

Supreme Court of Canada grants leave to appeal in Deans Knight

March 22, 2022

On March 10, 2022, the Supreme Court of Canada (SCC) granted leave to Deans Knight Income Corporation (Deans Knight) to appeal its loss in the Federal Court of Appeal (FCA) in an important tax case arising under the *Income Tax Act* (Canada) (ITA). Taxpayers have no automatic right of appeal to the SCC, which chooses to hear only two or three tax cases each year. Generally, the SCC will only hear cases where the issues at stake transcend the case between the litigants themselves and are more broadly applicable to warrant review and consideration by Canada's highest court.

What you need to know

- The taxpayer in Deans Knight sought to monetize tax losses accumulated by a corporation, via a carefully constructed series of transactions designed to allow an arm's-length third party to utilize those losses while staying within the limits of the rules governing permissible loss transfers.
- When control of a corporation is acquired, various ITA rules apply to prohibit or restrict the corporation's ability to use losses the corporation incurred prior to the acquisition of control (AOC) in the post-AOC period and vice versa.
- For this purpose, these rules define "control" as de jure control: the ownership of such number of the corporation's shares as would entitle the owner to elect a majority of the corporation's board of directors. A number of other ITA provisions use a different, broader, standard of control (de facto control) that looks to any ability (whether via share ownership or otherwise) constituting direct or indirect influence that (if exercised) results in control of a corporation.

The decision

The [FCA's judgment in *Deans Knight*](#) found that these transactions constituted an abuse or misuse of the relevant ITA provisions, validating the CRA's application of the general anti-avoidance rule (GAAR) in s. 245 ITA and cause the AOC loss restrictions to apply. This occurred despite the fact that the parties agreed that no AOC had occurred under the *de jure* control standard found in the relevant ITA rules. Instead, the FCA reviewed the parties' legal rights and obligations and concluded that the corporation was not a "free actor" due to the economic incentives and penalties created

by their legal agreements. Most importantly, the FCA concluded that the object, spirit, and purpose of the AOC provisions 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”. In doing so, the Court effectively imported a *de facto* control test into the interpretation of a provision that clearly uses a *de jure* control standard, a surprising result for the Canadian tax community.

The granting of leave by the SCC is a welcome development, as the questions and uncertainties created by the FCA’s judgment are in urgent need of resolution for taxpayers and tax authorities. In particular, hopefully the SCC will provide guidance on the following matters:

- What is the correct standard of control applicable to a GAAR analysis of the AOC loss restriction rules, and if it is the standard created by the FCA’s judgment, what does that standard mean;
- In conducting a GAAR analysis generally, how should the “object, spirit and purpose” of the relevant ITA provisions be determined, and did the FCA do so correctly on the facts of this case; and
- What extrinsic evidence may taxpayers and courts look to in trying to establish the “object, spirit and purpose” of ITA provisions.

For more information, please contact any of the key contacts listed below.

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

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