Cross-border repo: Not a sham, nor an abuse under Québec's Taxation Act

January 27, 2023

Kone c. ARQ

Overview

In a judgment rendered on Dec. 22, 2022, by the Honourable Gatien Fournier, J.C.Q.[1], the Court of Québec granted the application on appeal of seven (7) tax assessments from the taxpayer Kone Inc. (Petitioner) under Québec's *Taxation Act*, RLRQ, c. I-3. (Québec TA) for various taxation years (Years Covered), (the Judgment).

Key takeaways

- In the absence of presumptions or factual assumptions to demonstrate the existence of a sham, the assessments do not benefit from the same presumption of validity.
- A taxpayer cannot be required to rebut the accuracy of the assessment. The onus of proving, on a balance of probabilities, the facts to support its sham argument rests with ARQ.
- The U.S. "substance over form" doctrine does not apply in Canada and Québec.
- Québec GAAR may not be used to re-characterize a legitimate transaction with bona fide non-Quebec tax purposes because ARQ prefers a different tax treatment than the one achieved by Petitioner.

Québec GAAR is similar to Federal GAAR, thus this decision rendered under section 127.6 and following of the Québec TA may apply *mutatis mutandis* to situations raised under section 17 of the ITA.

The Court vacated the assessments pertaining to the Years Covered issued by the Agence du revenu du Québec (ARQ or the Respondent) on the following grounds:

- For the 2002, 2003 and 2004 taxation years, KONE Québec inc. (KQI) is not subject to imputed interest income calculated pursuant to section 127.6 of the Québec TA.

- For the 2002, 2003 and 2004 taxation years, KQI realized non-capital losses; accordingly, KQI is allowed to carry them back and forward.

Petitioner is a Canadian operating subsidiary resulting from a series of amalgamations in a group, which includes among others KQI, ultimately controlled by a parent corporation who is a Finnish public corporation. During the years in issue, KQI had an exempt surplus entitlement relating to KONE USA and other foreign affiliates owned by KONE USA directly or indirectly, equal to any accrued and unpaid dividends. All of the income earned in KONE USA was income from an active business as defined in the *Income Tax Act* (Canada) (ITA or Federal Act), carried on in the U.S.

Share Purchase Agreement/Share Repurchase Agreement

Kone Inc. (KONE Canada) advanced funds to KQI as an interest-bearing loan and share subscription proceeds to purchase. Pursuant to a share purchase agreement, KQI purchased from a non-resident affiliated company (Kone Holland B.V., (Kone B.V.)) all four authorized classes of preferred shares of a group company with active business income in the U.S. (Kone Holdings Inc., (KONE USA)), for a total purchase price of $394,000,000 (being $100,000 per share) (Share Purchase Agreement). The issued aforementioned shares had recently been issued to Kone B.V. as stock dividend. Kone BV used the funds received to indirectly fund purchases by the Kone group of targets with complementary businesses.

Concurrently, KQI and Kone B.V. entered into a repurchase agreement, according to which KQI agreed to resell to Kone B.V. such preferred shares in three and five years' at pre-agreed higher prices (Share Repurchase Agreement). In accordance to the agreement, the repurchase was performed and pursuant to section 589 of the Québec TA (s. 93 of the ITA), KQI included the gain arising from the sale as deemed dividends originating from its exempt surplus of KONE USA.

ARQ's position

In this case, ARQ's initial audit position was that during the 2001-2003 taxation years, an amount of $394,000,000 was owed to KQI by KONE B.V., and in the 2004 taxation year, an amount of $94,000,000 was owed, and thus section 127.6 of the Québec TA (Subs. 17(1) of the ITA) was engaged. At the objections stage, ARQ abandoned its section 127.6 of the Québec TA position. Instead, it concluded that following the acquisition and disposition of KONE USA shares by KQI under the Share Purchase Agreement and the Share Repurchase Agreement, no amounts were owing for purposes of section 127.6 of the Québec TA. According to ARQ, the purpose of the acquisition and disposition of the KONE USA shares in this manner was to avoid or reduce the income that KQ should have included in computing its income under section 127.6 of the Québec TA. Then invoked the specific anti-avoidance rule at 127.15 as a basis for the assessments (Subs. 17(14) of the ITA).

ARQ sought to impute interest income to KQI under TA s. 127.6, the Québec equivalent of ITA s. 17(1). This action was on the basis that the above repurchase, or "repo" transaction was a sham. ARQ sought to characterize the repurchase as an interest-free

loan by KQI to Kone BV or, alternatively, that the repo transaction represented an abusive avoidance of such s. 17 equivalent for Québec GAAR purposes.

Analysis of the Court of Québec

The analysis of the Honourable Gatien Fournier, J.C.Q., follows the four (4) following issues in dispute:

i. was ARQ precluded from raising the sham doctrine or the GAAR;
ii. does ARQ bear the onus of proof regarding the allegations of sham or the GAAR;
iii. whether the sale and repurchase transactions entered into by KONE B.V. and KQI constituted a sham designed to conceal or disguise a loan; and
iv. whether Kone should be assessed under the Québec GAAR.

Essentially, Justice Fournier, J.C.Q., concluded that ARQ was not precluded from raising the sham doctrine and/or the GAAR. Nonetheless, the Court rejected the allegation of sham and the application of Québec GAAR.

The argument of sham must fail

ARQ put forth the argument regarding sham at the judicial stage but never at the audit or objection stage. In the absence of factual assumptions or presumptions, ARQ bears the onus of proving, on a balance of probabilities, the facts that support its sham argument. The evidence administered by ARQ did not convince Justice Fournier, J.C.Q., of sham, on a balance of probabilities. To the contrary, the Court found that the evidence set forth by Petitioner clearly demonstrates that the respected the rights and obligations arising from the acquisition and disposal transaction by the parties and reflect their common intention, thus Petitioner was not deceitful and the allegation of sham must fail.

According to the Court, the interpretation of the true legal effects of the Share Purchase Agreement and Share Repurchase Agreement that raised questions for ARQ. In the absence of any element of deception, a divergent interpretation of the legal effects of transactions between parties does not make these transactions a false pretense or sham. Furthermore, Justice Fournier, J.C.Q., highlighted that the parties to the transactions, even for U.S. tax purposes recognize that the repurchase transaction is formally structured, as a sale of the U.S. preferred shares. The Court agreed with the Petitioner’s uncontradicted expert report and concluded that in the absence of the principle of "substance over form", which does not apply in Canada or in Québec, “[…] sale and repurchase transactions do not constitute an acquisition of shares for U.S. tax purposes.” In other words, dealing with a purchase and sale of shares both in Canada and the U.S., is only by considering the principle of "substance over form,” that it would be possible to conclude for the purposes of U.S. taxation that KQI holds a debt secured by the shares of KONE USA and whose debtor is KONE B.V. This does not apply in Canada or Québec, therefore, such characterization under the U.S. “substance over form” tax doctrine did not detract from the “actual legal obligations agreed to between the parties in Canada and Québec.”

In the absence of abuse, the application of Québec GAAR must fail

The Québec Court rejected the application of the Québec GAAR, as the element of abuse required for section 127.6 of the Québec TA to apply had not been established. Although the Court concluded to a tax benefit, it was not convinced that the transactions were undertaken or arranged primarily for purposes other than obtaining the tax benefit. Moreover, the Court agreed with Petitioner that ARQ is attempting to use the Québec GAAR to re-characterize a legitimate transaction with *bona fide* non-Québec tax purposes, because it prefers a different tax treatment than the one achieved by Petitioner.

The Court concluded that the acquisition and disposal transaction and the resulting tax advantage is consistent with the purpose and spirit of section 127.6 of the Québec's *Taxation Act*. Therefore, the existence of an abuse cannot be established. In rejecting the Québec GAAR application, Justice Fournier, J.C.Q., noted:

> "The purpose of this measure is to prevent the export of income and preclude Canadian corporations from using their capital outside of Canada by way of loans or advances, without a reasonable interest rate and remain unpaid for more than one year." [unofficial translation], which was not the case at bar.

Borden Ladner Gervais LLP was trial counsel to Kone Inc. in this matter. For further details, please contact the authors listed below or any other member of BLG's Tax Group.

[1] *Kone inc. c. Agence du revenu du Québec,* 2022 QCCQ 9892, subject to appeal, the time for which has not yet expired.

By

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