Supreme Court of Canada Won't Reconsider the GAAR in Birchcliff Energy Ltd.

November 22, 2019

On November 14, 2019, the Supreme Court of Canada denied the taxpayer's application for leave to appeal from judgment of the Federal Court of Appeal in *Birchcliff Energy Ltd. v The Queen*, 2019 FCA 151.[1] In dismissing the taxpayer's appeal, the Supreme Court of Canada declined to re-consider the General Anti-Avoidance Rule (GAAR).

Background

The case dealt with an appeal from the 2017 judgment of the Tax Court of Canada (TCC),[2] in which the TCC dismissed the appeal of Birchcliff Energy Ltd. (Birchcliff) from a reassessment of its 2006 taxation year denying approximately $16 million in non-capital losses that were incurred by Veracel Inc. (Veracel) and subsequently claimed by Birchcliff.

Birchcliff was formed by the amalgamation of Veracel and Birchcliff Energy Ltd. (Predecessor Birchcliff) in May 2005. Veracel and Predecessor Birchcliff entered into a number of agreements, which ultimately would apply the losses of Veracel, an unsuccessful medical instrument manufacturing business, to shelter the profits from certain oil and gas properties that Predecessor Birchcliff intended to acquire. In order to raise the necessary funds, Veracel sold subscription receipts to public investors. The subscription receipts included certain conditions to ensure that the funds would be used to acquire the oil and gas properties, including the condition that the funds would be released only if Veracel amalgamated with Predecessor Birchcliff. Furthermore, if the amalgamation did not take place, holders of subscription receipts would be entitled to a refund of their investment.

On May 31, 2005, the transactions (the Arrangement) were completed, including the following key steps:

- Class B Common shares of Veracel were issued to holders of subscription receipts;
- Veracel and Predecessor Birchcliff amalgamated;
- Birchcliff received a credit facility of up to $70 million; and
- Birchcliff purchased the oil and gas properties.

Following the completion of the Arrangement, the holders of the Class B Common shares of Veracel held approximately 34 million common shares of new Birchcliff, and the shareholders of Predecessor Birchcliff held approximately 20 million common shares of new Birchcliff.

As the holders of subscription receipts received a majority voting interest in Birchcliff, the loss streaming rules found at subsections 256(7) and 111(5) of the *Income Tax Act* (Canada)[3] (the Tax Act)that would otherwise restrict the carry-forward of the Veracel losses on an acquisition of control, did not apply.

The Tax Court of Canada Judgment

In a decision that superseded a prior decision of the TCC,[4] the TCC rejected the application of the sham doctrine as a basis for assessment, but concluded that the GAAR applied to deny the non-capital losses claimed by Birchcliff. The Court found that Birchcliff's use of the Veracel losses constituted a tax benefit and the series of transactions leading up to the amalgamation constituted an avoidance transaction contrary to the object and spirit of subsection 256(7), and were therefore abusive.

The Federal Court of Appeal

On appeal, the FCA upheld the decision of the TCC and found that the trial judge had correctly applied the GAAR.

Although the GAAR had not been raised at the time of the reassessment, the FCA remarked "the determination of the object, spirit or purpose of the relevant provisions is a question of law, […] and whatever inference could be drawn from the absence of a reference to the GAAR in the first reassessment, [is] of little assistance."[5]

The FCA noted that two provisions of the Tax Act were particularly relevant in determining whether the overall result achieved by the Arrangement was abusive:

- Subsection 111(5), which limits the ability of a corporation to carry forward non-capital losses if there has been an acquisition of control of that corporation; and
- Subsection 256(7), which contains rules to determine whether an acquisition of control has occurred on the amalgamation of two or more corporations.

The FCA reviewed Birchcliff's submissions with respect to the policy for the use of non-capital losses incurred in one year against income generated in another year underlying subsection 111(5), but noted that the real issue in the appeal was whether there was an abuse of subsection 256(7) such that Birchcliff could avoid the application of subsection 111(5). Accordingly, the policies underlying subsection 111(5) were of little assistance to the determination of whether there had been an acquisition of control.

The FCA noted that the holders of subscription receipts were entitled to either receive shares of new Birchcliff or their money back. Also, the combination of the issuance of Class B shares of Veracel to the subscription receipt holders followed immediately by the amalgamation of Veracel and Birchcliff "has the same effect and is equivalent to the holders of the subscription receipts only receiving shares of Birchcliff following the amalgamation of Veracel and the Predecessor Birchcliff."[6] Had that been the case, there

would have been an acquisition of control of Veracel on the amalgamation, triggering the provisions of subsections 111(5).

According to the FCA, clause 256(7)(b)(iii)(B) exists to prevent an acquisition of control of the larger of two amalgamating corporations by the smaller of the two, and to generally ensure that the shares issued by the amalgamated corporation to the shareholders of each predecessor corporation are reflective of the relative fair market value of each of the predecessor corporations.

The FCA agreed with the TCC that it was "abundantly clear that anyone paying for a subscription receipt was seeking to acquire shares of the amalgamated company."[7] Ultimately, the FCA concluded that the outcome achieved by the Arrangement was not consistent with the rationale for clause 256(7)(b)(iii))(B) of the Tax Act. As a result, the Arrangement constituted an abuse of that provision such that the GAAR applied to deny the non-capital losses claimed by Birchcliff.

Conclusion

With the denial of leave from the FCA judgment, taxpayers and their advisors are left with an uncomfortable uncertainty as to the applicability of the GAAR to loss trading between unrelated parties, and financings occurring before an amalgamation or reverse takeover. It is also another missed opportunity for the Supreme Court to reconsider the GAAR.

For more information, please contact one of the authors listed below.

[1] *Birchcliff* (2019 FCA)

[2] 2017 TCC 234 [*Birchcliff* (2017 TCC)]

[3] RSC 1985 c. 1 (5th Supp.).

[4] 2015 TCC 232

[5] *Birchcliff* (2019 FCA) at para. 32.

[6] *Birchcliff* (2019 FCA) at para. 48.

[7] *Birchcliff* (2019 FCA) at para. 49; *Birchcliff* (2017 TCC) at para. 50.

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