GAAR and sham are no match: Québec Court of Appeal greenlights repo transaction

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Recently, the Court of Appeal of Québec (the Court) released its decision in *Agence du revenu du Québec v. Kone inc.*[1] The Court dismissed the appeal, confirming the trial judgment, which rejected the Agence du revenu du Québec's (ARQ) arguments alleging sham and the application of the Québec general anti-avoidance rule (GAAR) under section 127.6 of the Québec *Taxation Act* (QTA), which is the Québec equivalent of section 17 of Canada's *Income Tax Act* (ITA). For a discussion on the 2022 trial judgment, see BLG's previous case commentary.

On appeal, the ARQ argued that the trial judge erred in law by concluding there was no sham and that the GAAR should not apply. The Court firmly rejected both grounds of appeal.

Key takeaways

The Court's decision is instrumental for taxpayers who engaged in cross-border share purchase and repurchase (repo) transactions, and sets a strong precedent for Canadian tax treatment of repo transactions. More specifically, the key findings read as follows:

- The discrepancy in tax treatment of a repo transaction in Québec tax law versus U.S. tax law is insufficient to support a finding of sham.
- The Court affirmed the primacy of legal substance over economic substance, even following the Supreme Court of Canada's decision in *Deans Knight*[2], which we analyzed in June 2023.
- In the aftermath of *Deans Knight,* the Court reaffirmed that a taxpayer is entitled to choose the legal structure that is most favourable to it from a tax perspective without violating GAAR.

Background: Kone's financing found non-abusive at 2022 trial

The tax assessments targeted a repo structured by Kone Inc. (Kone), a Canadian corporation that is part of an international group, to finance two acquisitions by its parent company, Kone B.V.

Kone used the borrowed funds to acquire preferred shares of a U.S. corporation (Kone U.S.) from a non-Canadian affiliate (Kone B.V.). Kone simultaneously agreed to resell the preferred shares back to Kone B.V. at a pre-agreed higher price plus cumulative dividends payable two years later. From a Canadian perspective, Kone deducted the interest on the money borrowed to buy the preferred shares, and no tax was outstanding on the dividends on these shares. From a U.S. tax perspective (where the "substance over form" rule is applicable), the repo was treated as a loan, with the dividends on the preferred shares being deductible as interest.

At trial, the ARQ contended that the purchase of Kone U.S. shares between Kone and Kone B.V. was a sham transaction, intended to disguise a loan. The trial judge dismissed this argument, as the ARQ failed to prove deceit and illusion, and thus failed to establish that the repo was a sham.

The ARQ also alleged that GAAR under section 127.6 of the QTA should apply. The trial judge dismissed this argument, stating that the repo was consistent with the object, spirit and purpose (OSP) of section 127.6 of the QTA, and thus did not constitute an abusive transaction.

On appeal, the ARQ submitted that the trial judge erred by: (a) determining there was no sham; and (b) finding that the GAAR was not applicable.

Analysis: A cross-border repo is not a sham and not subject to GAAR

a. The repo transaction is not a sham

The ARQ's principal argument was that the repo was a sham and that it was really a loan, such that section 127.6 applied. This argument relied on the fact that under U.S. tax law, the share purchase and repurchase agreement was viewed, including by Kone's U.S. tax advisors, as if it were a loan. In response to this argument, the Court confirmed the primacy of legal substance over economic substance for Canadian income tax purposes. At paragraph 23:

> "The mere fact that U.S. tax law looks at the economic substance of the repo transaction and treats it as a secured loan whereas Québec tax law looks at the form of the transaction, is not sufficient to transform the repo into a loan for Québec tax purposes. Moreover, this does not mean that the repo was a sham. The taxpayer is entitled, in those circumstances, to take advantage of the different treatment of the transaction under Québec tax law and U.S. tax law."[3]

By relying on the sham doctrine, the ARQ was essentially seeking to import U.S. tax treatment of repo transactions into Québec tax law. The Court confirmed the trial judge's finding that the ARQ failed to prove the element of deceit necessary to support a finding of sham. Both courts accepted that, for Québec tax law purposes, the repo was carried out as represented by Kone. Its legal substance was that of a share purchase and repurchase agreement, and the evidence put forth by the ARQ was insufficient to challenge this finding of fact.

b. The GAAR is not applicable

The ARQ's alternative ground of appeal was that the repo improperly avoided the application of section 127.6 of the QTA, and was caught by GAAR. At trial, it was determined that the repo transaction gave rise to a tax benefit and constituted an avoidance transaction. These findings were not appealed by Kone. Thus, only the third step in the GAAR test was reviewable on appeal.

Adopting an expansive interpretation of the Supreme Court's reasons in *Deans Knight,* the ARQ argued that the OSP of section 127.6 should not be limited to loans and other "amounts owing," and should instead capture any financing transaction by Canadian companies with non-residents that does not generate reasonable interest.

The Court rejected this argument, noting its contradictory nature. If one accepts that the OSP of section 127.6 captures any financing transaction (including but not limited to loans), it cannot on the other hand adopt a restrictive reading of this section to consider only whether the transaction generates interest:

> "One cannot ignore the fact that financing transactions that are not loans will not generate interest but may provide for other forms of return. In the present case, the ARQ cannot recharacterize the repo as a loan without recharacterizing the dividend as interest. A repo with a reasonable return in the form of dividends does not defeat the OSP of Section 127.6."[4]

The Court confirmed the trial judge's decision that Kone did not abuse section 127.6, and that the GAAR does not apply in these circumstances.

Future implications

The Court acknowledged the discrepancy in the treatment of repo transactions under Québec tax law and U.S. tax law. This discrepancy allowed Kone to receive tax-free dividends from Kone U.S. while Kone U.S. deducted the amount of the dividends as an interest expense.

As noted by the Court, "this mismatch arises from the QTA and the policies underlying it, and not from any improper action by the taxpayer." Kone received the dividends tax-free because they were paid out of Kone U.S.'s exempt surplus account, made up of its earnings from an active business on which it has already paid tax. This is a result of the legislator's decision to promote capital import neutrality, which allows Québec businesses to remain competitive internationally by not being double-taxed on their foreign active business income.

The Court wisely recognized that taxpayers have various structures they can utilize to minimize their tax liabilities while still abiding by GAAR: "GAAR does not require that the taxpayer choose the structure that results in it paying the most tax."[5]

Repos are common and well-known financing instruments, and represent an important and sizable market. As such, courts should not infuse the abuse analysis with "a value judgment of what is right or wrong nor with theories about what tax law ought to be or ought to do."[6] The Court warns that in these types of circumstances, courts must be cautious before routinely applying GAAR, particularly in repos:

> "[…] First, the ARQ and the legislator must be aware of the existence of repos and they have not to date provided any specific rules for how they are to be treated. Second, the scope of this market means that applying GAAR to repos and imputing interest on them will have wide-ranging consequences that the Court cannot predict or control. In those circumstances it would be inappropriate for the Court to try to fix what the ARQ now characterizes as a problem by applying GAAR."[7]

The Court's decision in *Kone* is a positive development for taxpayers in both the sham context and the GAAR landscape, in the aftermath of *Deans Knight*. The Court confirmed that the decision to address repos rests with the legislator.[8]

With repo transactions on the radar of Canadian tax authorities, this decision is an important tool to help taxpayers who embarked in cross-border repos navigate disputes arising from potential reassessments by the ARQ and by the CRA.

Contact us

Borden Ladner Gervais LLP was counsel to the taxpayer, Kone Inc., at trial and on appeal. For further details about this case or other tax disputes matters, please contact the authors or another member of BLG's Tax Disputes group.

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Footnotes

[1] *Agence du revenu du Québec v. Kone inc.*, 2024 QCCA 678 (*Kone*).

[2] *Deans Knight Income Corp. v. Canada*, 2023 SCC 16 (*Deans Knight*).

[3] *Kone*, supra note 1 at para 23.

[4] *Ibid* at para 34.

[5] *Ibid* at para 37.

[6] *Ibid* at para 38.

[7] *Ibid* at para 38.

[8] *Ibid* at para 38.

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