

Tax Avoidance and the Meaning of Control

Pooja Mihailovich, Osler, Hoskin & Harcourt LLP

The Canadian *Income Tax Act* (Tax Act) contains a general anti-avoidance rule (GAAR) which can negate tax benefits arising from "abusive" tax avoidance transactions. These are transactions that satisfy the requirements of the law, but are found to be contrary to the spirit or underlying policy of the legislation or its specific provisions.

On November 2, 2022, the Supreme Court of Canada heard an appeal from the decision of the Federal Court of Appeal in *Canada v. Deans Knight Income Corporation* (2021 FCA 160). This case concerned the application of the GAAR to a recapitalization arrangement. Specifically, the question to be decided was whether the taxpayer had abused, among other provisions, the loss restriction rules in subsection 111(5) of the Tax Act. Under the rule in subsection 111(5), if a person or group of persons acquires *de jure* control of a corporation, there are restrictions placed on the use that the corporation can make of losses incurred before that time.

Canadian courts have confirmed that *de jure* control, which is also known as effective control, means the acquisition of a majority of voting shares by persons in a position to vote them in common. At the Federal Court of Appeal, the Crown persuaded the Court to depart from this established legal standard for corporate control (being *de jure* or voting control) and use a novel standard of "actual control" to decide that the arrangement in issue had abused the tax rules governing the availability and use of losses. The case was appealed by the taxpayer to the Supreme Court of Canada.

The taxpayer was a Canadian public corporation with tax attributes comprising unused non-capital losses and other deductions. The taxpayer sought to monetize these tax attributes. To do so, it underwent a reorganization that, according to the Federal Court of Appeal, "turned the reins" over to a venture capital company, Matco Capital Ltd. (Matco). However, Matco did not acquire *de jure* control of the taxpayer. Matco arranged for the taxpayer to complete an initial public offering (IPO), with the taxpayer using the funds raised from the IPO to commence a new business that generated profits against which the losses were claimed. As a result of the IPO, the taxpayer became widely held and no specific person or group of persons acquired voting control of the taxpayer.

The Minister of National Revenue assessed the taxpayer to deny the pre-IPO losses on the basis that they had been lost as a result of an acquisition of control of the taxpayer or, alternatively, that the GAAR applied to prevent the taxpayer from claiming them. The Tax Court of Canada disagreed with this assessing position. It determined that the policy of subsection 111(5) is "to target manipulation of losses of a corporation by a new person or group of persons, through effective control over the corporation's actions," and that Matco did not have effective control.

The Federal Court of Appeal allowed the Crown's appeal and overturned the Tax Court's decision. Despite acknowledging that the term "acquisition of control" in subsection 111(5) had been judicially determined to mean *de jure* control, the Court concluded that the policy of the provision required it also to apply where there has been an acquisition of "actual control." The Federal Court of Appeal thus rearticulated the policy of subsection 111(5) as restricting "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." Having made this determination, the Court concluded that Matco had "actual control" of the taxpayer and, as a result, the GAAR applied.

On appeal to the Supreme Court, the taxpayer argued that the Court should not depart from the *de jure* control test and that the GAAR should not be found to apply.

Among others, the Tax Executives Institute intervened to make submissions to the Supreme Court regarding the scope of the GAAR. It argued that the proper function of the GAAR is to determine whether transactions are abusive based on the legislative scheme set out in the statute. It is not to rewrite legislative schemes that rely on established legal concepts and allow for predictable tax outcomes simply because a taxpayer has undertaken a primarily tax motivated transaction.

As was argued before the Supreme Court, the approach advocated by the Crown in this case is not workable as many ordinary commercial transactions are structured to minimize taxes. It is hoped that the Supreme Court will provide further direction on whether the application of the GAAR effectively enables the Minister and the courts to interpret and apply generally understood legal concepts differently based on tax motivation.