



Bennett Jones

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Recent Cases of Interest in Calgary

CPTS Annual Conference, June 6, 2023

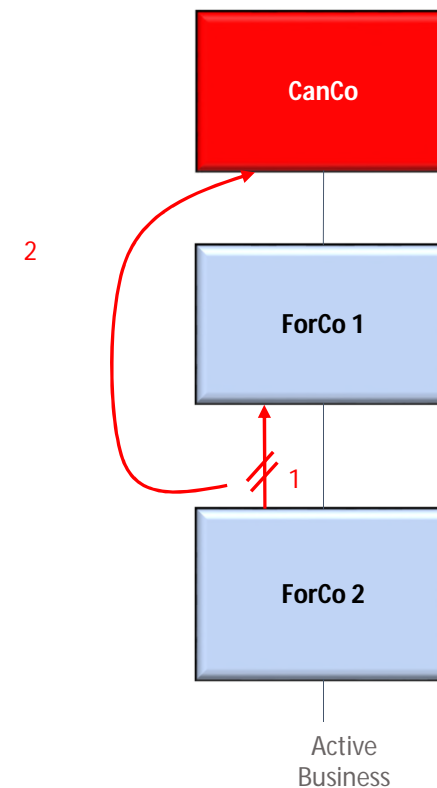
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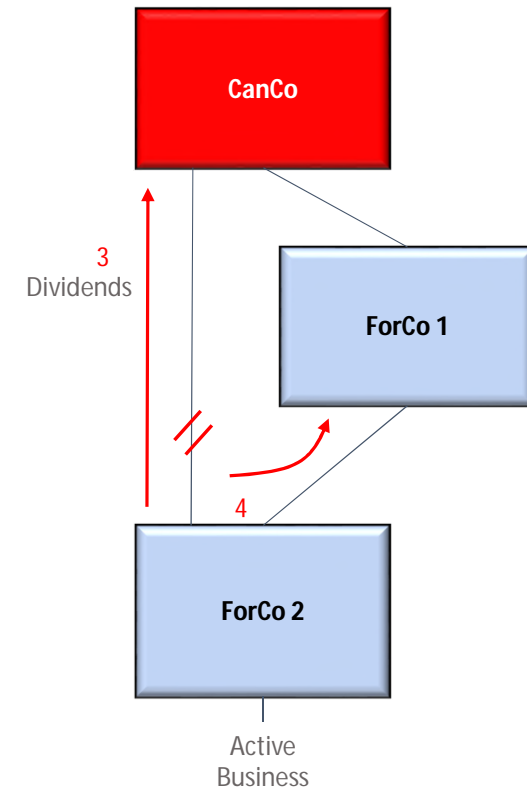
Kone v. QRA, 2022 QCCQ 9892 (under appeal)

- Simplified Example of Repo (Sale and Repurchase) Transaction:
 - **Step 1:** ForCo 1 subscribes for preferred shares of ForCo 2 with fixed dividend entitlement
 - **Step 2:** ForCo 1 sells preferred shares of ForCo 2 to CanCo under sale and repurchase agreement
 - Under the agreement, ForCo 1 agrees to repurchase the shares at a specified time in the future and for a specified price, to be reduced by any dividends



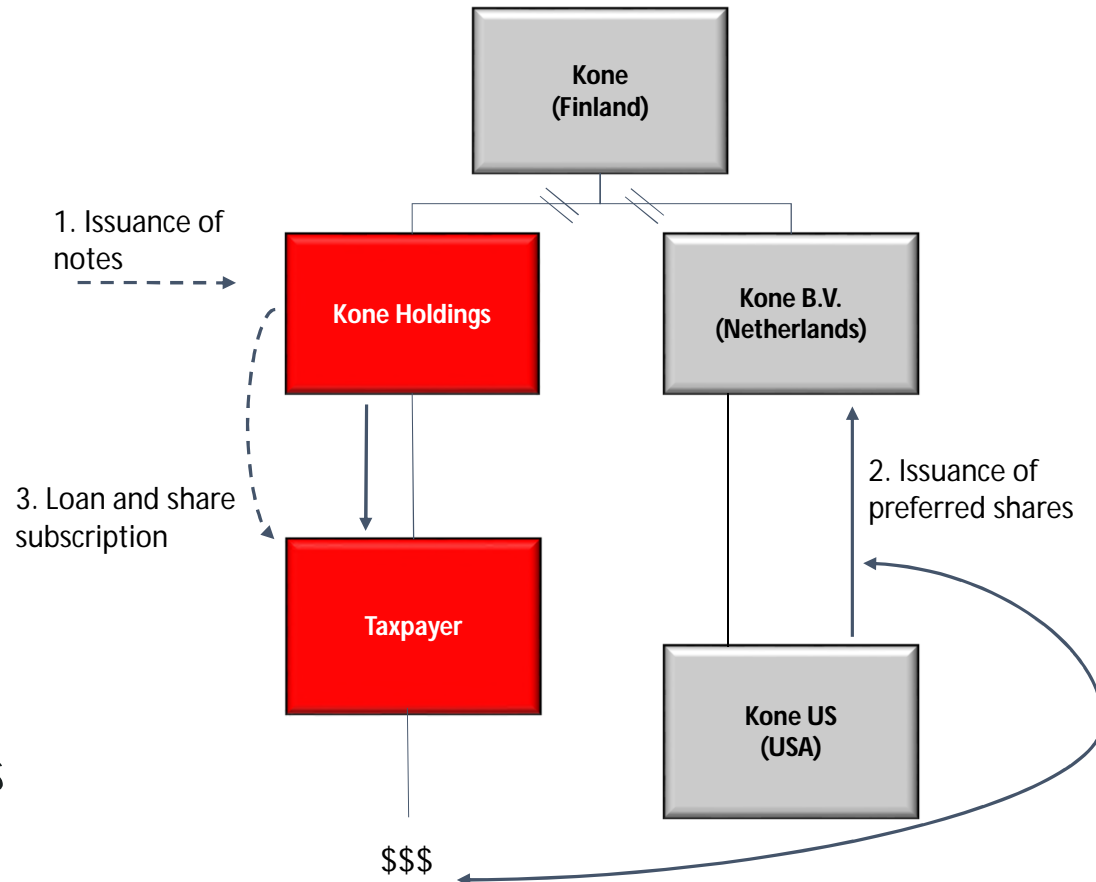
Kone v. QRA

- Simplified Example of Repo (Sale and Repurchase) Transaction
 - **Step 3:** ForCo 2 pays dividends to CanCo on the preferred shares
 - CanCo claims foreign affiliate dividend received deductions under ITA s. 113(1)(a) to the extent ForCo 2 has exempt surplus
 - **Step 4:** ForCo 1 repurchases the ForCo 2 preferred shares from CanCo



Kone v. QRA

- Repo structure
- Sale and repurchase in Canada (*legal form*) – deduction (interest on the notes) and no inclusion (exempt surplus dividend on sale of preferred shares)
- Loan in the US (*economic substance*) – deduction (premium considered interest)
- Prior to FAD and anti-hybrid rules



Kone v. QRA

- Was the agreement a sham?
 - No intent to hide the true legal agreement
 - Absence of economic substance ≠ sham
 - Application of US “Substance Over Form” doctrine not relevant
- Was there an abuse under the GAAR?
 - Alleged abuse of section 17
 - GAAR cannot be used to recharacterize a transaction (from a loan to a sale) based only on economic substance

Boliden Mineral AB v. FQM Kevitsa Sweden Holdings AB, 2023 ONCA 105

- Facts:
 - Boliden purchased shares of a Finnish company ("**Kevitsa**") from the Appellant in June, 2016
 - Appellant gave certain representations, warranties and indemnities in the SPA
 - While owned by the Appellant, Kevitsa accumulated tax losses
 - Under Finnish law, tax losses of a company after a change in control are forfeited unless a permit is obtained from the Finnish Tax Administration to use pre-existing tax losses
 - No value was attributed to the tax losses

Boliden

- Facts:
 - Kevitsa applied for such a permit after closing, and one was granted
 - The result was that Kevitsa was able to use the pre-closing accumulated tax losses against income in 2017 and 2018
 - In 2017, the Finish tax authority (“**FTA**”) commenced an audit of Kevitsa
 - Audit focused on a 2010 Reorganization
 - FTA denied certain expenses for Kevitsa’s 2012-2016 taxation years
 - Resulted in increased taxable income pre-closing and post-closing
 - Losses were shifted to shelter income in reassessed years

Boliden

- Share Purchase Agreement:
 - SPA included a general indemnifying obligation (“**General Indemnity**”)
 - Appellant required to indemnify Boliden and Kevitsa for any Losses arising from breach or inaccuracy of a representation
 - Tax specific indemnity (“**Tax Indemnity**”)
 - Did not require a breach or inaccuracy of a representation
 - Indemnified against any Taxes required to be paid or remitted by Kevitsa with respect to any Pre-Closing Tax Period

Boliden

- Ontario Superior Court:
 - Appellant liable for the 2017 and 2018 taxes under the General Indemnity
 - Representation: “[t]here are no grounds for reassessment”
 - 2010 reassessment was a breach or inaccuracy
 - Indemnification extends to 2017 and 2018 taxes
 - Appellant liable for the 2017 and 2018 taxes under the Tax Indemnity
 - 2017 and 2018 taxes are “with respect to any Pre-Closing Tax Period”

Boliden

- Ontario Court of Appeal:
 - Denied the appeal
 - General Indemnity - No reversible error
 - Tax Indemnity - Did not consider
 - ***Where do we go from here?***

Glencore Canada Corporation v. The Queen 2021 TCC 63

- Characterization of “commitment fee” and “non-completion fee” (“**Fees**”) received by Falconbridge in connection with a failed merger with DFR
- Together, the Fees were:
 - Contractual obligations set out in the Arrangement Agreement and Merger Offer Agreement
 - Not explicitly tied to lost business revenues or reimbursement of expenses

Glencore

- Tax Court held that the Fees were “ancillary business income” and received “in the course of earning income from business”
 - Under appeal to FCA (heard April 1, 2023)

Taxpayer’s Position

- Extraordinary receipt not from a “source” or the business
- Not subject to p. 12(1)(x)
- Proceeds of disposition resulting from contractual rights

Minister’s Position

- Income receipt tied to business operations
- Inducement/reimbursement under p. 12(1)(x)
- No proceeds of disposition of capital property

Glencore

“Falconbridge’s primary objective was clearly to acquire a 75% interest in the Voisey’s Bay deposit but, in doing so, it made sure that all its takeover bid expenses would be covered by the Commitment Fee and that a substantial profit would be realized if the bid failed. In fact, Falconbridge did not take any financial risk by entering into the Merger Offer Delivery Agreement with DFR and had as a secondary objective to make a substantial profit within a very short period of time in the event that the bid failed.”

“The potential acquisition of DFR was a means to acquiring the Voisey’s Bay deposit and the evidence clearly establishes that the Falconbridge’s business included the acquisition of mineral deposits.”

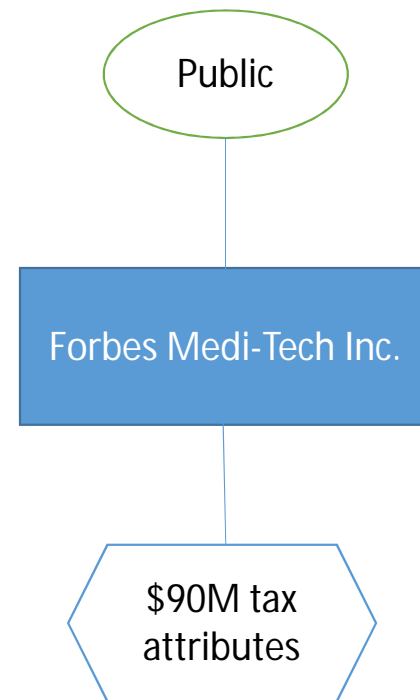
Paragraphs 72 & 74

Glencore

- Where do we go from here?
 - Characterize the lump-sum payment received
 - Determine what is the “business”
 - Consider principles of income recognition (SCC’s decision in *Ikea*)

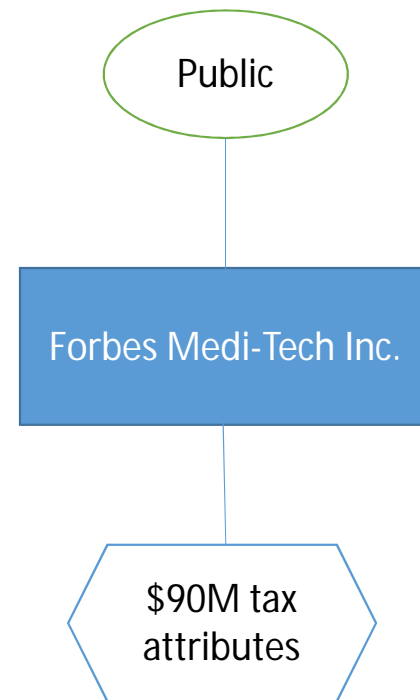
Deans Knight Income Corp. v. Canada, 2023 SCC 16

- Forbes Medi-Tech Inc. was a publicly-listed drug research and nutritional additive business
- Came into financial difficulty and had no prospect of utilizing more than \$90M of non-capital losses, SR&ED expenditures, and ITCs
- Sought to monetize value of tax attributes

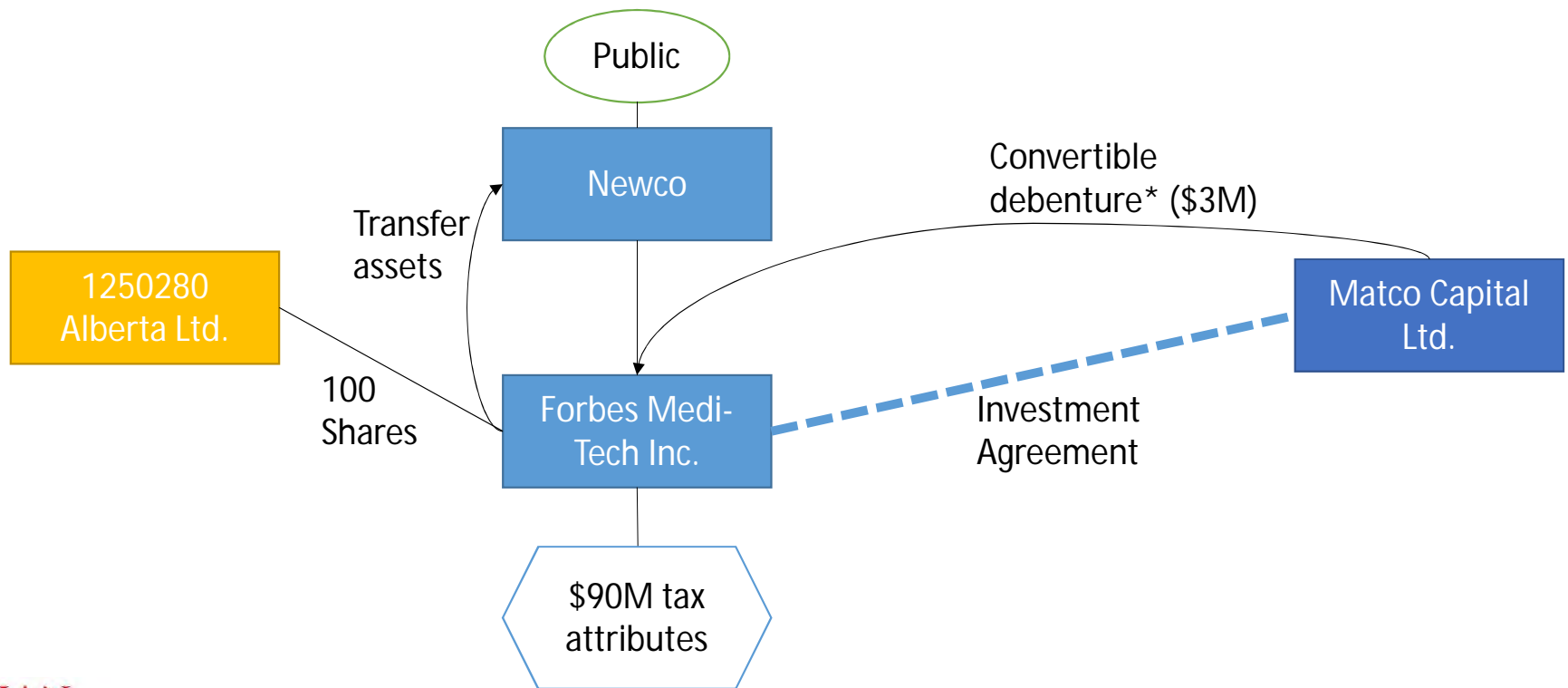


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Deans Knight

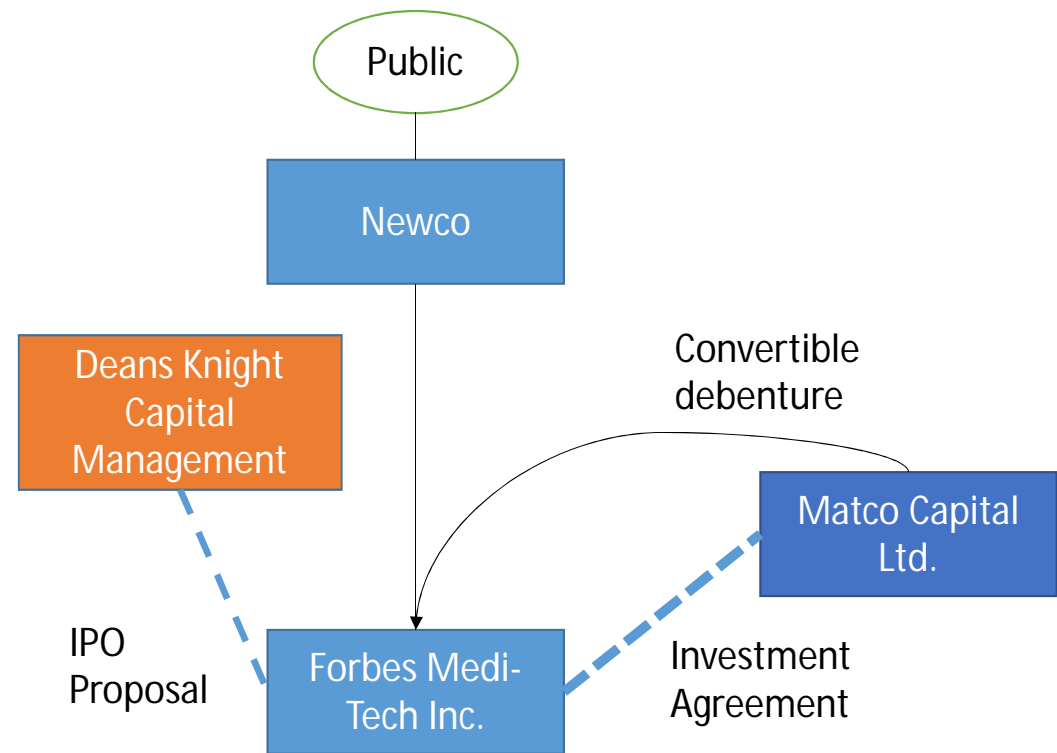


Deans Knight

- Convertible debenture held by Matco is convertible into 35% voting shares + 100% non-voting shares (79% equity)
 - 256.1 was not enacted at the time but would now be deemed an AOC in these circumstances
- Newco has right to sell remaining shares of Forbes to Matco for a minimum of \$800,000
- Investment Agreement restricts a variety of Forbes corporate acts
- Matco is obligated to find a business that could use Forbes' tax attributes

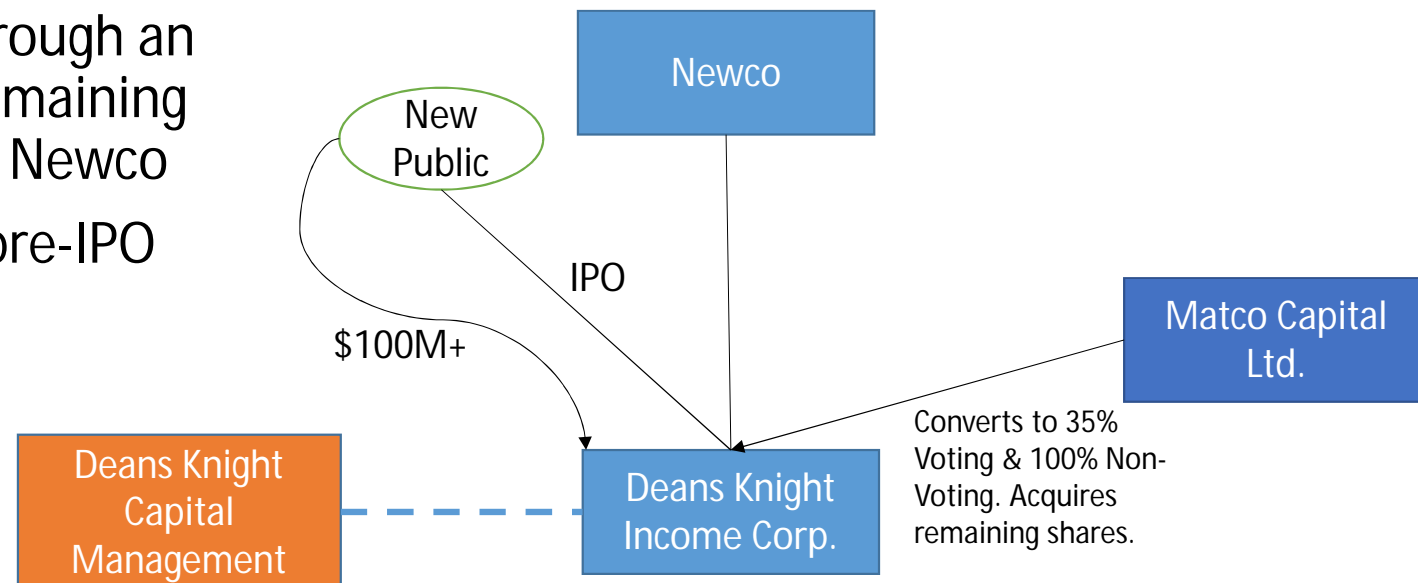
Deans Knight

- Deans Knight Capital Management proposes \$100M+ IPO
- Forbes will invest in corporate debt securities to generate income to be sheltered by the tax attributes
- Existing Forbes securities priced at \$5M
- Forbes changes name to Deans Knight Income Corp.



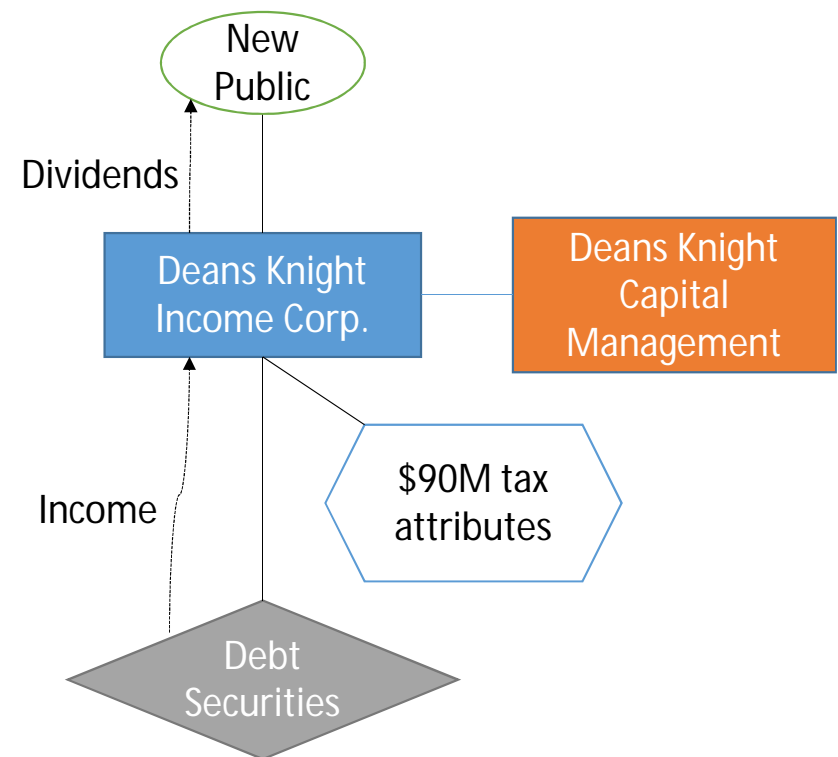
Deans Knight

- Prior to IPO, Matco converts convertible debentures to 35% voting & 100% non-voting
- Post IPO, Matco (through an affiliate) acquires remaining DKIC shares held by Newco
- Matco owns 100% pre-IPO shares



Deans Knight

- Successful investment business
- Operates 2009-2012 and winds-up
- DKIC shelters 2009-2012 income with historical tax attributes (claiming nearly \$65M).
- Minister reassesses to disallows the claimed losses and expenditures



Deans Knight – Tax Court (Paris J.)

- Matco did not obtain an option to acquire the majority of Newco's voting shares - no *de jure* control
- GAAR does not apply:
 - Use of tax attributes to reduce taxes was a tax benefit.
 - Primary purpose of the transactions was to monetize the tax attributes
 - Object, spirit and purpose of s. 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".
 - Matco did not have effective control as DKIC "participated freely in the transactions that resulted in the use of the Tax attributes..."

Deans Knight – Federal Court of Appeal

- Issues:
 - Crown did not appeal Tax Court's finding that Matco did not acquire *de jure* control of DKIC
 - DKIC did not appeal Tax Court's finding that the series of transactions were avoidance transactions giving rise to a tax benefit
 - Sole issue before the FCA – abusive tax avoidance?
 - What is the object, spirit and purpose of subsection 111(5) of the Act?
 - Were the transactions abusive of that object, spirit, and purpose?

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 - Crown did not appeal Tax Court's finding that Matco did not acquire *de jure* control of DKIC
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 - Sole issue before the FCA – abusive tax avoidance?
 - What is the object, spirit and purpose of subsection 111(5) of the Act?
 - Were the transactions abusive of that object, spirit, and purpose?

Deans Knight – Federal Court of Appeal

- Unanimous panel – GAAR applies
- Object, spirit and purpose of s. 111(5) is “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”.
- “Actual control” includes forms of *de jure* control and *de facto* control, but the actual control test is different from the *de facto* control test
- The Investment Agreement gave Matco actual control over the actions of DKIC

Deans Knight – Supreme Court

- Sole issue, as in Federal Court of Appeal, is whether the transactions abused the object, spirit and purpose of s. 111(5).
- 7 justices find GAAR applies (reasons by Rowe J.)
- 1 justice finds GAAR does not apply (Côté J.)

Deans Knight – Majority Reasons

- Setting the stage:
 - Distinguishing between the “rationale” and the “means”.
 - **“...when drafting legal tests, Parliament is seeking to establish a general standard that is most faithful to its objectives from the options which are available and practicable.”**

Deans Knight – Majority Reasons

- *Textual analysis (relevance of detailed and precise provisions):*
 - Precise terms and terms with well established meanings (like control) are not determinative of object, spirit and purpose:
 - **“Importantly, there is no bar to applying the GAAR in situations where the Act specifies precise conditions that must be met to achieve a particular result, as with a specific anti-avoidance rule. Thus, I do not agree with the appellant’s submission that where Parliament has legislated with precision, as here, where loss carryovers are denied in specific instances, the GAAR is not meant to play a role. Of course, the GAAR will not apply in all circumstances — the analysis is inherently case specific.”**
 - **“...Simply put, specific and carefully drafted provisions are not immune from abuse.”**
 - Minimizes prior jurisprudence which emphasizes the importance of detailed drafting: *Landrus* (2009, FCA); (*Ludco Enterprises* (2001, SCC))

Deans Knight – Majority Reasons

- *Textual analysis:*
 - “The appellant argues that the object, spirit and purpose of the provision is captured by the *de jure* control test within s. 111(5). In *some* cases, the object, spirit and purpose may be no broader than the provision itself. However, this is only where the text fully explains the provision’s underlying rationale (*Copthorne*, at para. 110). To determine whether this is the case for s. 111(5), the analysis must move to the context and purpose of the provision.”
- The disagreement lies in how much weight should be afforded to the text:
 - Majority minimizes the text (and particularly, the reference to “control”)
 - Côté highlights the significance of the word “control”

Deans Knight – Majority Reasons

- *Contextual analysis (relevance of de facto control):*
 - *De jure* control was “settled on” by Parliament to articulate its objective:
 - “... There is no doubt that *de jure* control is a clearer benchmark than *de facto* control, meaning greater certainty for the majority of transactions, which are not tax-motivated.”
 - “...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 — particularly given that the GAAR exists as a last resort. To ascertain the rationale underlying s. 111(5), more is needed than the simple fact that Parliament settled on *this* test to operationalize its intent.”

Deans Knight – Majority Reasons

- *Contextual analysis (relevance of subsection 256(8)):*
 - Deemed AOC rules show that subsection 111(5) is only a “rough proxy”
 - Subsection 256(8) “...demonstrates that the *de jure* control test in s. 111(5) does not, on its own, capture the full range of situations that Parliament sought to target; rather, the test in s. 111(5) is better understood as a rough proxy that seeks to give effect to Parliament’s broader aims, while offering a degree of clarity and stability in most cases”.

Deans Knight – Majority Reasons

- *Purposive analysis*
 - **“The legislative history behind s. 111(5) illustrates that Parliament’s intended purpose was to address a *specific mischief*. While the means Parliament has chosen to address these concerns have evolved over time, the *rationale* for including the loss carryover restriction in the Act has remained consistent.”**

Deans Knight – Majority Reasons

- *Object, spirit and purpose of s. 111(5) - conclusion:*
 - The Majority states that *de jure* control is not the rationale:
 - **“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”**
 - **“*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.”**
 - So what is the rationale?

Deans Knight – Majority Reasons

- *Object, spirit and purpose of s. 111(5) - conclusion:*
 - The rationale is stated very broadly (broader than the Crown argued).
 - **“...the object, spirit and purpose of s. 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 word “control” is notably absent from the majority’s description of the object, spirit, and purpose
 - Fortunately, the Majority’s application of the rationale ties back to the concept of *de jure* control

Deans Knight – Majority Reasons

- *2nd stage of abuse analysis – “Functional equivalence” to de jure control*
 - Despite not referring to “control” in its statement of rationale, the rationale that is actually applied by the Majority has *de jure* control at its core. The rationale is contravened when a person acquires (1) *de jure* control or (2) the functional equivalent of *de jure* control even if not meeting the definition of that concept.
 - “Functional equivalence” is not described as a legal test but as a circumstance/result that is to be evaluated on particular facts relative to *de jure* control
 - Improvement for taxpayers relative to the FCA’s broader notion of “actual control”

Deans Knight – Majority Reasons

- *2nd stage of abuse analysis – Was there an abuse?*
 - Key factual findings of the Majority:
 - **“Matco achieved the functional equivalent of such an acquisition of [*de jure*] 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...”**
 - **“The restrictions in favour of Matco resemble the fettering of discretion that would normally occur through a unanimous shareholder agreement and which would lead to an acquisition of *de jure* control... the powers of the directors were effectively neutralized for the duration of the [investment] agreement.”**
 - “But for” Matco’s control rights being in an Investment Agreement and not a USA, it would have had *de jure* control. Facts may have little precedential value.

Deans Knight – Facts proved critical

- Facts were critical – ultimately not much substantive disagreement on OSP:
 - Tax Court:
 - The OSP of s. 111(5) is **“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”**
 - Crown in oral argument:
 - **“...where some relationship displaces or strips the board of its normal authority, you have got yourself ... in a *de jure* control position without buying the voting shares... that is what drives the abuse...”**
 - Taxpayer in oral argument:
 - **“...the appellant’s position is that in order to abuse the *de jure* control provision, you would need to achieve control that is analogous or equivalent to it... it is not sufficient to just look at factors of *de facto* control”**
 - Majority:
 - **“Matco achieved the functional equivalent of such an acquisition of [*de jure*] control through the Investment Agreement”**

Deans Knight – Open point

- A broader rationale?
- In its second stage abuse analysis, the majority articulates and overlays, for the first time, another object, spirit and purpose:
 - **“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.”**
 - **“... the reorganization transactions resulted in the appellant’s near-total transformation...”**
 - **“...the appellant was gutted of any vestiges from its prior corporate “life” and became an empty vessel with Tax Attributes.”**
 - **“...the appellant ... was, in practice, a company with new assets and liabilities, new shareholders and a new business. Accordingly, the transactions resulted in a fundamental change in the identity of the taxpayer.”**
- No reference to control here

Deans Knight - Dissent

- Côté J. held that the transactions did not frustrate the rationale of subsection 111(5) or result in a misuse or abuse

“Despite Parliament’s unambiguous adoption of the *de jure* control test in s. 111(5) of the Income Tax Act, the majority has opted for an *ad hoc* approach that expands the concept of control based on a wide array of operational factors. 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.”

Deans Knight - Dissent

- Interpretation of a provision under GAAR cannot be disconnected or “dismembered” from the text of the statute

Where an anti-avoidance provision has been carefully crafted to include some situations and exclude others, it is reasonable to infer that Parliament chose to limit its scope accordingly.

It must be remembered that the text also plays an important role in ascertaining the purpose of a provision. The proper approach is one that *unifies* the text, context, and purpose, not a purposive one in search of a vague policy objective disconnected from the text.

Deans Knight - Dissent

- Role of textual analysis and approach to SAARs

“It should not be assumed that the GAAR plays a role in every transaction and in every context. There is agreement with the majority that there is no bar to applying the GAAR in situations where the Act specifies precise conditions that must be met to achieve a particular result, as with a specific anti-avoidance rule; however, a provision’s text can sometimes be conclusive and fully explain its underlying rationale.”

“Clearly defined rules are essential in banking and commercial transactions because they reduce costs related to litigation and promote predictability by allowing all parties to know their rights and obligations in advance.”

Deans Knight - Dissent

- Contextual analysis (relevance of *de facto* control)

The necessary implication that flows from my colleague's reasoning is that Parliament is unable to translate its objectives into effective means; the best it can do is choose text that is "most faithful to its objectives" In my view, Parliament often *intends* to do precisely what it actually does. If Parliament crafts a provision carefully, courts should pay close attention to the means chosen and not simply assume that Parliament drafted the provision incompetently.

Deans Knight - Dissent

- Narrower object, spirit, and purpose of subsection 111(5)

“In sum, a change in control is the singular event that triggers the loss trading restrictions found in s. 111(5). The notion of “control” is therefore central to the operation of s. 111(5), and any object, spirit and purpose that omits it lacks coherence. In my opinion, the object, spirit and purpose of s. 111(5) is to deny the use of specified losses of a corporation if a person or group of persons has acquired *de jure* control of that corporation.”

Deans Knight - Dissent

- The characterization of the transactions as “illusory” in effect “re-weighs” the evidence and facts determined by the Tax Court

“The Tax Court held that Newco’s right to retain its shares was *bona fide* and certainly not a sham. Re-characterizing this right to support the notion that Newco and Deans Knight were intending to abuse s. 111(5) is manifestly counter to the Tax Court’s finding.”

Deans Knight - Dissent

- Discussion regarding broad scope of “functional equivalence” and constating documents

“In my view, the Investment Agreement is of no relevance to *de jure* control.”

“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.”

Deans Knight – Final Takeaways

- Dichotomy of standards
 - Ordinary commercial transactions are assessed relative to the *de jure* control standard
 - Tax avoidance transactions are assessed relative to the rationale.
Engage in tax avoidance → deal with uncertainty
- Could “functional equivalence” become a common argument in GAAR cases involving a specific threshold?
- GAAR Proposals
- Other considerations



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Thank you

CPTS Annual Conference, June 6, 2023

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