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Supreme Court of Canada applies GAAR in *Deans Knight*

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On 26 May 2023, the Supreme Court of Canada (SCC) released its decision in *Deans Knight Income Corporation v. The King et al.*, 2023 SCC 16. The SCC dismissed the taxpayer's appeal. The appeal concerned the application of the general anti-avoidance rule (GAAR) under section 245 of the *Income Tax Act* (the Act) in respect of transactions undertaken by the taxpayer to monetize its unused non-capital losses and other deductions (collectively, the Tax Attributes) through a series of transactions that technically avoided the acquisition of control restriction in subsection 111(5) of the Act.

Subsection 111(5) restricts the use of non-capital losses when control of a corporation has been acquired, unless the corporation engages in the same or similar business. It has long been recognized that "control" under subsection 111(5) refers to *de jure* control.

In a 7-1 decision, the SCC held that the transactions were abusive on the basis that the result of the transactions frustrated the underlying rationale of subsection 111(5), which was sufficient to dispose of the appeal. The SCC held that the object, spirit and purpose of subsection 111(5) was 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 undertaken by the taxpayer achieved the very outcome that subsection 111(5) sought to prevent, which constituted abuse.

Since the time in which the transactions in *Deans Knight* occurred, the Act has been amended – by the addition of section 256.1 – to stop the sort of planning that was undertaken by the taxpayer in that case (as well as other non-acquisition of control loss trading transactions). However, the SCC decision will remain important, particularly with respect to the application of the GAAR when a specific anti-avoidance rule (SAAR) has been avoided.

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Facts

The taxpayer was a public corporation with its shares listed on the TSX and NASDAQ. However, the taxpayer's business was not profitable, and the taxpayer was on the brink of insolvency by 2007. Despite accumulating almost $90 million of unused Tax Attributes, it was unlikely that the taxpayer would be able to use any of the Tax Attributes on its own. Rather, a plan was devised such that the Tax Attributes could be monetized through a series of transactions, including the reorganization of the company and a subsequent takeover by another company.

In early 2008, the taxpayer reorganized through a court-approved plan of arrangement where the shares of the taxpayer were exchanged for shares of a newly incorporated company (NewCo), resulting in the taxpayer becoming a wholly owned subsidiary of NewCo.

The taxpayer and NewCo then entered into an agreement (the Investment Agreement) with an unrelated third party, AcquireCo. Pursuant to the terms of the Investment Agreement, AcquireCo acquired a $3 million convertible debenture of the taxpayer that could be converted into 35% of the voting shares and 100% of the non-voting shares that NewCo held in the taxpayer (in total, comprising approximately 79% of the equity in the taxpayer). Furthermore, NewCo could, but was not required to, sell its remaining shares of the taxpayer (i.e., 65% of the voting shares of the taxpayer) to AcquireCo for a minimum guaranteed amount of $800,000. The Investment Agreement provided that if AcquireCo did not present a suitable business opportunity to NewCo for the use of the taxpayer's Tax Attributes within a specified time period, AcquireCo would still be required to pay NewCo the minimum guaranteed amount of $800,000. NewCo would only forgo the $800,000 if AcquireCo presented a business opportunity and NewCo refused to accept it. The Investment Agreement further provided that if an acquisition of control of NewCo or the taxpayer occurred, then NewCo was required to repurchase the convertible debenture from AcquireCo and pay an additional $1 million to AcquireCo.

Prior to the execution of the Investment Agreement, the managing director of AcquireCo purchased 100 shares of the taxpayer through a holding company in order to prevent the Investment Agreement from constituting a unanimous shareholders agreement of the taxpayer. As a result of these transactions, AcquireCo avoided acquiring control of the taxpayer. The assets (including the $3 million from the convertible debenture) and liabilities of the taxpayer were then transferred to NewCo, so that only the Tax Attributes remained in the taxpayer.

AcquireCo searched for a corporate opportunity for the taxpayer and NewCo, such that sufficient profits could be generated to use the Tax Attributes. In seeking such an opportunity, AcquireCo found a mutual fund management company (FundCo) that was interested in investing in high-yield debt instruments. An arrangement was reached such that FundCo would use the taxpayer as a corporate vehicle for an initial public offering (IPO), and the taxpayer's Tax Attributes would then be used to shelter the income and capital gains generated by its portfolio.

Immediately prior to the IPO, AcquireCo converted its debenture into 35% of voting shares and 100% of the non-voting shares of the taxpayer, and immediately following the IPO (when the taxpayer was then widely held), it purchased the remaining 65% of the shares that NewCo held in the taxpayer. In this way, AcquireCo avoided acquiring control of the taxpayer.

The high-yield bond investment business was successful. From 2009 to 2012, the taxpayer used approximately $65 million of the Tax Attributes to reduce its tax liability and paid healthy dividends to its shareholders. The Canada Revenue Agency reassessed the taxpayer to deny these deductions. The taxpayer appealed the reassessments to the Tax Court of Canada (TCC).

Tax Court of Canada decision

Although there were two issues under dispute at the TCC, the main issue was whether the GAAR applied to deny the deductions of the Tax Attributes.[1] The TCC determined that the GAAR did not apply, as the transactions were not abusive.

The TCC held that the object, spirit and purpose of subsection 111(5) was to "target manipulation of losses of a corporation by a new person or group of persons, through effective control over the corporation's actions." [emphasis added] The TCC held that the *de jure* control test is a reasonable marker between situations where a corporation is a free actor versus a passive participant whose actions can be manipulated by a new person or group of persons in order to utilize the losses for their own benefit.

The TCC found that AcquireCo did not gain "effective control" despite changes in management, business activity, assets and name of the taxpayer post-IPO. Furthermore, the TCC held that AcquireCo did not have effective control over the remaining shares of the taxpayer, as NewCo was not required to sell its 65% of the shares to AcquireCo under the Investment Agreement.

[1] *Deans Knight Income Corporation v. The Queen*, 2019 TCC 76.

Federal Court of Appeal decision

The Crown appealed the decision to the Federal Court of Appeal (FCA).[2] The FCA allowed the appeal, concluding that the transactions undertaken by the taxpayer were abusive.

The FCA stated that the object, spirit and purpose of subsection 111(5) was to "restrict the use of specified losses, including non-capital losses, if a person or group of persons has acquired actual control over the corporation's actions, whether by way of *de jure* control or otherwise." [emphasis added] The FCA concluded that the terms of the Investment Agreement gave AcquireCo "actual control" over the actions of the taxpayer at a general level and in approving the corporate opportunities available. Therefore, the GAAR applied and the tax benefit should be denied.

Supreme Court of Canada decision

The SCC upheld the FCA's decision that the transactions were abusive and the GAAR applied to deny the tax benefits.

The SCC reiterated that the analysis required for the application of the third condition of the GAAR — i.e., whether the avoidance transactions were abusive — requires (1) a determination of the object, spirit and purpose of the relevant provisions, and (2) whether the result of the transactions frustrated that object, spirit and purpose, as outlined in the SCC's earlier decisions in *The Queen v. Canada Trustco Mortgage Co.*, 2005 SCC 54 and *Copthorne Holdings Ltd. v. The Queen*, 2011 SCC 63.

The SCC held that the object, spirit and purpose of a provision is a concise description of the underlying rationale of the provision. Since a provision's text does not always provide a full answer to the rationale underlying the provision, the determination of the underlying rationale requires a review of the provision's text, context and purpose. The contextual analysis examines other related sections within the Act that work in conjunction with the provision at issue to give rise to a certain effect. The purposive analysis considers the legislative history and extrinsic evidence to determine whether Parliament sought to achieve a certain outcome or promote particular aims.

Once the object, spirit and purpose of a provision is established, the next step is to determine whether the result of the transactions frustrates the provision's object, spirit and purpose. This analysis goes beyond legal form and technical compliance of the transactions. There must be a comparison of the result of the transactions to the underlying rationale of the provisions to determine whether that rationale has been frustrated.

[2] *The Queen v. Deans Knight Income Corporation*, 2021 FCA 160.

In applying the above-noted test, the SCC focused its analysis solely on subsection 111(5) of the Act. The SCC held that the object, spirit and purpose of subsection 111(5) was to prevent corporations from being acquired by unrelated parties in order to deduct unused losses against income from another business for the benefit of new shareholders.

The SCC drew this conclusion from textual, contextual and purposive analyses. Based on the text of subsection 111(5) of the Act, the SCC confirmed that the control referred to in the provision is *de jure* control, per its earlier decision in *Duha Printers (Western) Ltd. v. Canada*.[3] Although in some cases the text of the provision may fully explain the provision's underlying rationale, the SCC rejected the taxpayer's assertion that the object, spirit and purpose is sufficiently captured by the *de jure* control test within subsection 111(5) of the Act. The text of subsection 111(5) creates an exception that losses remain deductible if, after an acquisition of control, the corporation engages in the same or similar business. Accordingly, the connection to past losses can only be severed when control has been acquired and there is a break from the corporation's past business — a lack of continuity within the corporation as measured by the identity of its controlling shareholders and its business activity.

The SCC then examined the broader context of subsection 111(5) within the scheme of the Act. In examining paragraph 111(1)(a), the SCC concluded that subsection 111(5) acts as a delineation of the boundaries of paragraph 111(1)(a), such that the tax benefits associated with losses generated prior to an acquisition of control should not benefit a new set of shareholders carrying on a different business. Thus, an acquisition of control severs the link between the corporation's prior and post-acquisition operations.

The SCC held that the existence of a *de facto* control test in other provisions of the Act does not demonstrate Parliament's intent to reduce the object, spirit and purpose of subsection 111(5) to the *de jure* control test. The SCC found that Parliament decided between two imperfect tests, *de jure* control and *de facto* control, and opted for *de jure* control as a general test to provide greater certainty and a clearer benchmark for the majority of transactions. However, *de jure* control is not a perfect answer of the mischief that Parliament sought to address. In doing so, the SCC rejected the taxpayer's contention that where Parliament has enacted a SAAR with precision, such as subsection 111(5), the GAAR has no role to play.

The legislative history of subsection 111(5) suggested that Parliament was concerned with the trading of loss corporations, which undermines the tax base and creates inequity among taxpayers. The purposive analysis of subsection 111(5) demonstrated that while the means chosen by Parliament had evolved over time, the rationale for including a restriction on the non-capital loss carryover rule remained consistent.

[3] 98 DTC 6334.

Taken together, the underlying rationale of subsection 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. Fundamentally, an acquisition of control severs the link between the corporation's prior and post-acquisition operations and an unrelated party who takes the reins should not be able to reap the benefits stemming from the unused losses of the pre-existing business.

The SCC held that the lower courts erred by formulating the object, spirit and purpose of subsection 111(5) as a legal test (of "effective control" or "actual control"), rather than summarizing the rationale of the provision. The type of control (whether *de jure* control, *de facto* control, effective control or actual control) does not indicate *why* Parliament was concerned with an acquisition of control and the mischief it sought to address through subsection 111(5). The SCC emphasized that it is not the means (the *how*) but rather the rationale (the *why*) of the provision that is critical in defining the object, spirit and purpose of a provision. Accordingly, although *de jure* control was chosen by Parliament as the test for subsection 111(5), it does not, in and of itself, explain Parliament's underlying rationale for what subsection 111(5) was designed to achieve or prevent. As summarized by the SCC, the rationale of subsection 111(5) is to prevent corporations from being acquired by unrelated parties in order to the deduct their unused losses against income from another business for the benefit of new shareholders, which demonstrates Parliament's intent to deny unused losses to unrelated third parties who take the reins of a corporation and change its business.

In reviewing the transactions at issue, the SCC held that the outcome of those transactions frustrated the object, spirit and purpose of subsection 111(5). The transactions resulted in a fundamental transformation of the taxpayer: its assets and liabilities were transferred to NewCo and all that remained in the taxpayer were its Tax Attributes, which were then used for the benefit of another unrelated party to shelter the profits of a business that completely differed from that which generated the Tax Attributes.

Without triggering an acquisition of control, AcquireCo achieved the "functional equivalent" of an acquisition of control. It fundamentally changed the taxpayer's assets, liabilities, shareholders and business through the Investment Agreement. This functional equivalence of acquisition of control was evidenced by the fact that the Investment Agreement dictated who the taxpayer's directors would be, the Investment Agreement placed severe restrictions on the powers of the board of directors, the actions of the taxpayer required the written consent of AcquireCo, and the transactions allowed AcquireCo to reap significant financial benefits. Although the taxpayer argued that it had remained a free actor, the SCC found that any residual freedom under the Investment Agreement was illusory. The taxpayer was prohibited from engaging in any activity other than considering a corporate opportunity to be presented by AcquireCo and thus merely acted as a vessel for the corporate opportunity selected by AcquireCo. Failing to accept the selected corporate opportunity would have dire financial consequences for NewCo through the loss of the $800,000 guaranteed amount.

Although NewCo was not required to sell its remaining shares of the taxpayer to AcquireCo, it could not have reasonably sold its shares to anyone else.

In light of the object, spirit and purpose of subsection 111(5), the SCC held that the transactions undertaken by the taxpayer severed the continuity underpinning the provision. The series of transactions was created to ensure that the contracting parties would achieve the very mischief subsection 111(5) was intended to prevent. Therefore, the result obtained by these transactions frustrated the rationale of subsection 111(5) and constituted abuse.

Implications

The SCC emphasized that the correct approach to determining the object, spirit and purpose of a provision in a GAAR analysis is based on the underlying rationale of the provision. The first stage of the abuse analysis is not a legal test but rather a descriptive summary of Parliament's underlying rationale behind enacting the provision — what is the conduct that Parliament sought to encourage or prevent?

Accordingly, the abuse analysis will focus on *why* a provision was drafted rather than *how* the provision was drafted, through an examination of the text, context and purpose of the provision at issue.

While the specific transactions undertaken in this case, as well as other "loss trading" transactions, are now prevented by the SAAR in section 256.1, the SCC's reasoning will likely resonate in future cases where a taxpayer has undertaken transactions that are designed to avoid the application of a SAAR. As the SCC stated (at para. 72): "Simply put, specific and carefully drafted provisions are not immune from abuse. As with any other provision, the GAAR ensures that the rationale behind such provisions is not frustrated by abusive tax strategies."

Of course, it remains to be seen how the proposed amendments to the GAAR introduced in the 2023 federal budget[4] will affect the body of jurisprudence that has development under the GAAR since its introduction 1987, culminating in this most recent decision of the SCC.

[4] For more information, see EY Tax Alert 2023 Issue No. 20, *Federal budget 2023-24*.

Learn more

For more information on the GAAR, please contact your EY advisor or EY Law advisor or one of the following professionals:

Montreal

Marie-Claude Marcil
+1 514 879 8208 | marie-claude.marcil@ca.ey.com

Angelo Nikolakakis
+1 514 879 2862 | angelo.nikolakakis@ca.ey.com

Toronto

Daniel Sandler
+1 416 723 0016 | daniel.sandler@ca.ey.com

David Robertson
+1 403 206 5474 | david.d.robertson@ca.ey.com

Selena Ing
+1 416 943 4567 | selena.ing@ca.ey.com

Calgary

Sanjaya Ranasinghe
+1 780 441 4692 | sanjaya.ranasinghe@ca.ey.com

Jonathan Ip
+1 403 206 5409 | jonathan.ip@ca.ey.com

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