

Canada releases modified proposals to amend the general anti-avoidance rule

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On August 4, the Canadian federal government released a draft legislation package (August Proposals) with explanatory notes (Explanatory Notes) which includes, among other things, revised proposals to amend the general anti-avoidance rule (GAAR) in section 245 of the *Income Tax Act* (Canada) (Tax Act), and certain related provisions. These amendments follow a consultation process in 2022 and legislative proposals first introduced on March 28, 2023, when Finance Minister Chrystia Freeland tabled her third budget in the House of Commons (Budget 2023).

What you need to know

- **Changes to the GAAR.** The August Proposals contain modified proposals to amend the GAAR and related provisions first released in Budget 2023 to:
 - include a new preamble;
 - reduce the threshold for identifying an avoidance transaction from “primarily” to “one of the main purposes”;
 - add a rebuttable presumption that an avoidance transaction that is significantly lacking in economic substance results in a misuse or abuse; and
 - unless a transaction has been reported under the reportable transaction rules (including by means of a new voluntary disclosure rule) or the notifiable transaction rules:
 - provide for a penalty, equal to 25% of the increased taxes payable as a result of the application of GAAR, subject to a limited exception; and
 - extend the reassessment period by three years for assessments made as a consequence of the application of the GAAR.
- **Timing.** The amendments to the GAAR will apply to transactions that occur on or after January 1, 2024, except the GAAR preamble and the amendments to the related provisions, which will come into force on Royal Assent.
- **Consultation.** The government is accepting submissions on the August Proposals until September 8, 2023.

Background and introduction

The GAAR is designed to deny tax benefits arising from abusive tax avoidance. Such transactions may satisfy the technical requirements of the Tax Act but undermine the policy of the rules giving rise to tax benefits. The current GAAR applies where (i) there is a tax benefit; (ii) the tax benefit results from an avoidance transaction; and (iii) the avoidance transaction or a series of transactions that includes the avoidance transaction results in a misuse or abuse of particular provisions of the Tax Act or the Tax Act as a whole.

Budget 2023 proposed to introduce significant changes to the GAAR and related provisions, including the introduction of a preamble, a reduced threshold for identifying an avoidance transaction, a new economic substance test, a 25% penalty levied on the amount of a tax benefit and an extension of the normal reassessment period in certain cases. For our insights on the GAAR proposals introduced in Budget 2023, please see our [“Highlights of Canada's 2023 federal budget”](#).

Following a consultation period provided for in Budget 2023, the government released the August Proposals which include, among other things, revised proposals to amend the GAAR and related provisions. Notably, the August Proposals include a coming-into-force rule. According to the August Proposals, the amendments to the GAAR will apply to transactions that occur on or after January 1, 2024, except the GAAR preamble and the amendments to the related provisions, which will come into force on Royal Assent.

In this bulletin, we highlight the key differences to the proposals to amend the GAAR and related provisions in the August Proposals as compared to those included in Budget 2023. The government invites Canadians and stakeholders to make submissions on the August Proposals by September 8, 2023.

Amendments to the GAAR

Preamble

Budget 2023 proposed to add a preamble to the GAAR, the stated purpose of which is to help address interpretive issues and ensure that the GAAR applies in the intended manner. Prior to the August Proposals, the proposed preamble outlined that:

- i. the GAAR applies to deny the tax benefit from avoidance transactions that misuse provisions of the Tax Act while still allowing taxpayers to obtain benefits contemplated by particular provisions;
- ii. the GAAR aims to strike a balance between a taxpayer's need for certainty in planning their affairs and the government's responsibility to protect the tax base and the overall fairness of the tax system; and
- iii. the GAAR can apply regardless of whether a tax strategy is foreseen.

The August Proposals make slight modifications to the preamble as compared to the version proposed in Budget 2023. In particular, the government has removed the reference to the GAAR applying regardless of whether a tax strategy is foreseen. According to the Explanatory Notes, this aspect of the preamble is no longer needed, because the Supreme Court of Canada recently confirmed in *Deans Knight Income Corp. v. Canada*¹ that the GAAR can apply in both foreseen and unforeseen situations. The Explanatory Notes also highlight that the intention of the preamble is to inform the application of the GAAR, despite not forming a part of its analytic framework.

The preamble comes into force on Royal Assent. It therefore applies to transactions occurring on or after Royal Assent. It remains to be seen whether the preamble will be considered when applying the GAAR to transactions predating Royal Assent.

Avoidance transaction

Currently, the GAAR provides that a transaction is an avoidance transaction where it results directly or indirectly in a tax benefit, unless carried out primarily for *bona fide* purposes other than to obtain the tax benefit.

As introduced in Budget 2023, the definition of “avoidance transaction” is being amended to change the purpose test. As per above, the test under the current rules is whether the transaction or series is primarily motivated by *bona fide* purposes other than obtaining tax benefits. The new test is whether obtaining tax benefits is “one of the main purposes”. The August Proposals also reorganize the ordering of the subsection, but the Explanatory Notes state that the sole intended effect of the revisions is to change the legal test for an avoidance transaction.

Economic substance

Canadian tax law is generally premised on legal form rather than economic substance. In response to court decisions generally applying this principle in the GAAR context, Budget 2023 proposed to introduce an economic substance test into the misuse/abuse analysis. Under this proposal, a lack of economic substance would indicate that the transaction constitutes abusive tax avoidance. Budget 2023 provided the following non-exhaustive list of factors that should be considered when determining if a transaction has economic substance:

- a. there is no substantial change in the opportunity for gain or profit and risk of loss of the taxpayer, and non-arm's length persons, 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 the expected value of the tax benefit exceeds the expected value of the non-tax economic return (which excludes foreign tax benefits); 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 a tax benefit.

Budget 2023 states that the existence of one or more of these factors supports a finding that there is a lack of economic substance.

The August Proposals include a significant change to the economic substance test. If an avoidance transaction is significantly lacking in economic substance, it is **presumed** that the transaction results in a misuse or abuse. This change is a key shift from Budget 2023, which provided that a lack in economic substance **tends to indicate** that the transaction results in a misuse or abuse. If a transaction is considered to significantly lack economic substance, then the presumption applies for purposes of the misuse or abuse analysis, in other situations the standard misuse or abuse analysis applies. The Explanatory Notes highlight that the “significantly” qualifier before the “lacking in economic substance” language ensures that transactions which merely have some tax-planning elements are not subject to the presumption.

The Explanatory Notes state that, when integrating this amendment into the framework used by the Supreme Court in *Deans Knight*, a transaction significantly lacking in economic substance is presumed to frustrate the rationale of the provisions of the Tax Act giving rise to the tax benefit. However, the Explanatory Notes state that this presumption can be rebutted in appropriate circumstances: for example, where the underlying rationale of a provision of the Tax Act is to encourage certain activities, a taxpayer could rebut the presumption by demonstrating that the effect of the undertaken transaction is in line with what Parliament intended to encourage through the enacting of the provision. Further, the Explanatory Notes include the following two examples of situations in which the presumption can be rebutted: (i) transferring funds to a TFSA; and (ii) certain loss utilization transactions within a related group.

As set out above, Budget 2023 included a non-exhaustive list of factors that should be considered when determining if a transaction has economic substance. With regards to factor (a), the August Proposals have added a fourth circumstance the use of an accommodation party as an example of a technique that may be used to effect transactions that leave a taxpayer's economic position effectively unchanged. Factors (b) and (c) have remained unchanged in these August Proposals as compared to Budget 2023.

Penalty

Budget 2023 introduced a new penalty for a transaction subject to the GAAR. The amount of the penalty is equal to 25% of the amount of the tax benefit resulting from such transaction. The penalty is inapplicable if the transaction was disclosed under the reportable transaction rules, including under the proposed optional disclosure rule (discussed below). Budget 2023 provided that, where the tax benefit in question is an unutilized tax attribute, then the tax benefit would be deemed to be nil for purposes of calculating the penalty.

The August Proposals include a number of changes to the proposed GAAR penalty. First, rather than being calculated by reference to the amount of the tax benefit, the GAAR penalty will instead be calculated by reference to increased tax payable as a result of applying the GAAR, and will exclude any penalty assessed under the gross negligence provisions, to prevent duplication.

The basic rule provides that the penalty will apply to a transaction, or a series of transactions, that is subject to the GAAR, with the amount of the penalty for each taxation year equal to the following formula:

$$(A - B) \times 25\% - C$$

where

A = the tax payable by the person under the Tax Act for the year;

B = the tax that would have been payable under the Tax Act if the GAAR did not apply; and

C = the amount of any gross negligence penalty payable by the person under subsection 163(2) of the Tax Act in respect of the transaction or series and that did not reduce the penalty payable under this subsection in a preceding taxation year.

Given the change in approach in calculating the penalty, the deeming rule regarding unutilized tax attributes is no longer necessary. Notwithstanding, the Explanatory Notes confirm that, where the tax benefit obtained is the creation of a tax attribute, no penalty will apply until the year in which the tax attribute is used to reduce tax payable.

Second, the August Proposals add an exception to the penalty provision where a taxpayer can demonstrate that it was reasonable to conclude at the time a transaction or series was entered into that the GAAR would not apply to the transaction or series. This exception, however, is limited to situations in which the taxpayer can demonstrate that the conclusion was reasonable due to reliance on the transaction or series being “identical or almost identical” to a transaction or series that was:

- the subject of administrative guidance or statements that were published by the Minister of National Revenue or another relevant government authority; or
- the subject of one or more court decisions.

The Explanatory Notes emphasize that the threshold “identical or almost identical” is quite high and therefore using the same tax strategy or undertaking a transaction that is merely similar may be insufficient for this exception to apply. The exception does appear to look to the time at which the transaction or series was entered into, and thus presumably can be relied upon even if administrative guidance or jurisprudence subsequently change.

Lastly, the August Proposals extend the exception to the GAAR penalty to disclosures under either the reportable transaction rules (including under the proposed optional disclosure rule) or the notifiable transaction rules.

Amendments to related provisions

Optional disclosure under the reportable transaction rules

Further to the 2021 federal budget (Budget 2021), the mandatory disclosure regime in the Tax Act was recently enhanced to, among other things, expand the reportable transaction rules and introduce the notifiable transaction rules. Budget 2021 stated that the enhanced mandatory disclosure regime is intended to provide the government

with early access to information on aggressive tax planning strategies. Under these enhanced rules, which generally apply to transactions entered into after June 22, 2023, taxpayers (and certain advisors and promoters) are required to file a prescribed information return to disclose the following types of transactions:

- **Reportable transactions:** certain transactions that constitute avoidance transactions if one of three hallmarks (i.e., contingent fees, confidential protection or contractual protection) are also present; and
- **Notifiable transactions:** specific transactions that will be designated by the Minister of National Revenue.

Taxpayers are generally required to report transactions to the Canada Revenue Agency within 45 days of the earlier of the day the taxpayer (or a person who entered into the transaction for the benefit of the taxpayer) becomes contractually obligated to enter into the transaction or enters into the transaction.

In Budget 2023, the government proposed to revise the reportable transaction rules to provide for optional disclosure of transactions that are not otherwise subject to reporting under these rules, with the due date for any such filing being the same 45-day period under those rules, as described above.

The August Proposals, which will come into force on Royal Assent, retain this optional disclosure proposal, but provide that the due date for this optional disclosure is extended to the taxpayer's filing due date for the taxation year in which the transaction occurs. The August Proposals also include a late filing provision that permits an optional filing for up to one year after the taxpayer's filing due date. The Explanatory Notes state that this amendment is intended to allow taxpayers to voluntarily disclose transactions that are potentially subject to the GAAR with a view to excluding the transaction from the GAAR penalty and the extended reassessment period (described below). Importantly, the Explanatory Notes also state that a voluntary filing is not an admission that the GAAR applies.

Extended reassessment period for GAAR assessments

Budget 2023 proposed to include a three-year extension to the normal reassessment period for assessments made as a consequence of the application of the GAAR, unless the transaction was disclosed under the reportable transaction rules, including under the proposed optional disclosure rule (discussed above).

The August Proposals retain this proposal, but also add an exception to the extended reassessment period for transactions disclosed under the notifiable transaction rules and further provide that if a taxpayer chooses to late-file an optional disclosure under the reportable transaction rules, the reassessment period is extended by one year (and not three years). These amendments will come into effect on Royal Assent.

FOOTNOTES

To discuss these issues, please contact the author(s).

This publication is a general discussion of certain legal and related developments and should not be relied upon as legal advice. If you require legal advice, we would be pleased to discuss the issues in this publication with you, in the context of your particular circumstances.

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