community in respect of predominantly non-tax arrangements, and will have a deleterious impact on business transactions unless Finance is prepared to offer guidance in respect of many commercially-driven transactions and structures that have a "secondary" (in the sense of not being "the primary purpose") tax element.

5 Economic Substance

As a preliminary comment, we recognize that the 2022 Paper effectively framed the incorporation of an economic substance test into the GAAR as being pre-determined. While we believe that there is room for debate as to whether such a test is essential to an effective GAAR, we appreciate the transparency of the approach that was taken in the 2022 Paper and do not seek to debate that point in these comments. Accordingly, our comments are limited to narrower drafting and design matters.

We believe that the proposed rule raises a number of drafting questions. Our first comment relates to the drafting language "significantly lacking in economic substance." While the provision includes an interpretative rule that provides some guidance, for any case not captured by that rule it is not clear how a "significant lack" of substance is to be quantified, i.e., in dollar terms, in percentage terms, on a case-by-case basis determined by the particular context… We do not seek to be prescriptive here, but further explanation and elaboration of the general parameters the drafters would consider relevant would be beneficial.

More generally, the novel language of the economic substance test and the commentary in the BSI do not make entirely clear the exact impact that a lack of economic substance would have on a GAAR analysis. As the example provided in the BSI illustrates, there are many instances in which tax benefits that do not result in a misuse or abuse will arise in respect of transactions that lack "economic substance". The example is therefore helpful in making clear that where transactions lacking economic substance result in a tax benefit, it remains necessary and important to undertake a proper misuse and abuse analysis. We believe it would be beneficial if the Department of Finance could provide further examples of transactions or series of transactions which they believe lack economic substance and whether such transactions would result in a misuse or abuse.

Consistent with our observations above, there are many well-established transactions or series of transactions that lack economic substance and were not contemplated by the legislator, and yet the *"tax results sought are consistent with the purpose of the provisions or scheme relied upon"* (quote from the BSI). Examples of such transactions would include (but are not limited to):

The transfer of shares with high ACB created as a consequence of the death of an individual shareholder to a new company in what is commonly referred to as "Pipeline Planning".

- Arguably, the use of the new company lacks economic substance as it is part of a series and the only reason for establishing the new company is to increase the paid-up capital to the adjusted cost base at the time of death (as modified by section 84.1). Pipeline planning is commonly accepted and in the absence of such planning the combined tax rate on death and the extraction of surplus would be in excess of 75% in most provinces.

Loss utilization planning in what is commonly referred to as a “preferred debt loop”.

- Preferred debt loops are widely used to facilitate the use of losses in an affiliated and/or related group of companies. These structures result in a circular flow of funds and creation of the structures and flow of funds are part of a series of transactions carried out in close proximity. Notwithstanding their lack of economic substance (as noted in the 2022 Paper), they have long been accepted and accommodated as a *de facto* loss consolidation mechanism.

Our suggestion, in effect, is to provide a more neutral presentation of the economic substance analysis in any discussion of legislative proposals. This presentation should recognize the reality that a number of planning structures not originally contemplated by Parliament, and which may lack economic substance, nonetheless do not represent a misuse or abuse of the Act.

6 Penalty

The proposals contemplate a very significant penalty that would apply automatically to any assessment under GAAR, but which can be "*avoided if the transaction is disclosed to the [CRA]."* We question whether a "one-size-fits-all" penalty approach is appropriate to every transaction that is not disclosed to the CRA. There is, in our view, a considerable difference between a taxpayer that did not disclose a transaction because they genuinely, but mistakenly, believed that there was no GAAR risk, and another taxpayer that knew GAAR would be assessed but thought it might avoid detection. However, the current proposal would penalize each party to exactly the same extent. In a similar vein, the first taxpayer will pay a significant penalty when another taxpayer engaging in a highly aggressive transaction which they disclose will be subject to no penalty at all.

Given the proposals to expand the scope of GAAR, including the broader avoidance transaction test and the novel economic substance test, we believe that the proposed automatic 25% penalty is excessive and inappropriate from a tax policy perspective. The GAAR is inherently a more difficult provision to interpret and apply relative to other provisions of the Act. Jurisprudence has established that the GAAR should be a provision of "last resort" and its potential application involves significant uncertainty. In addition, we would expect significant uncertainty to persist for a long period of time while taxpayers wait for judicial guidance on the amended GAAR. Consequently, we question the propriety of a penalty altogether, but submit that if a penalty is to be imposed it should not apply automatically and the level of the penalty should be reduced. We also believe it would be beneficial if criteria were established as to when it would be appropriate to apply such a discretionary penalty.

In summary, we submit that the institution of an automatic penalty to all GAAR cases, or to all GAAR cases that were not disclosed, is inappropriate. In our view, a discretionary penalty would be more suitable to GAAR, allowing the CRA and/or the courts to calibrate its amount to the facts and circumstances of each case, and minimizing the possibility that the penalty could be a deterrent for the courts (and perhaps for CRA) to come to the decision with respect to the application of GAAR itself.

7 Going Forward: Further Consultations, Application Date

The BSI states that, after this current consultation, "*the government intends to publish revised legislative proposals and announce the application date of the amendments.*"

Given the significance and importance of the changes in this area, we believe that it is imperative that revised legislative proposals be published in draft form, with a further opportunity for the tax community to comment on them. We interpret the BSI as being consistent with this view.

We also believe that any proposals should apply on a purely prospective basis. The coming-into-force for the original introduction of the GAAR seems a reasonable and relevant model for such changes.[4]

Again, we thank you for the opportunity to provide input in regard to the draft legislative proposals. We look forward to answering any questions from Finance about this submission.

Contact us

Michelle Thornton
Partner, KPMG National Tax Centre
T 416-777-8108
E mathornton@kpmg.ca

www.kpmg.ca

[4] As noted in IC-88-2, the GAAR was originally enacted with application to transactions entered into after Royal Assent was given to the implementing legislation (Bill C-139), except for:
"(a) transactions that are part of a series of transactions, commencing before the day of Royal Assent and completed before 1989 (and for this purpose a series of transactions does not include any related transactions or events completed in contemplation of the series), or
(b) any one or more transactions, one of which was entered into before April 13, 1988, that were entered into by a taxpayer in the course of an arrangement and in respect of which the taxpayer received from the Department of National Revenue, before April 13, 1988 a confirmation or opinion in writing with respect to the tax consequences thereof."