taxnotes® international

Volume 103, Number 13 ■ September 27, 2021

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Reprinted from *Tax Notes International*, September 27, 2021, p. 1713

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In this article, Suarez analyzes the Federal Court of Canada's recent judgment in *Deans Knight*, which addressed the tax treatment of noncapital losses and other tax deductions under Canada's antiavoidance rules.

In *Deans Knight*, Canada's Federal Court of Appeal (FCA) reversed the taxpayer's win in the Tax Court of Canada (TCC) in a case involving the use of roughly C $90 million of accumulated noncapital losses and other tax deductions.[1] The FCA's decision upheld the application of the general antiavoidance rule in section 245 of the Income Tax Act (Canada) by the Canada Revenue Agency, which said the transactions in question constituted an abuse or misuse of the loss use restrictions in ITA section 111(5). As a result, the taxpayer's deduction of accumulated loss carryforwards from prior tax years was disallowed.

Most tax practitioners should find the FCA's reasoning surprising, and it raises many important questions that go beyond both the facts of the case and the correct interpretation of Canada's loss use restrictions.

The taxpayer has announced its intention to seek leave from the Supreme Court of Canada (SCC) to appeal its loss. Whatever the outcome of the case, it is hoped the SCC will agree to hear the appeal and resolve numerous questions regarding permissible loss transfers and how the GAAR should be interpreted and applied across the ITA.[2]

Factual Overview

The transactions involved a monetization of tax losses carefully designed to stay within the limits of the rules governing permissible loss transfers (primarily ITA sections 111(5) and 256(8)).[3]

Deans began as a publicly listed drug research and food additives company that experienced financial difficulty and underwent a reorganization under which it became a wholly owned subsidiary of a new widely held and publicly traded corporation (New Forbes).[4] New Forbes and Deans entered into an agreement with a third party (Matco) under which:

- Deans issued a convertible debenture to Matco[5] in exchange for C $3 million;
- Deans's business and the $3 million were transferred to New Forbes, effectively leaving Deans "a shell with no assets and

[1] *Deans Knight Income Corp. v. Canada*, 2021 FCA 160, *rev'g* 2019 TCC 76.

[2] Appeals of civil cases are heard by Canada's highest court only if it decides to accept them based on the presence of issues of national importance that transcend the litigants' interests.

[3] *See* Amanda Athanasiou, "Canadian Court Tosses Tax Court Ruling on Use of Tax Attributes," *Tax Notes Int'l*, Aug. 9, 2021, p. 747. *See also* Brian Arnold, "A General Policy in the Act Against Loss Trading: Deans Knight," The Arnold Report, Posting 211, Aug. 10, 2021; and Mark Jadd and Joel Nitikman, "The GAAR Analysis in *Deans Knight*: Apparently a Cigar Is Not Always Just a Cigar," XXIV(2) *Tax Litigation* (2021).

[4] Deans shareholders exchanged their shares for shares of New Forbes, with Deans becoming its subsidiary (a small number of Deans shares were held by others).

[5] The Deans voting and nonvoting common shares into which the debenture was convertible (at Matco's option) represented 79 percent of the equity value and 35 percent of the voting power (fully diluted) of Deans's share equity.

one liability: an obligation to pay principal and interest to Matco under the convertible debenture";
- Matco would use its expertise to arrange a corporate opportunity for Deans whereby new funds would be raised in an initial public offering so as to avoid triggering an acquisition of de jure control of Deans under ITA section 111(5) and used to establish a business whose income would be sheltered by Deans's tax losses; and
- Matco was obligated within a year to pay another $800,000 to New Forbes (either to acquire its remaining Deans shares or otherwise).[6]

Eventually, Matco arranged a $100 million IPO of Deans under which the money raised would be managed by Deans Knight Capital Management Ltd.[7] and used to earn income from corporate debt securities sheltered from tax using Deans's accumulated tax losses. Matco exercised its conversion right to convert the Deans's debenture into voting and nonvoting shares and purchased New Forbes' shares of Deans for the agreed $800,000. The result was that New Forbes received a total of $3.8 million for the Deans shares, and Matco's publicly traded Deans shares following the IPO were worth $5 million.

Relevant Provisions

Canada does not have a group relief or consolidation system for deductions and losses; rather, each corporation is required to compute its own income or loss and pay its own taxes. There are restrictions on loss utilization when a corporation undergoes (or is deemed to have undergone) an acquisition of control (AOC).[8] The general rule is that for this purpose, the term "control" refers to legal or de jure control as reflected by the ownership of sufficient shares of a corporation to enable the holder to elect a majority of the corporation's board of directors. ITA section 111(5) is supplemented by various antiavoidance rules that deem an AOC to occur (or not) in some circumstances[9] and deem rights relating to shares to have been exercised for those purposes.[10] The statute thus draws a fairly clear line beyond which a corporation's ability to use its accumulated losses from prior years will be denied or severely restricted.[11]

The GAAR in ITA section 245 allows the CRA to redetermine the tax consequences of a transaction as is reasonable in the circumstances if three conditions are met:
- the transaction (or series of transactions) results in a tax benefit;
- the transaction was not undertaken primarily for nontax reasons; and
- the transaction would directly or indirectly result in an abuse or misuse of the provisions of at least one tax enactment (including the ITA) or of those enactments as a whole.

The GAAR is meant to be used as an exceptional remedy when a taxpayer complies with the text of the relevant provisions, but the results still frustrate the object, spirit, and purpose or underlying rationale of those provisions (or the ITA as a whole). The onus is on the CRA to demonstrate that an abuse or misuse has occurred. The SCC has described the GAAR as:

> a legal mechanism whereby Parliament has conferred on the court the unusual duty of going behind the words of the legislation to determine the object, spirit or purpose of the provision or provisions relied upon by the taxpayer. While the taxpayer's transactions will be in strict compliance with the text of the relevant provisions relied upon, they may not necessarily be in accord with their object,

[6] The FCA described Matco's option to pay the additional amount without acquiring shares as necessary to avoid Matco acquiring de jure control if it was unable to arrange an IPO or similar transaction.

[7] The taxpayer changed its name to Deans Knight Income Corp. at this time.

[8] ITA section 111(5).

[9] Such as ITA section 256.1(3), which deems an AOC to occur when more than 75 percent of a corporation's equity (by value), irrespective of voting rights, is acquired by a person or group of persons.

[10] *See, e.g.*, ITA sections 256(8) and 251(5).

[11] Essentially, pre-AOC capital losses or losses from investment cannot be used following the AOC, while pre-AOC losses from a business can be used following an AOC only if the corporation continues to operate the business in which the losses were generated and only against income generated by the loss business or another business that is sufficiently similar to the loss business. For further discussion, see Steve Suarez, "Tax Planning With Losses in Canada," *Tax Notes Int'l*, Aug. 1, 2005, p. 451; and Suarez, "Using Tax Losses Within a Canadian Group of Companies," *Tax Notes Int'l*, Apr. 2, 2012, p. 59.

> spirit or purpose. In such cases, the GAAR may be invoked by the Minister. The GAAR does create some uncertainty for taxpayers. Courts, however, must remember that [ITA section] 245 was enacted "as a provision of last resort."[12]

The Courts

The CRA's position before the TCC was: (1) that the rights acquired by Matco under the agreement resulted in an AOC of Deans under a combination of ITA sections 256(8), 251(5)(b), and 111(5); and (2) the GAAR applied in any event because the transactions constituted an abuse or misuse of ITA sections 111(5) and 256(8). Its appeal to the FCA was limited to the second issue. In finding that the TCC had committed error and the GAAR applied, the key elements of the FCA's judgment were that:

- the "two purposive factors that shed light on the underlying rationale of subsection 111(5) are clear statements of government intent and jurisprudence acknowledging that the [ITA] generally aims to prevent loss trading";
- 1988 statements by a senior Department of Finance official[13] when the GAAR was introduced proved it "could not be clearer that the government believed in 1988 that the text of the restrictions on the use of non-capital losses did not fully reflect the purpose of this legislation";
- the object, spirit, and purpose of section 111(5) was "to restrict the use of specified losses, including noncapital 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"; and
- the term "actual control" means something broader than de jure control but is also distinct from de facto control as defined in ITA section 256(5.1).[14]

Thus, the FCA established a new standard of control (actual control) as the litmus test for determining whether an abuse or misuse of ITA section 111(5) has occurred.

Applying those principles to the facts at hand, the FCA found that the terms of the agreement were such as to give Matco actual control over Deans, thereby triggering an AOC, causing ITA section 111(5) to apply and deny the use of Deans's pre-AOC business losses against post-AOC income from a completely different economic activity. In the court's view, because of the economic incentives and penalties created by the agreement, Deans and New Forbes were not free actors but instead realistically could do nothing regarding Deans's actions other than "ensure that they fulfilled their obligation to assist Matco with the implementation of the Corporate Opportunity."

Discussion

While the ultimate outcome of *Deans Knight* is certainly of interest, this discussion focuses on the elements of the FCA's judgment that go well beyond the facts (and indeed the proper interpretation of the ITA loss use regime) and thus warrant guidance from the SCC.

Prior Jurisprudence: *Duha Printers*

One of the leading cases (if not the leading case) on permissible loss use transactions is *Duha Printers (Western) Ltd. v. Canada*, [1998] 1 SCR 795, a pre-GAAR unanimous SCC decision in favor of the taxpayer. It involved a carefully constructed series of transactions designed to ensure that de jure control of the corporation rested with the desired shareholder in order to stay in the confines of permissible loss utilization as prescribed by ITA section 111(5). As was the case in *Deans Knight*, the transactions in *Duha Printers* were tax-motivated and involved a corporation with accumulated losses.

The FCA in *Deans Knight* clearly infers that had the GAAR been in force at the time of the *Duha Printers* transactions, the SCC would have decided the case differently:

> [84] The [SCC in *Duha* Printers] commented that the *de jure* control test was selected "because in some respects it is a relevant and relatively certain and

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[12] *Copthorne Holdings Ltd. v. Canada*, 2011 SCC 63, para. 66.

[13] David Dodge, "A New and More Coherent Approach to Tax Avoidance," 36(1) *Canadian Tax J.* 1, 3 (1988).

[14] *See* para. 83: "It is true that the object, spirit and purpose of subsection 111(5) as articulated above does include forms of *de jure* and *de facto* control. However, the actual control test is different than the statutory *de facto* control test in [ITA] subsection 256(5.1)."

> predictable concept to employ in determining control." The Court also commented that if the distinction between *de jure* and *de facto* control is to be eliminated, this should be left for Parliament.
>
> [85] Parliament did respond. While Parliament did not change the *de jure* control test in subsection 111(5), it did enact the GAAR to respond generally to abusive tax avoidance. I note that the GAAR was enacted a few years after the transactions in *Duha Printers* were implemented. [Internal citations omitted.]

That is surprising, given that there is nothing in the judgment indicating or otherwise suggesting that the SCC found those transactions abusive or offensive.[15] Perhaps the SCC would have decided *Duha Printers* differently had the GAAR been in force when the transactions at issue occurred, but if that is so, it would be highly instructive to hear that from the SCC itself via the appeal in *Deans Knight*. In any event, it is very difficult to see any basis for the FCA's assertion that the GAAR's enactment should be interpreted as some sort of response to the transactions in *Duha Printers*.

Moreover, in *Duha Printers*, the SCC used the term "actual control" as being synonymous with *de facto* control — quite different from the FCA's use of that term in *Deans Knight* as being something distinct from both de jure and de facto control. That makes the FCA's reasoning in *Deans Knight* that much more difficult to reconcile with *Duha Printers*.

What Does 'Actual Control' Mean?

While ITA section 111(5) clearly uses a de jure control test for distinguishing acceptable and unacceptable loss transfers, the FCA concluded that some conceptually different standard of control marks the object, spirit, and purpose of that section. Because the GAAR as applied to ITA section 111(5) reduces the scope of the exemptions to the ITA's general policy to prohibit the transfer of losses between taxpayers, the FCA decision in *Deans Knight* creates a new demarcation line for permissible loss use transactions based on the novel concept of actual control.

It is by no means clear what the FCA meant by "actual control" or how it is determined. As noted above, the FCA's proffered actual control concept is clearly different from both de jure and de facto control and includes "forms of both" (all forms or only some?). Conceivably, the actual control concept is unique to ITA section 111(5) because it reflects (or is said to reflect) the legislative history and parliamentary intent — that is, object, spirit, and purpose — behind that section (and perhaps related provisions that affect its application, such as ITA section 256(8)). However, that conclusion is uncertain and is not stated in the FCA's judgment.

If indeed the correct demarcation line for acceptable loss utilization is the FCA's actual control standard in *Deans Knight*, considerably more insight from the courts is needed on what it means and how it is established. The SCC could provide taxpayers and the CRA with much needed guidance by clearly defining the FCA's standard for acceptable loss transfers (if it is indeed the correct one) and helping the tax community understand where else in the ITA it might be relevant, as well as filling in the gaps left by *Deans Knight*.[16]

Defining 'Abuse or Misuse' of Section 111(5)

A GAAR analysis requires the object, spirit, and purpose of the relevant provisions to be ascertained. The CRA argued before the FCA that the object, spirit, and purpose of ITA section 111(5) is part of a general ITA policy to "prohibit

[15] To the contrary, when discussing the FCA's reasoning on object and spirit in *Duha Printers*, the SCC said the parties were free to use what the FCA called "technicalities of revenue law" to achieve their desired end: to transfer de jure control of one entity to another while preventing the second from exercising actual or de facto control over the corporation's business. It said:

> Indeed, this is what [the parties] accomplished, and nothing in the "object and spirit" of any of the various provisions can serve to displace this result. That is, while the general purpose of [section] 111(5) may be to prevent the transfer of non-capital losses from one corporation to another, the parties successfully excepted themselves from the general rule by bringing the two companies under common control prior to their amalgamation.

[16] *See* Brian Nichols and Kelsey Horning, "*Deans Knight* Intersects Bill C-208: The Meaning of Control and Implications for Intergenerational Transfers," Tax Topics Report 2582 (Aug. 31, 2021).

the transfer of losses between taxpayers, subject to specific exceptions." That statement seems uncontroversial enough, but it tells us nothing about the scope of the exceptions, which is the fundamental question. The CRA went on to describe an AOC test "as a proxy for the degree of continuity of shareholder interest required to allow corporate losses to offset income from a new business." The support for that assertion is somewhat harder to find, given that the de jure control test in ITA section 111(5) is based on voting rights rather than economic interest and is framed in terms of a particular person (or group of persons) *acquiring* control as opposed to an existing shareholder (or group of shareholders) losing control.[17]

While the object, spirit, and purpose of ITA section 111(5) might be based on a continuity of shareholder principle, little or no actual evidence of that is found in the FCA's judgment. A hearing before the SCC on an appeal of *Deans Knight* would give the parties the opportunity to present their evidence on that matter and permit the Court to articulate what it thinks the required degree of continuity is, if indeed it is something different from (and broader than) the de jure control test in ITA section 111(5).

The FCA's reasoning on how abuse or misuse is to be determined is very hard to follow. It would be one thing if it had found that Matco had managed to acquire a degree of control over Deans that was functionally equivalent to de jure control without meeting the legal definition of that control so as to cross (by another mechanism) the very line that ITA section 111(5) establishes. That reasoning would infer that an abuse or misuse occurs when a taxpayer indirectly achieves a result that is clearly not what the relevant provisions allow (if directly achieved) in order to claim the relevant tax benefit — a plausible line of reasoning that gives all parties an understandable comparable to work with when determining what is permissible. However, that is simply not what the FCA said.

Instead, the CRA asserted that an abuse occurred because the parties "blatantly avoided" an AOC of Deans, caused the cessation of the business that generated the relevant tax attributes,[18] and severed the shareholder interest in the former business from the new business carried on as a result of the IPO. The FCA's conclusion that an abuse had occurred explicitly referenced the CRA's demonstration that blatant avoidance of an AOC had occurred.

There is little doubt that the parties sought to structure their transactions to avoid a de jure AOC, but if de jure control is the line established in ITA section 111(5) beyond which losses become restricted, how can making a conscious effort to stay on the right side of the line (blatantly or otherwise) demonstrate an abuse or misuse? Missing from the FCA's analysis is support for why whatever rights Matco *did* get produced a result contrary to the object, spirit, and purpose of ITA section 111(5) — that is, why they produce a degree of control that is at odds with and frustrates the rationale of the ITA's loss transfer provisions. In and of itself, blatantly avoiding an AOC is no more abusive than contributing to a tax-deferred retirement savings plan the exact amount permissible under the contribution limit rules. Regardless of whether the parties in *Deans Knight* crossed the line in terms of giving Matco rights that frustrate the rationale of ITA section 111(5),[19] the FCA's reasoning on its approach to abuse or misuse is not illuminating or well supported. The SCC should weigh in on whether that approach (as distinct from the result on the facts) is legally correct.

How Is Object, Spirit, and Purpose Established?

Determining that object, spirit, and purpose of a provision can be challenging. Frequently the courts will look to Department of Finance explanatory notes accompanying the introduction of legislation when determining what motivated the government to enact it and what the objectives were. Reference to other provisions of the ITA

[17] That is, an IPO or other transaction in which existing shareholders lose voting control because a large number of unrelated persons acquire widely held shares clearly does not constitute an AOC under the de jure control rule (or the broader de facto control test, for that matter).

[18] The cessation of the business would seem to be irrelevant, because if no AOC occurs, the requirement in ITA section 111(5) to continue operating the loss business does not apply.

[19] Certainly, the types of economic incentives cited by the FCA are quite different conceptually than the actual legal authority to act inherent in the de jure control test in section 111(5).

(and how the provision in question interacts with them) is also often of assistance.

In *Deans Knight*, the FCA did not cite any sources like that as part of its GAAR analysis. Instead, the judgment refers to only two extrinsic sources, neither of which really appears to support the court's conclusion. The first is a 1988 article by the then-senior assistant deputy minister of finance, from which the FCA quotes an excerpt. The full paragraph that excerpt was taken from in fact reads as follows:

> Stability of tax revenues is also an objective of the new rule. In this regard, it is sufficient to recall that the 1985-86 corporate tax revenues were $1.2 billion lower than the initial budgetary forecasts and that this shortfall was considered to be caused largely by the unexpected application of loss carryforwards. In his 1987 budget speech, the minister of finance made it clear that the government was concerned about the uncertainty and the erosion of corporate tax revenues attributable to tax avoidance transactions.[20]

That statement — taken at face value — would establish that in enacting the GAAR, the government was concerned with combating "abusive tax avoidance transactions that represented a significant factor in eroding corporate tax revenues."[21] The article also says that unexpected use of loss carryforwards reduced corporate tax revenues between 1985 and 1986 (a few years after the economic recession Canada experienced in 1980-1982). However — even assuming it could be taken as an official expression of parliamentary intention — there is nothing in the article stating that an unexpected use of loss carryforwards *was itself* abusive or contrary to the intention of the ITA loss use regime. Losses were used, and the GAAR was enacted to combat abusive tax avoidance, but there is nothing indicating that losses were used in an abusive manner or that loss utilization was the type of abusive planning that prompted the GAAR's enactment. With respect, then, it seems quite a stretch by the FCA to rely on that slender reed to conclude that "it could not be clearer that the government believed in 1988 that the text of the restrictions on the use of non-capital losses did not fully reflect the purpose of this legislation."

The second statement of government policy cited by the FCA in support of its GAAR analysis is a fairly anodyne observation from the finance minister when the AOC loss restriction was enacted in 1963 that sheds no light on where the line for establishing control should be beyond what the text already says (that is, de jure control).[22] Hence, while there is widespread agreement that the general policy behind ITA section 111(5) is to limit loss transfers, nothing in *Deans Knight* supports the FCA's proposed actual control standard, nor is there any authority to support determining object, purpose, and spirit by referring to an article written by a senior bureaucrat (however knowledgeable). With respect, whatever the right way is to determine object, spirit, and purpose in a reasoned and principled way consistent with the evidence, it can't be this.

Thus, it would be extremely helpful to hear from the SCC:

- whether the FCA has correctly identified the object, spirit, and purpose of ITA section 111(5);
- how the courts should determine the object, spirit, and purpose of ITA provisions in general; and
- what forms of extrinsic evidence taxpayers and courts may rely on in determining what the object, spirit, and purpose of any particular provision (or group of provisions) is.

It is hoped that Canada's highest court will hear the taxpayer's appeal and address the many questions left by the FCA's judgment in *Deans Knight*. ■

[20] *See* Dodge, *supra* note 13.

[21] *See id.* at n.7, quoting the minister of finance's 1987 budget speech to Parliament.

[22] *See Deans Knight*, 2021 FCA 160, at para. 42 (quoting the finance minister as saying the purpose of the AOC test was to stop the trafficking in shares of companies whose businesses had been discontinued, but which technically had some tax-loss carryforward entitlements).