# When Is "Loss Trading" Permissible? A Purposive Analysis of Subsection 111(5)

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## Abstract

This paper describes the tax policy rationale for allowing arm's-length loss trading in specific circumstances, notwithstanding a general policy against such transactions. It also provides a framework for analyzing whether a target corporation's preacquisition operating losses should be available following an acquisition of control, pursuant to the provisions of subsection 111(5) of the Income Tax Act. Some of the transactional issues that should be considered when value is ascribed to a target corporation's non-capital losses are also surveyed.

**Keywords** Acquisition of control; loss carryover; losses; operating losses; tax policy.

## Introduction

> *[T]he general policy of the* Income Tax Act *is against the trading of non-capital losses by corporations, subject to specific limited circumstances.*
>
> *OSFC Holdings Ltd. v. Canada*
> (Federal Court of Appeal; emphasis added)

It is not unusual, in a difficult economy, for accrued tax losses (most notably, non-capital losses) to become a significant asset[1] of an operating corporation. Questions arise as to the ability of such a corporation (referred to herein as a "Lossco") to "monetize" its losses. In an era in which tax planning is subject to increased moral scrutiny, such transactions, even if undertaken for sound commercial purposes, may raise the spectre of inappropriate "tax loss trading." One purpose of this paper is to articulate the position that not all tax loss trading is contrary to the policy of the Income Tax Act;[2] in fact, some loss utilization transactions are encouraged and are even beneficial for the fisc.

The quotation from *OSFC Holdings*[3] reproduced above asserts that there is a general policy against arm's-length loss trading.[4] The words "loss trading" do not, however, appear anywhere in the Act; rather, this policy is, for non-capital losses, reflected in the loss-streaming provisions of subsection 111(5).[5] It is equally notable, however, that the Act expressly permits arm's-length loss trading *in specific circumstances.*

To focus the analysis on the specific exception for arm's-length loss trading embedded in subsection 111(5), the discussion herein contemplates the scenario where there has been an "acquisition of control"[6] of a Lossco with significant preacquisition non-capital losses.[7] In that context, the focus of the paper is to articulate the policy rationale for allowing arm's-length loss trading in specific circumstances and to provide a framework for analyzing whether a Lossco's preacquisition operating losses should be available following the acquisition of control. Finally, the paper offers a survey of some of the transactional issues that should be considered when value is ascribed to a Lossco's non-capital losses.

## Overview of Subsection 111(5)

Subsection 111(5) provides that, following an actual or deemed acquisition of control,[8] a corporation's preacquisition non-capital losses are deductible in taxation years after the acquisition only if

1) the losses may reasonably be regarded as arising from the carrying on of a business (referred to herein as "the loss business"); and
2) the loss business[9] is carried on, throughout the tax year during which the deduction is claimed, by the corporation for profit or with a reasonable expectation of profit.

Subsection 111(5) imposes an "all-or-nothing" approach: no loss carryforward is allowed unless the loss business is continued during the particular tax year or years in which such losses are claimed. If and only if this requirement is satisfied, subsection 111(5) goes on to provide that the losses can be deducted, but only to the extent of income

1) from the loss business, or
2) where properties were sold, leased, rented, or developed or services were rendered in the course of carrying on the loss business, from any other business substantially all of the income of which was derived from the sale, leasing, rental, or development, as the case may be, of similar properties or the rendering of similar services.

The second prong of this test is often referred to as the "same or similar business" test.

Where the requirements of subsection 111(5) are satisfied, the indirect transfer of non-capital losses to a purchaser is permitted through the acquisition of equity interests in a Lossco, although the losses are never "traded" in the sense that they remain with the Lossco or a predecessor by way of amalgamation or windup. That losses can be indirectly transferred between arm's-length parties indicates some tolerance for the indirect monetization of tax losses. The reasons for this are discussed below.

The thrust of subsection 111(5) is clear—non-capital losses can be used post-acquisition of control only if there is a continuity of the loss business—but the application of the test is ambiguous. For example, the text of the provision is unclear as to whether the term "business" (that is, the loss business) refers to the particular operation (specific assets, location, employees, etc.) or whether it describes the type of endeavour. Since the provisions of the Act are to be interpreted using a unified textual, contextual, and purposive approach to find a meaning that is harmonious with the Act as a whole,[10] it is necessary to understand both the legislative purpose and the context of the loss business continuity requirement in subsection 111(5) in determining whether the requirements of that provision will be satisfied in any particular case.

## Legislative Policy

Subsection 111(5) is part of the Act's regime governing corporate losses, which includes rules denying the refundability or transferability of losses generally, specifying the prima facie entitlement of a corporate taxpayer to loss carryovers, providing specific limitations applicable in the context of an acquisition of control, and encouraging economic risk taking. The regime is an attempt to balance the following competing policy concerns, each of which is described further below:

- Full transferability of tax losses is undesirable because of the deleterious impact on government revenues and the possibility of encouraging transactions motivated primarily by tax, rather than commercial, advantages.
- At the same time, preserving the ability of a corporate taxpayer to utilize its losses is essential in properly measuring income on a multiyear basis and enhancing the level playing field of the tax system.
- Restrictions on the utilization of preacquisition-of-control losses following an acquisition of control and the corresponding change of shareholders is based on a (possibly outdated) notion that a corporation is an intermediary for its shareholders.
- It is recognized that economic risk taking should be encouraged, including the investment risk inherent in the process of making a loss business profitable when such investment arises from new ownership.

### Non-Refundability and Non-Transferability of Losses

The Act contains no system for the direct monetization of tax attributes; a corporate taxpayer is not entitled to "sell" its losses. It has been argued that losses should be freely tradable, since that would ensure that the benefit of the losses would accrue to the true participants (the shareholders of the corporation) who suffered the burden. The American Law Institute has, for example, argued that "unfettered trafficking" in losses may actually serve a positive good by distributing tax benefits where they belong.[11] If a corporation (or its shareholders) has incurred losses through the investment of funds in its business, why does the corporation not have the right to recoup a portion of its investment by selling the loss to others through an appropriate market transaction? The answer to this question rests, in part, in a policy decision as to the extent to which the government should share in the losses as well as the profits of a business.

The issue has been the subject of considerable governmental[12] and academic study. Some commentators[13] suggest that losses should be refundable to the taxpayer in the same way that profits are taxable, so as to ensure neutrality of the tax system. Full refundability of losses would mean that, when a loss was incurred, the government would provide a refund or offset equivalent to the tax value of the loss, thus treating annual losses and profits symmetrically. Given that a lack of refundability may deter corporations from making risky investments because the prospect of tax reduces profits without equally mitigating anticipated possible losses, it has been recognized that allowing such refundability could improve competitiveness and market efficiency and eliminate discrimination against more risky businesses that have greater volatility in earnings.[14]

While many economists regard full refundability of losses as the most conceptually pure treatment, the approach has been rejected by the governments of most, if not all, countries owing to its fiscal implications. In particular, such an approach has been described as offering an inappropriate incentive for inefficient businesses, creating the potential for abuse, and resulting in an "unacceptable loss of revenue to government."[15] This concern is significant when one considers that the Department of Finance, in 2008, estimated that Canadian corporations had access to over $206 billion in unutilized non-capital losses.[16]

Accordingly, losses are generally non-refundable. A corollary of this is that the only person who should be entitled to benefit from a tax loss is the person who suffered the associated economic loss. Thus, because the corporation is a stand-alone unit for taxation purposes, it is not permitted to transfer losses.

## Treatment of Losses Generally

Acknowledging that the government should provide some credit to taxpayers who have suffered losses, the Act permits business losses to be taken into account in determining income for prior or subsequent taxation years. This general policy to permit loss use subject to specific restrictions was acknowledged in *Landrus* as follows:

> [W]here there is a general provision in the Act allowing for the deduction of a loss, subject to a restriction or exception in certain circumstances, the limited nature of the exception can be seen as *underscoring the general policy of the Act to allow the loss.*[17]

The basic rule for utilizing non-capital losses is found in paragraph 111(1)(a), which provides that, absent an acquisition of control, non-capital losses can be deducted to offset income earned in the year or during the permissible carryforward (20-year) or carryback (3-year) period. In this way, losses are available to shelter income from one business against profits from the same or any other business or property—that is, there is no streaming of losses to a particular business[18]—and relief is provided to taxpayers whose income or loss fluctuates from year to year.

The permissibility evident in paragraph 111(1)(a) has itself evolved.[19] Until 1942, no rules existed to permit losses incurred in one year to be carried over to other years. In 1942, the precursor to paragraph 111(1)(a) permitted the deduction of losses incurred in one year in the following year only if the taxpayer carried on "the same business" in both years;[20] the carryback period was extended in 1944.[21] The relaxation of the "same business" requirement began in 1958 pursuant to amendments permitting losses to be applied to reduce income from other businesses,[22] at the same time as the enactment of the precursor to subsection 111(5).[23] That provision retained the "same business" requirement where more than 50 percent of the shares of the corporation had been acquired by persons who were not shareholders of the corporation in the year in which the loss was incurred.

Viewing the loss deductibility rules in this historical context, it becomes evident that, as paragraph 111(1)(a) was amended to permit greater flexibility in the use of losses from prior years, subsection 111(5) was introduced to curtail that flexibility in a specific context, namely, where there was a significant change of shareholders. The basis for this restriction seems to be the view taken on the "ownership" of corporate losses.

## "Ownership" of Corporate Losses

Adopting the policy that the benefit of any tax loss ought to be restricted to the persons who suffered the associated economic loss raises the related issue of identifying the true owner of corporate tax losses. While a corporation is an independent taxable unit, its losses have long been viewed as, in a sense, "belonging" to the corporation's shareholders, on the basis that the corporation is an intermediary acting for its shareholders.[24]

Whether the notion that a corporation is an intermediary for its shareholders is appropriate in today's marketplace of widely held and freely tradable public corporations is debatable, but this policy decision appears to have been firmly made, and it seems unrealistic to expect any revision of such view in the loss utilization context. It follows that losses should not normally be claimed by the corporation after a significant change of shareholders, on the basis that the former shareholders, who bore the economic costs of the losses, are no longer participants in the corporation's affairs.[25]

The precursor to subsection 111(5) that was introduced in 1958, at the same time as the scope of paragraph 111(1)(a) was expanded, utilized an aggregate-change-in-shareholdings test. An acquisition-of-control test was added in 1963,[26] and the aggregate-change-in-shareholdings test was eliminated in 1972.[27] The result, as under current rules, is a loss-streaming provision applicable on an "acquisition of control," but not, however, on a mere significant change of ownership. The acquisition-of-control test has been subject to criticism on the basis that the availability of tax attributes should not be entirely different depending on the change in any particular ownership threshold. Should the restrictions apply merely because of the acquisition of 51 percent of a Lossco's voting shares, but not if there is an acquisition of 48 percent of those shares?[28] The validity of the criticism aside, reliance on the acquisition-of-control threshold appears to be firmly embedded in the legislative scheme, likely as a matter of practicality.

In the early 1980s, to tighten the carryover restrictions further, subsection 111(5) was amended to permit the carryforward of losses only where the loss business was carried on with a reasonable expectation of profit and to limit deductibility of preacquisition losses to the corporation's income from the loss business or a similar business.[29] The loss business continuity requirement serves as a constraint on the "benefit" that can be derived by the shareholders of a Lossco on the sale of their equity interests. On a sale, the former shareholders will be able to obtain value from the preacquisition losses only to the extent that the post-acquisition Lossco can use the losses. In this way, the value that the former shareholders can expect to realize on their shares will, roughly, be based on the prospects of the corporation's existing business or a similar business prior to the acquisition.

## Tax-Avoidance Concerns

The 1963 budget materials surrounding the introduction of the acquisition-of-control test indicate that this measure was intended "to stop the device whereby a company that has experienced losses is purchased for the purpose of applying those losses against income from another business."[30] Similarly, the 1981 budget materials indicate that the 1981 amendments were made in response to "unprofitable corporations becoming targets for takeover bids solely because of tax considerations and not because of the underlying economic profitability of their businesses."[31] Thus, in the absence of any business or financial reasons for a combination, the loss business continuity requirement may serve to preclude a tax inducement to the combination of a Lossco with a profitable business. This is consistent with the general policy behind tax legislation of raising revenues in an economically efficient manner without distorting corporate decision making.

The budget commentary notwithstanding, subsection 111(5) does not incorporate a purpose test. Such inclusion was explicitly rejected by the Department of Finance in the 1980s, largely on the basis that the fisc's concerns with loss-trading transactions existed whether or not the participants had "malevolent intent" and also in recognition that a purpose test might rarely be satisfied, since the main purpose of an acquisition would generally be to acquire a business, with the loss attributes being only an additional factor.[32]

Although subsection 111(5) does not refer to any tax-avoidance concern, this factor has been given significant weight in the jurisprudence. In *Gaz Métropolitain*,[33] the Tax Court stated that the purpose of paragraph 88(1.1)(e) (which is comparable to subsection 111(5)) is to prevent taxpayers from acquiring control of a company more for the tax losses than for the business carried on by it. Similarly, in *Manac*,[34] the Tax Court indicated that, in enacting subsection 111(5), Parliament intended, in part, to prevent companies from speculating in companies with losses.

Arguably, the emphasis on tax purpose in the jurisprudence is not appropriate given the text of the provision. So long as the requirements of subsection 111(5) are satisfied, and absent any analysis under the general anti-avoidance rule (GAAR), losses should be available following an acquisition of control—notwithstanding the taxpayer's motivation for the transaction. That said, it is clear that, at least from a practical perspective, the parties' motivations will be a central factor, and it is beneficial to an acquiror to demonstrate the commercial purpose for the acquisition.

## Encouraging Profitability and Growth

The foregoing policies could be satisfied by a strict denial of loss carryforwards after an acquisition of control, but this is not what the rules provide. Rather, losses can continue to be utilized post-acquisition of control so long as the loss business is continued. This explicit permission is based on two interrelated principles. First, although a loss belongs to the corporation, it also belongs to the business that gave rise to it.[35] Given the rebuttable presumption that a corporation earns income from a business,[36] if a corporation is to have an identity independent of its shareholders, then perhaps such identity is based upon its particular business. Second, it is economically desirable to encourage the revitalization of a loss business, including through an acquisition of control and the replacement of management.[37]

The Department of Finance has acknowledged that the loss business continuity test is "[t]he single major exception" to the policy against loss trading, indicating that this exception is made in an attempt to support the recovery of unprofitable enterprises.[38] The ability to utilize losses post-acquisition offers a period of respite from tax burdens and may be the boost required to support the recovery of a loss business. The nature of the disincentive that could result in the absence of such permission has been explained as follows:

> There are some net-loss corporations for which there is some hope of turning profitable. In some cases a change of ownership might help to effect a turnaround. In the absence of taxes, a prospective purchaser would bid on the basis of what he thought he could do with the business, and if he thought he could do better than the old owners thought they could do, . . . then the corporation would be worth more to the prospective purchaser than to the old owner, and a sale would be likely to occur. If the greater optimism of the

> purchaser has any foundation in fact about his managerial capability, then the change is likely to be socially beneficial.
>
> Disallowance of loss carryovers on a transfer of ownership will distort the operation of this simple market mechanism, however, since a purchaser will have to predict pretax income substantially higher than the old owner predicts in order to achieve the same after-tax return, which is presumably what the bids are based upon.[39]

The acquisition of a loss (or any) business is generally based on the purchaser's being more optimistic than the current holder as to future after-tax income. If losses cannot be carried forward by a purchaser, but can be used by the current vendor, the result is that an acquisition would occur only where the purchaser's predictions of post-acquisition revenue were so much higher than those of the current holder as to compensate for the increased tax burden. In many cases, the result is that a loss business would be worth more to the current holder than to a potential buyer, thus impeding transactions and potential post-acquisition improvements that could be made to the business.

In *OSFC Holdings*, the Federal Court of Appeal acknowledged the commercial objective encouraged by the loss business continuity requirement:

> Where a corporation with unused losses is taken over, and the new managers make the acquired corporation's business profitable, then the acquired corporation's unused losses can be applied against the profits from the formerly unprofitable business, even though the profits were earned after the change of control. In that situation, *the takeover has accomplished the sound commercial objective of making an unprofitable business profitable, and there is no reason why the unused pre-takeover losses should not continue to be available.*[40]

The foregoing demonstrates that the loss business continuity requirement in subsection 111(5) is to encourage making an unsuccessful business profitable. Similar statements were made by the Tax Court in *Garage Montplaisir*[41] and by the Federal Court of Appeal in *Manac*.[42] This is an express recognition by Parliament that economic growth, including job creation or preservation, may be enhanced by providing incentives (or not providing disincentives) for sustaining or reviving a failing business. Permitting a carryforward of losses in these circumstances creates an incentive for the combination of a Lossco with a profitable corporation, since the benefit of the loss carryforward can be realized only if there are future earnings and the combination enhances the chance of fulfilling that condition.

While the Canadian tax literature is largely silent on the reason for the "similar" business restriction, I submit that this requirement reflects a desire to avoid a tax inducement toward uneconomic behaviour. If a loss carryover could be deducted from the profits of an unrelated business so long as the loss business was continued, there would be an incentive to continue the loss business even if it was only marginal to the other business, simply to preserve the benefit of the loss carryover. The ability to use losses only in the same or a similar business arguably prevents this.

## Specific Requirements of the Loss-Streaming Rules

While the requirements of subsection 111(5) are easy to articulate, applying those requirements to specific circumstances can be difficult. Notwithstanding that there are about 35 cases considering subsection 111(5) and its predecessors, the result in most is fact-specific and there are few definitive guidelines.

One source of difficulty in the jurisprudence is the absence of a clear articulation of the purpose of the loss business continuity requirement. While the analysis in any particular case will necessarily be fact-specific, using a purposive analysis of subsection 111(5) should give rise to a more principled approach and help to illustrate the logic that runs through the case law. Applying such an approach would, it is submitted, not usually change the result but would provide a useful predictive tool to determine whether the requirements of subsection 111(5) will be satisfied in any particular circumstance. Many of the leading cases have been discussed in the literature;[43] rather than repeat such discussion, the following portion of this paper attempts to extract the key principles from the case law, having regard to the legislative intent to support the recovery of unprofitable enterprises.

### Identification of the Loss Business

Subsection 111(5) permits the carryforward of non-capital losses after an acquisition of control only where the losses arise from carrying on a business and "that business" (that is, the loss business) is carried on by the taxpayer after the acquisition of control with a reasonable expectation of profit. It is accordingly necessary to identify the loss business. This requirement tends not to be explicitly discussed in the jurisprudence, and has historically been subsumed in the discussion of the loss business continuity requirement, discussed below. However, given that the purpose of subsection 111(5) is to encourage the revitalization and renewed profitability of a loss business, I suggest that the identification of the loss business should take on a greater importance in the judicial analysis.

From a policy perspective, there is clearly a greater chance of reviving a failing business where a taxpayer has the flexibility to change its operations. Given this, the courts should focus on the defining characteristics of the loss business, as opposed to any particular component of its operations. While such reasoning is not explicitly stated, the approach taken in the limited jurisprudence on the point is supportive.

The term "business," as used in subsection 111(5), is not a technical term[44] and is to be given its "normal or popular meaning."[45] In particular, there is a distinction to be made between the "business" of a corporation and the various operations through which the corporation carries on business.[46] As a consequence, identification of the loss business is not necessarily restricted by the location of its operations, management and employees, machinery, or customers at any particular time. Rather, the focus is to identify the "essence" of the business[47] or the long-term "primary purpose" of the corporation's activities.[48] The characterization issue will also depend on factors specific to the industry in question and the expertise of the Lossco's principals. This approach is reflected in the following examples from the case law:[49]

- The loss business was broadly identified as marine construction, rather than being limited to marine construction in a specific location, based upon evidence that marine construction businesses typically operate in various areas throughout the country.[50]
- The loss business was a retail hardware business, rather than the operation of a particular hardware store or the serving of a particular clientele.[51]
- Notwithstanding that the bulk of the corporation's revenues initially came from the conversion of vehicles to natural gas to facilitate future sales, the loss business was found to be the sale of natural gas, given the long-term purpose of the initial activities.[52]
- The loss business was found to be selling clothes, whether those clothes were sold to individuals or to retail and wholesale merchants, and whether they were ladies' clothing or men's and boys' clothing.[53]
- The loss business in relation to real estate can be generically defined. The high-water mark of this concept is reflected in a case where the loss business was determined to be the exploitation of a recreational site, which could encompass both the use of the site as an amusement park preacquisition and the use of the site as a marina and condo development post-acquisition.[54] In another case, the loss business was described as the business of developing property, selling property, and renting property;[55] in yet another, the loss business was found to be land speculation and land development, particularly given that the corporation's principals were experienced and knowledgeable in both elements (and thus were considered to be "savvy real estate operators").[56]
- The loss business was the cutting and processing of timber, lumber, pulpwood, and other forest products, rather than being limited to the cutting and processing of timber,[57] suggesting that a loss business involving production may be described by the generic industry, as opposed to the particular product involved.
- The loss business was the sale of an electronic shelf labelling system used to register and display prices on grocery shelves, but did not extend to the use of that technology in other industries, in the absence of any evidence that other applications had been considered by the Lossco prior to the acquisition.[58]

It will be to the taxpayer's advantage to define the loss business as expansively as possible. This identification necessarily drives the remainder of the analysis:

where the loss business is defined broadly (for example, as manufacturing), there is a greater likelihood that the loss business will be found to be continued, as compared with the case where the loss business is defined narrowly (for example, manufacturing of a certain widget). In other words, whether losses are available post-acquisition of control will often follow from how broadly the court defines the loss business.

Case law suggests that the loss business will be defined broadly and in conventional categories (for example, real estate development or production) so long as the evidence adduced by the taxpayer supports the expansive characterization. As a practical point, potential Losscos should ensure that their business is described in a broad-brushed manner in all public disclosures and in its income tax and financial records. If challenged, it will be incumbent on the Lossco (or its acquiror) to adduce evidence as to the breadth of its preacquisition activities, overall business plan, and long-term goals that supports a broad definition of its business consistent with the industry within which it operates, and that shows that its principals (both pre- and post-acquisition) have the expertise and knowledge to pursue that wide range of activities.

## Continuity of the Loss Business Prior to the Acquisition of Control

Once the loss business has been identified, it is necessary to establish that that business was carried on continuously prior to the acquisition of control. In many cases, the Lossco business will be ongoing with no significant changes from its historical practice, and establishing continuity will not be a practical issue. The issue can arise, however, where the Lossco is in financial distress and its operations have been significantly circumscribed. Where there is insufficient activity to demonstrate the continuance of a loss business, restarting of the business after some time (including after the acquisition of control) will not be sufficient.

The jurisprudence on this issue has focused on the degree and nature of the activity undertaken in the period in question to determine if a business continues. While minimal sporadic activity may not be sufficient to demonstrate the continuance of a business, a period of dormancy or low activity is not necessarily fatal to the analysis unless such low activity is also associated with a sale of the business's assets and the termination of most of its employees.[59] For example, in one case, the retention of uncollectible accounts receivable by an automobile sales business after the disposal of all its inventory, the forfeiture of its dealership franchise, and the discharge of its employees were held to be insufficient to constitute the continuance of a business;[60] however, in other cases, the continued collection of accounts receivable was held to be sufficient where the corporation's business previously consisted of the retail sale of household goods and the collection of money therefor,[61] or where the corporation remained in a position to execute and complete contracts in a manner that was consistent with the loss business's prior operations, including the continued retention of skilled labour.[62] In contrast, the performance of formalities to keep a corporation in existence, such as filing annual information returns, is insufficient,[63] as are minor activities undertaken to preserve long-term goodwill,[64] or the hiring of a single salesman in the absence of any other commercial activities.[65]

The issue of continuance may arise in circumstances where a Lossco is under creditor protection pursuant to the Companies' Creditors Arrangement Act (CCAA) or the Bankruptcy and Insolvency Act (BIA).[66] Paragraph 128(1)(g) provides that, where an absolute order of discharge is granted in respect of a corporation, the corporation's non-capital losses are no longer available for carryforward.[67] Absent such a discharge, the question whether a Lossco's business continues while under creditor protection is determined under general principles.[68] This position is consistent with the purpose of the BIA, which is to provide for an orderly distribution of assets where it is clear that the business can no longer continue, and with the purpose of the CCAA, which is to permit the continuation of normal business operations while restructuring to relieve financial distress.[69]

## Continuity of the Loss Business Following the Acquisition of Control

Once it is established that the loss business has not ceased prior to the acquisition of control, it must then be determined whether the "same" business continues following the acquisition. First, the analysis described above on the degree and nature of the continuing activity must be undertaken to determine whether a business continues. While a short period of low activity is acceptable,[70] the test is broader than the threshold of having a going concern.[71]

With respect to the "same" business requirement, the case law is clear that the requirement is for the "exact same business"[72] to be carried on, rather than just the same type of business.[73] It is this test that should, in my view, be applied having regard to the policy rationale for the loss business continuity test. From a practical perspective, it would be impossible to ever satisfy the requirement if it required continuity of all assets and operations and employment of all personnel. Business is subject to evolution, and to fulfill the legislative purpose of invigorating a loss business to make it profitable, new management needs to have the flexibility to significantly alter aspects of that business, including the integration of the acquiror's existing operations. Not all changes in operations will be fatal; indeed, some are practically necessary. As stated in *Crystal Beach*, "the changes effected demonstrate [the taxpayer's] efforts to enhance those aspects of the business that had been successful while improving those that had not."[74]

Conversely, to give the test any meaning, there ought to be more to the requirement than generic activities in a similar industry. Subsection 111(5) is designed to allow the use of loss carryforwards after an acquisition of control where the transaction encourages the profitability of the loss business. Given this, I suggest that the analysis should focus on whether, post-acquisition, there are sufficient indications that the essence of the loss business continues and that most significant alterations were commercially reasonable efforts to make the loss business profitable. In other words, the same business test in subsection 111(5) should be satisfied where the actions taken post-acquisition are a justifiable attempt to revitalize the loss business.

The focus of the courts to date has been on evidence of the interconnection, interlacing, or interdependence of the various business elements both pre- and post-acquisition—that is, the overlap between the operations of the Lossco prior to the acquisition of control and the operations post-acquisition. Where there is significant overlap, the "same" business has generally been found to continue. There are several judicial and administrative authorities that provide a number of factors and considerations to be taken into account in determining whether a taxpayer continues to carry on the same business following an acquisition of control:

- *The nature of the business activity.* Although not determinative on its own, a finding that a taxpayer's post-acquisition business is of the same nature, kind, or type as the business carried on prior to the acquisition of control is generally a strong indicator that the loss business is continued, particularly if it can be said that the taxpayer "continued to do business as before."[75] As above, consistency in the nature of the business activity is essential to the characterization of the loss business.
- *Services/products/maintenance of customer relationships.* The courts have recognized that, if the structure of a loss business is not maintained, at the very least its production of goods or services should be,[76] even if on a reduced scale. The capacity to perform the same services or provide the same products post-acquisition[77] and evidence of continuous marketing activity[78] have been critical factors. In a situation where the nature of the activities has changed, it is helpful to show that the change was designed to address the needs of the business's clientele and maintain their patronage.[79]
- *Scale of the business.* The courts generally recognize that a business that has sustained losses will likely have to take corrective measures (including a reduction in staff, inventory, and/or operating costs). Furthermore, in any acquisition involving the subsequent integration of two businesses, the staffing needs and asset requirements of the combined entity will be reviewed, and redundancies may arise. For example, in one case, the loss business was found to be continued notwithstanding the disposition of a majority of the fixed assets, the elimination of its administrative office, and the reduction of its permanent personnel from 20 to 2.[80] In another case, the loss business was found to have continued notwithstanding that only 2 of the acquired company's 29 employees were rehired.[81] Where the reduction of scale is due to a reduction in market activity, the taxpayer must be able to show that its approach is more than a passive "wait-and-see" attitude and that its assets and capital are capable of being deployed quickly when market conditions improve.[82]

- *Continuity of income-producing assets.* Some continuity of assets used in the loss business is helpful. For example, courts have held that the test is not satisfied where a Lossco in the building industry is acquired when it has no assets or liabilities, even if building activities are carried on post-acquisition, on the basis that there was no continuity of the activities of the loss business but rather the commencement of a new building business.[83] That said, in contrast to other provisions of the Act that specifically track tax pools to income from particular assets following an acquisition of control,[84] there is nothing in the text of subsection 111(5) to indicate that continuity of assets is necessarily required.
- *Location of operations.* While a change in the location of the business's operations or head office can indicate that the same business is not continued, this factor is not generally afforded significant weight so long as the location of activities was not part of the essence of the loss business.
- *Change of name.* While a change of name is not generally given weight in the analysis,[85] the use of the same name can be helpful where other factors might indicate a different business post-acquisition.[86]
- *Allocation of time and financial resources.* Although not expressly identified as a relevant factor in the jurisprudence, the Canada Revenue Agency (CRA) has indicated that the allocation of time and financial resources to the loss business following the acquisition is a significant factor.[87]

The degree to which changes may be made to the loss business following an acquisition of the Lossco without impairing the ability to utilize preacquisition losses is a question of fact, dependent on the particular circumstances of the business. In general, ensuring continuity of a significant number of employees and substantial assets from the preacquisition operations should demonstrate integration and the continuance of the loss business. Taxpayers are advised to adduce evidence to demonstrate that any changes were intended to enhance the successful aspects of the business, while remediating those aspects that were not as successful. A well-documented business plan where this is evidenced could well prove useful in the fullness of time.

## Reasonable Expectation of Profit

Subsection 111(5) requires both that the loss business continue to be carried on and that it be carried on with a reasonable expectation of profit (REOP). The leading case on this element of the analysis is *NRT Technology*,[88] the facts of which have been described elsewhere.[89] In that case, the Tax Court confirmed that although the REOP test might not apply in the determination of whether there is a source of income, it remains alive and well in the context of subsection 111(5). The court relied on comments in previous cases in articulating the factors to be considered in the analysis.

*NRT Technology* indicates that the following non-exhaustive criteria should be considered:

- profit and loss experience in past years and the persistence of the factors causing the historical losses;
- education, background, and experience of the taxpayer;
- the operational plan of the business and its intended course of action;
- the taxpayer's good faith and reputation;
- the time and energy devoted to the endeavour; and
- the capability of the venture as capitalized to show a profit.

Prior case law has indicated that reasonableness is to be assessed on the basis of all the relevant factors. While the factors are likely to expand over time, the test, at its core, requires a detailed look at the business in the context of its operations to assess whether profitability is reasonable in the foreseeable future, with such analysis being grounded in economic reality. A taxpayer should ensure that it can adduce evidence of its business plans and financial projections, and that the business is appropriately capitalized, with a view to showing that the potential market for the business has expanded or will soon expand, the management team and operational employees have the appropriate technical and commercial expertise, and commercially reasonable efforts are being made to pursue profitable opportunities.

## Same or Similar Business

Once it is established that the loss business has continued post-acquisition with a reasonable expectation of profit, subsection 111(5) goes on to provide that preacquisition losses can be deducted only to the extent of income

1) from the loss business, or
2) where properties were sold, leased, rented, or developed or services were rendered in the course of carrying on the loss business, from any other business substantially all of the income of which was derived from the sale, leasing, rental, or development, as the case may be, of similar properties or the rendering of similar services.

If the taxpayer carries on more than just the loss business, it is necessary to determine whether the other business is "similar."

This second arm of the test requires more than that the businesses be similar: the actual products or services provided must be similar, and substantially all (generally interpreted as 90 percent or more) of the income of the business must be derived therefrom. The CRA has interpreted the word "similar" to mean "of the same general nature or character," but to have a narrower meaning than "having characteristics in common."[90] In *Manac*,[91] the Federal Court of Appeal held that that the test requires a comparison between two similar activities, such that the sale, leasing, *or* development of properties, and not the sale, leasing, *and* development of properties, is required. In that case, the Tax Court held that a "similar business" will exist for the purposes of subsection 111(5) where there are (1) a commercial activity, (2) similar properties, and (3) income. The court suggested in obiter that the "similar" requirement was not satisfied where, prior to the acquisition of control, the taxpayer manufactured and sold one type of property (steel and aluminum panels), and after the acquisition of control that property was incorporated into another type of property (trailers) that was sold.

Where the loss business is integrated into the business of the acquiror, it is unclear whether the similar business test even has to be considered. In such a situation, presumably the income is from the loss business. The decision in *Gaz Métropolitain*[92] has created some uncertainty on the point but is nevertheless generally helpful to the taxpayer. There, the Tax Court observed that where the business of the Lossco has been merged with the business of the acquiror, it is impossible to determine what income is derived from the loss business versus the integrated business; it then becomes necessary to determine whether the income is earned from a business where substantially all of the income was derived from the sale, leasing, rental, or development of property similar to that sold, leased, rented, or developed by the subsidiary or target. The court held that the fact that it was not necessary to create a separate division to operate the loss business activities was evidence of the similarity between the loss business and the integrated business.

On the basis of the foregoing, determining whether one business is "similar" to another for the purposes of subsection 111(5) is a question of fact and law, but so long as the products sold or developed are of the same general nature or character, they should be considered "similar." Furthermore, if the activities of one business can be incorporated into the activities of the other business without creating a separate division, it is more likely that the businesses are similar.

## Transactional Issues

Preserving the potential tax advantages arising from the acquisition of a Lossco raises a different set of issues from other acquisition transactions. The tax-related considerations, generally, of a corporate acquisition have been well canvassed in the literature[93] and will not be repeated here; rather, the following portion of this paper considers key transactional issues that arise where value is being ascribed to tax losses of a target corporation, including, specifically, the allocation of risks associated with the use of such losses post-acquisition.

### Value of Losses

The price to be paid for non-capital losses of a target Lossco will depend on many factors. Anecdotal evidence and limited publicly available materials demonstrate a range of values, from $0.03 to $0.10 per dollar of non-capital losses, indicating that most purchasers will discount the predicted post-acquisition value of the losses. Aside from the valuation issues associated with any share acquisition, the appropriate "value" to be ascribed to non-capital losses will require an analysis of at least the following:

- *Verification of losses.* A first step is the verification of loss balances and an analysis of the factors that contributed to the creation of such balances, through due diligence and/or through representations and warranties. Losses attributable to prior aggressive tax positions taken by the Lossco should be more highly discounted owing to the risk that the losses will be denied when ultimately claimed. While a well-advised vendor may not feel comfortable providing a representation that there have been no "aggressive" positions taken, a higher ascribed value for the losses may be sought in circumstances where the Lossco shareholders are prepared to provide representations as to the quality of the tax losses being acquired.
- *Post-acquisition revenues.* The predicted post-acquisition revenues from the loss business or a similar business and the impact of such revenues on the time to use such losses are also key factors. Losses have diminishing economic value because of the time value of money. A natural consequence of this is that a Lossco that operates in a business sector in which there are many profitable participants can reasonably expect its tax attributes to have more substantial value than a Lossco engaged in a sector in which there are few profitable participants, since in the latter case there would be less demand for the losses[94] and less post-acquisition revenues available to absorb such losses.
- *Risk of legal change.* Perhaps the most difficult factor to evaluate is the scope under current laws for loss deduction post-acquisition and the risk of a change in the law. For example, in the public examples of trust conversions implemented as a unit-for-share exchange using a Lossco (implemented prior to the introduction of paragraph 256(7)(c.1)),[95] the prices reported to be paid for the losses were in the vicinity of $0.055,[96] presumably on the basis that the technical rules, as they then existed, did not preclude the use of the losses post-acquisition. Where significant value is attributable to a Lossco's non-capital losses, consideration may also be given to including a purchase price adjustment in the event that, in the period after signing but prior to closing, the Act is amended, or proposed to be amended, in a manner that would be expected to have an adverse effect on the ability to utilize the loss carryforward balances after the acquisition of control.

## Representations as to Tax Attributes

It is typical in most share acquisitions to obtain a representation from the target corporation that all tax returns required to be filed as of the closing date have been filed, and are true and correct, and that all taxes have been paid in full. It is arguable that such a clause includes by necessary implication a warranty that the non-capital loss balances shown on such returns are accurate. That said, where a portion of the purchase price is attributable to a Lossco's non-capital losses, consideration should be given to the necessity for a specific representation as to the quantum of the Lossco's non-capital losses as of its taxation year ending immediately prior to the acquisition of control.

The provision of such representations necessarily creates a tension between the goal of ensuring that the parties obtain what they bargained for versus concerns about drawing attention to "loss-trading" aspects of the transaction. Since the acquisition of a Lossco for the purpose of reinvigorating the underlying business is encouraged by the legislation, there should, in theory, be no disadvantage to seeking the appropriate representations. This, unfortunately, is not always the case in practice, with some courts having drawn a negative inference from the inclusion of such provisions. For example, although dealing with a transaction structured to avoid an acquisition of control and thus the loss business continuity requirement, in *Birchcliff Energy*,[97] the fact that the target corporation made representations and warranties as to its tax attributes was viewed by the Tax Court as evidence that the transaction was motivated primarily by the Lossco's tax attributes.

Where such a representation is desirable, the challenge is to provide adequate protections to the purchaser, without the Lossco's taking unnecessary or unintended risks. For example, representations that losses are "not less than" a specific number, that the losses are available in the normal course for deduction under paragraph 111(1)(a), that such losses are not restricted by any previous acquisition of control, and that the losses were incurred in the same business as currently operated by the Lossco would all be within the Lossco's knowledge. Such representations should make it clear that the loss balances are calculated as of a particular time (normally, Lossco's taxation year ending immediately prior to the acquisition of control), and such computations should take into account income earned by the Lossco up to such time, including, where applicable, the effect of writedowns under paragraph 111(4)(e) and subsections 111(5.1) and (5.2).

In contrast, neither the Lossco nor its shareholders will be in a position to provide a representation as to the availability of the losses post-acquisition, since satisfaction of the requirements of subsection 111(5) and/or the potential applicability of GAAR are factors outside present management's control; these are risks that should be borne by the purchaser. It may be possible to deal with this latter point by including explicit language that the vendor is making no representation or warranty as to the ability of any person to utilize the losses after the acquisition, except to the extent that such inability arises as a result of a prior acquisition of control or solely as a result of an action taken by the Lossco or its shareholders prior to the closing.

## Survival Period

The accuracy of tax representations and warranties in a public deal is generally a condition of closing, but such representations and warranties will not, subject to limited exceptions, typically survive closing. A representation as to the quantum of non-capital losses is worthwhile, notwithstanding the limited recourse that it provides, if only to ensure that the correct people's minds have been focused on the accuracy of the representation.

In a private deal, it is typical for representations and warranties to be provided by the target corporation's shareholders and to survive closing, thereby providing the purchaser with recourse should it subsequently be determined that any statement was untrue. Typically, the survival of tax-related representations and warranties is tied to the expiry of the reassessment period for pre-closing tax years. Such a survival period can, however, be problematic in the context of representations as to loss balances. In this regard, the normal reassessment periods in the Act do not start with the year in which a loss is realized; rather, absent a loss determination under subsection 152(1.1), the CRA can assess to deny a loss carryforward in any future year when it is claimed, since that future year will not be statute-barred.[98] Since the year in which a Lossco's losses are applied in the future is outside the control of the Lossco's preacquisition management, reliance on the normal reassessment period as the survival period for a representation regarding loss balances can, in practice, amount to an open-ended representation (at least until the expiry of the losses).

As noted above, where the purchaser is providing consideration for loss balances, such consideration will generally account for the estimated time horizon to utilize such losses. In such circumstances, it is not unusual for the parties to agree to an explicit survival period in respect of representations relating to tax loss balances; a survey of the limited public disclosure available indicates a range of six to seven years from closing of the acquisition.

## Damages and Indemnities

Where the shareholders of a Lossco have provided a representation as to the quantum of non-capital losses that survives closing and it is subsequently determined that the actual non-capital loss balances are lower than represented, the purchaser will presumably have recourse to the shareholders for breach of representation. The question then is whether the damages should be based on the value of the losses—calculated as the Lossco's effective tax rate multiplied by the shortfall in the represented non-capital loss balances—or on the purchase consideration ascribed to the losses.

To avoid disputes as to the calculation of damages, it is generally preferable for the Lossco shareholders to provide a stand-alone indemnity or separate and independent covenant[99] for deficiencies in the non-capital loss balances (presumably only to the extent that such shortfall does not arise solely as a result of actions of the purchaser or the Lossco after the acquisition). Such a clause would specify a methodology for valuing any shortfall in the non-capital losses, either using an assumed effective tax rate or specifying a dollar figure, with an upper cap set at the amount of the purchase consideration allocated to the non-capital losses. In this way, a properly drafted indemnification provision should restore the parties to the intended economic results negotiated at the time of the transaction. It will also be necessary to consider the appropriate indemnification obligation where, for example, a reduction in available non-capital losses is offset by an increase in another tax attribute (such as a lower non-capital loss balance that is offset by a higher undepreciated capital cost balance).

Consideration should be given to whether the indemnity provides an exclusive remedy to the purchaser, or whether the purchaser can also choose to sue for breach of representation. As is the case with all tax indemnities, the indemnity clause should specify a process to deal with CRA audit activities, tax assessments, and appeals pertaining to the quantum of tax pools.

A related issue arises in respect of a representation provided by the Lossco that all taxes have been paid. Where a subsequent assessment arises that could make the Lossco cash taxable in a preacquisition period, the Lossco shareholders will want to ensure that no indemnification or other damages obligation arises for such cash tax to the extent that there are preacquisition non-capital losses (or other tax attributes) of the Lossco that could, electively, be used to reduce such cash tax liability. Absent such a clause, there would be no need for the purchaser to claim the deduction under paragraph 111(1)(a) for the prior-year losses and to instead seek an indemnity payment from the vendor and preserve the losses for future use.

## Conclusions

The carryforward of losses following an acquisition of control is not, in and of itself, disallowed. Rather, Parliament has made a specific and well-considered policy decision to allow loss carryforwards where a loss business is continued following an acquisition of control, and subsection 111(5) specifies the limitations within which the indirect transfer of losses to a new purchaser is considered to be legitimate and permissible. Indeed, such transactions may facilitate transactions considered to be beneficial to the fisc. Structuring a commercial transaction to benefit from the use of losses within the confines of that rule should not result in a transaction viewed to be aggressive or abusive, even if accessing the losses is a significant motivation of the purchaser, since the use of such losses post-acquisition is clearly within the legislative plan.

## Notes

1 The term "asset" is used deliberately, on the basis that a non-capital loss offers the possibility of receiving future income free of tax if such income is earned during the loss carryforward period.

2 RSC 1985, c. 1 (5th Supp.), as amended (herein referred to as "the Act"). Unless otherwise stated, statutory references in this paper are to the Act.

3 *OSFC Holdings Ltd. v. Canada*, 2001 FCA 260, at paragraph 98; leave to appeal to the Supreme Court of Canada denied. Similar statements of tax policy are found in *Mathew v. Canada*, 2005 SCC 55.

4 Although the Act does not adopt a formal mechanism to transfer losses among related parties, general tax policy provides more flexibility with respect to internal related-party tax loss consolidation transactions. These issues are not discussed in this paper. For a discussion on the policy behind allowing internal loss consolidations, see Canada, Department of Finance,

*A Corporate Loss Transfer System for Canada* (Ottawa: Department of Finance, May 1985), included with the May 23, 1985 budget papers; and Canada, Department of Finance, *The Taxation of Corporate Groups: Consultation Paper* (Ottawa: Department of Finance, November 2010) (herein referred to as "the 2010 consultation paper"). See also Kim Wharram, "Loss Utilization," in *2013 Ontario Tax Conference* (Toronto: Canadian Tax Foundation, 2013), 4:1-33; and Perry Truster, "Effective Loss Utilization Within a Closely Held Group of Entities," in *2009 Ontario Tax Conference* (Toronto: Canadian Tax Foundation, 2009), 4:1-16.

5 A comprehensive review of the many provisions dealing with transfers of tax attributes other than non-capital losses is beyond the scope of this paper. On an acquisition of control, tax attributes such as undepreciated capital cost and cumulative eligible capital are treated somewhat similarly, in that such balances are required to be written down to the fair market value of the depreciable property or eligible capital property, as the case may be, with the excess being deducted in computing income in the tax year immediately prior to the acquisition of control and thus increasing the corporation's non-capital losses subject to the streaming rules in subsection 111(5). Resource tax pools (Canadian oil and gas property expense, Canadian development expense, and Canadian exploration expense) are treated somewhat differently under the successor corporation rules.

6 For a review of the common-law meaning of "control," see *Duha Printers (Western) Ltd. v. Canada*, [1998] 1 SCR 795. See also subsection 256.1(3), introduced in the 2013 federal budget, which dramatically expands the circumstances in which control of a corporation will be deemed to have been acquired. Thus, the control test must now be looked at by reviewing both the traditional acquisition-of-control rules and the broad deemed acquisition-of-control rules. The literature is replete with examples of planning strategies designed to avoid the application of the loss-streaming regime in subsection 111(5), by avoiding an actual or deemed acquisition of control; accordingly, those issues are not discussed in this paper. See, for example, Michael J. Munoz, "Loss Utilization in Arm's-Length Business Combinations," Corporate Tax Planning feature (2009) 57:3 *Canadian Tax Journal* 660-98; and John Burghardt and Sarah Chiu, "'Loss' Is Just a Four-Letter Word: Policy, Practice, and Proposals," in *Report of Proceedings of the Sixty-Fifth Tax Conference*, 2013 Conference Report (Toronto: Canadian Tax Foundation, 2014), 14:1-43.

7 In the typical Lossco deal, the purchaser and the Lossco will be amalgamated (or the Lossco will be wound up into the purchaser), so as to permit the amalgamated corporation access to the tax attributes: see subsections 87(2.1) and 88(1.1); the latter contains a test similar to the one in subsection 111(5).

8 The loss-streaming rules in subsection 111(5) apply where a corporation with accrued losses is subject to a "loss restriction event," which term is defined, in respect of a corporation, in paragraph 251.2(2)(a) as the time at which control of the corporation is acquired by a person or group of persons. For a discussion of the amendments giving rise to loss restriction events, see Rick Barnay, Sean Heibert, and Timothy Kirby, "When Is a Loss a Loss and When Can You Claim a Loss?" in *2015 Prairie Provinces Tax Conference* (Toronto: Canadian Tax Foundation, 2015), 11:1-37.

9 The reference in subparagraph 111(5)(a)(i) to "that business" is read as meaning the business that gave rise to the losses—that is, the loss business. See the discussion below under the heading "Specific Requirements of the Loss-Streaming Rules."

10 This principle was well expressed in *Canada Trustco Mortgage Co. v. Canada*, 2005 SCC 54, and has been repeatedly reaffirmed: see, for example, *Imperial Oil Ltd. v. Canada; Inco Ltd. v. Canada*, 2006 SCC 46; *Placer Dome Canada Ltd. v. Ontario (Minister of Finance)*, 2006 SCC 20; and *Redeemer Foundation v. Canada (National Revenue)*, 2008 SCC 46.

11 See American Law Institute, *Federal Income Tax Project, Subchapter C: Proposals on Corporate Acquisitions and Dispositions and Reporter's Study on Corporate Distributions* (Philadelphia: American Law Institute, 1982), at 212: "[I]f the restrictions on transferability were removed,

the true losers would be paid the full value of loss carryovers as part of the price of their shares. In this view there is nothing evil or immoral about trafficking in loss carryovers as such; indeed unfettered trafficking is a positive good, serving to distribute tax benefits where they belong."

12 See, for example, Canada, *Report of the Royal Commission on Taxation* (Ottawa: Queen's Printer, 1966) (herein referred to as "the Carter commission report"); and Canada, *Report of the Technical Committee on Business Taxation* (Ottawa: Department of Finance, April 1998) (herein referred to as "the Mintz committee report").

13 See, for example, Jack M. Mintz, "Economic Implications of Non-Refundability of Tax Losses," in *Policy Options for the Treatment of Tax Losses in Canada* (Toronto: Clarkson Gordon Foundation, 1991), 4:1-43; and Satya Poddar, "Refunding the Tax Value of Unutilized Losses," ibid., 5:1-26.

14 Mintz committee report, supra note 12, at sections 4.12-4.17.

15 Ibid., at 4:15. The Carter commission report, supra note 12, vol. 4, at 253, indicates that "a full sharing of losses by the government would be repugnant to most Canadians." See also Canada, House of Commons, *Debates*, February 20, 1987, at 3646, expressing a concern that the "existence of the large banks of unused losses [is] a continuing source of instability in the tax system."

16 See the 2010 consultation paper, supra note 4, annex 2, at 27.

17 *Landrus v. The Queen*, 2008 TCC 274, at paragraph 120 (emphasis added); aff'd. 2009 FCA 113.

18 This, of course, is subject to a number of exceptions. For example, capital cost allowance in respect of rental and real estate cannot create or increase a loss from that source: regulation 1100(11). A similar rule applies in respect of capital cost allowance on leasing property: regulation 1100(15). Similarly, a taxpayer that is a "principal business corporation" cannot deduct cumulative Canadian exploration expense to create a loss: subsection 66.1(2).

19 This paper references only selected amendments in the historical evolution of paragraph 111(1)(a) and subsection 111(5). For a more comprehensive summary, see Patrick Lindsay and Jean-Philippe Couture, "Update on Planning with Losses" (2014) 27 *Canadian Petroleum Tax Journal*; and David N. Finkelstein and Margaret Nixon, "Takeovers," in *Report of Proceedings of the Fifty-Sixth Tax Conference*, 2004 Conference Report (Toronto: Canadian Tax Foundation, 2005), 21:1-59.

20 Paragraph 5(1)(p) of the Income War Tax Act, as amended by SC 1942-43, c. 28, section 5.

21 Paragraph 5(1)(p) of the Income War Tax Act, as amended by SC 1944-45, c. 43, section 4.

22 Clause 27(1)(e)(iii)(A) of the Income Tax Act, as amended by SC 1958, c. 32, section 12.

23 Subsection 27(5) of the 1958 version of the Income Tax Act provided that paragraph 27(1)(e) (the provision permitting the carryforward of losses)

> does not apply to permit a corporation to deduct, for the purpose of computing its taxable income for a taxation year, a business loss sustained by it in a preceding taxation year in any case where
>
> (a) more than 50% of the shares in the capital stock of the corporation have, between the end of that preceding year and the end of the taxation year, been acquired by a person or persons who did not, at the end of that preceding year, own any of the shares in the capital stock of the corporation; and
>
> (b) the corporation was not, during the taxation year, carrying on the business in which the loss was sustained.

24 See, for example, the Mintz committee report, supra note 12, at 4:14; and the Carter commission report, supra note 12, vol. 4, at 262. See also the comments of David Dodge (then senior assistant deputy minister, Tax Policy and Legislation Branch, Department of Finance) under the heading "Loss-Trading Provisions: The Departmental Response" in William J. Strain, David A. Dodge, and Victor Peters, "Tax Simplification: The Elusive Goal," in *Report of Proceedings*

*of the Fortieth Tax Conference*, 1988 Conference Report (Toronto: Canadian Tax Foundation, 1989), 4:1-63, at 4:52-63.

25 It has been argued that one reason behind the prohibition of an outright transfer of corporate losses is the perceived double deduction. As articulated by Robert Couzin, "Current Tax Provisions Relating to Deductibility and Transfer of Losses," in *Policy Options for the Treatment of Tax Losses in Canada*, supra note 13, 3:1-42, at 3:40, where a corporation has lost money invested by shareholders, the sale of the corporation generally gives rise to a loss at the shareholder level; if the losses of the corporation can also be used by its purchaser, there is in some sense a double deduction. In response, as noted by Poddar, supra note 13, at 5:18, the so-called double deduction of losses is simply the inverse of the double taxation of corporate profits, an unavoidable consequence of a partially integrated tax system.

26 SC 1963, c. 21, sections 6(1) and (2).

27 SC 1970-71-72, c. 63, subsection 111(5).

28 For a thought-provoking review of whether the acquisition-of-control test provides any more than "rough justice," see Robert Couzin and Thomas E. McDonnell, "Policy Options: Reforming Current Provisions," in *Policy Options for the Treatment of Tax Losses in Canada*, supra note 13, 9:1-40, at 9:5-9 and 9:14-15.

29 SC 1980-81-82-83, c. 140, section 70(1).

30 Canada, Department of Finance, 1963 Budget, Budget Speech, June 13, 1963, at 12.

31 Canada, Department of Finance, 1981 Budget, Budget Papers, November 12, 1981, at 39.

32 See Dodge, supra note 24.

33 *Gaz Métropolitain Inc. v. The Queen*, 1998 CanLII 227 (TCC).

34 *Manac Inc. Corp. v. The Queen*, 96 DTC 1714 (TCC); aff'd. 98 DTC 6605 (FCA).

35 Mintz committee report, supra note 12, at 4:14-15.

36 *Canadian Marconi v. R*, [1986] 2 SCR 522.

37 That this same policy concern is not applicable to capital losses helps to explain why such losses cannot be carried forward after an acquisition of control: subsection 111(4).

38 Dodge, supra note 24, at 4:53.

39 American Law Institute, supra note 11, at 222.

40 *OSFC Holdings*, supra note 3, at paragraph 91, quoting with approval from Peter W. Hogg, Joanne E. Magee, and Ted Cook, *Principles of Canadian Income Tax Law*, 3d ed. (Toronto: Carswell, 1999), at 408.

41 *Garage Montplaisir Ltée v. MNR*, 92 DTC 2317, at 2321 (TCC), wherein the Tax Court held that the purpose of subsection 111(5) was the "strengthening or survival of a declining business." While the decision was upheld on appeal to the Federal Court Trial Division (96 DTC 6557), the court, at that time, held that the wording of subsection 111(5) did not support that statement.

42 *Manac*, supra note 34, at paragraph 14 (FCA).

43 See, for example, Finkelstein and Nixon, supra note 19, and Ian D. Heine, "Issues in Carrying On Business and Utilizing Losses," in *2003 British Columbia Tax Conference* (Toronto: Canadian Tax Foundation, 2003), 15:1-39.

44 From a purely accounting perspective, International Accounting Standards Board, *International Financial Reporting Standard* IFRS 3, "Business Combinations," at appendix A, defines "business" as "[a]n integrated set of activities and assets that is capable of being conducted and managed for the purpose of providing a return in the form of dividends, lower costs or other economic benefits directly to investors or other owners, members or participants." The acquisition of a business, for IFRS purposes, consists of three elements:

1) *inputs*: an economic resource that creates outputs when one or more processes are applied to it;
2) *process*: a system, standard, protocol, convention, or rule that, when applied to an input, created outputs; and
3) *outputs*: the result of inputs and processes applied to those inputs.

45 *Hoffman (Roy) v. Minister of National Revenue*, 50 DTC 284, at 285 (TAB).

46 *Canadian Dredge and Dock Company Limited v. MNR*, 81 DTC 154 (TRB).

47 *Crystal Beach Park Limited v. The Queen*, 2006 TCC 183.

48 *Gaz Métropolitain*, supra note 33.

49 Of course, there is a limit to how expansive a characterization will be permitted. For example, in *No. 678 v. MNR*, 60 DTC 45 (TAB), the Tax Appeal Board denied the taxpayer's argument that the loss business should be broad enough to include both the selling of trusts and cars and the operating of service stations. Similarly, in *Island Motor Trans. Ltd. v. MNR* (1963), 33 Tax ABC 365, the Tax Appeal Board held that the loss business was the operation of franchises, not the holding and operation of franchises.

50 *Canadian Dredge*, supra note 46. In contrast, however, see CRA document no. 9234795, May 19, 1993, where the Canada Revenue Agency (CRA) appeared to take the position that oil and gas properties in Saskatchewan constituted a different business than oil and gas operations in Alberta.

51 *Hoffman*, supra note 45.

52 *Gaz Métropolitain*, supra note 33.

53 *Martin & Co. (E.P.) v. MNR* (1959), 22 Tax ABC 254.

54 *Crystal Beach*, supra note 47.

55 *Wigmar Holdings Ltd. v. R*, [1997] 2 CTC 263 (FCA).

56 *STB Holdings Ltd. v. The Queen*, 2011 TCC 144, at paragraph 56.

57 *No. 717 v. MNR* (1960), 24 Tax ABC 367.

58 *NRT Technology Corp. v. The Queen*, 2012 TCC 420.

59 See also the CRA's position in *Interpretation Bulletin* IT-206 (Archived), "Separate Business," October 29, 1979, at paragraph 4.

60 *Oakley Motors Ltd. v. MNR*, 66 DTC 463 (TAB).

61 *Household Prod. Co. Ltd. v. MNR* (1964), 34 Tax ABC 441.

62 *Canadian Dredge*, supra note 46.

63 *Garden Investments Ltd. v. MNR*, 74 DTC 1014 (TRB).

64 *Cimi Inc. v. The Queen*, 2001 DTC 889 (TCC).

65 *Garage Montplaisir*, supra note 41.

66 Companies' Creditors Arrangement Act, RSC 1985, c. C-36, as amended; Bankruptcy and Insolvency Act, RSC 1985, c. B-3, as amended. For further discussion of this issue, see also Marie-Andrée Beaudry and Dean Kraus, "Financial Difficulty: Section 80 and CCAA—Paragraph 20(1)(c)," elsewhere in these proceedings.

67 See also *Holiday Knitwear Ltd. v. MNR* (1963), 31 Tax ABC 30.

68 The CRA has acknowledged that an assignment in bankruptcy, absent an order of discharge, in and of itself, does not result in a cessation of the loss business: see, for example, CRA document no. 9924355, September 23, 1999.

69 See generally Lloyd W. Houlden, Geoffrey B. Morawetz, and Janis P. Sarra, *Bankruptcy and Insolvency Law of Canada*, 4th ed. (Toronto: Carswell) (looseleaf). See also CRA document no. 2008-0294041E5, November 13, 2008, with respect to the purpose of the CCAA.

70 *Carland (Niagara) Ltd. v. MNR* (1964), 34 Tax ABC 386.

71 *NRT Technology*, supra note 58, at paragraph 36.

72 See, for example, *MNR v. Eastern Textile Products, Ltd.*, 57 DTC 1070, at 1075 (Ex. Ct.), where the taxpayer was unsuccessful in arguing that the reference was to the taxpayer's business as it existed from time to time. See also *MNR v. Ottawa Car and Aircraft Ltd.*, 57 DTC 1076 (Ex. Ct.); and *Waldman's Ltd. v. MNR* (1951), 5 Tax ABC 232. Although these cases were decided under a predecessor to subsection 111(5), they appear to remain good law.

73 While Finkelstein and Nixon, supra note 19, suggest that some jurisprudence evidences an inconsistency on the point, I submit that the result in those cases stems from an extremely broad characterization by the court of the identification of the loss business, rather than from a view that the only requirement is for the same type of business.

74 *Crystal Beach*, supra note 47, at paragraph 37.

75 *Dofin Limited and Miller Stationers Ltd. v. MNR*, 79 DTC 605, at 606 (TRB). The Tax Review Board held that the taxpayer continued to do what it did prior to the acquisition of control, notwithstanding significant operational changes.

76 *Garage Montplaisir*, supra note 41.

77 *Canadian Dredge*, supra note 46.

78 *NRT Technology*, supra note 58.

79 *Canadian Dredge*, supra note 46.

80 Ibid.

81 *Gaz Métropolitain*, supra note 33.

82 *NRT Technology*, supra note 58.

83 *Roscommon Builders Ltd. v. MNR* (1963), 34 Tax ABC 121. A similar result is seen in *Triad Building Associates Ltd. v. MNR*, 66 DTC 804 (TAB), and in *W.B. Sullivan Const. Ltd. v. MNR*, [1971] Tax ABC 373.

84 For example, the successoring provisions governing Canadian and foreign resource pools.

85 See, for example, *Carland (Niagara)*, supra note 70, and *Canadian Dredge*, supra note 46.

86 *NRT Technology*, supra note 58.

87 *Interpretation Bulletin* IT-302R3 (Archived), "Losses of a Corporation—The Effect That Acquisitions of Control, Amalgamations, and Windings-Up Have on Their Deductibility—After January 15, 1987," February 28, 1994, at paragraph 14.

88 *NRT Technology*, supra note 58.

89 See, for example, J. Scott Bodie and Wesley R. Novotny, "Acquisitions of Control Under the Income Tax Act—Recent Developments," in *2013 Prairie Provinces Tax Conference* (Toronto: Canadian Tax Foundation, 2013), 6:1-27.

90 IT-302R3, supra note 87, at paragraph 14. The CRA cites generally the decision in *Barnwell Consolidated School District No. 15 v. Canadian Western Natural Gas, Light, Heat & Power Co* (1922), 18 Alta. LR 261 (SCAD), in support of such proposition. See, for example, CRA document no. 9627815, October 17, 1996.

91 *Manac*, supra note 34.

92 *Gaz Métropolitain*, supra note 33.

93 For a review of the fundamentals and various checklists and example clauses, see, for example, Daniel Lang and Mark Woltersdorf, "A Fresh Look at Tax Clauses in Acquisition Agreements," in the 2013 Conference Report, supra note 6, 12:1-76; Kirsten Kjellander, "Tax 'Provision' in Purchase and Sale Agreements for Private Company Shares," in *2012 British Columbia Tax Conference* (Toronto: Canadian Tax Foundation, 2012), 9:1-21; and E.G. Kroft, "Tax Clauses in Acquisition Agreements," in *Selected Income Tax and Goods and Services Tax Aspects of*

*the Purchase and Sale of a Business*, 1990 Corporate Management Tax Conference (Toronto: Canadian Tax Foundation, 1991), 9:1-99.

94 Couzin, supra note 25.

95 Paragraph 256(7)(c.1), introduced in the 2010 federal budget, deems certain reverse takeovers of a corporation on a trust conversion to result in an acquisition of control of the corporation. For background, see Craig M. McDougall and Gail J. Lai, "Selected Aspects of Corporate Control: Groups of Persons and Control of Corporations by Trusts," in *Report of Proceedings of the Sixty-Second Tax Conference*, 2010 Conference Report (Toronto: Canadian Tax Foundation, 2011), 11:1-38.

96 See, for example, the provisions of the indemnification agreements in the transactions between Colabor Income Fund and ConjuChem Biotechnologies Inc. and between Premium Brands Income Fund and Thallion Pharmaceutical Inc.

97 *Birchcliff Energy Ltd. v. The Queen*, 2015 TCC 232. See also *NRT Technology*, supra note 58; there, although not commented on explicitly, the Tax Court noted the importance of the Lossco's covenants regarding tax losses in the acquisition documents.

98 A series of cases has established the longstanding principle that the minister is not bound by the assessment of a loss (or certain other tax balances) in a statute-barred year when reassessing a subsequent non-statute-barred year in which the loss carryforward from the statute-barred year is applied: see, for example, *New St. James Ltd. v. MNR*, 66 DTC 5241 (Ex. Ct.).

99 As pointed out by Kroft, supra note 93, at 9:14, the indemnity may be drafted as a covenant to pay because the loss may be suffered by some person other than the indemnified party, namely, the Lossco.