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September 8, 2023

The Honourable Chrystia A. Freeland, P.C., M.P.
Deputy Prime Minister and Minister of Finance
Department of Finance Canada
90 Elgin Street
Ottawa, Ontario K1A 0G5
Canada

Via email: Consultation-Legislation@fin.gc.ca

RE: Proposed GAAR Penalty

Dear Minister Freeland:

This letter addresses the proposed addition of a penalty provision (the "**Proposed Penalty")** to the General Anti-Avoidance Rule (the "**GAAR**") under section 245 of the *Income Tax Act* (Canada) (the "**Act**"), which was part of a package of proposed amendments to the GAAR released on August 4, 2023 (the "**August Proposal**"). This letter supplements our prior submission dated May 31, 2023 (the "**May Submission**"), and addresses changes contained in the August Proposal.[1] As noted in the May Submission, while our members have concerns with certain other changes to the GAAR, those concerns have been fully addressed by other stakeholders so need not be repeated here.

About TEI

TEI was founded in 1944 to serve the professional needs of in-house tax professionals. Today, the organization has 56 chapters across North and South America, Europe, and Asia, including four chapters in Canada. Our over 6,000 members represent 2,800 of the world's leading companies, many of which either are resident or do business in Canada. Over 15 percent of TEI's membership comprises tax professionals who work for Canadian businesses in a variety of industries across the country. TEI members are responsible for tax affairs of their employers and must contend daily with provisions of the tax law relating to the

[1] TEI's May Submission is available at https://www.tei.org/sites/default/files/tei_comments_-_canadian_gaar_penalty_-final_to_department_of_finance_may_31_2023.pdf.

operation of business enterprises. The following recommendations reflect the views of TEI as a whole but, more particularly, those of our Canadian constituency.

As the preeminent association of in-house tax professionals worldwide, TEI is dedicated to the development of sound tax policy, compliance with and uniform enforcement of tax laws, and minimization of administration and compliance costs to the mutual benefit of government and taxpayers. TEI is committed to fostering a tax system that works—one that is administrable and with which taxpayers can comply in a cost-efficient manner. The diversity, professional training, and global viewpoints of our members enable TEI to bring a balanced and practical perspective to the Proposed Penalty.

TEI Comments

In the May Submission we explained, *inter alia*, why any GAAR penalty should be subject to a significant fault requirement (like those required for other penalties under the Act), such as a due diligence defence, and identified several significant policy concerns arising in the absence of such a fault requirement. Unfortunately, the August Proposal does not address those concerns. We will not reiterate the points made in our May Submission here. However, we observe that the proposed reduction of the GAAR penalties for taxpayers subject to penalties under subsection 163(2), described in element C of proposed subsection 245(5.1), confirms our submission that existing penalties could apply to the sort of abusive activity targeted by this proposal and that the solution should not be a new penalty, but for the CRA to apply existing penalties.

Further, reducing the proposed GAAR penalty for taxpayers subject to penalties under subsection 163(2) means that the GAAR penalty will not have the effect of promoting compliance among taxpayers who knowingly or through gross negligence make false statements or omissions in their tax returns. That is, since they are already liable to existing penalties under subsection 163(2), the proposed GAAR penalty has no incremental impact on them. Rather, it will only penalize honest and duly diligent taxpayers who do not satisfy the Penalty Defence Provision (discussed in greater detail below). That is a perverse, seemingly unintended, result.

This letter outlines how proposed new subsection 245(5.2) (the "**Penalty Defence Provision**") fails to address many of the concerns we previously raised. In particular, the Penalty Defence Provision: (i) is too narrow and uncertain, and, in many instances, would only be available in circumstances where the GAAR is unlikely to apply; (ii) does not address the problem of imposing penalties in the face of genuine uncertainty as to the application of the GAAR; and (iii) arguably vacates the common-law due diligence defence that would otherwise be available to taxpayers. In our view, the Provision should be replaced with a broad-based fault requirement, similar to those found in the Act's other penalty provisions. Failing that, the Department of Finance ("**Finance**") should consider amending the Penalty Defence Provision so that it effectively applies as a trigger for the application of GAAR penalties rather than a defence, as outlined in greater detail below. Absent such amendments, we have significant doubts about the constitutional viability of the Proposed Penalty.

1. The Penalty Defence Provision is too Narrow and Uncertain

The Penalty Defense Provision is far too narrow and fraught with uncertainty. It only applies to transactions (or series of transactions) where it is reasonable to conclude that the GAAR did not apply to the transaction (or series) in reliance on either CRA administrative guidance or court decisions in respect of an identical or "almost identical" transaction or series. The universe of transactions that have been the subject of GAAR caselaw and/or CRA administrative statements is small, and much smaller than the universe of transactions potentially subject to the GAAR (i.e., everything). Moreover, unless the prior caselaw or CRA administrative guidance dealt with the exact fact pattern in question, it will never be the case that a subsequent transaction is "identical" to the transactions considered in those cases or administrative guidance (i.e., all sorts of potentially relevant factors will differ – the parties, the contractual terms, the timing, the dollar amounts, etc.). Nor is it clear what is meant by a transaction that is "almost identical" – is that different from "substantially similar" used in the mandatory disclosure context (itself a term that is uncertain)?

In addition, it is unclear as to what constitutes "administrative guidance or statements . . . published by the Minister . . . ." Would that include, for example, redacted rulings or technical interpretations, which are typically published not by the Minster of National Revenue, but in redacted form by private companies pursuant to access to information requests, often after significant delay and which are not generally publicly available except to tax professionals? Such rulings and technical interpretations are regularly relied on by taxpayers in assessing their obligations under the Act, could they be relied upon in this context? If so, would the Minister of National Revenue (and all other relevant governmental authorities) make publicly available all its statements as to the non-application of the GAAR, so that all taxpayers have access to such statements and could rely upon them in assessing whether to voluntarily report potential transactions?

Further, the Penalty Defence Provision raises the question of why does Finance expect the CRA to (successfully) apply the GAAR to transactions that are "identical or substantially identical" to transactions that have previously been the subject of either case law or CRA administrative guidance from which it is reasonable to conclude that the GAAR does not apply? Presumably, such prior case law or administrative guidance would provide that the GAAR did not apply to "identical" transactions otherwise, on what basis could taxpayers reasonably rely on it under the Penalty Defence Provision? In practice, we would expect that a taxpayer who effects a transaction identical to one considered in prior caselaw or CRA administrative statements will avoid a GAAR penalty on the basis that, if the courts or the CRA have previously determined that the GAAR does not apply to a particular transaction, then the GAAR is unlikely to apply to an identical (or "almost identical") transaction, and no penalty would be assessable. In that light, the Penalty Defense Provision may be substantively useless.[2]

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[2] We note that this is not universally true – for example, there may be circumstances where the law has changed in the interim. However, that the Penalty Defence Provision may apply in those narrow circumstances simply highlights how narrow its application is.

2. Absent a Fault Requirement there is No Mechanism for Diligent Taxpayers to Avoid the Imposition of GAAR Penalties in Unforeseen Circumstances Other than Reporting All Transactions

Neither the Penalty Defence Provision nor (as we discussed in the May Submission) the ability to make protective disclosure provides any practical comfort to taxpayers who consciously seek to avoid effecting transactions with a significant risk of the GAAR applying, but who may nevertheless be reassessed under the GAAR in an unexpected manner. Absent a due diligence defense (or other fault requirement), to avoid the imposition of a GAAR penalty, taxpayers must report every transaction (or series) it enters unless that transaction (or an "almost identical" transaction or series) has been the subject of CRA guidance or a prior court decision. Even if a taxpayer reasonably believes – perhaps based on CRA commentary or judicial decisions in respect of similar, but not "identical or almost identical" transactions – that a given transaction is not an "avoidance transaction, "does not give rise to a "tax benefit," and/or would not constitute an abuse or misuse if it did, it is always possible the CRA would disagree and apply the GAAR. As currently proposed, the only GAAR penalty safe harbour available to taxpayers is to make a protective disclosure. Given the potential magnitude of the GAAR penalty, the absence of a fault requirement effectively could result in taxpayers reporting all transactions on a proactive basis. This would impose an intolerable compliance burden on taxpayers and administrative burden on the CRA, but the August Proposal contains no other mechanism for diligent taxpayers to avoid the imposition of GAAR penalties in unforeseen circumstances.

3. The Inclusion of the Penalty Defence Provision Appears to Vacate the Common-Law Due Diligence Defence

We expressed our concern in the May Submission that the protective disclosure provision might be interpreted as vacating the existence of the common-law due diligence defence, the availability of which could alleviate our many concerns with the imposition of the GAAR Penalty. The August Proposal does nothing to alleviate that concern. On the contrary, the inclusion of the Penalty Defense Provision appears to reinforce the impression that Finance intends to vacate the common-law due diligence defence in respect of the GAAR penalty, given that the Penalty Defense Provision is very narrow and excludes a broad universe of duly diligent taxpayers. It is contrary to principles of fundamental justice to penalize taxpayers in the absence of a meaningful fault requirement.

4. The GAAR Penalty Should Include a Significant Fault Requirement

As stated in the May Submission, if Finance intends to impose a penalty in respect of the GAAR – which we continue to believe is inappropriate – it must include a significant fault requirement to be successful. This could be gross-negligence, consistent with the general penalty regime for technical non-compliance with the Act, or negligence, consistent with the common law due diligence defence and the explicit due diligence defenses found in other, similar, provisions of the Act, notably the "reportable transaction" and "notifiable transaction" rules.

If Finance is wedded to the language in the Penalty Defense Provision in lieu of a broad-based due diligence defence, its application should be reversed from an exception to the application of the GAAR penalty to a trigger for the application of the GAAR penalty, as follows:

> Subsection (5.1) applies to a person in respect of a transaction or series of transactions where the Minister demonstrates that, at the time that the transaction or series was entered into, it was reasonable for the person to have concluded that subsection (2) would apply to the transaction or series on the basis that the transaction or series was identical or almost identical to a transaction or series that was the subject of
>
> > (a) public[3] administrative guidance or statements that were published by the Minister or another relevant governmental authority; or
> >
> > (b) one or more court decisions.

Such a change would have significant advantages over the current language. First, by imposing penalties only in circumstances where it is reasonable to expect, based on existing caselaw or published administrative guidance, that the GAAR applies, it puts taxpayers on notice as to when they are reasonably expected to file protective disclosure. It also provides a safe harbour for transactions where there is genuine uncertainty as to the application of the GAAR (e.g., transactions (or almost identical transactions) which have not previously been considered by the CRA or the courts).

Second, it imposes a meaningful fault requirement. A taxpayer who effects a transaction in those circumstances and fails to make a protective disclosure can hardly be considered to be duly diligent.

Third, it would address the specific problem of taxpayers "playing the audit lottery" by taking positions they know, or ought to know, are unlikely to be successful if challenged by the CRA, without unfairly penalizing taxpayers who reasonably report their taxes on the basis that the GAAR does not apply.

Fourth, to the extent Finance is concerned that such a trigger for the application of a penalty provision is too narrow, we note that it could be expanded by CRA publicly listing transactions to which it would apply the GAAR. In this respect, the alternative formulation would be complemented by the existing "reportable transaction" rules which CRA could use to identify new transactions potentially subject to the GAAR and would parallel the new "notifiable transaction" rules.

Finally, not only is a fault requirement sound policy (for the reasons set forth in the May Submission), arguably the failure to provide for a meaningful fault requirement, coupled with the vacation of the common-law due diligence defence, transforms the proposed GAAR penalty from an administrative penalty intended to promote compliance with the regulatory purpose of the Act into a penal provision engaging the constitutional protections of the *Charter of Rights and Freedoms*, which are

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[3] Requiring guidance to be public ensures that all taxpayers have equal access to the relevant CRA administrative guidance and provides an incentive to CRA to disseminate guidance in a timely fashion.

not contemplated by the August Proposals. As the Supreme Court of Canada (the "**Court**") observed in *Guindon v. Canada* "a true penal consequence is imprisonment or a fine which, having regard to its magnitude and other relevant factors, is imposed to redress the wrong done to society at large rather than simply to secure compliance."[4] In that case, the Court described the Act as "a self-reporting and self-assessing [scheme] which depends upon the honesty and integrity of the taxpayers for its success" in order to carry out its ultimate purpose, the raising of government revenues . . . ."[5] Imposing a GAAR penalty in circumstances where a taxpayer has complied with the provisions of the Act – a necessary pre-condition for the application of the GAAR – and exercised due diligence in concluding that the GAAR does not apply does not have the effect of securing compliance with the regulatory purposes of the Act. As noted in the May Submission, the courts have repeatedly held that where a taxpayer exercises due diligence it is unreasonable to expect that the imposition of a penalty will change their behavior.[6] In that light, one is left to the conclusion that the imposition of a GAAR penalty in those circumstances is intended to be purely punitive in both purpose and effect, so as to constitute a penal consequence.[7] Absent significant changes, we have serious doubts as to the Proposed Penalty's constitutional viability.

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TEI appreciates to opportunity to, once again, provides its comments on the Proposed Penalty. TEI comments were prepared under the aegis of its Canadian Income Tax Committee, whose Chair is Steve Saunders of ATCO. Should you have any question regarding TEI's comments, please do not hesitate to reach out to Mr. Saunders at Steve.Saunders@atco.com or Benjamin R. Shreck at bshreck@tei.org or 202.464.8353.

Respectfully submitted,

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4 2015 SCC 41, at para. 75.

5 *Id*. at para. 54.

6 See, inter alia, *R. v. Sault Ste. Marie*, [1978] 2 SCR 1299 at p. 1311, and *A.G. (Canada) v Consolidated Canadian Contractors Inc.*, [1999] 1 F.C. 209 (FCA) at para 16.

7 2015 SCC 41, at para. 76.