THE AMENDED GAAR – ASSESSING THE IMPLICATIONS

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THE AMENDED GAAR – ASSESSING THE IMPLICATIONS

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Introduction

The general anti-avoidance rule (the "GAAR") in section 245 of the *Income Tax Act*[1] has been part of tax practice in Canada since it became law in September of 1988. From the very beginning the GAAR has presented unique challenges to the practice of tax. Although like other statutory regimes in the Tax Act the GAAR has conditions of application governing when it does or does not apply- its character is unique. The GAAR is different than other provisions in the Tax Act for a number

[1] R.S.C. 1985 (5th Supplement) c.1., as amended (referred to herein as the "Tax Act"). Unless otherwise indicated, all statutory references in the paper are to the Tax Act.

of reasons. Most importantly, it is a provision of last resort[2] that acts as an override to the ordinary application of other provisions. In addition, the application of the GAAR is inherently uncertain in its application[3] and requires that those applying the GAAR to look beyond the words actually employed by Parliament and look instead at the rationale underlying the choice of words.[4]

We suspect that many tax practitioners have little interest in becoming parliamentarian for a day and putting their mind to questions of Parliamentary intent. Practically, the ability to discern such intent can only be accomplished by examining a range of different extrinsic aids[5] - a time-consuming task which only adds to the difficult job of applying a vast and complicated body of specific taxing rules. However, as a result of the passage of Bill C-59 (An Act to implement certain provisions of the fall economic statement tabled in Parliament on November 21, 2023 and certain provisions of the budget tabled in Parliament on March 28, 2023) into law on June 20, 2024 and the introduction of, among other things, the notion of "economic substance"[6] to the GAAR regime and the GAAR penalty[7] - the necessity for tax practitioners to engage with the GAAR and all its attendant complexity and uncertainty has been heightened.

The purpose of this paper is not to provide a theoretical look at the GAAR (which has done by other authors in other papers[8]), but instead is to provide practical insights to tax advisers, primarily in an owner-manager context, on how to solve the problems of taxpayers looking to effect ordinary commercial, life and estate planning goals in light of the recent amendments to the GAAR.

This paper will consist of four main sections. The first section presents a high-level overview of the post Bill C-59 revised GAAR regime. The second section examines the Department of Finance technical notes accompanying the Bill C-59 amendments to the GAAR and recent Canada Revenue Agency ("CRA") commentary on the application of the amended GAAR. The third section will examine some of the transactions examined in recent CRA commentary with the aim of providing practitioners with insight into what reliance can be made by taxpayers and their advisers on such commentary. The fourth section of this paper attempts to provide practitioners with practical tools to handle the inherent uncertainty relating to the application of the revised GAAR and the GAAR penalty. Specifically, the fourth section looks at how to make use of the limited safe harbours afforded under the revised GAAR and what to do when an adviser must deal with a scenario outside

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[2] Canada, Department of Finance, *Tax Reform 1987: Income Tax Reform* (Ottawa: the department, June 18, 1987) at p. 137.
[3] See James R. Wilson, "The Legislative History of the General Anti-Avoidance Rule: From the White Paper Draft GAAR to the GAAR Enacted," in *The General Anti-Avoidance Rule: Past, Present, and Future* (Toronto: Canadian Tax Foundation, 2021), 4: 91-128 at p. 109 where the authors state that "By definition, a GAAR has no specific tax-avoidance target: it must be flexible enough to deal with unpredictable circumstances. By its nature, a GAAR that permits sufficient flexibility also creates an element of taxpayer uncertainty."
[4] *Deans Knight Income Corp. v. Canada,* 2023 SCC 16; aff'g 2021 FCA 160; rev'g 2019 TCC 76 at paras. 58, 59 and 60.
[5] These aids include "Parliamentary debates, textbooks, articles written by practitioners and scholars, statements made by finance ministers, and so on" see Colin Jackson, "Hows and Whys: Finding and Articulating the Object, Spirit, and Purpose of Income Tax Act Provisions after Deans Knight Income," in *2023 Atlantic Provinces Tax Conference* (Toronto: Canadian Tax Foundation, 2024), 3:1-23 at pgs. 9 -11.
[6] See subsections. 245(4.1), (4.2) of the Tax Act.
[7] See subsection 245(5.2).
[8] See for example Pooja Samtani and Justin Kutyan, "GAAR Revisited: From Instinctive Reaction to Intellectual Rigour" (2014) 62:2 *Canadian Tax Journal* 401-428.

of them. Finally, this paper will conclude with a brief summary which aims to provide some high level "take aways" that practitioners can use in their practice as they set about the business of advising clients in this new and more uncertain planning environment.

Part 1: Overview of Bill C-59 and the Amended GAAR

Introduction

It is outside the scope this paper to provide a detailed review of the changes made to the GAAR as part of Bill C-59,[9] however, the purpose of the outline below is to explain the major changes to the GAAR. The goal of this section is to also make clear the significance of these changes for tax planning especially in the owner-manager context.

Distilled to its essence, three changes will radically alter the approach required of practitioners when dealing with the GAAR: the introduction of the GAAR penalty in subsection 245(5.1) (the "GAAR penalty"), the introduction of a limited exception to the application of the penalty in subsection 245(5.2) (the "GAAR penalty exception") and the introduction of the concept of "economic substance" into the GAAR analysis as a consequence of the introduction of subsections 245(4.1) and (4.2).

While the GAAR has always had a degree of uncertainty in its application, the introduction of a mandatory[10] penalty (amongst other consequences)[11] has increased the monetary costs of planning that is successfully challenged under the GAAR.

Furthermore, because there are only two statutory safe habours from the application of a GAAR penalty to a transaction: disclosure of a transaction in accordance with subsection 237.3[12] or 237.4 or the GAAR penalty exception – advisers who desire certainty with respect to the GAAR penalty risk will have no recourse but to rely on one of them. It is important to note that since the GAAR penalty exception is drafted in such a way such that Parliament has (in effect) legislatively delegated discretion to the CRA (or another relevant government authority – e.g. the Department of Finance) to exempt planning from the application of the GAAR penalty, the significance of CRA administrative policy, in particular, on tax planning has increased considerably.

Preamble

The first noteworthy change to the GAAR is contained in subsection 245(0.1) of the Tax Act which adds a preamble to the GAAR. The Department of Finance stated that the purpose of the preamble is "to inform the application of the GAAR, despite not forming a part of its analytic framework."[13]

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[9] Please see for example Margaret Nixon and John J. Tobin, "GAAR and Risk Management for Tax Planners" in *2023 Ontario Tax Conference i*(Toronto: Canadian Tax Foundation, 2024).
[10] As discussed later it appears open to read in a due diligence defence to the GAAR penalty.
[11] Including the extension of the normal reassessment period pursuant to clause 152(4)(b)(viii) for transactions assessed under GAAR for which disclosure was not made under sections 237.3 or 237.4 of the Tax Act.
[12] Subsection 237.3(12.1) of the Tax Act also provides for an optional disclosure in respect of transaction for which an obligation to disclose has not arisen under 237.3 of the Tax Act(the reportable transaction rules) and 237.4 of the Tax Act (the notifiable transaction rules).
[13] Department of Finance Technical Notes (the "Finance Notes") accompanying Bill C-59, An Act To Implement Certain Provisions of the Fall Economic Statement Tabled in Parliament on November 21, 2023 and Certain Provisions of the Budget Tabled in Parliament on March 28, 2023, at pg. 327.

In particular, paragraph (b) of the preamble states that the GAAR strikes a balance between, "the Government of Canada's responsibility to protect the tax base and the fairness of the tax system" and "taxpayers' need for certainty in planning their affairs." It is unclear what (if any) effect this will have on the day-to-day world of tax planning.

Definition of Avoidance Transaction

A second change is that the definition of "avoidance transaction" was amended. This change in wording significantly lowered the threshold for what constitutes an "avoidance transaction" for the purposes of section 245 of the Tax Act. Previously, the GAAR looked to whether a transaction (or series) was "undertaken or arranged primarily for bona fide purposes other than to obtain the tax benefit." This definition has been amended to instead examine whether "one of the main purposes" of the transaction (or series) was to obtain a tax benefit. From a practical standpoint consideration of whether a transaction (or series) has a business purpose are rendered less significant by this change. That being said, a transaction (or series thereof) lacking a tax motivation would still not constitute an "avoidance transaction".

Economic Substance

Of particular significance in the owner-manager context were the changes introduced by new subsections 245(4.1) and (4.2) of the Tax Act which introduce an explicit economic substance test into the GAAR.

Subsection 245(4.1) sets out how the concept of "economic substance" is to inform the GAAR analysis and provides that if a transaction is significantly lacking in economic substance, "this is an important consideration that tends to indicate that the transaction results in a misuse under paragraph (4)(a) or an abuse under paragraph (4)(b)."

What this means in practice is at this point unclear. An earlier version of the legislation provided that if an avoidance transaction was significantly lacking in economic substance, it would be presumed that the transaction resulted in a misuse under paragraph 245(4(a) or an abuse under paragraph 245(4)(b).[14] The Finance Notes state that this language in subsection 245(4.1) was changed "to avoid subsection (4.1) being interpreted simply as a procedural shifting of the onus to demonstrate misuse or abuse from the Crown to the taxpayer" and that "the amendments are intended to cause the lack of economic substance to be taken into account as an important substantive factor in the analysis."[15] The Finance Notes further state that "where there is a lack of economic substance, the starting point would be that there is a misuse or abuse." However, the Finance Notes go on to state that "depending on the relevant facts and law, other considerations may demonstrate that the transaction does not actually frustrate the rationale of the provisions."[16]

Subsection 245(4.2) contains a list of factors which establish that a transaction (or series) is significantly lacking in economic substance. The list is not exhaustive.

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[14] Legislative Proposals Relating to the Income Tax Act and the Income Tax Regulations released by the Department of Finance on August 4, 2023.
[15] *Supra* note 13 at pg. 329.
[16] *Ibid*.

Subsection 245. (4.2) is as follows:

"Factors that establish that a transaction or series of transactions is significantly lacking in economic substance may include, but are not limited to, any of the following:

> (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 (other than those non-arm's length taxpayers who can reasonably be considered, having regard to the circumstances viewed as a whole, to have economic interests that are largely adverse from those of the taxpayer) — remains unchanged, including because of
>
> > (i) a circular flow of funds,
> >
> > (ii) offsetting financial positions,
> >
> > (iii) the timing between steps in a series, or
> >
> > (iv) the use of an accommodation party;
>
> (b) it is reasonable to conclude that, at the time the transaction or series 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."[17]

From the standpoint of tax planning, and critically, in an owner-manager context, many typical transactions (arguably) lack economic substance, for among other reasons, when the interests of related taxpayers are aggregated the opportunity for gain or profit and risk may remain unchanged.

It is worth noting that the term "economic substance" and the term "expected value" are not defined terms and this will likely create some uncertainty regarding the interpretation of the provision. The Finance Notes contain a paragraph that attempts to explain the factor in paragraph 245(4.2)(b).[18]

In our opinion, the use by the Finance Notes of the example of a contribution to a tax-free savings account as a transaction which may lack economic substance illustrates the degree to which this concept (arguably) acts as a poor filter of abuse.

GAAR Penalty, Exception in Subsection 245(5.2), Common Law Due Diligence Defense and Disclosure

Subsection 245(5.1) of the Tax Act introduces a penalty into the GAAR. The penalty applies automatically if a person's tax payable for a taxation year is increased as a result of the application of the GAAR.[19] It is outside the scope of this paper to undertake an in depth examination into the

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[17] For a more detailed review of these factors see Allison Blackler, "GAAR 2023: The Future is Now *If it ain't broke . . .*," in *2023 British Columbia Tax Conference*, (Toronto: Canadian Tax Foundation, 2023), 7A: 1-29 at pgs. 16 -18.

[18] *Supra* note 13 at pg. 333.

[19] See variable A of the GAAR Penalty.

nuances of the computation of the penalty. However, simplified, the amount of the penalty is equal to the formula of "(A+B) x 25% - C", where variable A is the amount by which a person's tax payable for a taxation year is increased as a result of the application of the GAAR, variable B is the amount by which a person's refundable tax credits for a taxation year are reduced as a result of the application of the GAAR and variable C is the amount of any penalty payable under subsection 163(2).[20]

There are two key safe harbours to the application of the GAAR penalty. The first is in subsection 245(5.2) of the Tax Act (the "GAAR penalty exception") which provides that the GAAR penalty will not apply to "to a person in respect of a transaction if the person demonstrates that, at the time that the transaction was entered into, it was reasonable for the person to have concluded that [the GAAR] would not apply to the transaction in reliance on the transaction or a series that includes the transaction being identical or almost identical to a transaction or series that was the subject of" either "published administrative guidance or statements made by the Minister or another relevant governmental authority" or "one or more court decisions."

The second safe harbour is that the GAAR penalty does not apply if the transaction (or series) was disclosed by a taxpayer in accordance with section 237.3 or 237.4 of the Tax Act. Those sections pertain respectively to the reportable transaction and notifiable transaction rules. We note that subsection 237.3(12.1) of the Tax Act allows a taxpayer the option to disclose a transaction where no positive obligation to do so under the reportable transaction rules exists.

As noted above, the GAAR penalty exception exempts transactions that are identical or almost identical to transactions in respect of which the CRA or another relevant government agency has opined is not subject to GAAR from being subject to a GAAR penalty. The effect of this penalty exception is arguably to grant the CRA administrative discretion to relieve taxpayers from the application of the GAAR penalty absent the taxpayer taking the active step of disclosing the transaction in accordance with section 237.3 of the Tax Act. As noted earlier, this gives the CRA administrative positions significantly more importance than they had previously.[21] However, it is important to re-iterate (and this will be discussed in more detail later in the paper) that the GAAR penalty exception in subsection 245(5.2) only applies to transactions that are "identical or almost identical" to ones that have been the subject of CRA administrative guidance or statements (or Department of Finance comments in Technical Notes to Tax Legislation). With respect to this standard, the Finance Notes state that: "[t]he "identical or almost identical" threshold is quite high and, as a result, using the same tax strategy or entering into a transaction that is merely similar would not be enough to qualify for the exclusion."[22] Accordingly, the question of what constitutes an "identical or almost identical" transaction may prove a critical consideration for planning as the validity of reliance on CRA statements(or Department of Finance statements) for the purposes of applying the GAAR penalty exception hinges on this determination. The use of the words

[20] Colloquially referred to as "gross negligence" penalties which applies when, among other things, a person "knowingly, or under circumstances amounting to gross negligence, has made or has participated in, assented to or acquiesced in the making of, a false statement or omission in a return, form, certificate, statement or answer".
[21] Risks and concerns relating to this facet of the GAAR penalty exception are discussed further on in this paper.
[22] *Supra* note 13 at pgs. 339-340.

“identical or almost identical” creates great uncertainty as to when this GAAR penalty exception is available.

We also note that with respect to the GAAR penalty exception, it is not entirely clear from the language of subsection 245(5.2) when statements made by CRA officials can be imputed to the Minister of National Revenue (the “Minister”). Some caution is in order when dealing with statements made by the CRA to ensure they represent the Minister – it is in theory possible that certain statements by CRA officials may not represent the views of the Minister. In our view, it would be appropriate for CRA publications to clearly indicate when statements represent the views the Minister.

With respect to the GAAR penalty exception, the Finance Notes state that “[a]s the test is applied as at the time the transaction was entered into, it could be relied upon even where there are subsequent changes in administrative position or jurisprudence.”[23] Accordingly, it is the outstanding administrative guidance at the time that the transaction is entered into that governs whether the GAAR penalty exception applies. It is also worth noting that any statements made with respect to the GAAR prior the recent amendments are of uncertain effect. While one would assume any statement by the CRA stating its view that it may apply the GAAR would continue to apply, it is unclear whether statements indicating that it would not apply the GAAR should be taken to reflect current CRA views, and/or support reliance on the GAAR penalty exception.

We also note that it is possible that a due diligence defence to the GAAR penalty could be read in by a court.[24] The leading case on whether a due diligence defence can be read into a penalty provision in a taxing statute is *Canada (Attorney General) v. Consolidated Canadian Contractors Inc.* [25] which read in a due diligence defence into an administrative penalty under the Excise Tax Act[26].

In *Consolidated Canadian Contractors* the distinction between strict liability and absolute liability is important. In the case of absolute liability there is no "due diligence" defence and liability flows inexorably from meeting the conditions of application of the penalty.

The *Consolidated Canadian Contractors* case sets out the following framework to determine whether a penalty provision is subject to a due diligence defence:

1. There is a rebuttable presumption that Parliament does not intend to create absolute liability administrative penalties,

2. That presumption can be rebutted "if the language chosen by the draftsperson is unequivocal that absolute liability was intended or where the penalty leads to trivial consequences,"[27] and

[23] *Ibid* at pg. 340.
[24] See Louis Tassé, "The Due Diligence Defence in Tax Matters," in *Report of Proceedings of Fifty-Third Tax Conference*, 2001 Conference Report (Toronto: Canadian Tax Foundation, 2002) 36:1-37 for greater detail on the reading in of a due diligence defence in tax matters.
[25] (C.A.) [1999] 1 FC 209.
[26] RSC 1985, c. E-15, as amended ("the ETA").
[27] *Supra* note 25 at para.37.

3. If the presumption is not rebutted "then it is necessary to determine whether the due diligence defence is incompatible with the legislative scheme or whether it frustrates the purposes for which the penalty was imposed."[28]

We note that that the Finance Notes state that with respect to the GAAR penalty exception that "[it] is not intended to replace any other defences that may be available under applicable law."[29] Accordingly, the presumption of strict liability is supported by this statement and there is some hope that a court will ultimately read in a due diligence defense into the GAAR penalty. Unfortunately, it may not be clear for several years whether a court will, in fact, read in a due diligence defence and as a result, relying on the assumption that such a defence will ultimately be read in poses risks to the adviser and the taxpayer alike.[30]

Extended Reassessment Period

As a final point regarding our comments of the amendments to the GAAR, we note that pursuant to clause 152(4)(b)(viii) of the Tax Act the normal reassessment period is extended for three years if the assessment is made to give effect to the application of the GAAR in respect of a transaction, unless the transaction was disclosed by the taxpayer in accordance with section 237.3 or 237.4 of the Tax Act.

Part 2: Department of Finance and CRA Views on Various Transactions

Introduction

This section constitutes the core of this paper and reviews the published commentary of both the CRA and the views expressed by the Department of Finance with respect to the amended GAAR. This review is undertaken to provide practitioners with an overview of the transactions that have been formally "greenlighted" by the CRA or Department of Finance, and those for which the GAAR concerns have been raised. This section will also highlight areas of uncertainty or inconsistency in the views expressed by CRA or the Department Finance. Annexed to this paper as Appendix "A" is a list of the extant commentary on the application of the amended GAAR by CRA and the Department of Finance as of the date of the writing of this paper. Although we cannot go through all the examples contained in that list, in this section we do provide an overview of the sources that practitioners can examine to get complete details.

Department of Finance Technical Notes

The final version of the amended GAAR was contained in Bill C-59. There were earlier draft versions of the amended GAAR regime which were accompanied by different explanatory notes but we refer only to the notes that accompanied Bill C-59 as there were important changes to the legislation by the time it reached its final form.

The Finance Notes contain examples dealing with the potential application of the GAAR in two places. The first set of examples (some of which are only partial) are in the section which attempts to explain the concept of economic substance and, in particular, the factors that are statutorily

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28 *Ibid*.
29 *Supra* note 13 at pg. 340.
30 See section 4 of our paper for more commentary on this point.

entrenched in subsection 245(4.2) of the Tax Act.[31] The second is a set of examples listed at the end of the section of the Finance Notes dealing with economic substance. These four examples are designed to illustrate how the amended GAAR regime is intended to be applied. [32]

With respect to the first set of examples the most noteworthy example relates to a transaction most practitioners refer to as a "capital gains strip" which the Department of Finance stated was a transaction lacking economic substance but refrained on commenting whether such a transaction was abusive.[33] The first set also discusses transferring funds to a TFSA and corporate loss trading transactions.

The four examples in the second list are: (1) the incorporation of a business, (2) the incorporation of a business immediately before a sale to take advance of the lifetime capital gains exemption of a taxpayer, (3) the use of exchangeable shares in the context of an acquisition by a U.S. purchaser of a Canadian corporation, and (4) an example dealing with the flow-through share regime.

In each case, the commentary provides for a series of arguments as to why economic substance may or may not present. In some of the examples, the Department of Finance takes a position on whether the transaction is abusive or not (usually referencing aspects of a taxing regime which are cited as evidence that the result was intended (or not intended) by Parliament). In our view, the method of reasoning advanced in these examples is not convincing and cannot effectively be utilized with a high degree of accuracy to distinguish an abusive from a non-abusive transaction.

CRA Views

In addition to the Finance Notes, there are currently three CRA documents explicitly commenting on the amended GAAR regime CRA Doc. 2024-1008251I7 entitled "IC 88-2 and new GAAR" (the "Planning TI"), CRA doc. 2023-0987941I7 entitled "Amendments to GAAR and Advance Income Tax Rulings"(the "Pipeline TI") and CRA doc.2024-1016011E5 entitled "General Anti-Avoidance Rule"(the "Crystallization TI").

In the planning TI, the CRA stated that, in its view, the conclusions reached in Information Circular ("IC") 88-2 and IC 88-2, supplement 1 (which provided examples of when the GAAR as it existed when those ICs were issued would or would not apply) "should remain the same under the amended section 245." The CRA noted, however, that the potential application of amended section 245 is dependent on a full review of all of the facts and circumstances of each particular case (including a review of the object, spirit, and purpose of the impugned provisions, and with due weight given to economic substance). We note that IC 88-2 was issued shortly after the introduction of the GAAR on October 21, 1988 while IC 88-2, supplement 1 was released on July 13, 1990.

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[31] *Supra* note 13 at pgs. 330-334.
[32] *Ibid* at pgs. 335-339.
[33] The example essentially involves the intentional triggering of a capital gain on shares of a corporation in order to use that "hard" adjusted-cost base to extract funds from a corporation. See also Robert Santia, "Interpreting "Tends To Indicate Misuse or Abuse" or: How I Stopped Worrying About Economic Substance and Learned To Embrace Principles of Statutory Interpretation" (2024) 24:2 *Tax for the Owner-Manager* 3-4.

IC 88-2 (also referred to as “list 1”) and IC 88-2 (also referred to as “list 2”) supplement 1 (collectively, “the ICs”) cover a wide range of transactions, however in this paper we will only examine a few select examples in any level of detail. Appendix “A” to this paper provides a table detailing all these examples. Listed below are a selection of examples from these ICs, in which the CRA provided examples of transactions that were avoidance transactions) but that (if specific criteria in the ICs were met) would not be subject to the GAAR[34]:

- divisive reorganizations under 55(3)(b) (list 1, paragraph 7)[35];
- loss-and-profit consolidation transactions within a related corporate group (list 1, paragraph 8);
- estate freezes accomplished via a rollover to a holding corporation, under subsection 85(1), or via share exchange, under section 86, whereby the transferor takes back voting-control preferred shares, and a family trust for minor children is issued the growth shares where corporate attribution has been addressed appropriately (list 1, paragraph 10);
- the incorporation of a sole proprietorship to access the small business deduction (list 1, paragraph 11);
- purification transactions, designed to enable a corporation to qualify for the capital gains exemption, which move redundant assets via an intercorporate redemption of shares governed by subsection 55(2) (list 1, paragraph 15); and
- “crystallizing” capital gains deductions (list 2, paragraph 3).

Two of the transactions that the CRA identified in the ICs as being subject to the GAAR were

- “disguised sales” conducted through a partnership via a rollover under subsection 97(2) (list 1, paragraph 12), and
- the use of a common holding corporation by two unrelated corporations to ensure that dividends received are not subject to part IV tax (list 1, paragraph 14).

The second source of CRA commentary on the application of the amended GAAR is the Pipeline TI. In the Pipeline TI, the CRA confirmed that it would continue to issue favourable rulings for post-mortem pipelines that meet the agency’s existing administrative guidelines, set out in

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[34] See our article from which some of this material in this paper including this section is derived “Tax Planning Under the New GAAR: The CRA Comments” (2024) Vol. 24., No. 3 Tax for the Owner-Manager.

[35] It is outside the scope of this paper to fully cover the interaction between the amended GAAR regime and the butterfly rules, but we would refer readers to Marc Ton-That, “CRA Update on Subsection 55(2) and Safe Income Where Are We now?” that was delivered to the Canadian Tax Foundation on November 28, 2023 (the “CRA Safe Income Update Paper”) and which sets out CRA policy with respect to safe income. The Ton-That paper indicates various scenarios where CRA would challenge a purely technically compliant butterfly (apparently) under GAAR – accordingly any divisive reorganization should consider the possible application of these positions to the transactions. Also see CRA doc. no. 2024-1005011E5 which confirms that the paper reflects CRA assessing policies with respect to 55(2) and provides certain guidance in respect thereof. Our fourth example, in the example section of our paper, examines this paper in a cursory fashion.

document no. 2018-0748381C6 (March 29, 2018). However, the CRA stated that it would not rule on transactions colloquially referred to as "capital gains strips" because those transactions were identified as raising the GAAR concerns. The CRA cited the Finance Notes (referred to in the previous section) which stated that, after these transactions, “there has been no change in the opportunity for profit or gain or risk of loss” and no “change in economic position (other than with respect to the tax paid on the capital gain).”[36] The CRA also stated that it would not rule on non-arm's-length transactions, one of the main purposes of which is to create cost basis to extract retained earnings. Finally, the CRA concluded by stating that it would continue to consider rulings that do not "frustrate the object and purpose of specific provisions of the Act designed to limit the extraction of retained earnings without the payment of a taxable dividend."[37]

In the third source of CRA commentary on the amended GAAR, the Crystallization TI, the CRA (in response to the Budget 2024 announcement of a change in the capital gains inclusion rate) stated that while the, “potential application of the GAAR requires an analysis of all the facts and circumstances relating to a particular situation”[38] nonetheless concluded that it was their view that, “where a taxpayer crystallizes an accrued capital gain prior to the increase in the capital gains inclusion rate, the GAAR would generally not apply to redetermine the inclusion rate in respect of the crystallized capital gain.”[39] This was accompanied by some notable caveats including the following comment, “It is important to note, however, that the crystallization of an accrued capital gain as part of a series of transactions, one of the main purposes of which is to obtain a tax benefit …. would not be immune from scrutiny under the GAAR.”[40] The CRA then referred taxpayers to its letter dated February 29, 2024 (CRA document 2023-0987941I7), in which CRA stated it would not provide rulings in respect of a series of transactions in which an individual shareholder proposes to engage in non-arm’s length transactions, one of the main purposes of which was to facilitate the extraction of corporate retained earnings other than in the form of a dividend.

We note that these two statements in the Crystallization TI approving of crystallization transactions while cautioning against “capital gains strips” appear to be at cross-purposes or are (arguably) inconsistent. We note that the intentional triggering of a capital gain by a corporation through non-arm’s length transactions (also known as a crystallization transaction) would, in the normal course, create the surplus accounts (RDTOH and a capital dividend account balance) that if utilized result in a transaction that is arguably indistinguishable from the “capital gains” strips which the CRA cautioned against.

Can Any Inferences be Drawn Regarding the CRA’s views on the Role of Economic Substance?

It is worth noting that the Planning TI does seem indicative of a muted role for economic substance (or at least one might infer that CRA takes that view in light of the conclusions it reached). The fact that the Planning TI states that the CRA reached the same conclusions with respect to the entirety of the IC 88-2 and 88-2 supplement 1 lists notwithstanding the introduction of economic substance into the GAAR analysis and notwithstanding that certain of the factors that “establish”

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[36] Pipeline TI at pgs. 4-5.
[37] Pipeline TI at pg. 5.
[38] Crystallization TI at pg. 3.
[39] Crystallization TI at pg. 4.
[40] Crystallization TI at pg. 4.

a lack of economic substance appear to be present in certain of the examples - suggest that the CRA is placing a muted emphasis on economic substance. Or perhaps more precisely one might infer that the CRA is placing a muted emphasis on economic substance if it regards the planning as being consistent with the policy of the relevant provisions or the Tax Act as a whole. In circumstances where the planning fails a CRA "smell test", we do wonder whether this (apparent) lack of focus on economic substance would be maintained or whether its absence would be advanced as a serious argument in favour of a finding of abuse.

Part 3: Examples

Introduction

In this section of the paper, we are going to look at three examples taken from CRA commentary on the amended GAAR and attempt to show the practical difficulties associated with relying on it – especially if the aim is to make use of the GAAR penalty exception. We will also examine one final example which examines how pre-existing CRA GAAR commentary (that is commentary issued before the recent amendments to GAAR) can affect planning.

Estate Freeze

In paragraph 10 of IC 88-2 the CRA expressed the view that certain estate freeze transactions should not attract the application of the GAAR. In that commentary the CRA first provides a general statement of facts that outline what it regards as an "estate freeze". That outline is as follows:

"Under a typical estate freeze arrangement, a parent transfers to a newly formed corporation all of the shares of an operating company and elects under subsection 85(1) in order to defer recognition of the gain on the transfer. The consideration for the transfer is preferred shares retractable at the option of the parent for an amount equal to the fair market value of the shares of the operating company transferred. The preference shares carry voting control. A trust for minor children of the parent subscribes for common shares of the new company for a nominal amount."[41]

This is then followed with an analysis of why it does not regard such transactions as being subject to the GAAR. These comments include the following statements:

"The Explanatory Notes state that estate freezes would not ordinarily result in misuse or abuse given the scheme of the Act including the recently enacted Subsection 74.4(4). Section 74.4 was enacted to deal with income splitting and could have application to certain estate freeze arrangements.

…

Subsection 245(2) will not apply to the transfer of the shares to the corporation where subsection 74.4(2) applies to deem the parent to receive an amount as interest. Similarly, subsection 245(2)

[41] IC 88-2 at pg. 4.

would not apply where, for the reasons stated above, subsection 74.4(2) does not apply to deem the parent to receive an amount as interest.

…

Similar considerations would apply to other types of estate freezes involving a transfer of property by a parent to a corporation. For example, in an estate freeze carried out pursuant to section 86 of the Act, the parent would dispose of the shares of the operating company and receive preferred shares of the company having a redemption amount equal to the fair market value of the shares disposed of."[42]

Consider the following hypothetical scenario. Mr. Smith is the sole owner of ("Smith Opco") an operating company incorporated under the *Business Corporations Act* (Ontario). He holds common shares, and these shares are qualified small business corporation shares ("QSBC").[43] Mr. Smith wishes to undertake an estate freeze as he has learned that a freeze could have several benefits from a tax and estate planning perspective.

A simple plan is developed – the articles of Smith Opco will be amended to create a class of redeemable and retractable preferred shares with an aggregate redemption amount equal to the fair market value of the common shares for which they will be exchanged (the "Smith Freeze Shares"), including a price adjustment clause to deal with a challenge to the fair market value by the CRA and a dividend entitlement at a rate based on the redemption amount of a preferred share. The shares may be voting or non-voting. Under this plan, Mr. Smith will exchange all of his existing common shares for the Smith Freeze Shares on a tax deferred basis in the Articles of Amendment under section 86 of the Tax Act. A new family trust will be settled by an arm's length party with the beneficiaries consisting of Mr. Smith's spouse, and Mr. Smith's issue with Mr. Smith acting as sole trustee. The family trust will then subscribe for a new class of common shares of Smith Opco for a nominal amount using the settlement funds.

Strong arguments could be made that this transaction is identical or almost identical to the transaction discussed by the CRA in IC 88-2. It should be noted that the example in the ICs only discusses a trust for minor beneficiaries. Is the plan still "identical or almost identical" to the example in the ICs if adult children, the spouse and/or Mr. Smith himself are included as beneficiaries of the trust? However, now suppose a few more wrinkles are introduced to the estate plan.

Mr. Smith indicates that the operating company may accumulate profits beyond the working capital needs of the Smith Opco in the future. Mr. Smith is advised that the proposed structure can be a good way to keep Smith Opco free of passive assets so that its shares can qualify for the lifetime capital gains exemption if a corporation can be included as a beneficiary of the family trust. Extra profits earned by Smith Opco, can be paid as a dividend on the common shares held by the family trust and can then be allocated to the corporate beneficiary of the family trust. That dividend can then be received tax free as an intercorporate dividend provided that Smith Opco is "connected" with the corporate beneficiary within the meaning of subsection 186(4) of the Tax

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[42] IC 88-2 at pgs. 4-5.

[43] See section 110.6 of the Tax Act.

Act and provided that the dividend is paid out of the safe income attributable to the common shares of Smith Opco held by the family trust.

This wrinkle seems to be inoffensive planning – however – nothing in relation to this planning is mentioned in the CRA example. While it may be reasonable to take the view that such planning should not attract the application of the GAAR, there is no principled basis to say that such planning is “identical or almost identical” to the views expressed in the CRA example regarding estate freezes which focuses its commentary on corporate attribution and not issues relating to the use of a trust as a vehicle to achieve purification.

Now consider a third wrinkle. Mr. Smith indicates that he may want to sell his corporation within 24 months after the freeze and wants to ensure that the beneficiaries of the trust can use their lifetime capital gains exemption. Mr. Smith is advised that under the current plan, the trust must hold the common shares that it subscribed for in Smith Opco for twenty-four (24) months prior to the sale, otherwise those shares will not qualify for the capital gains exemption.[44] Mr. Smith is then advised to consider amending the current plan. Instead of exchanging the common shares for the Smith Freeze Shares, the following additional steps could be undertaken. First, the Articles of Smith Opco would be amended to create a class of high-low stock dividend freeze shares (the “Stock Dividend Freeze Shares”) instead of the Smith Freeze Shares. The Stock Dividend Freeze Shares will be redeemable and retractable preferred shares with an aggregate redemption amount based on the fair market value of the common shares, a price adjustment clause to deal with a challenge to the fair market value by the CRA and a dividend entitlement at a rate based on the redemption amount of a preferred share. These shares may also be voting or non-voting. Second, a stock dividend would be declared on the common shares of Smith Opco and would be paid by the issuance of the Stock Dividend Freeze Shares.   Mr. Smith could sell the now nominal value common shares of Smith Opco to the trust for fair market value consideration. The Trust could pay the purchase price with some of all of funds used to settle the trust. As a result of this plan, the common shares of Smith Opco should now on a technical basis be “qualified small business corporation shares, notwithstanding that the trust has not held the shares for twenty-four (24) months.[45] Under this plan, Mr. Smith could not be a beneficiary of the family trust.

This third version of the plan now has at least two critical distinctions from the example approved of by the CRA. First, the freeze was accomplished by a stock dividend. Second, the shares are issued to the trust via a sale by the freezor for fair market value proceeds. There is frankly no way to know if this transaction would be regarded by the CRA as abusive on the basis of the example the CRA provided.

This example illustrates two important points with respect to relying on CRA GAAR views. First, the scope of what the CRA is saying is not subject to the GAAR in any individual statement may not be clear. From the commentary provided in IC 88-2 paragraph 10 – one view

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[44] paragraph (b) of the definition of “qualified small business corporation share “in subsection 110.6(1) and paragraph 110.6(14)(f) of the Tax Act.
[45] See David Carolin, Manu Kakkar, and Stan Shadrin, "Capital Gains Exemption Planning, Trusts, and the 24-Month Holding Period Rule" (2021) 21:3 *Tax for the Owner-Manager* 2-3.

is that CRA was primarily commenting on corporate attribution although clearly the transaction as described was determined to not be subject to the GAAR.

It is important to note that, slight changes in any planning can involve other tax provisions that will then render the transaction no longer "identical or almost identical" to the one discussed by the CRA. Accordingly, in such circumstances, reliance on the GAAR penalty exception may not be possible. The second problem associated with reliance on CRA commentary on the GAAR is that it is not clear which aspects of the transaction itself are being commented upon. In our example, the use of a trust in the context of an estate freeze as a purification tool is not clearly within the scope of the commentary provided. Since a transaction can have multiple tax purposes and, if the CRA only comments on one aspect the use of a particular structure, the use of the same structure for other purposes may be outside of the scope of reliance that can safely be made.

Purification Transactions

The CRA expressed the view in paragraph 15 of IC 88-2 that (certain) purification transactions that are designed to ensure that shares of a corporation qualify as QSBC shares should not be subject to the GAAR. The facts discussed in that example were as follows:

"The common shares of a corporation would be "qualified small business corporation shares" as defined in subsection 110.6(1) except that at the time in question all or substantially all of the assets of the corporation are not used in an active business carried on primarily in Canada. The shareholders wish to sell their shares and to have the gains qualify for the special increased capital gains exemption provided by subsection 110.6(2.1) of the Act. To achieve this result, the shareholders incorporate a corporation and transfer to this corporation shares of the operating corporation that have a fair market value equal to the fair market value of the assets that are not used in the active business of the operating corporation. The operating corporation purchases these common shares from the new corporation and pays the purchase price of the shares by transferring the non-business assets to the new corporation. The operating corporation may have a tax liability arising from the disposition of the non-business assets. The new corporation may be subject to subsection 55(2) of the Act if the gain on the purchased shares is attributable to something other than income earned or realized by the operating corporation."[46]

The CRA opined in respect of these facts that:

"The formation of the new corporation and the transfer of the shares to the new corporation is not an abuse of the Act. The transfer of the non-business assets is governed by subsection 55(2) of the Act. Since the definition of a qualified small business corporation share does not require that all or substantially all of the assets be used in carrying on an active business in Canada for a particular period of time prior to the sale of the shares, the distribution of the non-business assets prior to the sale is acceptable. Therefore, in this case, the transactions undertaken to "purify" the corporation are in accordance with the scheme of the Act."[47]

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[46] IC 88-2 at pg. 15.
[47] *Ibid*.

This example should give some comfort to tax practitioners using redemptions to remove redundant assets before a sale. However, as with the previous example relating to an estate freeze, small changes from what are discussed by the CRA could result in the transaction being sufficiently different that a taxpayer may not be able to rely on the GAAR penalty exception.

We note that the Pipeline TI cautions against non-arm's-length transactions that are designed to extract retained earnings without the payment of a dividend. The CRA's statements in its commentary on purifications appear to be (arguably) inconsistent with that statement. This inconsistency arises because it may be impossible, depending on the proximity of a sale or the possibility of a sale, to distinguish a purification transaction (approved by the ICs) from a surplus-stripping transaction that raise the GAAR concerns.

If for example because of a purification transaction the corporation receiving the redemption proceeds realizes a gain as a result of the application of subsection 55(2) – would the mere act of at some future date paying a capital dividend and/or a taxable dividend then place such a transaction outside the scope of the CRA commentary in IC 88-2 relating to purification transactions? What in the CRA's view would distinguish the one from the other? It is not apparent to us that there is a principled basis to distinguish one transaction (purifications) from the other (capital gains strips). We expect that other planning scenarios will bring to light similar inconsistencies as time passes.

Post-Mortem Pipeline

In the Pipeline TI the CRA expressed its view that it does not consider "the use of a pipeline transaction as a means to preserve the capital gain arising on the death of a shareholder while limiting double taxation on the subsequent distribution of Opco's assets to be a misuse described in paragraph 245(4)(a) or an abuse within the meaning of paragraph 245(4)(b)."[48] However, that view was conditional on meeting the CRA's existing administrative guidelines described in CRA doc. no. 2018-0748381C6.

We note that one of the administrative guidelines that the CRA set out in CRA doc. no. 2018-0748381C6 was that the pipeline contemplated the continuation of the particular business of the corporation subject to a pipeline transaction for at least one year following which "a progressive distribution of the corporation's assets would occur over a period of time." The one-year time frame set out in this guidance has, in our view, no clear statutory basis but rather amounts to an administrative simplification of the complex case law surrounding the application of subsection 84(2) of the Tax Act.

If a taxpayer were to undertake a pipeline but continue the business for 8 months rather than a year and the CRA were to apply the GAAR – the taxpayer arguably could not rely on the GAAR penalty exception to ensure that no GAAR penalty could be imposed. This result is of concern because the period of one year has no clear statutory basis. Yet, by not complying with this arbitrary time frame the taxpayer may be shunted out of the limited safe harbour provided by the GAAR penalty exception.

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[48] Pipeline TI at pg. 6.

Reorganization under Subsection 55(3)(a)

As we noted previously, the CRA Safe Income Update Paper[49] sets out a variety of CRA positions with respect to section 55 of the Tax Act. Of particular interest (and concern) to tax practitioners are the positions pursuant to which the CRA would seek to apply the GAAR to otherwise technically compliant transactions. Although, the CRA Safe Income Update Paper was issued prior to the recent amendments to the GAAR, it seems reasonable to assume the positions on the applicability of the GAAR would not be weakened by the recent amendments.

The purpose of this example is partially to illustrate how such GAAR pronouncements can significantly affect the ability to undertake fairly standard planning especially in the owner-manager context.

In the CRA Safe Income Update Paper the author states with respect to the "related party" exemption in subsection 55(3)(a) that:

"it was necessary to preserve the paragraph 55(3)(a) exemption to facilitate bona fide reorganizations by related persons since those reorganizations would typically require transfers of property that are followed by a redemption of shares under subsection 84(3)… the technical notes clarified that the amendments to paragraph 55(3)(a) and the introduction of subsection 55(2.1), although the text being silent on the consequent restriction of the application of paragraph 55(3)(a), should not be interpreted as a green light to use paragraph 55(3)(a) to manufacture basis. As indicated in the technical notes, the paragraph 55(3)(a) exemption is "not intended to be used to accommodate the payment or receipt of dividends or transactions or events that seek to increase, manipulate, manufacture or stream cost base." Clearly, the application of the paragraph 55(3)(a) exemption should be consistent with the scheme of subsection 55(2) and an attempt to use the paragraph 55(3)(a) exemption to circumvent the application of paragraph 55(2.1)(b) would be subject to a challenge under GAAR."[50]

Furthermore, with respect to the computation of "safe income" itself the author states that:

"It is incorrect to argue that the legislation on safe income is a complete code for its calculation particularly given its legislative and jurisprudential history; nor would a strict textual approach, ignoring its context within the scheme of subsection 55(2), be correct."[51]

It should also be noted that the CRA's views on safe income on reorganization and inappropriate cost increase due to misalignment of ACB (and safe income) "*are based on logic and reasonableness, in accordance with the integration of the concept of cost and the scheme of subsection 55(2)*."[52]

Taken together, we are of the view that these comments mean that the CRA believes that Parliament drafted section 55 of the Tax Act in an incomplete fashion with the intention of allowing

[49] *Supra* note 35.
[50] *Ibid* at pg. 16.
[51] *Ibid* at pg. 19.
[52] *Ibid* at pg.38.

the CRA to administer the provisions in such a manner that fulfills the policy objectives that were too complex or burdensome to put into proper legislative format.

This approach taken by CRA with respect to section 55 is now of greater concern because of the potential application of the GAAR penalty.

While the scope of this paper prevents us from providing a fully detailed example in the manner of the previous examples, we refer the reader to pages 39 through 72 of the CRA Safe Income Update Paper which sets out the CRA's positions with respect to circumstances where a corporate reorganization can result in "inappropriate cost" increases due to misalignment of ACB and safe income. An extensive presentation was made at the 75th Annual Tax Conference on this subject.[53]

From a practitioner's perspective these positions present two distinct challenges. The first challenge is ensuring that planning does not inadvertently run afoul of CRA positions due to a lack of records regarding historical reorganizations. Secondly, because the CRA's positions are made in the form of examples and not legislation, tax advisers are unable to rely on the precision ordinarily expected of tax legislation and must, to some extent, intuit where otherwise compliant reorganizations might run afoul of CRA positions with respect to the application of section 55.

Example 17 of the CRA Safe Income Update Paper,[54] illustrates the problem. In this example a holding company ("Holdco") owns an operating company("Opco") with two appreciated assets. One asset was purchased with the Opco's entire income realized after tax and has an adjusted cost base and fair market value of equal amounts. The second asset owned by Opco has a fair market value equal to that of the first asset but has no adjusted cost-base (or in other words is pure untaxed appreciation). Holdco spins-out the first asset to a new corporation ("Newco") under a reorganization that qualified for the exemption under paragraph 55(3)(a) of the Tax Act. The position of the CRA is that, after the reorganization, it would be inappropriate for the remaining shares of Opco held by Holdco to retain any of the safe income because the tax-cost reflective of the after-tax earnings of Opco was in an asset that has been transferred to Newco.

Recognizing that a strict tracing approach is impossible, the CRA has advanced a formula which in its view should govern the allocation of the direct safe income after the corporate reorganization. That formula is as follows:

"DSI[55] on the shares of Newco: DSI of Opco prior to reorg X net cost amount of assets transferred to Newco / total cost amount of assets of Opco prior to reorganization.

DSI on the shares of Opco after reorg: DSI of Opco prior to reorg X net cost amount of assets retained by Opco / total cost amount of assets of Opco prior to reorganization."[56]

Example 17 of the CRA Safe Income Update Paper could easily encompass a simple purification transaction of the type mentioned in our second example. If, however, subsequent, to a purification

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[53] Rick McLean & Gwen Watson, "Safe Income Allocations After an Internal Reorganization" (Canadian Tax Foundation: 75th Annual Tax Conference, November 26-28, 2023).
[54] *Supra* note 35 at pgs. 40-41.
[55] DSI is used to mean "direct safe income" in the CRA Safe Income Update Paper.
[56] *Supra* note 35 at pg. 41.

a sale of the shares of the operating company occurs and the allocation of safe income that otherwise would be permissible under section 55 violates CRA example 17 – this could result in the CRA applying the GAAR. For example, if the operating company were to pay a safe income dividend the holding company prior to the sale, and the CRA were to determine that the safe income is present because of an unreasonable allocation of safe income after the purification transaction, the GAAR could be applied, and depending on the reasonable consequences of the GAAR assessment, a significant penalty could attach to the planning. We note that the internal reorganization could have occurred years before the dividend was declared and paid.

There are also examples in CRA Safe Income Update Paper in which the CRA is of the view that a reorganization should be undertaken in a manner that streams adjusted cost-base to avoid what it regards as an inappropriate result.[57] Accordingly, the failure to do so could also result in the application of GAAR.

From a practical standpoint when undertaking planning that relies on the exemption in paragraph 55(3)(a)of the Tax Act, practitioners should keep in mind the general concerns raised by the CRA in the CRA Safe Income Update Paper. To the extent possible it may also be prudent for taxpayers and their advisers to keep records regarding how safe income should be allocated in the wake of corporate reorganizations for future reference – in the same manner that records regarding historical cost are kept. We note that a court may ultimately disagree with the CRA positions. However, it is important for practitioners to be aware of these positions in order to properly assess the GAAR risk associated with otherwise inoffensive related party reorganizations under paragraph 55(3)(a) of the Tax Act.

Part 4: Practical Approaches for Planners dealing with the Potential Application of the GAAR

Introduction and General Comments on Tax Practice under the Amended GAAR

This section of our paper will attempt to provide a kind of practitioner's "rough and ready" toolkit for dealing with practical realities of providing tax advice in such an uncertain planning environment. As our examples illustrate, the limited safe harbours provided by the GAAR penalty exception and the GAAR disclosure mechanism, leave a vast grey area between transactions which the CRA(or the Department of Finance) has explicitly approved and those transactions that the CRA or the Department of Finance have indicated raise the GAAR concerns. This grey area will consist of transactions for which there is no CRA(or Department of Finance) guidance, or for which the CRA(or Department of Finance) guidance is partial, inconsistent, or unclear in application. As time progresses, the CRA administrative guidance may grow and that grey area may slowly shrink, but in the interim taxpayers and their advisers will be regularly dealing with planning scenarios for which there is no certainty with respect to the potential application of the GAAR and/or the GAAR penalty.

However, before discussing the practical aspects of this section, we now provide some brief commentary on the nature of the problem from a more theoretical perspective. Without venturing too deeply into the history of the GAAR, it is noted that from the outset of the introduction of the

[57] *Supra* note *35* & see Example 23 at pg. 58.

GAAR concerns were raised by various practitioners regarding the GAAR's inherent uncertainty of application. Some early commentors were of the view that the GAAR was constitutionally suspect or suspect under general rule of law principles.[58] There were limited efforts to challenge the GAAR on constitutional or quasi-constitutional bases and these were ultimately unsuccessful.[59] Whether, upon revisiting these issues under the amended GAAR regime, a court might reach a different conclusion is an interesting question but one which is outside the scope of this paper. We do note that some commentators pointed out the especially egregious nature of imposing a penalty where the GAAR was found to apply. David Nathanson wrote in 1988 the following with respect to a prospect of penalty in respect of the GAAR:

"Easily the most offensive aspect of the proposed general anti-avoidance rule is the government's suggestion that some form of penalty for engaging in an "avoidance transaction" is necessary or desirable. That suggestion serves only to underscore the brute force of the proposed rule. The government itself has expressly recognized that "the introduction of the new rule will inevitably carry with it a degree of uncertainty that in some cases can only be clarified through judicial interpretation of specific cases."... The attachment of a penalty to a transaction, the "avoidance" character of which would often be relatively uncertain until an after-the-fact judgment had been made on the basis of problematic criteria, therefore would be exceedingly inappropriate. There is no place in our law for treating as a quasi-crime a transaction adjudged ineffective on the basis of as vague and theological a test as failing to have a non-tax factor as the primary purpose for it."[60]

Notwithstanding these concerns, planners must deal with the law as it is not how they wish it would be. That being said, the true consequences of a GAAR penalty, including its effects on the general functioning of the tax system, may not become fully apparent except with the passage of time.

Certain observations of Justice Rowe made during the hearing of the Supreme Court in *Dean's Knight*[61] were related in a recent paper[62] and were described as follows:

[Justice Rowe] "*began by describing a place on Newfoundland's East Coast Trail, where the trail borders a cliff that rises about 150 feet above the rocks along the shore. Someone following the trail can venture to within three inches of the edge of the cliff. As Rowe J observed, if you do that, there is no certainty that you will lose your balance, but you know you are taking a far greater risk than if you remained 8 or 10 feet from the edge.*"

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[58] See for example Joel Nitikman, "Is GAAR Void for Vagueness" (1989) 37:6 *Canadian Tax Journal* 1409-1447.

[59] See James R. Wilson, "The Legislative History of the General Anti-Avoidance Rule: From the White Paper Draft GAAR to the GAAR Enacted," in *The General Anti-Avoidance Rule: Past, Present, and Future* (Toronto: Canadian Tax Foundation, 2021), 4: 91-128 which provides a discussion of these cases – including *Mathew et al. v. The Queen*, 2002 DTC 1637 (TCC), *Gregory v. The Queen*, 2000 DTC 2027 (TCC) and *The Queen v. Gregory*, 2000 DTC 6561 (FCA).

[60] David C. Nathanson, "The Proposed General Anti-Avoidance Rule," in *Report of Proceedings of the Thirty-Ninth Tax Conference*, 1987 Conference Report (Toronto: Canadian Tax Foundation, 1988), 9:1-27 at p. 27.

[61] 2023 SCC 16.

[62] Brian R. Carr, Brittany D. Rossler, and Molly Martin, "What Is a Tax Planner To Do After Deans Knight?" Corporate Tax Planning feature (2024) 72:1 *Canadian Tax Journal* 231-80 at pgs. 242-243.

These comments were intended to reflect the core of the tax planner's task with respect to the GAAR risk. The view expressed appears to be that while the GAAR may not apply with precision, planners should be able to distinguish the degree of the GAAR risk of a transaction, in the same way that a hiker can judge the risk of falling off a cliff by having a sense of "how close to the line" a party might be. The GAAR risk, in other words, is a spectrum with the fuzzy line separating the safe from the unsafe not being clear but in respect of which an astute planner can make judgements about how close that fuzzy line (or cliff's edge) might be.

With all due respect to Justice Rowe, the metaphor about the cliff's edge may be a bit stretched. While it may have been apparent to Justice Rowe in the context of *Dean's Knight* that the taxpayer was approaching the edge of the cliff – it is far from clear in other cases whether you are a mere inch from the cliff or 12 feet (at least ex ante). Arguably, how far away from the precipice the taxpayer stands from "the cliff" amounts to nothing more than posturing regarding whether a transaction passes a "smell test".

Justice Rowe's metaphor was employed in service of the reasoning ultimately articulated in *Deans Knight* in which the Supreme Court stated the following:

"There may be circumstances where the provision's underlying rationale is no broader than its text because, having regard to its context and purpose, the provision's text "fully explains its underlying rationale" (Copthorne, at para. 110). A court, however, must not lose sight of the goal of the exercise — to discern the underlying rationale of the provision — and the reality that this rationale "may not be captured by the bare meaning of the words themselves" (Copthorne, at para. 70). As explained by Noël C.J. of the Federal Court of Appeal, "[w]hile one cannot rule out the possibility that the underlying rationale for a provision will be fully captured by the words, this must still be demonstrated by inquiring into the provision's reason for being" (Oxford Properties Group, at para. 88, citing Copthorne, at paras. 110-11)."[63]

Tax planners are confronted with practical requests by taxpayers to achieve certain tax objectives and then are asked to develop a plan to achieve those objectives. While common sense dictates that a smell test may suffice in some circumstances to identify transactions bearing a higher degree of the GAAR risk – that "quick and dirty" approach is fraught with difficulties.

Asking tax practitioners to look beyond the plain text of a provision to see whether their planning frustrates the aims of Parliament is a task more simply asked for than completed. A standard tax planning transaction – as was seen with the example an estate freeze – may involve multiple statutory provisions. While the CRA gave "the green light" to "estate freezes" – there are multiple versions of that same transaction. As noted earlier, slight differences from what the CRA approves may alter a transaction sufficiently such that taxpayers cannot rely on the GAAR penalty exception.

The question for practitioners is how to practice in light of this uncertainty. The following portion of this paper provides some suggestions[64]. Although we would like to think these suggestions can provide some practical assistance – undoubtedly, the practice of tax after the amendments to the

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[63] *Supra* note 61 at paragraph 65.
[64] Nixon and Tobin, S*upra note 9* discuss similar some suggestions in their paper.

GAAR will simply be riskier for taxpayers and their advisers regardless of the techniques that taxpayers and their advisers employ to mitigate the GAAR risk.

The Three Categories of Transactions – Approved, Government GAAR Concerns and Grey

Before discussing practical strategies to address the uncertainty relating to tax practice arising because of the amended GAAR, the following is an outline for categorizing transactions. The outline divides transactions into three categories as follows:

1. Transactions that are identical or almost identical to transactions in respect of which there is guidance from the CRA or another relevant governmental authority ("category 1 transactions");
2. Transactions that have been identified as raising the GAAR concerns by the CRA, or the Department of Finance ("category 2 transactions"); and
3. Transactions for which no guidance has been issued or in respect of which there is partial or contradictory guidance ("category 3 transactions").

With respect to category 1 transactions – a tax practitioner should be able to undertake them with relatively low risk to the client. Although we note that there is no estoppel in a tax context[65] and the CRA is not bound by its own administrative positions, relying on these statements if still valid at the time the transactions are entered into should preclude the application of a GAAR penalty because of the GAAR penalty exception.

With respect to category 2 transactions – tax practitioners should be extremely cautious of undertaking these transactions. Although the CRA's (or the Department of Finance's) views are not law, as a consequence of the possible application of the GAAR penalty and the extended reassessment period (if the transaction is not disclosed in accordance with either sections 237.3 or 237.4 of the Tax Act) the potential tax risk to the client in respect of such transactions is significantly increased as compared to risk that would exist before the recent amendments to the GAAR.

With respect to category 3 transactions, tax practitioners should consider using the tools that the next several subsections of this paper to address the inherent uncertainty. Tax practitioners should also consider the sophistication of the parties and the degree to which they have been apprised of the GAAR risk relating to the transaction. While it is outside of the scope of this paper, tax practitioners should consider the professional negligence laws governing their profession when undertaking tax planning and might wish to consider taking steps as part of their planning procedures to properly protect themselves, particularly, when dealing with category 3 transactions.

Disclose the Transaction(s)

The first and most obvious answer to the possibility of the application of a GAAR penalty to transaction(s) undertaken by a taxpayer would be to disclose them pursuant to subsection 237.3(12.1)of the Tax Act. This strategy has several drawbacks. The first and most obvious is that this strategy could attract CRA scrutiny and could potentially trigger a costly and lengthy tax audit. The second drawback is one of professional fees. Given the seriousness of such a disclosure,

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[65] See for example *Mattabi Mines Ltd. v. Ontario (Minister of Finance)* [1988[, 2 SCR 75 at para 27.

taxpayers will want to ensure that the disclosure is properly drafted in a technically accurate manner. Such a submission will (likely) result in taxpayers incurring significant professional fees. If an adviser is confident that a transaction will survive audit scrutiny then provided the taxpayer is willing to cover the costs of preparing the disclosure, this may be an appropriate way to deal with a category 3 transaction.

Seeking a ruling or technical interpretation

Another alternative to consider in respect of transactions, but especially with respect to category 3 transactions, would be to seek a ruling or technical interpretation. This strategy has two advantages over the option to disclose the transaction under subsection 237.3(12.1)of the Tax Act. First, the ruling would occur prior to the transaction(s) being implemented – meaning the taxpayer will have certainty regarding its outcome before undertaking the transactions. The second advantage is that each ruling adds to the body of certainty that other taxpayers can rely on when undertaking planning – of course this is in the nature of a public good – so this is not necessarily something that an adviser can consider when deciding whether to pursue this option. This option has, in our view, three main drawbacks. As with respect to the disclosure option, seeking a ruling or technical interpretation is costly. In addition, the CRA may decline to rule or provide a technical interpretation if there are questions of fact which cannot be adjudicated by the CRA. Finally, the process of securing a ruling or technical interpretation can be slow and the taxpayers may not want to wait.

GAAR Opinions?

A taxpayer could also seek to obtain a tax opinion on a transaction or series of transactions from tax advisers/counsel. The utility of such a strategy will depend on whether a due diligence is ultimately read into the GAAR penalty by a court. The chief drawback of this option is that the efficacy of the opinion largely hinges on the status of the due diligence defence which may not be known until well after the transaction is completed. The other drawbacks are cost, and the length of time required to secure an opinion. In addition, given the lack of case law on the amended GAAR, it is also unclear whether tax advisers/counsel would be willing to provide such opinions.

Waivers

Finally, if none of the options discussed above are of use, then ultimately the adviser will need to use his or her judgment to decide whether running the risk of undertaking a category 3 transaction carries a high degree of the GAAR risk. It is outside the scope of this paper to discuss questions of professional responsibility or negligence, but it may be worthwhile to, after having fully explained the risk inherent with respect to category 3 transactions, obtain a written acknowledgement from the client stating that the client understands the risk and wishes nonetheless to proceed with them.

Conclusion

Oscar Wilde wrote that “experience is merely the name men gave to their mistakes.”[66] It is our hope that this paper will assist tax practitioners from accumulating more experience than they would wish to as they adapt to the more uncertain world of the amended GAAR. With that said,

[66] Oscar Wilde (1891), “The Picture of Dorian Gray”, Chapter 4.

here are a few "takeaways" tips that tax practitioners may wish to employ as they navigate this new more uncertain environment: (1) try and determine which category (to use our own jargon) a transaction falls into and use that determination to choose an appropriate method of handling the GAAR risk, (2) don't assume that your initial sense of what may or may not be subject to the GAAR will be the prevailing judgment at some future date if the transaction(s) are ultimately reviewed by the CRA or a court, and (3) although tax advisers are better positioned to assess the GAAR risk than their clients, the risk is ultimately borne by the client and the client "risk sensibilities" should inform the decision-making process. Ultimately, no amount of practical "tips" can restore the level of certainty that was present prior to the recent amendments to the GAAR. Whatever certainty is arrived at will develop over time as court decisions are rendered and CRA administrative practice becomes known. Until then, as with most things in tax, advisers will need to use their best judgment to navigate a challenging environment.

APPENDIX "A"

Transaction	*Approved*	*Will Apply the GAAR or GAAR Concerns*	*CRA or Finance*	*Source*
Post-Mortem Pipelines	Yes		CRA	CRA document no. 2023-0987941I7
Crystallization of gains before inclusion rate change announced in Budget 2024	Yes		CRA	CRA document no. 2024-1016011E5
Capital Gains Strips		Yes (Finance - lacking in economic substance)	CRA and Finance	Discussion of Economic Substance in C-59 Explanatory Notes, CRA document no. 2023-0987941I7, and parenthetically in CRA document no. 2024-1016011E5, see also IC 88-2 para.25
55(3)(b) butterflies	Yes		CRA	IC 88-2 para. 7,
Transfer of property with unrealized gain to a related corporation with a net capital loss which then on sells the property to an arm's length purchaser	Yes		CRA	IC 88-2 para. 9
Estate Freezes	Yes		CRA	IC 88-2 para. 10
Incorporation of a proprietorship to benefit from SBD	Yes		CRA	IC 88-2 para. 11
Disguised sale via partnership		Yes	CRA	IC 88-2 para. 12

rollover under 97(2)				
Instead of selling property directly which would result income or a capital gain, a corporation sells the property for preferred shares of the purchaser and elects under 85(1) to defer the gain – the shares are then redeemed and the taxpayer receives the proceeds as deductible dividend 112(1)	Yes (if non depreciable redemption triggers 55(2) and would realize a capital gain)	Yes (if property is depreciable or the property would have resulted in regular income)	CRA	IC 88-2 para. 13
Transferring the shares of a payer corporation held by two private corporations into a common holding corporation to achieve "connected status"		Yes	CRA	IC 88-2 para. 14
Purification of an operating company to qualify for capital gains exemption	Yes		CRA	IC 88-2 para. 15
Deduction of unpaid amounts for services rendered by an arm's length party outstanding for 2 years	Yes		CRA	IC 88-2 para. 16
Services rendered to a corporation with which the individual does not	Yes		CRA	IC 88-2 para. 17

deal at arm's length where no salary paid so as to not increase loss				
Reasonable Bonusing Down	Yes		CRA	IC 88-2 para. 18
Borrowing by parent from bank to fund subsidiary which could not secure outside financing deducted by parent	Yes		CRA	IC 88-2 para. 19
Purchase of an operating corporation via the incorporation of a holding corporation which borrows funds to finance the purchase which then amalgamates with the target to deduct the interest against the income of the business of the amalgamated company	Yes		CRA	IC 88-2 para. 20
Amalgamation of an operating company with a shell corporation to trigger a year end producing a tax benefit		Yes	CRA	IC 88-2 para. 21
Rollover of land inventory to a partnership under 97(2) with purchaser corporation contributing		Yes	CRA	IC 88-2 para. 22

nominal amount to the partnership, followed by sale of partnership interest for shares of the purchasing corporation under 85(1), after which the partnership is wound up				
Certain planning to avoid debt forgiveness rules.		Yes	CRA	IC 88-2 para. 23 and IC 88-2 Supplement 1 eg. 6
Sale of real property to an arm's length party deferred by the use of an intermediary company to effect the sale		Yes	CRA	IC 88-2 para. 24
Payment of ordinary annual dividends as a stock dividend to shareholders with purchase by a related corporation or third-party broker to convert dividends into "tax-free capital gains"		Yes	CRA	IC 88-2 para. 26
Issuance of preferred shares to an employee which are redeemable at a premium reflecting salary or bonus with purchase by related corporation followed by a redemption		Yes	CRA	IC 88-2 para. 27

converting salary or bonus into a capital gain				
An amalgamation of a taxable Canadian corporation with a shell corporation is effected with minority shareholders given preferred shares in the amalco which are immediately redeemed in order to avoid the prohibition on boot under 87(1)(c)		Yes	CRA	IC 88-2 para. 28
Crystallizing capital gains deduction	Yes		CRA	IC 88-2 Supplement 1 eg. 3
Incorporation of a holdco to purchase QSBC shares from arm's length shareholder of opco, with post purchase amalgamation of holdco and opco	Yes		CRA	IC 88-2 Supplement 1 eg. 4
Consolidation of profits and losses in a related corporate group		Yes	CRA	IC 88-2 para.8, IC -88-2 Supplement 1 eg. 5, CRA Ruling 2023-0994301R3 F
Payment of safe income dividend by Canadian subsidiary owing Canadian real property to US parent subject to	Yes		CRA	88-2 Supplement 1 eg. 7

withholding tax under the Treaty in advance of sale of Canadian subsidiary to arm's length purchaser				
Planning where Canco owning three businesses is to be sold to 1 a purchaser that only wishes to retain one business and on sell other two businesses - planning using section 54.2 and paragraph 88(1)(d) bump	Yes		CRA	88-2 Supplement 1 eg. 8
Shift of Paid-Up Capital to Preferred Shares Created on an Amalgamation to give Capital Gains to Preferred Shareholder on Redemption	Yes		CRA	88-2 Supplement 1 eg. 9
Incorporation of a business	Yes		Finance	C-59 Explanatory Notes Example 1
Incorporation of a business before a sale in order to claim the LCGE	Yes		Finance	C-59 Explanatory Notes Example 2
Exchangeable Shares	Not Lacking in Economic Substance		Finance	C-59 Explanatory Notes Example 3
Sale of flow-through shares immediately following holding period	Yes		Finance	C-59 Explanatory Notes Example 4

Contribution to a TFSA	Yes		Finance	Discussion of Economic Substance in C-59 Explanatory Notes
Loss Trading within a related group	Yes		Finance	Discussion of Economic Substance in C-59 Explanatory Notes
164(6) Planning	No current GAAR concerns * (however "no guidance issued") – **may not be able to rely on this statement for the GAAR Penalty Exception			STEP CRA roundtable June 4, 2024, Q5