ACQUISITIONS OF CONTROL

AND

THE EFFECTIVE USE OF CORPORATE LOSSES

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I. INTRODUCTION

Corporate losses are valuable to the extent that it can be used to reduce the taxable income of a business. It has been a long standing principle that a taxpayer is permitted to arrange his or her affairs to minimize taxes.[1] Applying this principle, a corporation with a profitable business (the "Profitco") may acquire a corporation with losses from an unsuccessful business (the "Lossco") so that Lossco's losses may offset the income generated by Profitco. However, certain provisions in the *Income Tax Act* (Canada) (the "ITA")[2] specifically restrict the utilization of losses in this way, depending on whether there has been an acquisition of control of the Lossco or whether there has been a transfer of property outside an affiliated or related group.

This paper discusses the following topics:

1. when is the control of a corporation acquired and consequences of such acquisition of control; and
2. effective loss utilization techniques by a corporate group.

II. ACQUISITIONS OF CONTROL

The loss restriction rules in subsections 111(4) to (5.5) and the rules on a deemed year end in subsection 249(4) are triggered when the control of a corporation[3] has been acquired by a person or group of persons.[4] The ITA does not define "control" or "group of persons"; therefore, their common law meanings are considered and applied.

This section discusses the following topics:

1. the common law meanings of "control" and "group of persons";

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[1] *Inland Revenue Commissioners v. Duke of Westminster*, [1936] AC 1 (HL).
[2] All references herein refer to the *Income Tax Act* (Canada).
[3] The loss restriction rules have been extended to apply to trusts in the 2013 Federal Budget, to be effective on or after March 21, 2013. This paper focuses on the utilization of losses by corporations. For loss restriction rules concerning trusts and the acquisition of control of trusts, see also section 251.2. The rules concerning trusts are not discussed in this paper.
[4] A change of control will not necessarily result in an acquisition of control.

2. when do subsections 256(7), 256(8), and section 256.1 deem the control of a corporation to have been acquired and not acquired; and

3. the loss restriction rules resulting from an acquisition of control.

A. COMMON LAW

i. The meaning of "control"

"Control" for the purposes of subsections 111(4) to (5.5) and the rules on the deemed year end in subsection 249(4) is *de jure* control (not *de facto* control[5]), which is not defined in the ITA.

De jure control is held by person(s) with "effective" control of a corporation – this usually means the control by the shareholders who carry sufficient votes to elect the board of directors.[6] However, *de jure* control can rest with shareholders who do not have the power to elect the board of directors if they have the power to vote for all other corporate activities since these shareholders would have effective control of the corporation.[7]

The determination of *de jure* control includes an examination of the corporation's share register and constating documents, including any unanimous shareholders' agreements which may restrict the directors' powers.[8]

ii. The meaning of "group of persons"

Determination of whether a group of persons controls a corporation is only made if such company is not controlled by a single person.[9] In order for there to be control by a group of persons, "there must be a common link or interest between members of a group, or evidence that they act together in order for control to be determined."[10] This could depend on an agreement among the group of persons to vote their shares jointly, an agreement or evidence to act in concert to control the corporation, or facts about a particular business or family relationship.[11]

B. SUBSECTIONS 256(7) AND 256(8)

[5] *De facto* control applies when the ITA uses the expression "controlled, directly or indirectly in any manner whatever" as defined in subsection 256(5.1).
[6] *Buckerfield's Ltd. v. MNR*, 64 D.T.C. 5301 (Can. Ex. Ct.) (1964).
[7] *Donald Applicators Ltd. v. MNR*, 71 D.T.C. 5202 (SCC) (1969).
[8] *Duha Printers (Western) Ltd. v. R.*, 98 D.T.C. 6334 (SCC) (1998).
[9] *Southside Car Market Ltd. v. R.*, 82 D.T.C. 6179 (FCTD) (1982).
[10] *Silicon Graphics Ltd. v. R.*, 2002 D.T.C. 7112 (FCA) at para. 55 ("*Silicon Graphics*").
[11] *Silicon Graphics* at para. 36.

Subsection 256(7) sets out instances where the control of a corporation is deemed to have been acquired and not have been acquired for particular provisions of the ITA, including the loss restriction rules in section 111 and the deemed year end in subsection 249(4). This affects the corporation's loss utilization techniques.

For example, subsection 256(7) deems an acquisition of control to have taken place in certain reverse takeover situations.[12] Subsection 256(7) also deems an acquisition of control not to have taken place when:

1. a person acquires shares from a related person, from a corporation related to a person, as a result of becoming an executor of an estate, or receiving shares from an estate from the death of a person related to a person;[13] and
2. on an amalgamation if the persons that control the amalgamated corporation controlled the predecessor corporations.[14]

In determining whether an acquisition of control has taken place, subsection 256(8) further restricts loss utilization techniques by deeming an option to acquire shares under paragraph 251(5)(b) to have been exercised for the purposes of section 111 and subsection 249(4).

C. SECTION 256.1

Section 256.1 is an anti-avoidance rule introduced by the 2013 Federal Budget to be applicable to transactions occurring on or after March 21, 2013. This provision deems that an acquisition of control has taken place when more than 75% of the FMV of a corporation's shares are acquired by a person or a group of persons.[15] Accordingly, this provision appears to extend the application of the loss restriction rules in section 111 by relying on a concept of control that is beyond the traditional application of *de jure* control.

In introducing section 256.1, the Minister of Finance gave an example of the type of transaction this section is intended to prevent:

> …a profitable corporation (Profitco) transfers, directly or indirectly, income-producing property to an unrelated corporation

[12] Paragraph 256(7)(c).
[13] Subparagraph 256(7)(a)(i).
[14] Paragraph 256(7)(b).
[15] Subsections 256.1(2) and (3)

> with loss pools (Lossco) in return for shares of Lossco. Profitco seeks to avoid acquiring control of Lossco because that would result in restrictions being imposed on the subsequent use of those loss pools. Profitco acquires shares of Lossco that represent more than 75% (often greater than 90%) of the fair market value of all Lossco's shares, but that – in order to avoid an acquisition of control and the attendant tax consequences – do not give Profitco voting control of Lossco. Lossco uses its loss pools to shelter from tax all or part of the income derived from the property. Lossco then pays Profitco tax-free inter-corporate dividends.[16]

If section 256.1 applies:

1. an acquisition of control is deemed to have occurred for the corporation and each corporation controlled by the corporation;[17] and
2. for each corporation for which there is a deemed acquisition of control above (and any corporation that is subsequently formed and controlled by such corporation), that corporation is deemed not to be related to, or affiliated with, any persons to which it was related to, or affiliated with, immediately before the deemed acquisition of control.[18,19]

The deemed acquisition of control in subsection 256.1(3) is triggered when all the conditions in subsection 256.1(2) below are satisfied:

1. a person or members of a group of persons owns more than 75% of the FMV of all issued shares of a corporation;[20,21,22,23]
2. that person or group of persons does not control the corporation;[24] and
3. objectively, one of the main purposes that person or group of persons does not control the corporation is to avoid the application of specified provisions.[25]

Effectively, section 256.1 restricts many arm's length loss utilization techniques that were previously available to corporations.

[16] Federal Budget 2013, Supplement Information, March 21, 2013: *Corporate Loss Trading.*
[17] Paragraph 256.1(3)(a).
[18] Paragraph 256.1(3)(b).
[19] This effectively "quarantines" a corporation by prevent affiliated loss utilization techniques with this corporation.
[20] Subsection 256.1(1) definition of a "person" includes a "partnership".
[21] In determining FMV, the person or group of persons is deemed to have exercised any outstanding options, warrants or other rights pursuant to paragraph 256.1(4)(b).
[22] If the corporation (usually the Lossco)'s shares have no FMV, subsection 256.1(5) deems the corporation to have net assets of $100,000 and income of $100,000 for the purposes of the 75% FMV determination.
[23] If it is reasonable to conclude that one of the reasons a transaction has occurred is to avoid 75% of the FMV from being acquired, then such transaction will be disregarded pursuant to paragraph 256.1(4)(a).
[24] Control refers to *de jure* control (not *de facto* control).
[25] Specified provisions defined in subsection 256.1(1) include the loss restriction rules in subsections 111(4) to (5.3).

D. RESULTS OF ACQUISITIONS OF CONTROL

When the control of a corporation has been acquired by a person or group of persons, restrictions on loss utilization arise to prevent arm's length transfers of losses when the original business of the corporation (prior to the acquisition of control) discontinues (i.e., a "loss restriction event" has occurred upon an acquisition of control). Another consequence of an acquisition of control is that, pursuant to subsection 249(4), the taxation year of the corporation is deemed to end immediately before the time that control is acquired and a new taxation year is deemed to begin at that time.

Below are some of loss utilization restrictions in subsection 111 that arise upon an acquisition of control:

i. Expiration of net capital losses: Net capital losses cannot be carried back or carried forward.[26]

   Where the adjusted cost base (the "ACB") of non-depreciable capital property of a corporation exceeds the fair market value (the "FMV") of such property immediately before the time that control of the corporation is acquired, such excess is required to be deducted from the ACB of that property.[27] The excess is deemed to be a capital loss of the corporation for its taxation year that deemed to end immediately before the acquisition of control.[28]

   A corporation can designate, immediately before the acquisition of control, a deemed disposition of a capital property.[29] This designation could, for example, be made to generate a capital gain to offset capital losses that cannot be carried forward into the post-acquisition period or to generate a capital dividend to be paid before control of the corporation is acquired by another person or group of persons.[30] This effectively uses the expiring net capital losses to increase the cost base of the designated capital properties after acquisition of control.

ii. Non-capital losses: Non-capital losses can only be carried back and carried forward after an acquisition of control if all of the following conditions are satisfied:[31]

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[26] Paragraphs 111(4)(a) and (b).
[27] Paragraph 111(4)(c).
[28] Paragraph 111(4)(d).
[29] Paragraph 111(4)(e); the designation in paragraph 111(4)(e) can include a depreciable capital property, but such designation only applies to properties other than ones to which paragraph 111(4)(c) or subsection 111(5.1) apply.
[30] The proceeds from the deemed disposition of the property may be any amount designated by the corporation that is neither less than the ACB of the property nor greater than its FMV immediately before its deemed disposition.
[31] Subsection 111(5).

(a) the loss was from carrying on a business;[32,]

(b) that business continued to be carried on for profit or with a reasonable expectation of profit throughout the year;[33,34] and

(c) the losses are applied against income from the same or similar business.[35]

Case law shows that there is great uncertainty as to when the threshold required to be considered as "carrying on a business" under subsection 111(5) is met after an acquisition of control. In a 2013 case that examined such threshold,[36] the federal court of appeal held that the subsection 111(5) threshold for carrying on a business was not met because the purchaser corporation (the "Profitco") of Telepanel electronic shelf labels had ended, even though Profitco used the technology on other applications, retained two former employees of the target company (the "Lossco"), collected income (although minimum) from the business, maintained an equipment inventory from the Lossco's business, and was ready to provide technical support (although none was utilized). This ruling departed from previous case laws that set a lower threshold for considering whether the post-acquisition-of-control corporation is carrying on a business for the purposes of subsection 111(5).[37]

iii. Depreciable property: When the undepreciated capital cost (the "UCC") of a class of depreciable property exceeds the FMV plus the capital cost allowance (the "CCA") or the terminal loss of such property for the taxation year that deemed to have ended immediately before the acquisition of control, subsection 111(5.1) forces the corporation to claim the difference as CCA.[38,39] This forces a write-down of depreciable property to its fair market value at the time of acquisition of control.[40]

III. EFFECTIVE USE OF CORPORATE LOSSES

[32] Paragraph 111(5)(a).
[33] Subparagraph 111(5)(a)(i).
[34] The factors that the CRA considers in determining whether "that business" continues to be carried on is described in IT-302R3 at para. 14: "(a) location of the business carried on before and after the acquisition of control, (b) nature of the business, (c) name of the business, (d) nature of income-producing assets, (e) existence of a period or periods of dormancy, (f) extent to which the original business constituted a substantial portion of the activities of the corporation in the allocation of time and financial resources…"
[35] For CRA's administrative position, see IT-206R (Separate Businesses) at para. 5 and IT-302R3 (Losses of a Corporation – The Effect that Acquisition of Control, Amalgamations, and Windings-Up have on their Deductibility – After January 15, 1987) at para. 14.
[36] *NRT Technology Corp. v. R.* 2012 TCC 420 aff'd 2013 FCA 221.
[37] See, for example, *Garage Montplaisir Carland (Niagara) Ltd. v. MNR*, 2000 D.T.C. 6216 (FCA).
[38] Subsection 111(5.1). This write-down is on a class-by-class basis (not an aggregate basis).
[39] The non-capital losses arising out of the subsection 111(5.1) forced write-down may be utilized after an acquisition of control if the loss-streaming rules in subsection 111(5) are satisfied.
[40] Prior to 2017, subsection 111(5.2) applied to eligible capital property. The eligible capital property category was eliminated by the Federal Budget 2016 and replaced with a new CCA class, Class 14.1. Subsection 111(5.2) was since repealed.

Within a corporate group, it is inefficient for one corporation to pay income taxes while another corporation has unutilized losses; however, the ITA does not have a formal system of corporate group taxation that allows loss consolidation within a corporate group.

While it has been the Canada Revenue Agency's (the "CRA"'s) position that loss utilization within a related (but not affiliated) corporate group is permitted and is not an abuse of the ITA under s.245(4);[41,42] stop-loss rules in the ITA[43] prevents the transfer of property with a "pregnant loss" within an affiliated group.

Section 251.1 sets out the rules concerning how persons are affiliated within a corporate group. For individuals, affiliated persons are the individual's spouse or common law partner.[44,45] For corporations, affiliation is determined by, among other things, the *de facto* control (not *de jure* control) of the corporations.[46]

A. UTILIZATION OF CORPORATE LOSSES

Below is a non-exhaustive list of effective loss utilization techniques.

i. The amalgamation of a Profitco with Lossco pursuant to subsection 87(1) allows Profitco to utilize the non-capital and net capital losses of Lossco;[47] provided however, if the amalgamation results in an acquisition of control, the net capital losses are lost and the use of the non-capital losses is restricted pursuant to subsection 111(5).[48]

ii. The winding-up of Lossco into Profitco pursuant to subsection 88(1) allows Profitco to utilize the non-capital and net capital losses of Lossco;[49] provided however, if the winding-up results in an acquisition of control, the net capital losses are lost and the use of the non-capital losses is restricted similar to subsection 111(5).

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[41] *Income Tax Technical News No. 9* (February 10, 1997) for affiliated (but not related) groups.
[42] Loss consolidation within related (but not affiliated) group is not abusive – see TI 2009-0332571R3.
[43] Subsections 40(3.3) to (3.6).
[44] Paragraph 251.1(1)(a).
[45] "Related persons" include the individual's children and siblings. However, the concept of "related persons" is broader than "affiliated persons" and not all "related persons" would not be considered "affiliated persons".
[46] The definition of "controlled" in subsection 251.1(3) means "controlled, directly or indirectly in any manner whatever."
[47] Subsection 87(2.1).
[48] Paragraph 256(7)(b) deems when acquisition of control is acquired on amalgamation.
[49] Subsections 88(1.1) and 88(1.2).

iii. Transfer of Profitco's profitable business to Lossco on a subsection 85(1) tax-deferred basis to utilize Lossco's non-capital losses.[50]

iv. Transfer of Profitco's appreciated asset to Lossco on a subsection 85(1) tax-deferred basis before a sale to a third party to utilize Lossco's losses.[51,52,53]

v. Transfer of Lossco's appreciated asset on a taxable basis to Profitco in exchange for an interest bearing promissory note to utilize Lossco's losses.[54] This would result in a step-up in the ACB of the appreciated asset on the transfer. Furthermore, Profitco could claim an interest deduction on interest paid on the promissory note and CCA if the appreciated asset is depreciable property.[55,56,57] Alternatively, Profitco could lease the appreciated asset back to Lossco.[58]

vi. Lossco can charge intercorporate fees (e.g., management fees) or lease property to Profitco. Lossco can use its non-capital losses to shelter the income received from Profitco and Profitco receives a deduction.[59]

vii. If Lossco has expiring non-capital losses,[60] it should not claim discretionary deductions,[61]—consider selling assets not required to a third party or capitalize interest expenses.[62]

viii. Preferred Share / Loan Transaction: This is a common technique to utilize non-capital losses in a subsidiary Lossco by a Profitco parent. The steps involved are generally as follows:

(a) Profitco takes out a daylight loan to subscribe for preferred shares in a related Lossco;[63]

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[50] The elected amount pursuant to subsection 85(1) would be at the UCC of the profitable business to avoid recapture.
[51] Lossco's capital and non-capital losses could be used to offset the gain on the sale to the third party and Lossco's non-capital losses could also be used to offset any recapture.
[52] A review of subsection 55(2) is required to ensure that any dividends received as part of this series of transactions are not recharacterized as capital gains.
[53] Subsection 69(11) is unlikely to apply to the tax-deferred transfer of Profitco's appreciated asset to Lossco since Profitco and Lossco are affiliated.
[54] Lossco's capital and non-capital losses could be used to offset the gain on the sale to Profitco and Lossco's non-capital losses could also be used to offset any recapture.
[55] This technique is more effective if the appreciated asset does not generate significant income resulting in taxes payable by Profitco.
[56] Paragraph 13(7)(e) may limit the write-up of CCA for Profitco.
[57] Assuming the appreciated asset was acquired by Profitco to produce income from property or business and therefore eligible for interest deduction under paragraph 20(1)(c).
[58] The leaseback would be more effective if the CCA claimed offsets the rental income.
[59] Section 67 requires that the payment of fees must be reasonable in order for Profitco to get a deduction.
[60] Non-capital losses can be carried forward 20 years under paragraph 111(1)(a). Net capital losses can be carried forward indefinitely.
[61] For example, CCA or reserves.
[62] Section 21.
[63] The preferred shares of Lossco should have a dividend rate in excess of the interest rate charged on the day-light loan at least by 0.1% to satisfy the paragraph 20(1)(c) income earning test.

(b) Lossco lends the proceeds from the share subscription back to Profitco with interest equal to the daylight loan (the "Lossco Loan");

(c) Profitco uses the Lossco Loan to repay the day-light loan;[64] and

(d) when Lossco's non-capital losses are fully utilized, Lossco redeems the preferred shares and Profitco uses these proceeds to repay the Lossco Loan.

As a result of the above transactions, the Profitco parent receives tax-free dividends on the preferred shares of Lossco that it holds. It uses these dividends to pay interest on the Lossco Loan and receives an interest deduction on the interest it pays. Lossco shelters the interest income it receives with its non-capital losses.[65,66,67,68]

B. LOSS RESTRICTION RULES

The loss restriction rules as described below prevents the transfer of property with a "pregnant loss" within an affiliated group. The loss is kept suspending in the transferor's hands, and can be claimed upon a "triggering event", i.e., once the property is no longer in the affiliated group.[69]

i. Subsections 40(3.3) to (3.6) set out rules applicable to non-depreciable capital property. These rules deem the corporate transferor's loss to be nil and suspended until a triggering event.[70]

ii. Subsection 13(21.2) sets out parallel rules applicable to depreciable capital property.[71] These rules deem the transferor to have disposed of the depreciable capital property for proceeds equal to the lesser of (1) the transferor's capital cost of the transferred property and (2) the amount that the UCC exceeds the FMV of the property. The transferor is deemed to continue to hold a notional depreciable property with a capital cost equal to the amount of the deferred loss. The transferee can claim CCA on the difference between the tax cost and the actual

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[64] The interest paid by Profitco on the Lossco Loan is deductible pursuant to subsection 20(3) which deems the Lossco Loan to have been incurred to acquire the preferred shares of Lossco.
[65] The CRA has confirmed this is an acceptable loss utilization strategy – see *Income Tax Technical News No. 30* (May 21, 2004).
[66] To ensure Profitco gets a paragraph 20(1)(c) interest deduction, the dividend rate on the preferred shares should exceed the interest rate on the Lossco Loan by at least one basis point.
[67] The interest rate on the Lossco Loan must be commercially reasonable.
[68] Importing foreign losses are not permitted.
[69] Pursuant to paragraph 40(3.4)(b), a triggering event includes: (1) after a 30-day period where neither the transferor nor a person affiliated with the transferor owns the property; (2) when the transferor ceases to be a Canadian resident and there is a deemed disposition; (3) acquisition of control of the transferor; or (4) windup of the transferor corporation (except for a windup of a wholly-owned subsidiary).
[70] *Ibid.*
[71] Subsection 13(21.2) did not apply to a trust before 2013; see now section 251.2. Parallel stop-loss rules in subsections 18(13) to (16) apply to certain inventory, which is beyond the scope of this paper.

> proceeds of disposition. If a triggering event occurs,[72] the transferor can then claim a terminal loss.

Furthermore, if the transferor disposes of an appreciated property on a subsection 85(1) tax-deferred basis to an unaffiliated Lossco to shelter the capital gain from the subsequent sale of the property to an arm's length third party within three years, subsection 69(11) deems the transferor to have disposed of the appreciated property at FMV on the initial transfer (i.e., subsection 85(1) does not apply to the initial transfer). However, subsection 69(11) would not apply if the initial transfer of the appreciated property was to an affiliated Lossco.

IV. CONCLUSION

The ability for a corporation to utilize its loss depends on whether there has been an acquisition of control of that corporation. Upon an acquiring control of a corporation, its non-capital losses are generally expired and the use of its non-capital losses are generally restricted.

The policy behind the loss restriction rules upon an acquisition of control is to deny the utilization of certain tax deductions or losses realized prior to the time control was acquired, because those deduction and losses belong to a different economic unit. While it prevents the trading of losses, the policy also allows and promotes the efforts to sustain or revive failing businesses by permitting the utilization of business losses following an acquisition of control only to the extent that the loss business is carried on with a reasonable expectation of profit after the acquisition of control. There are effective ways to utilize losses within a corporate group; however, the loss restriction rules would suspend the utilization of such losses until a triggering event. Furthermore, the anti-avoidance rules applicable to transactions after March 20, 2013 significantly restrict many loss utilization techniques that were previously available to corporations.

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[72] *Ibid.*