

Deans Knight Income Corporation v. The King—Case Study

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14 August 2023

In the case of *Deans Knight Income Corporation v. The King* [1], the Supreme Court of Canada used the opportunity to expand the scope of the General Anti-Avoidance Rule (“GAAR”) of the Income Tax Act (Canada) (ITA”) [2] in a novel fashion.

GAAR 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 ITA. The court will engage in a two-stage process to determine whether the transaction is abusive. First, the court determines the object, spirit and purpose (“OSP”) or legislative rationale for the relevant provisions of the ITA. Second, the court decides whether a specific transaction has frustrated or abused the OSP or legislative rationale.

In this case, the CRA asserted that GAAR applied to transactions specifically designed to avoid the rules under subsection 111(5) of the ITA, which limit a corporation that has undergone an acquisition of control (“AOC”) from using pre-AOC accumulated business losses in post-AOC taxation years. These rules interpret “control” as *de jure* control: i.e. the ownership or control over the voting rights of that number of the corporation’s shares as would entitle the owner/controller to elect a majority of the corporation’s board of directors.

Case Summary

Deans Knight Income Corporation (formerly, Forbes Medi-Tech Inc.) had accumulated CAD\$90 million of business losses and tax credits. A venture capital company, Matco Capital Ltd. (“Matco”), arranged for Deans Knight to enter into a court-approved Plan of Arrangement to tuck old Deans Knight under a new parent corporation, (“Newco”), transfer all the assets of Deans Knight up to Newco, and for the Deans Knight shareholders to get Newco Shares. The remaining shell, now Deans Knight, retained its tax losses and tax credits.

Matco subscribed for a CAD\$3M Deans Knight convertible debenture representing 35% votes/79% value; it entered into an Investment Agreement with Deans Knight and Newco for the purpose of finding a loss-use “opportunity”; and Matco committed to provide a further CAD\$800K payment to Newco.

Matco converted the debenture and paid Newco CAD\$800K for the remaining Deans Knight shares. Matco arranged a CAD\$100M initial public offering of Deans Knight; and new funds were invested into Deans Knight to earn investment income.

As a result, Newco received \$3.8M from Matco; Matco profited from the IPO on its Deans Knight shares; and Deans Knight’s taxable investment income was fully offset by Deans Knight’s pre-transaction business losses and tax credits.

The Courts Below

At each level, the courts struggled with the notion of “control”, and whether Matco had acquired control of Deans Knight in a manner that was abusive under the ITA. At the Tax Court of Canada, the manner was held not to be abusive, because Matco “simply did not have effective control over [Deans Knight] or need such control to make the arrangement work”. [3] Moreover, the transactions did not frustrate the OSP of the provisions of the ITA. At the Federal Court of Appeal, a contrary finding was made: the OSP of subsection 111(5) was “to restrict the use of specified 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”. [4] Matco’s Investment Agreement gave it control over Deans Knight.

The Supreme Court of Canada

In a decision that was concurred in by 7 justices and dissented in by 1, the Court held that the transactions were abusive, such that GAAR applied to deny the sought-after tax benefits. The Court stated that in order to determine the application of the test for misuse or abuse the following steps must be taken:

- determine the OSP of the relevant provisions, and
- decide if the result of the transactions frustrated the OSP.

In this context, the OSP of a provision is a concise description of the underlying *rationale* of the provision. Given that the text of a provision does not always provide a full answer to the rationale underlying the provision, the determination of such underlying rationale requires a review of the provision's text, context and purpose. The contextual analysis examines other related sections in the ITA that work in conjunction with the provision at issue. The purposive analysis takes into account the legislative history and extrinsic evidence to determine whether Parliament sought to achieve a certain outcome or promote particular aims.

Once the OSP of a provision is established, the next step is to determine whether the result of the transaction frustrates the OSP of the provision. This analysis must go beyond the legal form- the *how* as to the manner of the transaction, and must consider the *why* as to the underlying rationale of the particular provision. In doing so, there must be a comparison of the result of the transaction to the underlying rationale of the provision to determine whether that rationale has been frustrated.

In examining subsection 111(5), the Court determined that the OSP 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 shareholders and its business activity.

Without triggering an AOC, Matco achieved the “functional equivalent” of an AOC. It fundamentally changed the taxpayer's assets, liabilities, shareholders and business through the Investment Agreement. This result was evidenced by the fact that Matco dictated who the taxpayer's directors would be. The Investment Agreement placed severe restrictions on the powers of the board of directors. Any actions to be taken by the taxpayer required the written consent of Matco, and Matco reaped significant financial benefits from the IPO engineered by Matco.

What made this transaction abusive was not just that Matco found a way to acquire the functional equivalent of *de jure* control without directly acquiring the voting shares of the taxpayer, but rather it was the break in continuity from the identity of the owners to the nature of the business activity. The taxpayer was reduced to a shell with tax attributes only, and that proved fatal.[5]

IMPLICATIONS

The GAAR has long been criticized for creating uncertainty for taxpayers. The majority's decision will add sustenance to that criticism.

In future, the abuse analysis will focus on the *why* a provision was drafted and not the *how* the provision was worded or *how* the transaction under review was undertaken. The goal is not just to determine the meaning of a provision but its rationale. While examining the text, context and purpose of a provision, the elevation of “purpose” to determine the rationale reflects a tendency toward a results-oriented form of reasoning, and increases the discretionary element in the abuse analysis. Going forward, taxpayers can expect the CRA to advance the “functionally equivalent” test to support applying GAAR in borderline cases (especially where sophisticated tax planning has been undertaken).

Finally, the court's recitation of the steps taken by Matco to strip away the assets, business and ownership of Dean Knight, leaving behind just a shell with tax attributes shows that the economic substance test in Canadian courts is alive and well. A PDF version is available to download [here](#).

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[1] 2023 DTC 5041 (SCC).

[2] Section 245 of the ITA.

[3] *Deans Knight*, 2019, TCC 76.

[4] *Deans Knight*, 2021, FCA 160.



[5] It is interesting to note that the majority decision in commenting on the small set of tax-motivated transactions to which GAAR may be applicable, stated that the prospectus for the IPO expressly recognized the risk of a successful challenge to the use of the taxpayer's tax attributes.

(This blog is provided for educational purposes only, and does not necessarily reflect the views of Gardiner Roberts LLP).

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