We write further to our prior submission of May 3, 2023 (the "May 2023 Submission")[1] on the proposed amendments to the general anti-avoidance rule ("GAAR") in s. 245 of the *Income Tax Act* (Canada) ("ITA") set out by the government in the federal budget of March 28, 2023 (the "March 2023 Proposals").[2] This letter supplements our prior submission, in light of the recent decision of the Supreme Court of Canada in *Deans Knight Income Corp. v Canada,*2023 SCC 16.

As you may be aware, the Chamber served as an intervener in this case. While taking no position on the outcome as between the litigants, the Chamber was concerned with the uncertainty created by the Federal Court of Appeal decision being appealed from, and solicited guidance from the Supreme Court as to the "object, spirit and purpose" ("OSP") of the corporate loss restriction regime at issue in that case and the determination of OSP generally.[3]

One of the essential points of the May 2023 Submission is that the existing GAAR jurisprudence (reviewed in detail therein) already deals appropriately with both the subject matter of the interpretive preamble in proposed s. 245(0.1) and the role of "economic substance." The Chamber believes that the Supreme Court's judgment in *Deans Knight* strongly reinforces this conclusion, and eliminates whatever justification may have existed for these elements of the March 2023 Proposals.

In the March 2023 Budget, the government explained the need for the interpretative pre-amble proposed to be added as new s. 245(0.1) as follows:

> A preamble would be added to the GAAR, in order to help address interpretive issues and ensure that the GAAR applies as intended. It would address three areas where questions have arisen.
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> While the GAAR informs the interpretation of, and applies to, every other provision of the *Income Tax Act*, it fundamentally denies tax benefits sought to be obtained through abusive tax avoidance transactions. It in effect draws a line: while taxpayers are free to arrange their affairs so as to obtain tax benefits intended by Parliament, they cannot misuse or abuse the tax rules to obtain unintended benefits.
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> As noted in the original explanatory notes accompanying the GAAR, it is intended to strike a balance between taxpayers' need for certainty in planning their affairs and the government's responsibility to protect the tax base and the fairness of the tax system. "Fairness" in this sense is used broadly, reflecting the unfair distributional effects of tax avoidance as it shifts the tax burden from those willing and able to avoid taxes to those who are not.

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[1] "The March 2023 GAAR Proposals: Solutions in Search of Problems", at https://chamber.ca/canadian-chamber-shares-post-budget-comments-on-the-general-anti-avoidance-rule-gaar/

[2] Tax Measures: Supplementary Information, 2023 Federal Budget, Department of Finance, available at https://www.budget.canada.ca/2023/report-rapport/tm-mf-en.html .

[3] The Chamber's factum is available at https://www.scc-csc.ca/WebDocuments-DocumentsWeb/39869/FM030_Intervener_Canadian-Chamber-of-Commerce.pdf .

> Finally, the preamble would also clarify that the GAAR is intended to apply regardless of whether or not the tax planning strategy used to obtain the tax benefit was foreseen.

As discussed at length in the May 2023 Submission, the existing GAAR jurisprudence already incorporates all three of these principles. The Supreme Court's decision in *Deans Knight* could not demonstrate this fact more clearly. With respect to the general role of GAAR, the Supreme Court in *Deans Knight* commented as follows:

> [47] The *Duke of Westminster* principle, however, has "never been absolute" (*Lipson*, at para. 21) and it is open to Parliament to derogate from it. Parliament has done so through the GAAR. The GAAR does not displace the *Duke of Westminster* principle for legitimate tax planning. Rather, it recognizes a difference between legitimate tax planning — which represents the vast majority of transactions and remains unaffected, consistent with the *Duke of Westminster* principle — and tax planning that operates to abuse the rules of the tax system — in which case the integrity of the tax system is preserved by denying the tax benefit, notwithstanding the transactions' compliance with the provisions relied upon. Even where the purpose of a transaction is to minimize tax, taxpayers are allowed to carry it out unless it results in an abuse of the provisions of the Act (*Lipson*, at para. 25). Where the transaction is shown to be abusive, the *Duke of Westminster* principle is "attenuated" by the GAAR (*Trustco*, at para. 13).

Similarly, the Supreme Court plainly acknowledged GAAR's balancing of protecting the tax base with taxpayers' desire for a reasonable degree of certainty in arranging their affairs:

> [48] In establishing a general anti-avoidance rule that operated to deny tax benefits on a case-specific basis, Parliament was cognizant of the GAAR's implications for the level of certainty in tax planning. Parliament sought to balance "the protection of the tax base and the need for certainty for taxpayers" (Department of Finance, *Explanatory Notes to Legislation Relating to Income Tax* (1988), at p. 461). The GAAR was enacted to be "a provision of last resort" to address abusive tax avoidance only and was therefore not designed to create more generalized uncertainty in tax planning (*Trustco*, at para. 21; *Copthorne*, at para. 66). Some uncertainty is unavoidable when a general rule is adopted (Dodge, at p. 21; *Copthorne*, at para. 123). However, a reasonable degree of certainty is achieved by the balance struck within the GAAR itself.
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> [50] . . . Within this analysis, the principles of certainty, predictability and fairness do not play an independent role; rather, they are reflected in the carefully calibrated test that Parliament crafted in s. 245 of the Act and in its interpretation by this Court.

Finally, the Supreme Court acknowledged that GAAR can apply to tax planning that is both foreseen and unforeseen:

> [45] . . . Abusive tax avoidance can involve unforeseen tax strategies (*Canada v. Alta Energy Luxembourg S.A.R.L.*, 2021 SCC 49, at para. 80). For example, in *Alta Energy*, this Court treated evidence of Parliament's knowledge and acceptance of the tax strategy at issue as a relevant consideration when ascertaining its intent. However, the GAAR is not limited to unforeseen situations; as this Court has explained, it is designed to capture situations that undermine the integrity of the tax system by frustrating the object, spirit and purpose of the provisions relied on by the taxpayer (*Lipson v. Canada*, 2009 SCC 1, [2009] 1 S.C.R. 3, at para. 2; *Copthorne Holdings Ltd. v. Canada*, 2011 SCC 63, [2011] 3 S.C.R. 721, at paras. 71-72; see also *The Gladwin Realty*

> *Corporation v. The Queen*, 2020 FCA 142, [2020] 6 C.T.C. 185, at para. 85; D. G. Duff, "General Anti-Avoidance Rules Revisited: Reflections on Tim Edgar's 'Building a Better GAAR'" (2020), 68 *Can. Tax J.* 579, at p. 591).

With respect to the government's concern that "[t]he GAAR does not sufficiently take into consideration the economic substance of transactions,"[4] the May 2023 Submission reviewed the GAAR jurisprudence in detail and found extensive evidence of the caselaw applying economic substance (whether or not using that specific term) in both determining the relevant legislative rationale and testing the taxpayer's actions against it, when undertaking an abuse or misuse analysis. Once again, the Supreme Court's decision in *Deans Knight* supports that conclusion. In searching for Parliament's legislative rationale for the corporate loss restriction rules at issue, Justice Rowe quoted extensively from comments made by the then-Minister of Finance in 1963, including the following (at para. 107):

> <u>People with profitable businesses who were paying taxes on their profits were making a practice of acquiring companies, often shells which had nothing in them but which were in possession of a loss-carry-forward entitlement, for the purpose of applying this entitlement against their profits and thus avoiding the payment of tax. That is what this clause is intended to prevent.</u> I am prepared to admit that in theory, certainly, if you look upon the corporation which has the entitlement as being a separate entity, it does lose its rights, where its ownership has been transferred to somebody else. However, that is the very thing we are trying to stop. [Emphasis added by Justice Rowe.]
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> (*House of Commons Debates*, vol. V, 1st Sess., 26th Parl., November 1, 1963, at p. 4287 (Hon. Walter L. Gordon))

See further at para. 110:

> When a corporation changes hands, and the loss business ceases to operate, the corporation is effectively a new taxpayer who cannot avail itself of non-capital losses accumulated by the old taxpayer. The following provides a useful explanation:
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> > First and foremost, the carryover of losses following a change of control is not generally supported in tax policy terms. Normally, one taxpayer cannot avail himself of another taxpayer's losses. <u>In the case of an artificial entity such as a corporation, when its control changes it is essentially regarded as a new taxpayer, because different shareholders then become entitled indirectly to enjoy the benefits of its financial success.</u> [Emphasis added by Justice Rowe.]
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> > (Strain, Dodge and Peters, at p. 4:52)

Similarly, when considering whether the taxpayer's actions contravened the legislative rationale of the corporate loss utilization regime, Justice Rowe found it both appropriate and necessary to incorporate considerations of economic substance:

> [124] Section 111(5)'s rationale is to prevent corporations from being acquired by unrelated parties in order to deduct their unused losses against income from another business for the benefit of new shareholders. As previously explained, s. 111(5) reflects the proposition that when the identity of

[4] Modernizing and Strengthening the General Anti-Avoidance Rule, Consultation Paper, Department of Finance, August 2022, available at https://www.canada.ca/en/department-finance/programs/consultations/2022/general-anti-avoidance-rule-consultation/modernizing-strengthening-general-anti-avoidance-rule.html .

> the taxpayer has effectively changed, the continuity at the heart of the loss carryover rule in s. 111(1)(a) no longer exists. From this perspective, the same result was achieved through the impugned transactions. Indeed, the reorganization transactions resulted in the appellant's near-total transformation: its assets and liabilities were shifted to Newco, such that all that remained were its Tax Attributes. Put differently, the appellant was gutted of any vestiges from its prior corporate "life" and became an empty vessel with Tax Attributes.
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> [127] As for its business activity, the appellant was used as the vessel for an unrelated venture planned by DKCM and selected by Matco. Thus, the only link between the appellant after the transactions and its prior corporate "life" was the Tax Attributes; in other respects, it was, in practice, a company with new assets and liabilities, new shareholders and a new business. Accordingly, the transactions resulted in a fundamental change in the identity of the taxpayer. The appellant's continued ability to benefit from the loss carryover deductions frustrates the rationale behind Parliament's decision to sever the continuity of tax treatment in s. 111(5), particularly considering the rights and benefits obtained by Matco.
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> [133] Third, the transactions allowed Matco to reap significant financial benefits. Through the transactions at issue, Matco became a significant equity owner and maintained a stake in the corporation worth $4.5 million following the IPO.
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> [140] Considering the foregoing circumstances as a whole, the result obtained by the transactions clearly frustrated the rationale of s. 111(5) and therefore constituted abuse. The object, spirit and purpose of s. 111(5) is to prevent corporations from being acquired by unrelated parties in order to deduct their unused losses against income from another business for the benefit of new shareholders. The transactions achieved the very result s. 111(5) seeks to prevent. Without triggering an "acquisition of control", Matco gained the power of a majority voting shareholder and fundamentally changed the appellant's assets, liabilities, shareholders and business. This severed the continuity that is at the heart of the object, spirit and purpose of s. 111(5).

The Supreme Court's decision in *Deans Knight* strongly reinforces the conclusion in the May 2023 Submission that the existing GAAR jurisprudence already performs the very functions that the March 2023 Proposals relating to abuse and misuse purport to address. In order to avoid undermining the guidance provided by the existing GAAR caselaw on these points (including now the Supreme Court's decision in *Deans Knight*),tThe government should reconsider and withdraw these elements of the March 2023 Proposals, or (if not) clearly explain how they deviate (if at all) from the existing GAAR jurisprudence, *viz.*, are they intended to change the current state of the law, and if so how. Should the government proceed to enact these amendments without explaining their intended impact on the current caselaw (despite being repeatedly asked to do so), at this point a reasonable reader could only conclude that they will merely codify the current state of affairs and no constitute any substantive change in tax policy or the law on GAAR. We note in this regard that the Supreme Court had the opportunity to address or otherwise support

the Discussion Paper,[5] or to identify an opportunity for Parliament to amend the law if it felt that the Discussion Paper called for changes to the existing law, but did not do so. The government should not ignore this signal from the Supreme Court.

As to the suggestion in the March 2023 Proposals to include a GAAR-specific penalty, again, *Deans Knight* illustrates the deficiency in this proposal. This case was ultimately one of legitimate interpretive uncertainty (i.e., what was the threshold for invoking the corporate loss restrictions and what factors are relevant in applying it?) and differences of opinion on the facts over how free an actor the taxpayer remained. It is difficult to see why a penalty should apply in such circumstances, in particular given that success was divided at different levels in the courts. *Deans Knight* constitutes a further example of why a blanket penalty whenever GAAR is found to be applicable is not justifiable from a policy perspective and was considered and rejected in 1988. The Chamber again strongly urges the government to withdraw the proposed GAAR-specific penalty included in the March 2023 Proposals.

Finally, *Deans Knight* also illustrates the importance of the government's own suggestion to make greater efforts in articulating the OSP of legislation it enacts. As the May 2023 Submission states:

> Since the clarity of a particular legislative rationale is almost exclusively in the government's hands to articulate (for the benefit of all concerned), the government can win a higher proportion of its GAAR cases by expending more effort to set out the legislative rationale. While doing so is not a costless exercise, the government is the party by far best-placed to do this and to bear the cost, and when compared against the government's cost of auditing, re-assessing and litigating GAAR cases, the overall impact of better expressing its OSP must certainly be a net cost savings to the government alone, quite apart from the vast savings that would be enjoyed by taxpayers. Tax advisors and litigators would be the only disadvantaged parties. There is nothing a government interested in preserving the "fairness" of the tax system could do that would have a greater and more beneficial impact than this.
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> In urging greater effort to express legislative rationale, the business community should not be understood to be seeking perfection or "certainty." However, there are clearly areas of recurring GAAR controversies such as surplus stripping and loss utilization that can be targeted first, as priority areas where the government can achieve greater clarity and have immediate impact without being asked to prepare a user's guide for the entire statute.

Fundamentally, *Deans Knight* can be reduced down to a case with a modest (although important) high-level conceptual legal issue that could have been forestalled with a single sentence in the Technical Notes that accompanied the legislation enacting GAAR: "While s. 111(5) applies where an acquisition of *de jure* control occurs, the tax policy underlying these rules is applicable whenever an unrelated person (or group of persons) acquires a functionally equivalent degree of control over the corporation (whether through share voting rights or otherwise)." The Chamber encourages the government to articulate what further steps it proposes to take to better set out

[5] The Attorney General for Ontario brought the Discussion Paper to the specific attention of the Supreme Court in the Factum of the Intervener, Attorney General for Ontario in *Deans Knight Income Corp. v Canada*, at para 15.

the legislative rationale for the principal provision of the ITA that are recurring sources of GAAR controversies.