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TAX MATTERS

Looming legal changes that will affect Canadians' ability to pay less tax

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In 1936, the Duke of Westminster had structured his affairs to allow for a deduction of an amount paid to his gardener that would otherwise not be deductible. The British tax authorities of the day didn't like it, but the judge, Lord Tomlin, ruled that, "every man is entitled, if he can, to order his affairs so that the tax attaching under the appropriate Acts is less than it would otherwise be. If he succeeds in ordering them so as to secure this result, then, however unappreciative the Commissioners of Inland Revenue or his fellow taxpayers may be of his ingenuity, he cannot be compelled to pay an increased tax."

The decision gave birth to what is known today as the Duke of Westminster principle and is referenced in hundreds of tax court cases here in Canada.

The rules today

In 1988, our government introduced a rule to our tax law to put limits on the Duke of Westminster principle and the ability of Canadian taxpayers to structure their affairs to avoid taxes.

The General Anti-Avoidance Rule (GAAR) was introduced to stop a cycle that looks something like this: (1) The government introduces a new tax law to shut down a particular tax planning idea; (2) tax professionals find a way to get around the new law with a new idea; (3) the government adds another rule to shut down the new idea; (4) only to have tax professionals devise a way to get around that new law. Rinse and repeat.

The GAAR basically allows the Canada Revenue Agency (CRA) to deny a tax benefit where there has been a tax avoidance transaction and the taxman views the idea as being a misuse or abuse of the Income Tax Act.

From the time the GAAR was enacted through to March 2021, it has been applied in more than 1,300 cases (some involve many taxpayers, so the number of actual taxpayers is much higher). From 2016 to 2021 alone, more than $4.1-billion in taxes were assessed by the CRA using the GAAR. I can tell you for certain that it comes up every day in tax-planning discussions as tax professionals advise their clients. It has been effective – as is.

The rules tomorrow

Nevertheless, the Department of Finance released a consultation paper on Aug. 9 that aims to give the GAAR even more legs, restricting further the type of tax planning that Canadians can undertake (in addition to changes introduced in the 2022 federal budget). The reason? There are some court decisions on the issue of the GAAR that the CRA has lost – and the taxman doesn't like to lose.

For the GAAR to apply, three things have to be true: (1) there must be a tax benefit realized (this is rarely in dispute); (2) there was a tax avoidance transaction (that is, the tax benefit was achieved because the primary purpose of a transaction was to avoid income tax); and (3) the avoidance transaction constitutes a misuse or abuse of the Income Tax Act (that is, the intention of the tax law has been violated).

It's criteria (2) and (3) that the CRA has been frustrated with. Some court decisions have been lost by the taxman because the tax benefit was derived from a choice the taxpayer made, not a specific transaction. If it's not a transaction, then it can't be an "avoidance transaction." For example, one taxpayer chose to pay an amount as a dividend to other companies (which is often a tax-free intercorporate dividend) rather than as a return of money that would have been taxable. The CRA didn't like this choice, went to court and lost.

What has the government proposed? The consultation paper suggests changing the GAAR to expand the definition of "transaction" to include a "choice" by a taxpayer. This could mean that the GAAR may apply in an incredibly far-reaching manner. If there's one theme this government has perpetuated, it is to control as much as possible.

Another proposal deals with the "misuse or abuse" of the tax law. Currently, the onus is on the CRA to prove that a transaction violated the intention of the tax law for the GAAR to apply. The proposal? There should be an automatic assumption of misuse or abuse (forget about innocent until proven guilty), and the onus should be on the taxpayer to demonstrate that they did not frustrate the intention of the law.

Here's the stated rationale: The government doesn't understand the intention of the tax law any better than taxpayers and therefore the onus to interpret that intention and build an argument for a misuse or abuse should not fall on the government's shoulders. The paper argues that taxpayers have just as much insight into the intention of the law as the government.

Wow. Just, wow.

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