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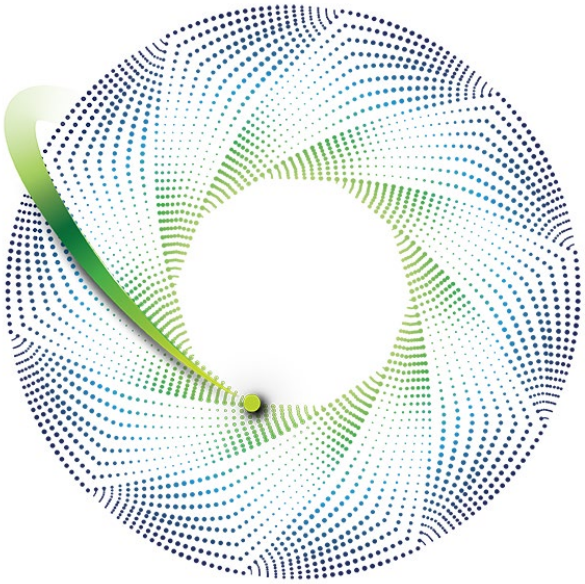

Canadian Tax & Legal Alert

Deans Knight Income Corporation v. Canada

July 5, 2023

C-suite briefing notes

In *Deans Knight*,[1] the taxpayer was party to (and implicated in) a complex set of transactions or arrangements that sought to retain access to significant tax losses from a previous and unrelated business in circumstances where an acquisition of *de jure* control did not occur. The Supreme Court of Canada (SCC or the "Court") found that the object, sprit, and purpose (OSP) of subsection 111(5) of the *Income Tax Act* (the "Act") was frustrated and the general anti-avoidance rule (GAAR) applied to restrict access to those losses despite there being no acquisition of *de jure* control.

This may represent a departure from conventional thinking in that a highly specific anti-avoidance rule was found to be vulnerable to abuse.

This case may have a negative impact on organizations that have undergone recapitalization and restart transactions where there are significant losses from a previous business.

[1] *Deans Knight Income Corp. v. Canada*, 2023 SCC 16 (herein referred to as "*Deans Knight*").

For the tax practitioner, the analytical framework for the GAAR remains substantially the same. However, the Court provided additional guidance in assessing the OSP – also referred to as the underlying rationale – of the provision(s) at issue. In determining the underlying rationale of a provision, the means (the "how") may not fully capture the "why" (the rationale). In other words, the means may be an imperfect reflection, or an incomplete explanation, of what Parliament sought to address in enacting a provision. In such a case, the Canada Revenue Agency (CRA) and the courts can look beyond the means to determine the underlying rationale. This means that the GAAR can apply even where the precise conditions of a provision are met or not met as the case may be; for example, it can apply where the precise conditions for the application of a specific anti-avoidance rule (SAAR) are not met.

This evolution in guidance can play out in multiple ways. It could create increased uncertainty if taxpayers cannot agree with the CRA on the underlying rationale of the relevant provisions – particularly in some of the more complex and nebulous areas of the Act. However, taxpayers and the CRA often agree on the rationale of a provision. In GAAR cases, the taxpayer's transaction, of necessity, complies with the text of the provision. In Deans Knight, the SCC reaffirmed that the CRA must demonstrate something about a transaction is so unusual that, despite its compliance with the text, the transaction nevertheless offends the rationale of the provision. Taxpayers and their advisors may find it easier to arrange their affairs in an environment where the CRA is unlikely to be able to apply the GAAR to a transaction carried out using normal commercial arrangements which complies with the apparent rationale of a provision.

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Detailed discussion

The SCC decision in *Deans Knight* was released on May 26, 2023. This decision was highly anticipated for several reasons. First, it is the second decision (after *Alta Energy*[2]) involving the GAAR and the first on domestic legislation rendered recently by the SCC and other than Justice Abella (now retired from the bench) who heard *Alta Energy*, none of the justices in these last two decisions were on the bench at the time of the previous GAAR decision in *Copthorne Holdings.*[3] Second, the decision in *Alta Energy* caused some to believe that this Court's strong adherence to the *Duke of Westminster* principle[4] and certainty, predictability, and fairness signalled a more limited role for the GAAR. And third, the Department of Finance (Finance) released proposals to amend the GAAR with Budget 2023 and some questioned whether this decision could cause the government to rethink certain aspects of the proposals.

The Court dismissed the taxpayer's appeal 7-1 (Justice Brown, who participated actively in oral argument on November 2, 2022, did not participate in the final disposition of the judgment). Thus, the government's concerns about this Court's overly rigid adherence to certainty, predictability, and fairness may have been premature. In addition, the decision may allay any concerns Finance may have had that the Court would take a literal approach to interpreting avoidance rules, potentially creating a need for more significant amendments to the GAAR. Indeed, as discussed further below, the decision may be construed as moderating the need for certain aspects of the GAAR proposals. For those counting, the SCC has now decided six GAAR cases, 4-2 in favour of the Crown.

[2] *Canada v. Alta Energy Luxembourg S.A.R.L.*, 2021 SCC 49 (herein referred to as "*Alta Energy*").
[3] *Copthorne Holdings Ltd. v. Canada*, 2011 SCC 63 (herein referred to as "*Copthorne Holdings*").
[4] *Commissioners of Inland Revenue v. Duke of Westminster*, [1936] A.C. 1.

Facts

Forbes Medi-Tech Inc. (Forbes) was in financial difficulty. It had approximately $90 million of unused non-capital losses, scientific research and development tax expenditures, and investment tax credits but it did not have income against which to use such attributes. Note that both sides in the case agreed that the restrictions on the use of each of these tax attributes were the same and the Court dealt only with the losses.

Forbes entered into an investment agreement with a venture capital company, Matco, whereby Matco would find a new business venture for Forbes and the profits from this venture could be sheltered by the losses that Forbes could not otherwise utilize. The arrangement was structured in a manner that avoided the restrictions on claiming losses in subsection 111(5) of the Act.

This type of loss transaction is often referred to as a "recap and restart". Matco found a mutual fund company, Deans Knight Capital Management (Deans Knight), that agreed to use Forbes as a vehicle for raising money through an initial public offering (IPO) to invest in high-yield debt instruments. Matco had no meaningful link either to Forbes' old business or the business Forbes carried on after Matco found a "buyer".

The investment business was successful, and the losses were used by Deans Knight (Forbes was renamed) from 2009 until 2012. Prior to the IPO, Forbes' net assets were transferred to a new parent company (Newco) and, pursuant to an investment agreement, Matco purchased a debenture convertible into 35% of the voting shares and all the non-voting shares of Forbes owned by Newco. Importantly, the investment agreement also precluded Newco and Forbes from making many significant decisions without the consent of Matco. Although Newco was not obliged to sell its shares to Matco, it was promised a guaranteed amount if it sold the shares or if such an opportunity did not present itself. These proceeds (including the convertible debenture) were essentially consideration paid to Newco for the tax attributes.

The Minister applied the GAAR on the basis that the use of the losses constituted abusive tax avoidance. The Tax Court of Canada found for the taxpayer, essentially concluding that the loss restriction rules in the Act were governed by a *de jure* control standard. The Federal Court of Appeal unanimously decided that the GAAR applied to deny the benefit of the losses on the basis that the purpose of subsection 111(5) of the Act was frustrated. The SCC dismissed the taxpayer's appeal, although, as discussed below, the approach to determining abusive tax avoidance differed from that in the Federal Court of Appeal.

The majority decision

After an extensive review of legislative history and various extrinsic aids, Justice Rowe, writing for the majority, concluded that the OSP of subsection 111(5) 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. The Court found that Deans Knight underwent a fundamental transformation that achieved the outcome that Parliament sought to prevent, while circumventing the text of subsection 111(5). Matco gained the power of a majority voting shareholder so that it could find a buyer through contracts that fundamentally changed Deans Knight's assets, liabilities, shareholders, and business without triggering an acquisition of control. The result obtained by the transactions frustrated the rationale of subsection 111(5) and therefore constituted abuse.

Justice Rowe found that subsection 111(5):

- operates within a scheme for carrying over non-capital losses;[5]
- does not operate independently but serves to complement paragraph 111(1)(a);[6]

[5] *Deans Knight*, supra note 1, at para. 86.
[6] Ibid., at para. 87.

- functions so that the tax benefits associated with losses may not benefit a new shareholder base carrying on a new business;[7] and

- serves to delineate the boundaries of paragraph 111(1)(a) and to promote consistency with other provisions which treat the corporation as, effectively, a new taxpayer following an acquisition of control.[8]

Justice Rowe also concluded that although there were valid reasons for Parliament's choosing the *de jure* control standard in subsection 111(5), "it does not follow that the provision's rationale is fully captured by the *de jure* control test. Rather, *de jure* control was the marker that offered a roughly appropriate proxy for *most* circumstances with which Parliament was concerned."[9] The existence of other deeming provisions – namely paragraph 251(5)(b) and subsections 256(7) and (8) of the Act – "suggests that *de jure* control is not a perfect reflection or complete explanation of the mischief that Parliament sought to address" in subsection 111(5).[10] Citing *Oxford Properties*,[11] Justice Rowe said that consideration of subsequently enacted section 256.1 – a provision that operates to deem an acquisition of control in circumstances like *Deans Knight* – "was neither necessary nor warranted in this case."[12] To more accurately ascertain the object, spirit, and purpose, Justice Rowe supplemented that contextual analysis with an extensive review of legislative history and extrinsic evidence of Parliament's purpose in search of the rationale of subsection 111(5),[13] concluding as set out above.[14]

Justice Rowe found that both the lower courts and the appellant erred in their formulation of the OSP as a legal test:

> Respectfully, both the lower courts and the appellant formulated the object, spirit and purpose as a legal test, rather than summarizing the *rationale* of the provision. This ultimately distorted their GAAR analysis. *De jure* control, "effective" control and "actual" control do not indicate *why* Parliament was concerned about an acquisition of control and the *mischief* it sought to address (*Oxford Properties Group*, at para. 101). To define the object, spirit and purpose of s. 111(5) based on Parliament's choice of test or substitute it for another test would, in this case, result in prioritizing the means (the *how*) over the rationale (the *why*).
>
> In 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. As with any provision, Parliament had to select a general test for s. 111(5) among the options available: it had good reason to select the *de jure* control test over a broad *de facto* control test, which would have captured a variety of conduct unrelated to Parliament's aims. Again, the test to apply on the straightforward application of s. 111(5) is not in dispute. However, *de jure* control does not, in itself, explain what was concerning to Parliament, as is amply demonstrated by a careful analysis of the intrinsic and extrinsic evidence. Respectfully, my colleague's reasons conflate the means found within a provision's text (in this case, *de jure* control) with the provision's underlying rationale; this approach would have implications for a variety of provisions involving a control test, such that the GAAR would effectively not apply.

[7] Ibid., at para. 88.
[8] Ibid., at para. 90.
[9] Ibid., at para. 94.
[10] Ibid., at para. 95.
[11] *Canada v. Oxford Properties Group Inc.*, 2018 FCA 30 (herein referred to as "*Oxford Properties*").
[12] *Deans Knight*, supra note 1, at para. 98.
[13] Ibid., at paras. 99-112.
[14] Ibid., at para. 113.

> [...] accurately setting out the object, spirit and purpose that *underlies* the provision does not change the applicable test *within* the provision. [...] As I explained, within the GAAR analysis, courts are not formulating a new legal test when they determine a provision's object, spirit and purpose; rather, they seek to capture a provision's rationale, thereby providing a synthesis of what the provision was designed to achieve or prevent. Nor are courts "applying" the object, spirit and purpose as if it was a new bright-line test in the abuse analysis. The analysis is comparative: for a provision to be abused under a GAAR analysis, the result that the transactions achieved – transactions which have already been shown to have the primary purpose of avoiding taxes – is assessed against the provision's rationale to determine whether this rationale is frustrated (*Trustco*, at para 57; *Copthorne*, at para. 60).[15]

Having established the rationale of subsection 111(5), Justice Rowe then examined the factual context at length and concluded that the impugned transactions frustrated the rationale of subsection 111(5).[16]

Dissenting opinion

Justice Côté began her dissent with the statement that "[this] case is of profound concern to Canadian taxpayers."[17] Although unstated, this is likely attributable to perspectives conveyed by the interveners. She frames the competing concerns of the interveners as "the interest of the taxpayer in minimizing his or her taxes through technically legitimate means and the legislative interest in ensuring the integrity of the income tax system."[18] She repeats Justice Binnie's warning in his dissent in *Lipson*[19] that "[t]he GAAR is a weapon that, unless contained by the jurisprudence, could have a widespread, serious and unpredictable effect on legitimate tax planning." Justice Côté believes that the other justices on the bench and the Federal Court of Appeal did not show due restraint. It is noteworthy that Justice Côté was also the sole dissenting judge in *MacDonald*[20] where, as in *Deans Knight,* she expressed concerns about appellate courts ignoring the factual findings of the trial court.

Justice Côté claims that Justice Rowe, rather than adopting as the rationale of subsection 111(5) the unambiguous choice made by Parliament (i.e., the restrictions were intended to apply when the *de jure* control test is satisfied), "opted for an *ad hoc* approach that expands the concept of control based on a wide array of operational factors. [Moreover,] this approach invites the exercise of unbounded judicial discretion and will result in the loss-trading restrictions in s. 111(5) being applied to transactions on a circumstantial basis."[21]

Justice Côté's essential point is that the GAAR cannot be used to override Parliamentary intent and Justice Rowe's OSP analysis does so by going beyond the judicially developed *de jure* control test incorporated by Parliament into the provision. Justice Côté says her approach echoes *Canada Trustco*[22] where the SCC in that case held that "cost" is a "well-understood legal concept" and "nothing in the GAAR or the object of the [capital cost allowance] provisions permits [the Court] to rewrite them to interpret 'cost' to mean 'amount economically at risk'."[23] In short, "the GAAR cannot override Parliament's intent; it must give effect to it."[24] Justice Côté also said that even if Justice Rowe's determination of the rationale was correct, an abuse determination would require overturning certain findings of fact by the Tax Court.[25]

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[15] Ibid., at paras. 115-117.
[16] Ibid., at paras. 121-140.
[17] Ibid., at para. 142.
[18] Ibid., at para. 143.
[19] *Lipson v. Canada*, 2009 SCC 1, at para. 55.
[20] *MacDonald v. Canada*, 2020 SCC 6.
[21] *Deans Knight*, supra note 1, at para. 144.
[22] *Canada Trustco Mortgage Co. v. Canada*, 2005 SCC 54.
[23] Ibid., at para. 75.
[24] *Deans Knight*, supra note 1, at para. 174.
[25] Ibid., at para. 193.

Key observations

Preliminary comments

The reasons of both the majority and the dissent are lengthy, cover considerable ground and usefully address competing perspectives in each other's analysis. Both are well reasoned. At the core, the difference lies in the search for the underlying rationale and the varying appetites for going beyond the literal meaning of the words used in the provisions, particularly where the statutory language can be said to reflect a clear choice and intent.

After *Alta Energy*, it was perhaps surprising that Justice Côté stood alone in dissent. That said, we think the decisive victory for the Crown reflects the notion that *Deans Knight* was a tax deal (made clear with Matco's involvement) in the tax-loss trading area (a distinguishing aspect of the factual context to which Justice Côté seems to attribute little significance). Compared to the tax treaty policy ambiguity at issue in *Alta Energy*, the law and policy on tax-loss trading are substantially more developed and coherent. Nevertheless, we also think the Court – while following the analytical framework for the GAAR that it has developed – provided some additional guidance that is likely to be consequential in future GAAR cases. (See our discussion in the next two sections below.)

Distinguishing the means chosen in a provision (the "how") from the rationale (the "why")

The most consequential aspect of *Deans Knight* is likely to be the new guidance provided with respect to the analytical process for determining the OSP of the relevant provisions (i.e., the underlying rationale). Justice Rowe goes to some length to distill the decided cases and distinguish the means chosen by Parliament in a provision (the "how") from the rationale of the provision (the "why"), reinforcing that the object, spirit and purpose of a provision must be worded as a description of its rationale. The rationale may or may not be completely aligned with the practical means chosen to achieve Parliament's aim or intent. Again, this is the main point of departure between the majority and the dissent – how speculative might the search for underlying rationale become? That said, Justice Rowe also reinforces the notion that the OSP analysis must be rooted in a textual, contextual and purposive analysis of the provisions and reiterates the manner in which such analysis must be undertaken (including a review of the legislative history and extrinsic aids or evidence) before applying the framework in a latter section of the decision.[26]

On the one hand, this is not particularly new (more evolutionary than revolutionary). On the other hand, this will prove to be a very difficult assessment in many cases where it's unclear whether the means chosen does or does not reflect Parliament's intent. As indicated above, the tax-loss trading area has steadily developed over decades. The main concern in practice is that the CRA or the courts push the boundaries of OSP determinations having regard to commentaries or purported authorities (extrinsic aids) that may not reflect Parliament's intent.

Abuse analysis requires a comparison of the tax results to the rationale of the provisions

Justice Rowe then proceeds to say that once the OSP has been ascertained, "the abuse analysis goes beyond the legal form and technical compliance of the transactions to consider whether the [tax] result frustrates the provision's rationale."[27] As indicated above, this does not involve the courts creating a new legal test in the relevant provision (e.g., *de jure control* versus some other control concept in *Deans Knight*); rather, the statutory test remains but the tax benefit is denied under the GAAR if on a comparison of the tax results of the transaction to the rationale of the provisions, the tax results defeat or frustrate such rationale.

Again, this is not particularly new, and it is helpful to have more clarity on the nature of the legal tests. That said, we expect some combination of increased disputes at the stage of determining the rationale of the relevant provisions and, if abusive tax avoidance is found, in determining reasonable tax consequences in the circumstances.

[26] Ibid., at para. 58-68.
[27] Ibid., at para. 73.

Selected implications for the GAAR amendments proposed in Budget 2023

The preamble

The Court cites the GAAR Consultation Paper,[28] although it does not otherwise comment on it. That said, it seems as though the Court had each element of the preamble in mind in setting out its reasons. For example, with regard to the purpose of the GAAR (broadly aligned with proposed paragraph 245(0.1)(a)), the Court said the following, anchored in extrinsic evidence from the time the GAAR was introduced and as initially established by the Court in *Canada Trustco*:

> In light of the foregoing, the GAAR is best understood as a way to overcome the disadvantages of a system based solely on specific rules ([Department of Finance, *The White Paper: Tax Reform 1987* (1987)], at p. 57; [D. A. Dodge, "A New and More Coherent Approach to Tax Avoidance" (1988), 36 *Can. Tax J.* 1], at p. 8). The GAAR was a choice, made by Parliament, to complement its specific anti-avoidance efforts with the enactment of a general rule. To achieve this aim, the GAAR "draws a line between legitimate tax minimization and abusive tax avoidance" (*Trustco*, at para. 16).[29]

That said, the Court restates and repackages its findings in subtly different ways in different cases with the effect of emphasizing different aspects. For example, in *Alta Energy*, the Court added that:

> *Canada Trustco* recognized that the line between legitimate tax minimization and abusive tax avoidance is "far from bright" (para. 16). As a result, "[i]f the existence of abusive tax avoidance is unclear, the benefit of the doubt goes to the taxpayer" (*Canada Trustco*, at para. 66; see also *Copthorne*, at para. 72).[30]

With respect to the *Duke of Westminster* principle[31] and the balance between the taxpayer's need for certainty and the government's responsibility to protect the tax base and fairness of the tax system (broadly aligned with proposed paragraph 245(0.1)(b)), the Court made several statements that collectively reflect a concerted effort to achieve a balance:

> The *Duke of Westminster* principle, however, has "never been absolute" (*Lipson*, at para. 21) and it is open to Parliament to derogate from it. Parliament has done so through the GAAR. The GAAR does not displace the *Duke of Westminster* principle for legitimate tax planning. Rather, it recognizes a difference between legitimate tax planning — which represents the vast majority of transactions and remains unaffected, consistent with the *Duke of Westminster* principle — and tax planning that operates to abuse the rules of the tax system — in which case the integrity of the tax system is preserved by denying the tax benefit, notwithstanding the transactions' compliance with the provisions relied upon. Even where the purpose of a transaction is to minimize tax, taxpayers are allowed to carry it out unless it results in an abuse of the provisions of the Act (*Lipson*, at para. 25). Where the transaction is shown to be abusive, the *Duke of Westminster* principle is "attenuated" by the GAAR (*Trustco*, at para. 13).
>
> In establishing a general anti-avoidance rule that operated to deny tax benefits on a case-specific basis, Parliament was cognizant of the GAAR's implications for the level of certainty in tax planning. Parliament sought to balance "the protection of the tax base and the need for certainty for taxpayers" (Department of Finance, *Explanatory Notes to Legislation Relating to Income Tax* (1988), at p. 461). The GAAR was enacted to be "a provision of last resort" to address abusive tax avoidance only and was therefore not designed to create more generalized uncertainty in tax

[28] Ibid., at para. 44.
[29] Ibid., at para. 45.
[30] *Alta Energy*, supra note 2, at para. 33.
[31] Supra, note 4.

> planning (*Trustco*, at para. 21; *Copthorne*, at para. 66). Some uncertainty is unavoidable when a general rule is adopted (Dodge, at p. 21; *Copthorne*, at para. 123). However, a reasonable degree of certainty is achieved by the balance struck within the GAAR itself.
>
> First, as Professor Jinyan Li noted, "the GAAR cases generally involve situations that do not concern the majority of taxpayers, and the transactions are well planned and executed on the basis of professional tax advice" ("'Economic Substance': Drawing the Line Between Legitimate Tax Minimization and Abusive Tax Avoidance" (2006), 54 *Can. Tax J.* 23, at p. 40). The GAAR only scrutinizes transactions motivated by tax avoidance, and even a tax-motivated transaction that is consistent with the object, spirit and purpose of the provisions of the Act is unaffected by the GAAR (see *Explanatory Notes*, at p. 461). By virtue of the rigorous analysis required by s. 245, the GAAR only affects a small subset of transactions, largely conducted by sophisticated parties with the ability to properly evaluate the risks inherent in a GAAR reassessment. Indeed, this is precisely what occurred in the present case: the prospectus relating to the appellant's IPO expressly recognized the risk of a successful challenge to the use of the Tax Attributes.
>
> Second, a proper application of the GAAR methodology serves to ensure reasonable certainty in tax planning (P. Samtani and J. Kutyan, "GAAR Revisited: From Instinctive Reaction to Intellectual Rigour" (2014), 62 *Can. Tax J.* 401, at p. 403). The GAAR is not a tool to sanction conduct that courts find immoral (*Copthorne*, at para. 65; *Alta Energy*, at para. 48). Rather, courts must conduct an "objective, thorough and step-by-step analysis" (*Copthorne*, at para. 68). Within this analysis, **the principles of certainty, predictability and fairness do not play an independent role; rather, they are reflected in the carefully calibrated test that Parliament crafted in s. 245 of the Act and in its interpretation by this Court** [emphasis added]. It is to this test that I now turn.[32]

The passages above draw extensively from explanatory notes, comments by government officials, academics, practitioners, and prior decisions of the Court. The section concludes (emphasis added above) with a declaration that "the principles of certainty, predictability and fairness […] are reflected in the carefully calibrated test that Parliament crafted in […] the Act and in its interpretation by this Court." Whether the notion of fairness contemplated by the Court is the same as that contemplated by proposed paragraph 245(0.1)(b) is not entirely clear; however, the Court in this passage has noted specifically the integrity of the tax system and that the small proportion of transactions affected by the GAAR is often carried out by sophisticated parties with the ability to evaluate the risks. Absent further statutory direction, it is unlikely the Court will seek to strike a different balance amongst these competing principles. That said, for those more inclined to watch what the Court does than parse what it says, the decision in *Deans Knight* clearly takes into account broader fairness considerations at the expense of certainty and predictability.

The SCC caused some confusion when it released *Alta Energy* because the Court posited that the GAAR does not apply to foreseen tax strategies, the notion being that Parliament's awareness of a tax strategy, together with inaction, suggests that the strategy is not abusive. The third element of the preamble in the proposed GAAR amendments provides that the GAAR can apply regardless of whether a tax strategy is foreseen (proposed paragraph 245(0.1)(c)). Finance was seemingly concerned that the Court's statement in *Alta Energy* could be applied by taxpayers as a safe harbour from GAAR in cases where it could be established that the tax strategy was foreseen. The Court returned to this point in *Deans Knight* and provided some helpful clarification:

> […] Abusive tax avoidance can involve unforeseen tax strategies ([*Alta Energy*], at para. 80). For example, in *Alta Energy*, this Court treated evidence of Parliament's knowledge and acceptance of the tax strategy at issue as a relevant consideration when ascertaining its intent. However, the GAAR is not limited to unforeseen situations; as this Court has explained, it is designed to capture

[32] *Deans Knight*, supra note 1, at paras. 47-50.

> situations that undermine the integrity of the tax system by frustrating the object, spirit and purpose of the provisions relied on by the taxpayer […].[33]

The Court in *Deans Knight* seems to have addressed any concern Finance may have had by clarifying that whether a tax strategy is foreseen is merely a relevant consideration in the GAAR analysis.

The question arises whether the proposed preamble adds anything new. The Court would seem to suggest that it is already mindful of these various elements of the proposed preamble and has taken them into account in the interpretive framework it has developed. An alternative view is that these elements are not always taken into account in the same manner and a preamble (even if codifying judicially developed principles) would help to clarify and stabilize the operation of the GAAR, especially in light of the different views amongst judges.

Economic substance

Although the courts routinely address in some fashion the elements of the preamble in the GAAR proposals, they are significantly less inclined to address economic substance and *Deans Knight* is no exception. *Deans Knight* is an interesting case to which to apply the proposed amendment to the GAAR concerning an economic substance aspect in subsection 245(4.1). At a high level, there were four participants in the transactions: (i) the old Forbes shareholders who received some consideration through Newco for Forbes' losses; (ii) Matco who would have received consideration for arranging the transactions; (iii) Deans Knight which enjoyed the tax benefit of the losses continuing to be available; and (iv) the new investors in Forbes after the IPO who indirectly enjoyed the tax benefit of the losses.

The facts in *Deans Knight* illustrate how difficult it may be to show that a transaction is significantly lacking in economic substance. Deans Knight and the new investors were the only parties that benefited from the losses; however, their economic circumstances changed (paragraph 245(4.1)(a)) and it is likely the case that their pre-tax returns on the high yield securities investments exceeded the tax benefit (paragraph 245(4.1)(b)). The economic circumstances of the old Forbes shareholders and Matco changed too, and they did not enjoy any tax benefits as the old Forbes shareholders in effect sold the losses and Matco essentially provided an arranging service. It may have been reasonable to conclude that the entire purpose for undertaking or arranging the transaction or series was to obtain the tax benefit (paragraph 245(4.1)(c)), although it is also difficult to separate the loss deal from the recapitalization and restart and substantial investments in securities.

The question would also arise as to the consequences of any potential finding that the transactions were significantly lacking in economic substance. The indication in subsection 245(4.1) is that such a finding would tend to indicate abusive tax avoidance. Viewed this way, had this proposed amendment applied, the decision may have been easier to reach, or it could have potentially influenced Justice Côté's analysis.

As is customary, the courts focused on the legal rights and obligations and not the economic substance. As such, there were no findings of fact in this regard. On the legal substance of the transactions, the Court said the following:

> […] 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. From this perspective, the same result was achieved through the impugned transactions. Indeed, the reorganization transactions resulted in the appellant's near-total transformation: its assets and liabilities were shifted to Newco, such that all that remained was its Tax Attributes. Put differently, the appellant was gutted of any vestiges from its prior corporate "life" and became an empty vessel with Tax Attributes.[34]

[33] Ibid., at para. 45.
[34] Ibid., at para. 124.

Interestingly, the Court was of the view that much had happened to alter legal rights and the identity of the appellant. Given tax law traditions in Canada, it will take considerable time and experience to begin to appreciate the impact of an economic substance aspect in the GAAR.

Concluding remarks

The decision in *Deans Knight* is not too surprising in light of the extreme facts of the case. Had the board and management of Forbes effected the recapitalization and restart – without an interlocutor like Matco and possibly raising capital from the same investors – perhaps the outcome would have been different (subject to subsequently enacted section 256.1). As always with GAAR cases, factual context is key.

Although there is little reason for concern based on the SCC's GAAR decisions to date, we share on some level Justice Côté's concern that the Court's approach to determining the OSP could invite an unhealthy level of judicial discretion. This could in turn embolden the CRA, increasing compliance and administrative costs and undermining confidence in the system. As *Deans Knight* confirms that even carefully crafted SAARs are not immune from abuse, many other complex regimes may also be subject to determinations of their underlying rationales in future GAAR cases. In certain respects, *Deans Knight* was relatively straightforward, involving one main provision and a few supporting rules. Many regimes – for example, international tax and corporate reorganization rules – are more complex and involve more boundaries (some arbitrary, some in effect negotiated with stakeholders), warranting the restraint advocated by Justice Côté. In fairness, that restraint was exercised by the Court in *Alta Energy*.

We said at the outset that Finance may have been concerned the Supreme Court of Canada would allow the appeal in *Deans Knight*, a result which may have prompted a legislative response. Rather than that scenario, the Crown enjoyed a decisive victory.

How can Deloitte help you?

Deloitte's professionals can help you understand how this case may impact your business.

If you have questions on any of the above, please reach out to your Deloitte advisor or any of the individuals noted on this alert.

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