Supreme Court of Canada issues much-anticipated decision on GAAR

May 26, 2023

On Friday, May 26, 2023, the Supreme Court of Canada (SCC or the Supreme Court) dismissed the taxpayer's appeal in *Deans Knight Income Corp. v Canada*, 2023 SCC 16 (*Deans Knight*). This much-anticipated decision deals with the general anti-avoidance rule (GAAR) in section 245 of the *Income Tax* Act[1] (Act). The GAAR, where applicable, allows the Canada Revenue Agency (CRA) to redetermine the tax consequences of a transaction. For GAAR to apply, the taxpayer must have engaged in a transaction or series of transactions with the primary purpose of obtaining a tax benefit, in such a manner as to result in an abuse or misuse of one or more provisions of the Act. To date, relevant jurisprudence has established that a two-stage GAAR analysis be employed to determine whether a transaction is abusive. First, the court determines the object, spirit, and purpose of the relevant provisions of the Act. Second, the court decides whether a particular transaction has frustrated that object, spirit, and purpose.

Deans Knight represented an opportunity for the Supreme Court to provide taxpayers with much needed certainty regarding the role and application of GAAR in the Canadian tax regime, and more specifically, the process by which courts ought to determine the object, spirit, and purpose of provisions under the Act, positions which BLG advanced before the Supreme Court as counsel to the intervener, the Canadian Chamber of Commerce.

Overview

The specific context of *Deans Knight* was the potential application of the GAAR to transactions designed to avoid triggering restrictive provisions, specifically s.111(5) of the Act, which prohibit or restrict the ability of a corporation, having undergone an "acquisition of control" (AOC), to use its pre-AOC accumulated business losses in post-AOC taxation years.[2] The taxpayer in *Deans Knight* had been a public corporation that accumulated $90 million of business losses, which it sought to monetize via a series of transactions designed to avoid creating an AOC, thus preserving its ability to utilize those losses.

The relevant restricting provisions define "control" as *de jure* control: the ownership or control over the voting rights of such a number of the corporation's shares as would entitle the owner/controller to elect a majority of the corporation's board of directors.

Several other provisions within the Act rely on a broader standard known as *de facto* control, which considers any ability (whether via voting control of shares or otherwise) constituting direct or indirect influence that, if exercised, results in control of a corporation.

The Majority Decision

In a majority decision penned by Justice Rowe, the Supreme Court found that the transactions at issue were abusive such that the GAAR applied to deny the tax benefit.

The majority held that it is critical when determining the object, spirit, and purpose of a provision to distinguish the rationale behind the provision from the means chosen by Parliament to give effect to the rationale. The majority determined that a review of s.111(5)'s text, context, and purpose revealed that its underlying rationale was to deny loss carryovers when there is a lack of continuity within the corporation, as measured by both the identity of its controlling shareholder(s) and its business activity. Further, the majority held that s.111(5)'s rationale is not fully captured by the *de jure* test and is, instead, illuminated by related provisions which both extend and restrict the circumstances in which an AOC has occurred, including by looking beyond the standard documentation under the *de jure* control test. The majority held that, taken together, the object, spirit, and purpose of s.111(5) is to prevent corporations from being acquired by unrelated parties in order to deduct the corporation's unused losses against income from another business for the benefit of new shareholders.[3]

Upon reviewing the transactions at issue, the majority determined that the parties achieved the outcome Parliament sought to prevent as the transactions allowed an unrelated third party to achieve the functional equivalent of an AOC of the taxpayer through an investment agreement with Deans Knight, while circumventing s. 111(5). Specifically, the majority held that:

1. the third party contracted for the ability to select Deans Knight's directors,
2. the investment agreement placed severe restrictions on the powers of the board of directors which, but for a circuit-breaker transaction that occurred, would normally occur through a unanimous shareholders agreement and which would lead to an acquisition of *de jure* control,
3. the transactions allowed the third-party to reap significant financial benefits while depriving Deans Knight's legal majority voting shareholder, of each of the core rights that it could ordinarily have exercised, and
4. any residual freedom Deans Knight had was illusory because it was prohibited from engaging in any activity other than studying and accepting corporate opportunity, and because the consequences of refusing the opportunity were severe.

The Dissent

Dissenting, Justice Côté opined that the appeal ought to have been allowed and that the majority's decision constituted an *ad hoc* approach that expands the concept of control based on a wide array of operational factors despite Parliament's unambiguous adoption of the *de jure* control test in s. 111(5). Justice Côté reasoned that the majority's approach to determining the object, spirit, and purpose of s. 111(5) failed to

account for the central principle that the GAAR does not and cannot override Parliament's specific intent regarding provisions of the Act. Justice Côté reiterated previous jurisprudence that GAAR analysis must rely on the same interpretive approach employed by the Court in all questions of statutory interpretation. In such an interpretation, the text of a provision can, in certain circumstances, is conclusive. This is especially true for specific anti-avoidance rules such as s.111(5) where the key question is whether Parliament specifically intended to prevent or permit a certain type of transaction.

Applying this interpretative approach, Justice Côté determined that the object, spirit, and purpose of s. 111(5) is to restrict the use of tax attributes if accessed through an acquisition of *de jure* control. Parliament never intended courts to consider factors other than those related to share ownership in determining who has control over a corporation. Further, Justice Côté argued that the majority's introduction of functional equivalence, which treats an investment agreement as a constating document, ignores the 'radically different' ways these types of agreements are enforced and results in the Court overriding Parliament's clear intent and articulation of a *de jure* control test for restricting losses under s. 111(5).

We expect that much of the commentary on this decision will build on the reasons and concerns articulated by Justice Côté as the tax community continues to analyze the Supreme Court's judgment.

What will be particularly interesting going forward will be the impact of this decision on the legislative amendments to GAAR proposed by the government in the federal budget of March 28, 2023. The government's rationale for proposing these amendments, to make it easier to apply GAAR, had been an alleged reluctance on the part of the courts to find an abuse or misuse of the Act's provisions, which seems difficult to reconcile with a careful review of the jurisprudence.[4] The government's success in *Deans Knight* will severely undercut any justification which may have existed for legislative amendments to further tilt the playing field in favour of the government in GAAR cases.

We intend to contribute to this discussion with a more detailed analysis of the implications of the Supreme Court's decision in *Deans Knight* on tax planning, tax disputes and the Ministry of Finance's ongoing GAAR consultation process. Subscribe to our bulletins to stay up-to-date.

[1] RSC 1985, c 1 (5th supp) [Act].

[2] Please see our prior discussion of the issues in *Deans Knight* online Supreme Court of Canada grants leave to appeal in Deans Knight, and Taxpayer Seeks to Appeal Antiavoidance Case to Supreme Court of Canada.

[3] *Deans Knight Income Corp. v Canada,* 2023 SCC 16 at para 78.

[4] See in this regard the submission of the Canadian Chamber of Commerce dated May 3, 2023, available online Canadian Chamber shares post-budget comments on the general anti-avoidance rule (GAAR) .

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