

# BUDGET 2023: AN EXPANDED GENERAL ANTI-AVOIDANCE RULE IS ON THE HORIZON

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The *Income Tax Act* (Canada) (the “**Tax Act**”) contains a General Anti-Avoidance Rule (the “**GAAR**”) that disallows tax benefits arising from certain tax-motivated transactions where the Federal Government (the “**Government**”) can establish that the transactions represent a misuse or abuse of the provisions of the Tax Act (i.e., the transactions result in “abusive tax avoidance”).

When applying the GAAR, the Supreme Court of Canada has held that the burden rests with the Government to establish that a particular transaction or series of transactions gives rise to “abusive tax avoidance”. The Supreme Court has sought to carefully set out the parameters of what constitutes “abusive tax avoidance”. The Supreme Court has held:

... abusive tax avoidance [may arise] when a taxpayer relies on specific provisions of the Income Tax Act in order to achieve an outcome that those provisions seek to prevent. As well, abusive tax avoidance will occur when a transaction defeats the underlying rationale of the provisions that are relied upon. An abuse may also result from an arrangement that circumvents the application of certain provisions, such as specific anti-avoidance rules, in a manner that frustrates or defeats the object, spirit or purpose of those provisions. By contrast, abuse is not established where it is reasonable to conclude that an avoidance transaction ...was within the object, spirit or purpose of the provisions that confer the tax benefit.

The Government has been unhappy with the manner in which the Courts have assessed whether a transaction or series of transactions results in “abusive tax avoidance”. The Government has expressed particular concern that transactions that lack “economic substance” may be found not to violate the GAAR.

In Budget 2022, the Government announced its desire to expand the scope of the GAAR and solicited comments from interested stakeholders in a public consultation process that concluded in September, 2022.

## Proposed Structural Changes to the GAAR

In Budget 2023, the Government has proposed amendments to the GAAR that will:

- i. introduce an interpretative preamble,
- ii. expand the range of transactions that may fall within the ambit of the GAAR,
- iii. introduce an “economic substance” condition that appears to be aimed at reducing the burden borne by the Government in establishing “abusive tax avoidance” to support a GAAR reassessment,
- iv. impose a penalty on taxpayers that are subject to a GAAR reassessment if the underlying transaction has not previously been reported to the Canada Revenue Agency (the “**CRA**”),
- v. extend the limitation period during which a GAAR reassessment may be issued absent advance reporting of a transaction, and
- vi. introduce a potentially expansive voluntary reporting regime for those that wish to guard against GAAR penalties and extended reassessment periods.

#### ***(i) Introduction of a Preamble to the GAAR***

Budget 2023 proposes to add a preamble to the GAAR, ostensibly to aid in the interpretation of the GAAR. While interpretative preambles are included in certain international tax agreements, none of the other 281 sections of the Tax Act include an interpretative preamble.

The proposed preamble to the GAAR will (a) reiterate principles that were expressed in the Department of Finance Technical Notes and Government announcements that accompanied the introduction of the GAAR in 1987 and 1988, and (b) state that the GAAR may apply to counteract the tax benefits attributable to a tax planning strategy “whether or not the tax planning strategy used to obtain the benefit was foreseen”.

Given the novelty of including an interpretative preamble in a section of the Tax Act, the extent to which the preamble will materially affect the interpretation of the GAAR is unclear.

The Canadian courts have traditionally referenced extrinsic aids like Department of Finance Technical Notes when undertaking a textual, contextual and purposive interpretation of a legislative provision, so the simple reiteration of statements already contained in historical extrinsic aids may not have an appreciable impact on the application of the GAAR. However, the last statement in the preamble may raise interpretative difficulties. If the latter portion of the preamble is taken to refer to “tax strategies” that are not foreseen from the perspective of the government, a seemingly high level of uncertainty may be introduced as taxpayers are left to determine what “unforeseen” strategies would be considered an abuse or misuse of the provisions of the Tax Act, the regulations to the Tax Act or a tax treaty if the relevant drafters had turned their attention to the “tax strategy” at issue. The last statement in the preamble also appears to suggest that the GAAR can apply to preclude tax benefits from arising from a tax strategy that was not contemplated by a taxpayer when undertaking a transaction or series of transactions. From a policy perspective, it may be difficult to reconcile the objective of the GAAR (i.e., to discourage taxpayers from undertaking transactions that amount to abusive

tax avoidance) with the suggestion that a tax benefit from a strategy that was not foreseen by a taxpayer could subsequently be disallowed under the GAAR.

### ***(ii) Scope of the GAAR Expanded***

Currently, the GAAR applies to transactions that constitute “avoidance transactions”. Generally speaking, an avoidance transaction captures a transaction, that either alone or as part of a series of transactions, results, directly or indirectly, in a tax benefit, unless the transaction may reasonably be considered to have been undertaken or arranged primarily for bona fide purposes other than to obtain the tax benefit.

Budget 2023 proposes to change the definition of an “avoidance transaction” to provide that a transaction will be an “avoidance transaction” where it may reasonably be considered that “one of the main purposes” for undertaking or arranging the transaction was to obtain a tax benefit. It is possible that a transaction may have several “main purposes”. As a consequence, under the proposed revisions to the GAAR, a transaction may be an “avoidance transaction” even if the transaction was undertaken primarily for bona fide commercial purposes.

### ***(iii) “Economic Substance” Condition Introduced***

The Government has expressed concern that transactions that lack “economic substance” may give rise to tax benefits that are not precluded by the GAAR due to an inability of the Government to establish that such transactions amount to abusive tax avoidance. To address its concern, the Government has proposed what appears to be a new interpretative rule that seems to be aimed at conditioning when a transaction would be considered to result in the misuse or abuse of the provisions of the Tax Act, the regulations to the Tax Act or a tax treaty.

The new proposed “economic substance” condition states that if an avoidance transaction is “significantly lacking in economic substance”, such a state of affairs “tends to indicate that the transaction results in a misuse...or an abuse” of provisions of the Tax Act, the regulations to the Tax Act or a tax treaty. The new “economic substance” condition further provides that, for the purposes of assessing a lack of “economic substance”, the following factors “tend – depending on the particular circumstances – to establish that a transaction or a series of transactions is significantly lacking in economic substance”:

- (a) all or substantially all of the opportunity for gain or profit and risk of loss of the taxpayer – taken together with those of all non-arm’s length taxpayers – remain unchanged, including because of
  - i. a circular flow of funds,
  - ii. offsetting financial positions, or
  - iii. the timing between steps in the series;

(b) it is reasonable to conclude that, at the time the transaction was entered into, the expected value of the tax benefit exceeded the expected “non-tax economic return” (which excludes both the tax benefit and any tax advantages connected to another jurisdiction); and

(c) it is reasonable to conclude that the entire, or “almost” entire, purpose for undertaking or arranging the transaction or series was to obtain the tax benefit.

It appears that the “economic substance” condition is aimed at lessening the burden of proof borne by the Government in establishing abusive tax avoidance in a GAAR case. However, the proposed provision does not define what constitutes “economic substance” or “non-tax economic returns”. The proposed “economic substance” condition also uses language that is less precise than the language used in other provisions of the Tax Act. In this regard, it is interesting to note that the words “tends” and “almost”, which are used in the proposed new “economic substance” condition, are not used anywhere else in the Tax Act. The parenthetical exclusion of tax benefits and other tax advantages connected to another jurisdiction in the illustrative examples presented above appears to be aimed at addressing the Government’s concern that transactions primarily motivated by non-Canadian tax advantages, but which give rise to Canadian tax benefits, could escape the application of the GAAR.

More fundamentally, it is unclear how the new “economic substance” condition will be reconciled with the way in which the Courts have historically sought to determine whether a transaction results in abusive tax avoidance. In Budget 2023, the Government acknowledged that many transactions that are expressly encouraged by the provisions of the Tax Act (e.g., contributions to Tax-Free Savings Accounts) ostensibly have no “economic substance”, but are not intended to be precluded by the GAAR. It is unclear how a Court is to distinguish between permissible transactions that lack “economic substance” and those transactions that are not permitted.

#### ***(iv) New GAAR Penalty***

Budget 2023 proposes to introduce a new penalty to be imposed on taxpayers that are reassessed under the GAAR. The penalty is proposed to equal 25% of the amount of the tax benefit that is disallowed under a GAAR reassessment. However, a penalty will not be imposed where the transaction that is the subject of the GAAR reassessment was previously disclosed to the CRA.

Budget 2023 proposes to introduce a voluntary reporting channel through which taxpayers may disclose transactions to the CRA. Transactions that have previously been disclosed to the CRA will not be subject to a GAAR penalty, even if they are subsequently the subject of a GAAR reassessment. However, in many instances, a taxpayer may be unaware, or not believe, that a transaction is an “avoidance transaction” or otherwise gives rise to “abusive tax avoidance”. If the proposed preamble to the GAAR is taken to suggest that the GAAR may

apply in respect of transactions where a tax benefit is not foreseen, taxpayers may be exposed to a potential GAAR penalty in respect of transactions for which they do not currently foresee a tax benefit unless they make a precautionary report to the CRA.

### ***(v) Extended Reassessment Period***

Budget 2023 proposes to extend the period during which a taxpayer may be reassessed on the basis of the GAAR by an additional 3 years unless the transaction(s) that are the subject of the GAAR reassessment were previously reported to the CRA.

### **New Consultation Period**

The Government has invited interested stakeholders to make representations on the proposed amendments to the GAAR raised in Budget 2023. Representations may be made to the Department of Finance until May 31, 2023. After considering stakeholder representations, the Government has indicated that it will publish revised legislative proposals to amend the GAAR and announce the date upon which the revised GAAR will come into force.

by [Michael Friedman](#)

### **A Cautionary Note**

The foregoing provides only an overview and does not constitute legal advice. Readers are cautioned against making any decisions based on this material alone. Rather, specific legal advice should be obtained.

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