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A new GAAR – Pretty chilly right now

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On August 4, 2023, the Department of Finance released revised draft legislation ("the proposals") that would amend the general anti-avoidance rule (GAAR) in the Income Tax Act (the Act). Given the very short comment period ending on September 8, it is expected that final legislation will be introduced this fall.

The proposals will significantly strengthen GAAR. And this is happening at a time when many other significant changes have recently been made to assist the Canada Revenue Agency (CRA) in auditing, enforcing and collecting tax. See these prior articles about these recent developments: As a matter of tax | Manulife Advisors and As a matter of tax - July 2023 | Manulife Advisors

And if you like podcasts listen to this, which was recorded before the August 4 draft legislation: The Manulife Exchange | Manulife Advisors

Some background on the proposals

In the proposals, the threshold for the application of GAAR is being lowered. The purpose test in the definition of "avoidance transaction" is changing. Currently, if a transaction results directly or indirectly in a "tax benefit" it meets the definition unless it "may reasonably be considered to have been undertaken or arranged primarily for *bona fide* business purposes other than to obtain the tax benefit." The proposals would change this to "**unless** it may reasonably be considered that obtaining the tax benefit is **not** one of the main purposes for undertaking or arranging a transaction." This language changed from a prior draft that was released with the 2023 Federal budget that used similar but slightly different wording: "one of the main purposes" for undertaking the transaction was to obtain a tax benefit.

Is this change semantics or substantive? Although the Minister has the onus of proving a transaction results in a tax benefit and an avoidance transaction (and indeed misuse or abuse as we discuss

below), it feels like the default is that there is an avoidance transaction. We already know that moving from "primarily" to "one of the main purposes" to obtain the tax benefit is lowering the threshold. Is proving the negative – that **unless** the tax benefit is **not** one of the main purposes – creating an evidentiary requirement that shifts the burden to the taxpayer to establish?

The next major change – the introduction of an economic substance test – clearly establishes a presumption in favour of a finding of misuse or abuse that shifts the onus to the taxpayer to rebut. The proposals provide several factors that signal when a transaction is "significantly lacking in economic substance" which would invoke the presumption.

The factors include:

- all or substantially all of the opportunity for gain or profit and risk of loss of the taxpayer remains unchanged including because of a circular flow of funds, offsetting financial positions, the timing of steps in a series or the use of an accommodation party;
- it is reasonable to conclude that when entering the transaction the expected value of the tax benefit exceeded the expected non-tax economic return; and
- it is reasonable to conclude that the entire or almost the entire purpose was to obtain the tax benefit.

Of note and concern to many in the tax planning community is the reference in Finance's explanatory notes relating to the economic substance provisions to one type of surplus strip transaction that brings about capital gains as opposed to dividends from a private company using an *inter-vivos* pipeline. Could this open the door for the CRA to apply the GAAR in the post-mortem pipeline planning context? Post-mortem pipelines are frequently undertaken pursuant to an advanced income tax ruling. Will taxpayers have to get rulings every time and now also seek a GAAR ruling on the specific transaction?

The last change is probably the most significant from a practical perspective. The penalties if GAAR applies - 25% of the increase in tax payable as a result of GAAR applying or nil in the case of a tax attribute – are meaningful and will be a significant deterrent to entering into transactions that may attract GAAR. However, there is an out from the penalties applying – if there is voluntary disclosure of the transaction by the taxpayer (or if it was otherwise disclosed either as a reportable or notifiable transaction). This will lead to more voluntary reporting of transactions. With more reporting, there will be more qualified leads for CRA's auditors to look into.

Analysis in the tax and estate planning context

Here are our thoughts and questions:

Are the proposed changes to GAAR going to be relevant to common (even mundane) tax and estate planning arrangements?

Yes. On its face almost everything is in until it's out. As demonstrated by the explanatory notes – even a contribution to a TFSA is ostensibly in but is distinguished because it fits squarely into the incentive

created by the Act. But isn't that the case with any tax planning that is potentially subject to GAAR? Technically it works – the planning fits within the provisions of the Act.

There is also an exception to the penalty where a taxpayer demonstrates that, at the time of the transaction, it was reasonable to conclude that GAAR wouldn't apply given it was identical or almost identical to transactions that were the subject of CRA administrative guidance or court decisions. Identical or almost identical is a pretty high bar.

Which tax and estate planning transactions then will be subject to GAAR? Is organizing your affairs to get interest deductibility using cash to pay for a personal residence (a la *Singleton*) or life insurance and borrowing to invest in the mundane TFSA category? Probably. But if you get any fancier than that, say using corporate-owned property (such as a life insurance policy) as security for a personal loan to invest and your investment is in shares or debt of the corporation, does it get into GAAR territory?

It is all pretty uncertain right now. When the original GAAR was introduced, there was a period of many years where there was a real chill on tax planning. This could happen again. Or as noted above, voluntarily reporting transactions may become a new normal. But the problem with the latter is that as a result, there is a significantly more expensive and onerous process in defending a GAAR challenge. And more GAAR challenges will result simply because the CRA will not have to find the transactions, they will have a qualified list of leads provided to them. And even though taxpayers may still win in the end by successfully disputing a GAAR challenge, it will be a long hard expensive battle. It just may not be worth it.

A word about aggressive tax planning strategies involving insurance

Notwithstanding the uncertainty in how the new GAAR will apply, there are some things we're certain about. There are some aggressive tax planning strategies that incorporate life insurance (or other types of insurance including critical illness or disability insurance) to deliver results similar to surplus strips at zero tax (not even capital gains) while a life insured person is alive. If these are not subject to GAAR now we believe they certainly will be under the new GAAR.

What's next?

We expect the final legislation will be released this fall and enacted before the end of the year. There may well be changes to the language. But the government does seem intent on enacting changes to GAAR. That is our sense.

FOOTNOTE:

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