TAX FOR THE Owner-Manager

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Tax Planning Under the New GAAR: The CRA Comments

The CRA recently issued two important technical interpretations addressing the effect of the revised general anti-avoidance rule (GAAR) on tax planning: (1) CRA document no. 2024-1008251I7, February 28, 2024, titled "IC 88-2 and New GAAR" ("the planning TI"); and (2) CRA document no. 2023-0987941I7, February 29, 2024, titled "Amendments to GAAR and Advance Income Tax Rulings" ("the pipeline TI"). The pipeline TI and the planning TI contain specific information that should help guide practitioners in determining whether the new GAAR applies to a host of standard tax-planning techniques.

New GAAR: Important Highlights

It is outside the scope of this article to cover all of the changes to GAAR introduced by Bill C-59. For the purposes of this article, it is important to note that the legislation amends the existing GAAR to introduce the notion of "economic substance" and provides for an automatic penalty if GAAR applies. This penalty is subject to a limited exception in subsection 245(5.2) ("the GAAR penalty exception"), and it does not apply if a disclosure has been made to the CRA under section 237.3 ("reportable transactions") or section 237.4 ("notifiable transactions") of the ITA. The reportable transaction rules under section 237.3 also provide for an optional disclosure mechanism in subsection 237.3(12.1) whereby a positive obligation to report does not exist.

In simplified terms, the GAAR penalty exception provides that no penalty will apply if, at the time that the transaction was entered into, it was reasonable for the person to have concluded—in reliance on the transaction (or a series of transactions including it) being identical or nearly identical to a transaction or series covered by published CRA guidance or court decisions—that GAAR would not apply to the transaction. We note that it appears open to a court to read in a broader due diligence defence than the one provided for in the GAAR penalty exception.

The Planning TI

In the planning TI, the CRA stated that, in its general view, the conclusions reached in IC88-2 and IC88-2, supplement 1 (which provided examples of when the existing GAAR 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).

IC88-2 ("list 1") and IC88-2, supplement 1 ("list 2") (collectively, "the ICs") cover a wide range of transactions. In these ICs, the CRA provided multiple examples of transactions that were avoidance transactions but that (if specific criteria in the ICs were met) would not be subject to GAAR. These included the following transactions:

- divisive reorganizations under paragraph 55(3)(b) (list 1, paragraph 7);
- 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 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 Pipeline TI

In the pipeline TI, the CRA confirmed that it would continue to issue favourable rulings under the new GAAR for post mortem pipelines that meet the agency's existing administrative guidelines, set out in document no. 2018-0748381C6 (May 29, 2018). However, the CRA will not rule on transactions colloquially referred to as "capital gains strips" because those transactions were identified as raising GAAR concerns. The CRA cited the Department of Finance technical notes to the new

GAAR, 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)." It should be noted that the proposed increase in the capital gains inclusion rate, announced in the 2024 federal budget, will have the effect of making these capital gains strips—designed to access corporate funds at capital gains rates—less attractive.

The CRA also stated in the pipeline TI 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. The CRA noted that it will 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."

The CRA's Approach to the New GAAR

The planning TI and the pipeline TI both address several transactions that, though arguably lacking economic substance, the CRA has nonetheless determined are not subject to GAAR. It is important to note that the factors establishing lack of economic substance, which are set out in subsection 245(4.2), are present in many owner-manager tax-planning transactions. This is the case because owner-manager tax transactions often result in, among other things, unchanged opportunities for gain or loss when aggregating the interests of related taxpayers.

In the technical notes accompanying Bill C-59, however, Finance stated its view that "where there is a lack of economic substance, the starting point would be that there is a misuse or abuse." However, Finance went 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."

It is important to note that positions taken by the CRA in the planning TI and the pipeline TI are not law, and the CRA is not estopped from assessing contrary to its stated positions. Accordingly, taxpayers must be cautious when relying on this type of guidance. A taxpayer is, however, protected from a GAAR penalty if the GAAR penalty exception applies. That said, given the general nature of CRA guidance, the question of whether a transaction fits within the GAAR penalty exception could be the subject of dispute.

GAAR and Tax Uncertainty

As shown above, the combined effect of the GAAR penalty and the GAAR penalty exception gives CRA administrative guidance significantly more importance than it previously had. Between the extremes of transactions specifically identified by the CRA as constituting abuse and those "green-lighted" by the CRA, there are a wide range of transactions for which no direct CRA guidance exists, only partial guidance exists, or, arguably, contradictory guidance exists.

For example, the CRA ICs (see list 1, paragraph 15) approve "purification" transactions that are undertaken to remove redundant assets in advance of sale so that the shares of the corporation qualify as "qualified small business corporation shares." The CRA discussion of that example notes that on a redemption of shares to effect the purification, "[t]he new corporation may be subject to subsection 55(2) of the [ITA] if the gain on the purchased shares is attributable to something other than" safe income. At the same time, 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 appear to be at cross-purposes in that 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 raises GAAR concerns. We note that the CRA issued document no. 2024-1016011E5 (April 29, 2024), approving the crystallization of gains (subject to various caveats), in advance of the announcement, in the 2024 budget, of the proposed change in the capital gains inclusion rate. This CRA document raises similar concerns, because in certain circumstances—for example, if a corporation crystallizes accrued gains through non-arm's-length transactions (creating RDTOH and a CDA balance)—an otherwise acceptable crystallization transaction, approved by the CRA, may be converted into a transaction that raises GAAR concerns. Accordingly, the adviser must use his or her judgment to decide whether GAAR or the GAAR penalty exception (or both) may apply.

From a practical standpoint, it may be impossible to determine whether a transaction or a series of transactions will be challenged successfully by the CRA under the amended GAAR. In our view, taxpayers who undertake tax planning of which the CRA neither specifically approves nor specifically disapproves will face three options: (1) seek a ruling, (2) opt to disclose the transaction or series of transactions and thereby avoid the GAAR penalty, or (3) undertake the transaction or series of transactions notwithstanding that the GAAR penalty (and its adverse consequences) could potentially apply. The appropriate route will not always be clear, and tax practitioners will need to adapt themselves to a much more uncertain planning environment.

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