
CURRENT CASES

Co-Editors: Ryan L. Morris and Andrew Stirling*

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SUPREME COURT OF CANADA

BLURRED LINES: PAVING THE WAY TO A RESULTS-DRIVEN GAAR REGIME

Deans Knight Income Corporation v. Canada
2023 SCC 16

KEYWORDS: GENERAL ANTI-AVOIDANCE RULE ■ LOSSES ■ ACQUISITION OF CONTROL ■ CORPORATE REORGANIZATIONS ■ SHAREHOLDERS

INTRODUCTION

In *Deans Knight*,¹ the Supreme Court of Canada in a 7-1 decision found that the general anti-avoidance rule (GAAR) applied and that the application of tax attributes from a past business to shelter income from a new business abused subsection 111(5) of the Income Tax Act² despite a lack of an acquisition of de jure control. Although the majority upheld the decision of the Federal Court of Appeal and agreed that the decision of the Tax Court of Canada was correctly overturned, they did not adopt the reasoning of either of the lower courts. Rather than focusing on the different control tests, the majority adopted a results-driven approach based on an analysis of whether the impugned transactions led to an outcome that Parliament sought to prevent.

* Ryan L. Morris is of WeirFoulds LLP, Toronto (e-mail: rmorris@weirfoulds.com); Andrew Stirling is of McMillan LLP, Toronto (e-mail: andrew.stirling@mcmillan.ca). Contributors of case notes in this issue are Michael Ding of WeirFoulds LLP, Toronto; and Michael H. Lubetsky of McMillan LLP, Toronto.

1 *Deans Knight Income Corp. v. Canada*, 2023 SCC 16.

2 RSC 1985, c. 1 (5th Supp.), as amended (herein referred to as “the Act”). Unless otherwise stated, statutory references in this feature are to the Act.

FACTS

The issue in *Deans Knight* was whether the appellant abused the loss-streaming rules in subsection 111(5). The appellant, Deans Knight Income Corp. (previously Forbes Medi-Tech Inc.), carried on a drug research and food additives business with approximately \$90 million of accrued non-capital losses, among other tax attributes (scientific research and experimental development tax credits and investment tax credits). The appellant undertook a corporate reorganization, through which its shareholders exchanged the shares of the appellant for shares of a new company (“Newco”), with the result that the appellant became a wholly owned subsidiary of Newco.

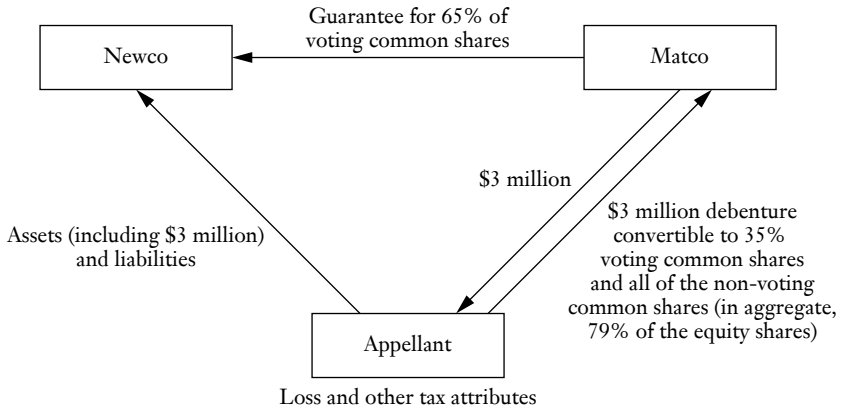
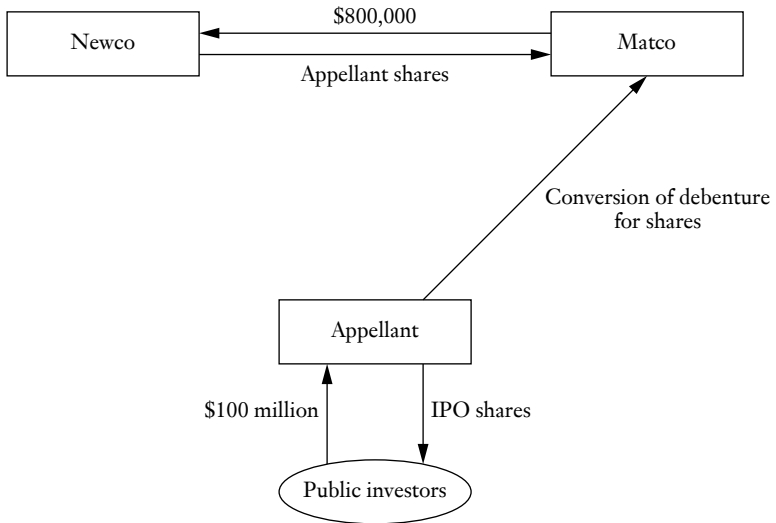
About a month after the reorganization, the appellant and Newco entered into an investment agreement with a venture capital firm (“Matco”) in an attempt to use the tax attributes (the losses) against income from a new business. Under that agreement, the parties undertook to carry out the following transactions (illustrated in figure 1):

- Matco would purchase a debenture from the appellant for \$3 million (subject to adjustments), convertible to 35 percent of the appellant’s voting common shares and all of its non-voting common shares (in aggregate, 79 percent of the equity shares in the appellant).
- Matco guaranteed to Newco that the remaining 65 percent of the voting common shares of the appellant could be sold for a minimum amount of \$800,000.
- The appellant’s assets (including the amount received for the convertible debenture) and liabilities were to be transferred to Newco. (The appellant would retain the losses and tax attributes.)
- Matco had one year to present Newco with a business opportunity that could generate sufficient profit against which the appellant could apply its losses. If Newco rejected the proposed business opportunity, Matco would be relieved of its obligation to pay the \$800,000. Both the appellant and Newco would require the consent of Matco before taking ordinary corporate actions, such as entering into contracts, issuing shares, paying dividends, and incurring debt.

About eight months after entering into the investment agreement, Matco negotiated with Deans Knight Capital Management regarding a takeover of the appellant by way of an initial public offering (IPO). The appellant then changed its name to “Deans Knight Income Corporation” and subsequently closed the IPO, raising \$100 million.

Immediately before the IPO, Matco converted the debenture bought from the appellant. After the IPO, Newco sold its remaining shares of the appellant to Matco. Subsequently, the non-capital losses were applied by the appellant against its taxable income. Throughout the above-noted transactions (illustrated in figure 2), Matco never acquired more than half of the voting shares, or de jure control, of the appellant.

Despite the lack of de jure control, the Canada Revenue Agency (CRA) reassessed the appellant, denying the non-capital losses claimed. The minister of national revenue

FIGURE 1 Transactions Under the Investment Agreement**FIGURE 2 Post-Agreement Transactions**

asserted that the transactions described above abused subsection 111(5), which prohibits a company from utilizing historical non-capital losses following an acquisition of control. Although the Act does not define the term “control,” the courts have interpreted control in the context of subsection 111(5) to mean *de jure*, or legal, control (generally, ownership of 50 + 1 percent of voting shares) rather than a broader concept of *de facto*, or factual, control used in other provisions of the Act. The CRA submitted that GAAR applied to the above transactions because they were entered into for the purpose of inappropriately avoiding the application of the loss-streaming rules in subsection 111(5).

THE TAX COURT OF CANADA'S DECISION³

The Tax Court found that Matco did not have effective control of the appellant, and therefore subsection 111(5) was not abused. Paris J determined that the object, spirit, and purpose of subsection 111(5) were to target the manipulation of losses of a corporation by a new person or group of persons through effective control of the corporation's actions.⁴ Although the Crown argued that there was an acquisition of effective control and pointed to changes in the appellant's management and the type of business, and its lack of resemblance to the loss company, the Tax Court rejected this line of argument, finding that the factors identified by the Crown were not markers of a change of effective control.

THE FEDERAL COURT OF APPEAL'S DECISION⁵

At the Federal Court of Appeal, the only issue in dispute was the third step in the GAAR analysis—whether the avoidance transactions were abusive. In its analysis, the court found that Matco obtained “actual control” of the taxpayer and frustrated the object, spirit, and purpose of subsection 111(5).

Woods J determined that the object, spirit, and purpose of subsection 111(5) are “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.”⁶ Here Woods J replaced “effective control” with “actual control.” The court found that the object, spirit, and purpose of subsection 111(5) were not fully reflected in its text, nor was the application of the provision limited to a *de jure* control test. Instead, the object, spirit, and purpose of subsection 111(5) contain forms of both *de jure* and *de facto* control.

The Federal Court of Appeal disagreed with the Tax Court and held that the terms of the investment agreement gave Matco “actual control” over the taxpayer. Woods J listed specific examples in the agreement of restrictions on entering into contracts and engaging in activities other than the opportunity presented by Matco, and a general requirement to cooperate with Matco to implement the opportunity presented. In essence, the investment agreement severely restricted the corporate actions that both the appellant and Newco could take such that the appellant and Newco were not free actors with respect to the subject matter contemplated in the agreement. Therefore, Woods J found that the series of transactions was abusive, since the agreement allowed for a blatant avoidance of an acquisition of control of the appellant and led to circumvention of the object, spirit, and purpose of subsection 111(5). The Federal Court of Appeal thus overturned the Tax Court's decision, leading to the appeal to the Supreme Court.

3 *Deans Knight Income Corporation v. The Queen*, 2019 TCC 76.

4 *Ibid.*, at paragraph 134.

5 *Canada v. Deans Knight Income Corporation*, 2021 FCA 160.

6 *Ibid.*, at paragraph 72.

THE SUPREME COURT OF CANADA'S MAJORITY DECISION

At the Supreme Court, Rowe J, in writing for the majority, determined that the abuse analysis should focus on whether the result of the avoidance transactions frustrated the provision's object, spirit, and purpose, rather than on the specific control test to be met. In conducting this broad query, the courts are to go beyond legal form and technical compliance with the provision (that is, *de jure* control based on shareholdings). Applying that approach, the Supreme Court found that Matco obtained the "functional equivalent" of an acquisition of control of the appellant, resulting in abuse of the object, spirit, and purpose of subsection 111(5).

In determining the object, spirit, and purpose of the provision, the court distinguished the rationale behind the provision from the means chosen to give that rationale effect.⁷ As the court held in its earlier decision in *Copthorne*,⁸ the object, spirit, and purpose of a provision together constitute a description of its rationale against which a textually compliant transaction is to be scrutinized.⁹ In considering the application of GAAR, a textual, contextual, and purposive analysis is required to determine the provision's rationale. This includes an examination of the provision's legislative history and other extrinsic evidence.

Subsequently, the abuse analysis is to focus on whether the result of the impugned transactions frustrates the provision's rationale. In *Deans Knight*, the Supreme Court described the legal test as follows:

At the abuse stage, the avoidance transactions will be abusive where the outcome or result of the avoidance transaction "(a) is an outcome that the provisions relied on seek to prevent; (b) defeats the underlying rationale of the provisions relied on; or (c) circumvents certain provisions in a manner that frustrates the object, spirit and purpose of those provisions." . . . These considerations are not independent of one another and frequently overlap. . . . Ultimately, the analysis remains squarely focused on abuse. Courts must go beyond the legal form and technical compliance of the transactions; they must compare the result of the transactions to the underlying rationale of the provision and determine whether that rationale has been frustrated. In coming to such a conclusion, the abusive nature of the transaction "must be clear."¹⁰

Rowe J rejected the appellant's argument that GAAR cannot apply where a specific anti-avoidance rule exists and where that rule provides specific instances in which loss carryovers are denied. In fact, GAAR is to be applied in order to ensure that the rationale of a specific anti-avoidance provision is not frustrated by abusive tax strategies.¹¹

7 *Deans Knight*, supra note 1, at paragraph 59.

8 *Copthorne Holdings Ltd. v. Canada*, 2011 SCC 63.

9 *Deans Knight*, supra note 1, at paragraph 60.

10 *Ibid.*, at paragraph 69.

11 *Ibid.*, at paragraph 72.

The court summarized the proper approach to the application of GAAR in determining whether an avoidance transaction was abusive as follows:

- The object, spirit and purpose is a description of the provision’s underlying rationale. The means (the how) do not always provide a full answer as to the rationale underlying the provision (the why).
- The text, context and purpose of a provision provide indicia of its rationale. The text can shed light on what the provision was designed to encourage or prevent based on what it expressly permits or restricts, how it is worded and structured, and the nature of the provision. Similarly, the context can serve to identify the function of the provision within a coherent scheme. Finally, the provision’s purpose can help to discern the outcomes that Parliament sought to achieve or prevent.
- Once the object, spirit and purpose has been ascertained, the abuse analysis goes beyond the legal form and technical compliance of the transactions to consider whether the result frustrates the provision’s rationale.¹²

Applying the approach described above, the court found that Parliament’s rationale for enacting subsection 111(5) was to complement the loss carryover rule in paragraph 111(1)(a) and thereby ensure that the taxpayer who incurred the non-capital loss would be able to deduct it, while a new taxpayer who did not generate the loss would be prevented from using it. Because an acquisition of control severs the link between a corporation’s pre- and post-acquisition activities, it is used to delineate the circumstances in which subsection 111(1)(a) would apply.¹³ As stated by Rowe J,

[s]ection 111(5)’s rationale 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. As previously explained, s. 111(5) reflects the proposition that when the identity of the taxpayer has effectively changed, the continuity at the heart of the loss carryover rule in s. 111(1)(a) no longer exists.¹⁴

Following the establishment of the rationale behind subsection 111(5), the court opined that the lower courts contributed to confusion in their application of different wordings to a control test. Referring to the lower courts’ use of “effective control” and “actual control,” the Supreme Court determined that they had missed the central issue in the GAAR abuse analysis, which is to focus on the reasons for Parliament’s concern about an acquisition of control and the mischief to be addressed. The lower courts therefore erred in defining the object, spirit, and purpose of subsection 111(5) (the why) on the basis of the type of control test (the how).¹⁵

12 Ibid., at paragraph 73.

13 Ibid., at paragraphs 88 to 90.

14 Ibid., at paragraph 124.

15 Ibid., at paragraph 115.

The majority agreed that the applicable test for control is *de jure* control, but it is only a marker and does not encompass the entire GAAR analysis. Rowe J explained that

[i]n s. 111(5), Parliament has clearly chosen a test for control: *de jure* control. *De jure* control was a reasonable marker for the situations in which a corporation's identity has changed. This being so, it is primarily a means of giving effect to Parliament's aim, rather than a complete encapsulation of the aim itself.¹⁶

In line with the aforementioned principles, the court looked beyond the strict requirements of the *de jure* control test and held that the avoidance transactions were abusive:

Matco achieved the *functional equivalent* of such an acquisition of control through the Investment Agreement, while circumventing s. 111(5), because it used separate transactions to dismember the rights and benefits that would normally flow from being a controlling shareholder. Several aspects of the transactions at issue demonstrate this *functional equivalence*, by which I mean that Matco achieved an outcome that Parliament sought to prevent without directly acquiring the rights that would have triggered s. 111(5).¹⁷

The court determined that the facts supported a finding that subsection 111(5) was abused where the avoidance transactions achieved the outcome that Parliament intended to prevent. The appellant and Matco were able to circumvent subsection 111(5) even though Matco obtained the benefits of an acquisition of control. Indicators of Matco's control included the ability to select Newco's directors, severe restrictions placed on the powers of the board of directors such that significant corporate activities required Matco's prior written consent, and Matco's becoming a significant equity owner, with a post-IPO stake in Newco worth \$4.5 million.¹⁸ As Rowe J explained,

[d]uring this intervening period, Matco deprived Newco, the majority voting shareholder on paper, of each of the core rights that it could ordinarily have exercised. . . . While Newco maintained its voting rights in theory, most decisions that would normally be subject to a shareholders vote—such as a change in the corporation's by-laws—could only occur with the consent of Matco. . . . Similarly, it may have had a right to dividends on paper, but any such dividends could only be declared with the consent of Matco. . . . Finally, Newco may have been entitled to the appellant's remaining property upon dissolution, but again, the directors were prohibited from taking such a step without Matco's approval. . . . In any case, all of the appellant's assets had been removed through the reorganization transactions. In this way, the appellant corporation had changed hands, but Matco obtained such a result through a series of transactions rather than through the acquisition of a majority of the voting shares in the appellant.

16 Ibid., at paragraph 116.

17 Ibid., at paragraph 128 (emphasis added).

18 Ibid., at paragraph 133.

In response, the appellant argues that it remained at all times a free actor. In my view, any residual freedom under the Investment Agreement is illusory and merely reinforces how the transactions frustrated the rationale of s. 111(5).¹⁹

In conclusion, the majority found that the avoidance transactions frustrated the rationale of subsection 111(5) and were thus abusive. The object, spirit, and purpose of subsection 111(5) are to prevent corporations from using unused losses against income from another business for the benefit of new unrelated owners. Where the heart of the rationale behind subsection 111(5) has been violated, one must look beyond the technical application of the *de jure* control test.

THE LONE DISSENT

In the dissenting judgment, Côté J took a narrower approach, asserting that GAAR cannot be used to override parliamentary intent and that the abuse analysis must be examined through the *de jure* control test. In her view, the majority incorrectly expanded the concept of control through an *ad hoc* approach even though Parliament unambiguously adopted a specific *de jure* control test for subsection 111(5). Côté J concluded that *de jure* control is a bright-line test, and the court should not expand its analysis to find a “functional equivalent” of a *de jure* acquisition of control:

Despite correctly pointing out that *de jure* control “remains the standard for the application of s. 111(5),” my colleague introduces the notion of “functional equivalence” (paras. 117 and 128). This novel concept treats the Investment Agreement as a constating document for the purposes of control (para. 122). The nuance lost on my colleague is that constating documents and external agreements are enforced in radically different ways. That being so, an ordinary contract can never be functionally equivalent to a constating document. In this regard, I see no difference between my colleague’s approach and the Federal Court of Appeal’s “actual control” test. Both ignore the rationale behind the *de jure* and *de facto* control tests and erode the distinction between them.

The jurisprudence is clear that the GAAR cannot be invoked to override Parliament’s clear intent. It seems to me, however, that this is what my colleague is doing in this case. Indeed, his approach departs from what is otherwise Parliament’s clear articulation of a *de jure* control test for restricting losses under s. 111(5). Beyond this, my colleague introduces the novel and unprecedented concept of functional equivalence, which has no known boundaries. With respect, this approach illustrates the potential overriding power of the GAAR, as cautioned against in *Canada Trustco*.²⁰

Applying a narrower textual analysis, Côté J opined that the majority had overlooked the factual findings from the Tax Court. She explained that the facts showed that Matco did not obtain control over the sale of the remaining shares, nor was

19 Ibid., at paragraphs 133 to 134.

20 Ibid., at paragraphs 178 to 179, citing *Canada Trustco Mortgage Co. v. Canada*, 2005 SCC 54.

Matco required to present third parties with a sale opportunity for those shares. In addition, oral testimony indicated that Newco believed that it could choose to accept or reject Matco's offer to purchase the remaining shares.²¹ The abuse analysis should not disregard or lessen the importance of share ownership, which was not diminished by the investment agreement. In summary, Côté J found that the majority's reasoning was an inappropriate attempt to reweigh the factual evidence considered by the Tax Court, in the absence of a palpable or overriding error.²²

Overall, the dissenting judgment held that Matco did not acquire de jure control of the appellant but was only a facilitator of the transactions. It was a "great leap in logic to infer that Matco 'acquired' Deans Knight," resulting in uncertainty as to the abuse that existed.²³ Pursuant to the Supreme Court's decision *Canada Trustco*, where uncertainty exists, the benefit of the doubt should go to the taxpayer.²⁴ Accordingly, Côté J held that the avoidance transactions did not frustrate the rationale of subsection 111(5).

COMMENTS

The majority took a broad approach that focused on the underlying rationale of the provision (substance over form) whereas the dissent took a narrow approach that relied on strict application of a bright-line control test (form over substance). The broad approach requires courts to look beyond a pre-established legal framework and consider extrinsic materials in determining whether the impugned transactions align with the object, spirit, and purpose of the provision at issue. Even where the transactions satisfy certain technical requirements, GAAR can still be applied to find abuse as long as the rationale of the provision has been violated. The majority's approach thus provides the courts with more discretion and reduces predictability and certainty for taxpayers in planning their affairs.

According to Rowe J, the relevant test to determine the applicability of subsection 111(5) remains the de jure test. However, with this decision, the test does not provide the same level of assurance as it used to. The majority concluded that the tax benefit can still be denied under GAAR, even in the absence of a de jure acquisition of control, where the tax results of the transactions defeat the rationale of the provision. Taxpayers should expect courts to apply a "functionally equivalent" test to support the application of GAAR in close cases. Arguably, if the appellant had had more favourable facts (such as less control and fewer restrictions from Matco on the appellant's operations), it may have been more difficult for the majority to look beyond the de jure control test and take a "functionally equivalent" approach.

21 *Deans Knight*, supra note 1, at paragraph 190.

22 *Ibid.*, at paragraph 193.

23 *Ibid.*, at paragraph 196.

24 *Canada Trustco*, supra note 20, at paragraph 66.

PROPOSED EXPANSION OF GAAR AND THE MANDATORY DISCLOSURE PROVISIONS

The Supreme Court's decision is in line with the results-driven and broad approach adopted in the proposed expansion of GAAR and the mandatory disclosure provisions.²⁵ The majority's reasoning and the expanded GAAR and mandatory disclosure provisions demonstrate that the balance is now tilted toward the protection of Canada's tax base rather than taxpayers' need for certainty in planning their affairs.

Just as the majority's broad approach diminishes the longstanding certainty provided by the *de jure* test, the "one of the main purposes" test contained in the expanded GAAR and reportable transaction provisions creates ambiguity. If there appears to be a possible misuse or abuse, even tax planning that complies with specific anti-avoidance provisions can be broadly subject to GAAR.

Under the existing version of GAAR, it is more difficult to show that avoidance transactions such as those undertaken by the appellant and Matco in *Deans Knight* are abusive. Because the onus will be reversed to the taxpayer where transactions are presumed to result in a misuse or abuse under the expanded GAAR and there is a significant lack of economic substance, it will make it easier for the courts to reach a conclusion that transactions were abusive. To this extent, the technical notes for subsection 245(4.1) specifically refer to and integrate the Supreme Court's framework from the *Deans Knight* decision in applying the misuse or abuse test:

However, this presumption could be rebutted by demonstrating that the transaction is consistent with the rationale (to use the term from *Deans Knight*) of the provision. Looking at the text of the relevant provisions and considering their context and purpose, along with the relevant legislative history and extrinsic evidence, it should be clear that Parliament intended to provide access to certain tax benefits (i.e., loss carry-forwards) based upon the existence of certain relationships. This effectively allows for the utilization of losses in certain circumstances within a related group. This policy is constrained by the existence of certain relationships, as it was noted in *Deans Knight* that "Parliament sought to ensure that a lack of continuity in a corporation's identity was accompanied by a corresponding break in its ability to carry over non-capital losses."²⁶

It is expected that future GAAR appeals will be examined under the broad approach applied by the majority in *Deans Knight*. This places in question the utility of specific anti-avoidance provisions and of legal tests created by case law to determine the application of various provisions of the Act. Although the majority in *Deans Knight* sought to eliminate the confusion in the lower courts' application of the established test for determining control, their decision has effectively created more ambiguity

25 The proposed expansion of GAAR involves the amendment of several subsections of section 245. The new mandatory disclosure rules are contained in sections 237.3 through 237.5.

26 Department of Finance Canada, *Explanatory Notes to Legislative Proposals Relating to the Income Tax Act and Regulations* (Ottawa: Department of Finance, August 4, 2023), at 122.

in that taxpayers can no longer rely on a strict legal test where frustration of a provision's underlying rationale may exist.

Michael Ding