

Quebec Court of Appeal provides decision on loss consolidation transactions

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Authors: [Joanne Vandale](#), [David Wilson](#), [Laura Scheim](#)

On February 17, 2022, the Quebec Court of Appeal released its decision in *Agence du revenu du Québec vs. J.D. Irving Limited*, in which it dismissed Revenu Québec's appeal of a decision rendered by the Court of Quebec.

The appeal involved Revenu Québec challenging a related group loss consolidation arrangement undertaken by the taxpayer and affiliated entities. In brief, the loss consolidation was achieved by way of the transfer of a piece of pollution control equipment that was integrated into the plant of another entity within the group, Irving Pulp and Paper Limited (IPPL). By transferring ownership of the equipment within the corporate group, the taxpayer, a profitable entity, was able to claim capital cost allowance deductions on the equipment, while recaptured income was realized in an affiliated company that had losses. While the taxpayer owned the equipment, it provided pollution abatement services to IPPL up to certain required standards, and subcontracted certain aspects of the operation of the equipment to IPPL, all by virtue of operating and services agreements.

Revenu Québec attacked the transactions by seeking to apply a regime called the leasing property rules to the operating and services agreements, which would have had the effect of limiting the available capital cost allowance deductions on the equipment to the amount of the fees paid by IPPL for the pollution abatement services, thereby significantly curtailing the effectiveness of the intended loss consolidation transaction. Revenu Québec did not invoke sham or the general anti-avoidance rule, but instead argued at trial and on appeal that the operating and services agreements should be recharacterized as leases.

As the operating and services agreements were governed by the law of New Brunswick, Justice Gaetan Fournier found at trial that the essential elements of a lease under the common law, namely peaceful enjoyment and exclusive possession, were not present in the agreements and that the obligations therein, and the parties' intentions in concluding the agreements, went well beyond those of a lease.

On appeal, Revenu Quebec sought to attack this conclusion with several arguments that were all variations of the same theme: that the elements of the agreement that were subcontracted to IPPL should be effectively read out of the agreement, and that what remains is a lease. One argument employed by Revenu Québec to seek this result was to apply the common law doctrine of merger, a doctrine which is an extension of the rule against contracting with oneself, and extinguishes a contract if the obligations of debtor and

creditor of the obligation lie with the same person. The Court of Appeal agreed with the taxpayer that the doctrine could not apply to cancel certain elements of a contract out against each other and recharacterize what remains.

The Quebec Court of Appeal confirmed that this was not an appropriate instance for the recharacterization of a contract. In addressing Revenu Québec's arguments on this point, it also confirmed that, in order for an agreement to be a service contract, it is not necessary for the party providing the service to be in that particular business (in this case, the business of providing anti-pollution services) and that the entirety of a business can be carried on through subcontractors.

The Quebec Court of Appeal's decision is a helpful reminder that under Canadian tax law, in the absence of a sham, the legal transactions entered into by a taxpayer must be respected unless the label attached to those transactions does not properly reflect their actual legal effect. In this case, both the trial and appellate courts confirmed that the taxpayer's characterization of the transactions was entirely consistent with the legal effect of those transactions and the intentions of the parties. This decision is also anticipated to be a helpful precedent for Québec taxpayers engaged in normal course loss consolidation transactions, which rely on the legal form of the transactions being respected.

Osler, Hoskin & Harcourt LLP advised J.D. Irving in this matter with a team consisting of Louis Tassé, Joanne Vandale, Laura Scheim and David Wilson.