Canada's Supreme Court Upholds GAAR Application in *Deans Knight*

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Canada's highest court has upheld the application of the general antiavoidance rule to deny benefits of tax attribute monetization transactions, finding that the transactions clearly frustrated the rationale of noncapital loss carryover restrictions.

The transactions undertaken by the taxpayer in *Deans Knight Income Corp. v. Canada* resulted in its "near-total transformation" and an outcome that Parliament meant to prevent, the Court said in a highly anticipated judgment released May 26.

The judgment says the results frustrated the "object, spirit, and purpose" of Income Tax Act subsection 111(5), a provision the majority described as designed to prevent the acquisition of corporations by unrelated parties to offset income of another business with unused losses in order to benefit new shareholders. The outcome achieved by Deans Knight "therefore constituted abuse," the Court said.

In the sole dissent, Judge Suzanne Côté said that even if the majority's characterization of the object and spirit of subsection 111(5) is correct, the appeal should have been resolved in the taxpayer's favor. She said that both Judge Malcom Rowe, who wrote for the majority, and the Federal Court of Appeal, which held for the government in a 2021 decision in *The Queen v. Deans Knight*, "failed to apply the GAAR with due restraint."

The transactions at issue were undertaken by Deans Knight, then operating as Forbes Medi-Tech Inc., as its drug research and food additive business was struggling and it sought to take advantage of C $90 million in unused tax attributes comprising noncapital losses, research and development expenditures, and investment tax credits.

Deans Knight transferred its business to a new publicly traded parent corporation (Newco) and entered into an investment agreement with venture capital company Matco, which purchased a debenture that could be converted into 35 percent of the taxpayer's voting common shares and all of its nonvoting common shares. Newco could sell its remaining shares for a guaranteed minimum of C $800,000 under the agreement, but it wasn't obligated to sell its shares to Matco.

According to the plan, Matco was to come up with a new business venture for the taxpayer, the profits from which would be sheltered by its unused tax attributes. Deans Knight took deductions for most of its noncapital losses — which were denied by the minister of national revenue — between 2009 and 2012.

In an April 2019 judgment, Canada's tax court concluded that the transactions satisfied the tax benefit and avoidance transaction conditions of the GAAR but did not abuse tax attribute streaming restrictions. Matco didn't have a right to acquire Deans Knight's remaining shares and didn't control the sale of those shares, it concluded.

In August 2021 the Federal Court of Appeal rejected that decision, finding that the tax court's conclusion that Matco lacked effective control of Deans Knight didn't align with the details in the investment agreement. The avoidance transactions circumvented loss restrictions and weren't pursued primarily for legitimate purposes other than the tax benefits, it said.

"Courts must go beyond the legal form and technical compliance of the transactions" and compare the transactions' results with the rationale of the provision at issue, the Supreme Court said in its May 26 judgment. While abuse must be clear, "there is no bar to applying the GAAR in situations where the [ITA] specifies precise conditions that must be met. . . . Even specific and carefully drafted provisions are not immune from abuse," it said.

In its application to the Supreme Court, Deans Knight argued that the government's approach is to apply a de jure control test to taxpayers undertaking transactions for mostly commercial reasons and an actual control test to taxpayers undertaking transactions primarily for tax benefits. However, the Court said the question "is not whether Matco holds de jure control or satisfies some other test such as de facto control."

Parliament clearly chose a de jure control test for subsection 111(5), but "de jure control does not, in itself, explain what was concerning to Parliament," the Court said. "It is primarily a means of giving effect to Parliament's aim, rather than a complete encapsulation of the aim itself."

The abuse analysis asks courts to compare the impugned transactions with a provision's rationale, and in this case, the results achieved by the taxpayer clearly frustrated the rationale of subsection 111(5), the Court said. "Finding that a transaction falling short of de jure control has abused subsection 111(5) in this case does not mean that every transaction falling short of de jure control will be found abusive of this provision," it added.

"This case is of profound concern to Canadian taxpayers," Côté wrote in her dissent, accusing the majority of attempting to reweigh evidence presented in the tax court. "The GAAR cannot be invoked to override Parliament's clear intent," she said, adding that it seems that's what the majority opinion has done in this case.

Côté said the "object, spirit, and purpose of [subsection] 111(5) is to restrict the use of tax attributes if accessed through an acquisition of de jure control." The tax court found that Matco didn't acquire effective control of the taxpayer, she said, adding, "I see no reviewable error in this conclusion."

Côté's reasons "conflate the means found within a provision's text (in this case, de jure control) with the provision's underlying rationale," Rowe said in the majority opinion. "This approach would have implications for a variety of provisions involving a control test, such that the GAAR would effectively not apply," he said.

"The tax community will certainly study *Deans Knight* and the implications that it stands for, including its impact on the government's current proposals to amend the GAAR," said Kim Moody of Moodys Tax Law.

Canada's government vowed to update the GAAR in its 2021 budget, and in August 2022 it released legislative proposals that would permit the application of the rule to transactions affecting unused tax attributes. The 2023 budget proposed GAAR amendments that include a change to the avoidance transaction standard and the introduction of an economic substance rule.

In post-budget comments, the Canadian Chamber of Commerce said the March 2023 proposals and August 2022 discussion paper "seem something of a solution in search of a problem." The March proposals are based on the government's incorrect conclusion that its losses "are attributable to a deficiency in the GAAR legislation or the courts' application of it, rather than the government itself over-reaching in applying GAAR and insufficiently articulating Parliament's legislative rationale," it said.

The Supreme Court's judgment reinforces the point that the GAAR consultation process is in search of a problem that doesn't exist, said Laurie Goldbach of Borden Ladner Gervais. "Clearly, our top Court is willing to stretch quite a bit to apply GAAR in circumstances where they believe the results warrant it. My read is that means they think the existing GAAR is fit for purpose," she said in an email, adding that the government "can no longer claim that the courts are not sufficiently willing to apply it."

The outcome in *Deans Knight* is closely connected to the facts, and "there will be opportunities to distinguish it," Goldbach said. "To the extent that the majority's judgment encourages the application of the GAAR on a discretionary (or at least not evidence-based) basis, the GAAR test continues to lack the rigour and the process the business community and tax planner hoped to see from the case," she added.

"Not only does the majority of the Court depart from Parliament's clear adoption of the de jure test for control in [subsection] 111(5), but it substitutes its own meandering test for control that is neither de jure or de facto," Roy Berg of Roy Berg International Tax Law said in an email. "Without a clearly defined test (notwithstanding Parliament's adoption of the de jure test), the decision adds to the increasingly uncertain body of jurisprudence regarding the application of the GAAR standard."

Both the majority and dissenting opinions "will likely be given significant consideration by the government's current review of GAAR," Berg said. "In light of the Court's departure from the de jure test adopted in the legislation, I would be very surprised if the government's review does not mention this case by name."

"In view of the proposed changes to the GAAR . . . tax planning is already in uncharted waters," said Ron Choudhury of Miller Thompson LLP. "The scope for planning is continuing to get severely restricted."