Docket: 2006-421(IT)G

BETWEEN:

HUSKY OIL LIMITED,

Appellant,

and

HER MAJESTY THE QUEEN,

Respondent.

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Appeal heard on September 29 and 30, October 1 and 2, 2008,
at Calgary, Alberta.

Before: The Honourable Justice Robert J. Hogan

Appearances:

| | |
|---|---|
| Counsel for the Appellant: | Barry R. Crump<br>Michel Bourque |
| Counsel for the Respondent: | Donald G. Gibson |

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**JUDGMENT**

The appeal from the assessment made under the *Income Tax Act* for the 1998 taxation year is dismissed, with costs to the Respondent, in accordance with the attached Reasons for Judgment.

Signed at Ottawa, Canada, this 24th day of February 2009.

"Robert J. Hogan"

Hogan J.

Citation: 2009 TCC 118
Date: 20090224
Docket: 2006-421(IT)G

BETWEEN:

HUSKY OIL LIMITED,

Appellant,

and

HER MAJESTY THE QUEEN,

Respondent.

## REASONS FOR JUDGMENT

**Hogan J.**

I. Introduction

[1] The Appellant and Balaclava Enterprises Ltd. ("Balaclava"), a significant shareholder of Mohawk Canada Limited ("Mohawk Canada"), joined forces to complete a takeover of Mohawk Canada. Balaclava transferred its interest in Mohawk Canada to a corporation, HB Acquisition Inc. ("HB Acquisition"), formed by the Appellant and Balaclava to complete the takeover. Balaclava received securities of HB Acquisition for its shares of Mohawk Canada and significantly less cash than was offered to the other Mohawk Canada shareholders.

[2] Balaclava and the Appellant agreed to allow Balaclava to acquire the Residual Assets (defined below) of Mohawk Canada through the amalgamation of its subsidiary, Mohawk Lubricants Ltd. (the owner of the Residual Assets) ("Mohawk Lubricants"), and a subsidiary of Balaclava. The parties disagree on the impact of the amalgamation. The Appellant argues that Mohawk Canada disposed of the shares of Mohawk Lubricants in a tax-free rollover under subsection 87(4) of the *Income Tax Act* (Canada) (the "*Act*"). The Respondent, on the other hand, submits that Mohawk Canada took back shares in the amalgamated entity that were worthless as part of a plan to defer capital gains tax for 25 years. This plan was also followed by Balaclava, which allegedly received worthless shares in HB Acquisition. As a result of these mutual promises to accept worthless shares, the Respondent argues, Mohawk Canada

should be taxable on the disposition of the shares of Mohawk Lubricants for one or more of the following reasons:

a) Mohawk Canada gifted the value of its shares in Mohawk Lubricants for the benefit of its parent corporation, HB Acquisition, and/or Mohawk Canada received non-share consideration on the amalgamation involving Mohawk Lubricants, contrary to the prohibition contained in subsection 87(4) of the *Act*.
b) HB Acquisition appropriated the value of the Mohawk Lubricants shares for its own benefit contrary to the prohibition in subsection 69(4) of the *Act*.
c) Subsection 56(2) applies to the amalgamation.

## II. Factual background

[3] At the outset of the trial, the parties provided me with a Statement of Agreed Facts (the "Statement of Agreed Facts") along with supporting documents contained in a joint book of exhibits (the "Joint Book of Exhibits"). The Appellant called three witnesses, Mr. Thomas Lindsay, a senior vice-president of Balaclava and a director of Mohawk Canada, Mr. Robert Kopstein, a tax partner with Ladner Downs in Vancouver at the time of the transactions, and Mr. Ian McNair, who was the tax director at Husky Oil Limited ("Husky" or the "Appellant"). The Respondent called two witnesses, Ms. Sandra Pereversoff, a tax avoidance auditor with the Canada Revenue Agency ("CRA") and Mr. Michael Weevers, the appeals officer who considered the Appellant's Notice of Objection. I will quote from the Statement of Agreed Facts before summarizing the witnesses' testimony and reviewing the relevant documentary evidence.

### A. The Parties

1. The Appellant, Husky Oil Limited ("Husky") is a corporation formed under the laws of Canada and is resident in Canada for the purposes of the Income Tax Act, R.S.C. 1985 (5th Supp., c. 1 (the "Act"). On January 1, 1999, Husky Oil Limited amalgamated with Mohawk Canada Limited. Prior to August 25, 2000, Husky was continued into the Province of Alberta. On August 25, 2000, Husky and Husky Oil Operations Limited and Renaissance Energy Ltd. were amalgamated, with the resulting corporation being Husky Oil Operations Limited.

2. Husky Mohawk Long Term Ltd. ("HMLT") is a corporation formed under the laws of Canada on October 17, 1996. At all times, Husky owned all the issued and outstanding voting shares of HMLT. The terms of HMLT's common and preferred shares are set out in HMLT's Articles of Amendment . . . .

3. HB Acquisition Inc. ("HB Acquisition") was a corporation formed on or about April 1, 1998 under the laws of Canada. HB Acquisition's initial share capital consisted of common shares. The characteristics of the common shares are set out in HB Acquisition's Articles of Amendment dated June 29, 1998 and September 18, 1998 . . . .

4. Balaclava Enterprises Ltd. ("Balaclava"), now known as Belkin Enterprises Ltd., is a corporation formed under the laws of the Province of British Columbia and is resident of Canada for the purposes of the Act.

5. BEL Acquisition Inc. ("BAI") is a corporation formed under the laws of the Dominion of Canada and is resident in Canada for the purposes of the Act. BAI is a wholly-owned subsidiary of Balaclava.

6. 3470750 Canada Inc. ("347") is a corporation formed under the laws of the Dominion of Canada on or about June 11, 1998, and is resident in Canada for the purposes of the Act. At all material times 347 was a wholly-owned subsidiary of BAI.

7. Mohawk Canada Limited ("Mohawk Canada") was a public corporation formed under the laws of the Dominion of Canada and was resident in Canada for the purposes of the Act. Mohawk Canada carried on the business of an automotive fuel retailer (the "Retail Business") and its common shares were listed on the Toronto Stock Exchange.

8. Mohawk Lubricants Ltd. ("Mohawk Lubricants") was a corporation formed under the laws of British Columbia on October 19, 1981 and continued under the *Canada Business Corporations Act* on July 2, 1998, and it was resident in Canada for the purposes of the Act. Mohawk Lubricants, a wholly-owned subsidiary of Mohawk Canada, carried on the business of re-refining and distributing recycled oil. Mohawk Lubricants also owned certain other assets (shares of Pound-maker Agventures Ltd. [the "Pound-maker shares"], a certain Jade Royalty and certain Jade Inventory) [the "Jade Investment"] and its recycled oil business and other assets are collectively referred to as the "Residual Assets".

9. At all times material to this Appeal, Husky and HB Acquisition were not related to Balaclava, BAI, and 347, and Balaclava, BAI and 347 were not related to Mohawk Canada and Mohawk Lubricants.

10. Prior to July 8, 1998 Husky and HB Acquisition were not related to Mohawk Canada and Mohawk Lubricants.

11. Where the expression "related" is used in this Agreement, the parties agree that the expression refers to its meanings in and for the purposes of subsections 251(1) and 251(2) of the Act.

12. Upon HB Acquisition tendering its notice to take up and pay for Mohawk Canada shares tendered to the joint bid, on July 6th, 1998, as further particularized at

paragraph 35 herein, Husky and HB Acquisition became related to Mohawk Canada and Mohawk Lubricants.

**B. Facts Relating to Mohawk and Events Leading up to Transaction**

13. At all material times prior to July 8, 1998, a control block comprising 42% of Mohawk Canada's common shares was held directly or indirectly by one shareholder, Hugh B. Sutherland ("Sutherland"), while a further 23% of the common shares of Mohawk Canada (or debentures convertible into common shares of Mohawk Canada) were owned by Balaclava. The remaining 35% of Mohawk Canada common shares were widely held by the investing public, including common shares owned directly or indirectly by employees of Mohawk Canada.

14. In June 1997, the board of directors of Mohawk Canada (the "Mohawk Board") established a special committee of the Mohawk Board (the "Special Committee") to assist the Mohawk Board in developing and evaluating strategic alternatives available to Mohawk Canada to enhance shareholder value.

15. After considering a number of alternatives, the Mohawk Board accepted the Special Committee's recommendation that financial advisors be retained to explore a sale, merger, or other business combination involving Mohawk Canada's Retail Business. CIBC Wood Gundy Securities Inc. ("Wood Gundy") was appointed as financial advisor to the Special Committee and Mohawk Canada announced its strategic intentions in a press release to the public on or about September 23, 1997.

16. From September 1997 through January 1998, Wood Gundy actively solicited bids for the acquisition of the Retail Business of Mohawk Canada. By early December 1997, Wood Gundy had received non-binding expressions of interest from seven parties, including Husky, who had reviewed a confidential information memorandum concerning Mohawk Canada's Retail Business. On December 9, 1997, the Mohawk Board allowed several of these parties, including Husky, access to data rooms to allow them to engage in detailed due diligence investigation of the Retail Business before being invited to make a final acquisition proposal.

17. Upon completion of this due diligence process described in . . . paragraph 16, three parties, one of which was Husky, were invited by the Mohawk Board to submit proposals for the acquisition of the Retail Business. By February 11, 1998 the Mohawk Board, in consultation and with the recommendation of Wood Gundy and legal counsel, decided to enter into exclusive negotiations with Husky, as well as Balaclava, with a view to implementing a plan of arrangement under the *Canada Business Corporations Act* whereby Husky would acquire the Retail Business.

18. At all material times Husky made it clear that it would not participate in any transaction that would result in it acquiring the Residual Assets. However, Balaclava was prepared to consider acquiring the Residual Assets as Balaclava was engaged in a business complementary to the re-refining business of Mohawk Lubricants that comprised the main part of the Residual Assets.

19. On February 11, 1998, the Mohawk Board established an independent committee (the "Independent Committee") to examine and make recommendations to the Mohawk Board on any proposal to acquire the Residual Assets. The Independent Committee retained RBC Dominion Securities Inc. ("RBC Dominion") to assist the Independent Committee in its mandate and to provide a fairness opinion in connection with any proposal to acquire the Residual Assets.

20. Initially, Husky was only prepared to pay $90 million for the Retail Business of Mohawk Canada, but later increased it to $103 million.

21. As a result of the negotiations amongst the Mohawk Board, including its Independent and Special Committees and their financial advisors, and Balaclava, a transaction structure (the "Structure") was created that would see:

(a) Husky acquire the Retail Business for its stated (and firm) acquisition price of $103 million;

(b) Balaclava acquire the Residual Assets; and

(c) Husky and Balaclava participate in a joint bid for the common shares of Mohawk Canada at Husky's acquisition price of $103 million.

22. By late April 1998, Husky advised the Special Committee that it was prepared to explore the possibility of a joint acquisition of all the common shares of Mohawk Canada through a joint takeover bid with Balaclava. The Mohawk Board then expanded the mandate of the Independent Committee to review and to make recommendations concerning any joint takeover bid made by Husky and Balaclava (the "Joint Bid"). The Independent Committee was assisted in assessing the Joint Bid by Wood Gundy who were also retained to provide a fairness opinion from a financial perspective to the shareholders of Mohawk Canada concerning a Joint Bid.

**C. The Joint Bid**

23. By early June 1998:

(a) Husky and Balaclava entered into a joint bid agreement (the "Joint Bid Agreement") for a takeover bid of all of the outstanding common shares of Mohawk Canada not owned by Balaclava, BAI or HB Acquisition at a cash price of $7.25 per share. The $7.25 cash offer (the "Offer") was not available to BAI as it was a joint bidder. It was a condition precedent to the Offer that 90% of the Mohawk Canada common shares be deposited to the Offer. . . .

(b) Sutherland, HB Acquisition as the offeror under the Joint Bid Agreement, and Husky entered into an agreement (the "Lock-Up Agreement") under which Sutherland agreed to deposit, or cause to be deposited to the Offer, all of his common shares (or debentures convertible into common shares) of Mohawk Canada. . . .

(c) HB Acquisition, Husky, Balaclava, BAI, and Mohawk Canada entered into an agreement (the "Support Agreement") under which HB Acquisition agreed to make the Offer and Mohawk Canada agreed to recommend to its shareholders that they accept the Offer. . . .

(d) the Independent Committee received a fairness opinion from Wood Gundy (the "Wood Gundy Fairness Opinion") that the Offer contemplated under the Joint Bid Agreement was fair, from a financial point of view, to the Mohawk Canada shareholders . . . and,

(e) the Independent Committee received a fairness opinion from RBC Dominion (the "RBC Dominion Fairness Opinion") that Balaclava's proposed acquisition of the Residual Assets, and specifically the price offered by Balaclava in its acquisition of the Residual Assets, was fair, from a financial point of view, to the Mohawk Canada shareholders. . . .

24. If sufficient common shares of Mohawk Canada were deposited under the Offer, Balaclava agreed, and was obligated, to convert all debentures held by it into common shares of Mohawk Canada and to transfer to HB Acquisition 2,854,267 common shares of Mohawk Canada. At the $7.25 per share offer price, these shares were to be transferred in exchange for instruments totalling $20,693,436.00 as follows:

(a) 9,565,402 shares of HB Acquisition at $1.00 per share;

(b) cash in the sum of $5,193,436.00, equivalent to $1.82 per Mohawk Canada common share owned by Balaclava; and

(c) a promissory note by HB Acquisition payable to BAI in the sum of $5,934,598.00.

25. Under the Joint Bid Agreement, Mohawk Canada, Balaclava, and BAI negotiated an option and put agreement (the "Option and Put Agreement") pursuant to which Mohawk Canada granted an option to BAI to acquire the shares of Mohawk Lubricants, which owned the Residual Assets, for consideration that included a non-interest bearing promissory note in the amount of $9,565,402.00 maturing in 2023. In addition, under this agreement, BAI granted a put option to Mohawk Canada under which BAI could be required to purchase the common shares of Mohawk Lubricants for the same consideration. . . .

26. Husky was not a shareholder of Mohawk Canada when the Option and Put Agreement was negotiated.

27. The Option and Put Agreement was amended by an agreement dated July 7, 1998 amongst Mohawk Canada, Balaclava, BAI, and Husky (the "Amended Option and Put Agreement") which modified the Option and Put Agreement in the following manner:

(a) Mohawk Canada, instead of receiving an [*sic*] non-interest bearing promissory note issued to it for Balaclava's acquisition of the Residual Assets, would instead receive preferred shares issued pursuant to an amalgamation of Mohawk Lubricants and 347; and

(b) BAI would receive preferred shares of HB Acquisition that were redeemable for a non-interest bearing note maturing in 2023 as part of the consideration for transferring its shares in Mohawk Canada to HB Acquisition, instead of directly receiving a promissory note having the identical terms.

. . .

28. The Amended Option and Put Agreement was made after Husky and HB Acquisition had entered into the Support Agreement and after they had mailed the takeover bid.

29. Under both the Option and Put Agreement and the Amended Option and Put Agreement BAI agreed it would not, prior to June 1, 2023 demand payment of the principal of the promissory note of $5,934,598.00 from HB Acquisition unless the amalgamation of Mohawk Lubricants did not occur by September 30, 1998 and Balaclava gave notice to redeem its 9,565,402 common shares at $1.00 per share.

**D. Pre-Closing Transactions**

30. On or about May 20, 1998, Balaclava transferred 2,286,086 common shares of Mohawk Canada and $2.5 million of convertible debentures issued by Mohawk Canada to BAI in exchange for 100 common shares of BAI.

31. Balaclava and BAI jointly elected to have the provisions of section 85(1) of the Act apply to the transfer described in paragraph 30. The agreed amount was $11,128,034, which amount was equal to the adjusted cost base ("ACB") of the common shares to Balaclava.

32. On July 3, 1998, Mohawk Canada transferred all of the shares it owned of Pound-maker Agventures Ltd., the Jade Royalty and the Jade Inventory to Mohawk Lubricants in exchange for 2,538,740 preferred shares issued by Mohawk Lubricants from treasury.

33. On July 5, 1998, Mohawk Lubricants declared a series of 48 separate dividends in the amount of $100,000 each. The dividends were paid by the issuance of 4,800,000 preferred shares issued by Mohawk Lubricants from treasury. As the issued and outstanding shares of Mohawk Lubricants had "safe income" equal to or in excess of the declared dividends, the provisions of subsection 55(2) of the Act were not applicable.

34. As at July 5, 1998, Mohawk Canada owned 1 common share and 7,338,740 preferred shares of Mohawk Lubricants, the ACBs of which were $2,552,441 and $7,338,740 respectively.

**E. Closing Transactions**

35. On July 6, 1998, 9,420,050, Mohawk Canada common shares (excluding the Mohawk Canada common shares held by BAI) (the "Tendered Shares"), were validly deposited pursuant to the Offer. In total, 98.2% of the total outstanding Mohawk Canada common shares (held by BAI, Sutherland and the investing public) were deposited pursuant to the Offer.

36. On July 6, 1998, Husky, through an indirect wholly-owned subsidiary, Husky Mohawk Holdings Ltd., subscribed for 103,000,000 common shares of HB Acquisition for $103,000,000 ("Husky Subscription"). Out of the $103,000,000, HB Acquisition used $73,559,202 to acquire the Tendered Shares.

37. On July 7, 1998, BAI sold 2,854,267 common shares of Mohawk Canada to HB Acquisition in exchange for $5,193,436 in cash (on hand as a result of the Husky Subscription), a non-interest bearing demand promissory note in the amount of $5,934,598 (the "BAI Note") and 9,565,402 common shares issued by HB Acquisition from treasury at a value of $1 per common share. The 9,565,402 common shares represented 8.5% of all the issued and outstanding common shares of HB Acquisition. . . .

38. BAI and HB Acquisition jointly elected to have the provisions of subsection 85(1) of the Act apply to the disposition described in paragraph 37. The agreed amount was $11,128,034, which amount was equal to the adjusted cost base ("ACB") of the Mohawk Canada common shares to BAI.

39. On July 7, 1998:

(a) Husky, Husky Mohawk Holdings Ltd., Balaclava, BAI and HB Acquisition entered into a Shareholders' Agreement, under which the parties agreed to not transfer any common shares of HB Acquisition other than in the manner contemplated in the Shareholders' Agreement and the Amended Option and Put Agreement. . . .

(b) Husky, Balaclava, BAI and Mohawk Canada entered into the Amended Option and Put Agreement . . . under which BAI was granted an option to acquire all of the common shares of Mohawk Lubricants pursuant to an amalgamation of Mohawk Lubricants and 347. Under the terms of the Amended Option and Put Agreement, BAI could assign its option to any person affiliated or associated with BAI.

40. On July 8, 1998:

(a) BAI exercised its option under the Amended Option and Put Agreement to acquire the shares of Mohawk Lubricants by way of amalgamation (the "Amalgamation");

(b) 347, Mohawk Lubricants, Mohawk Canada, Husky and Balaclava entered into an amalgamation agreement (the "Amalgamation Agreement"), under which 347 and Mohawk Lubes would amalgamate to form Mohawk Lubricants Ltd. ("Lubes Amalco"). . . .

(c) Upon the Amalgamation, Mohawk Canada received 7,338,740 Class A preferred shares of Lubes Amalco for the preferred shares it held in Mohawk Lubricants and 8,161,260 Class B preferred shares and one Class C preferred share of Lubes Amalco for the common shares it held in Mohawk Lubricants;

(d) Upon the Amalgamation, BAI received one common share of Lubes Amalco in exchange for its common share of 347; and

(e) the share capital of Lubes Amalco is described in the Certificate and Articles of Amalgamation dated August 1, 1998 . . .

41. Following the Amalgamation, the shareholders of Lubes Amalco were as follows:

| Shareholder | Common | Class A Preferred | Class B Preferred | Class C Preferred |
|---|---|---|---|---|
| Mohawk Canada | nil | 7,338,740 | 8,161,260 | 1 |
| BAI | 1 | nil | nil | nil |

**F. Post-Closing Transactions**

42. On September 29, 1998, BAI transferred 9,565,403 common shares of HB Acquisition to HMLT in exchange for 9,565,403 preferred shares of HMLT issued from treasury. BAI and HMLT jointly elected to have the provisions of subsection 85(1) of the Act apply to the transfer.

43. The terms of HMLT's preferred shares described in paragraph 42 are set out in HMLT's articles of Amendment . . . .

44. On September 30, 1998, HMLT transferred 9,565,403 common shares of HB Acquisition to Husky in exchange for 9,565,403 preferred shares of Husky issued from treasury. HMLT and Husky jointly elected to have the provisions of subsection 85(1) of the Act apply to the transfer.

45. On November 30, 1998:

(a) Lubes Amalco gave notice that it would redeem and did redeem the 7,338,740 Class A preferred shares owned by Mohawk Canada. The redemption price was paid

> by the issuance by Lubes Amalco of a non-interest bearing promissory note due in 2023 in the amount of $7,338,740 (the "Mohawk Note"). . . .
>
> (b) HB Acquisition and Mohawk Canada entered into an Assignment and Assumption Agreement pursuant to which Mohawk Canada agreed to pay the BAI Note in consideration for which HB Acquisition gave Mohawk Canada a promise to pay $5,934,598 on demand to Mohawk Canada. . . .
>
> (c) BAI and Lubes Amalco entered into an agreement pursuant to which BAI assigned its rights under the BAI Note to Lubes Amalco in consideration for which Lubes Amalco gave BAI a non-interest bearing promissory note due in 2023 in the amount of $5,934,598 (the "Assignment Note"). . . .
>
> (d) Mohawk Canada and Lubes Amalco agreed to set off and cancel the BAI Note and the Mohawk Note with Lubes Amalco issuing in favour of Mohawk Canada a new non-interest bearing promissory note due in 2023 in the amount of $l,404,142 (the "Set-off Note"). . . .
>
> **G. Other**
>
> . . .
>
> **H. Assessments, Reassessments and Objections Leading to the Appeal**
>
> 47. The assessment under appeal was made by Notice of Reassessment under the Act dated February 26, 2004 with respect to the Appellant's taxation year ending December 31, 1998. The Appellant filed a Notice of Objection in a timely fashion. The Minister confirmed the assessment under appeal by Notification of Confirmation made November 10, 2005.

[4] I will be using the defined terms from the Statement of Agreed Facts throughout my reasons for judgment unless I indicate otherwise.

Mr. Lindsay's Evidence

[5] Mr. Thomas Lindsay was called as a witness to provide the Court with an overview of the circumstances that gave rise to the acquisition of Mohawk Canada.

[6] Mr. Lindsay testified that the Mohawk Canada board members (the "Board") met to discuss the low trading range of the Mohawk Canada shares in the spring of 1997. The stock was thinly traded on the TSX and the Board felt that the trading price did not reflect Mohawk Canada's inherent value.

[7] He explained that a low stock price meant that Mohawk Canada's cost of capital was higher than its competitors', making it expensive for Mohawk to raise capital for the purpose of refurbishing its 360 service stations.

[8] A special committee (the "Special Committee") of the Board was set up to review strategic options and to make recommendations to the Board as to how shareholder value could be maximized. The options considered by the Special Committee included the rearrangement of Mohawk Canada's capital structure and the sale or merger of Mohawk Canada's Retail Business.

[9] Mr. Lindsay testified that the Board spent three months reviewing the strategic alternatives. The Special Committee finally recommended to the Board that Mohawk Canada hire financial advisors to guide it through a sales process. CIBC Wood Gundy and First Capital were hired to assist the Board. The financial advisors prepared a book on Mohawk Canada that was given to interested parties who were likely to submit expressions of interest. Husky was identified as an interested party as it had made overtures to acquire Mohawk Canada in the past.

[10] Mr. Lindsay explained that Mohawk had a very good footprint in Western Canada with 360 service stations, and the Board was confident that the process would result in an offer at a substantial premium over Mohawk Canada's trading range of $3.50 to $4.50 per share.

[11] However, the task of selling Mohawk Canada was not without its own unique set of challenges. A preliminary analysis had indicated that all of the likely buyers would be interested in making offers for some or all of Mohawk Canada's Retail Business. They were not interested in the Residual Assets.

[12] In January of 1998, Mohawk Canada's financial advisors recommended to the Board that Mohawk Canada should enter into exclusive negotiations with Husky. Husky had made an initial offer of $90 million to acquire the Retail Business in an asset-based transaction. This was the best offer received.

[13] Mr. Lindsay testified that he worked on several plans to deal with the Residual Assets that included keeping these assets in Mohawk Canada after the Retail Assets had been sold or transferring the assets to a new corporation that would be transferred to Mohawk Canada's shareholders as a dividend in kind, thus paving the way for a sale of the shares of Mohawk Canada. The latter option was preferred as it would have resulted in the lowest amount of corporate taxes having to be paid. It became quickly apparent that neither option would work. Mr. Sutherland's desire for an all-cash transaction in the $7.50 per share range could not be met. Additionally, the

investment bankers advised the Board that the new public corporation would be too small to attract public shareholder interest.

[14] Mr. Lindsay came up with the final plan, under which Balaclava would end up owning Mohawk Lubricants (being the main asset) the Jade Inventory and the Pound-maker shares (previously defined as the Residual Assets). Husky would purchase Mohawk Canada, which would continue to own the Retail Business, the Minnedosa Ethanol Plant and an insurance policy. This plan meant that Mr. Sutherland and the public shareholders would receive an all-cash payment for their shares while Balaclava would receive a much smaller cash payment and the Residual Assets for its interest in Mohawk Canada. As Balaclava was a significant shareholder of Mohawk Canada, an independent committee of the Board was appointed to oversee the fairness of the transaction, with RBC acting as its financial advisor to provide a fairness opinion on the related-party transaction.

[15] Mr. Lindsay testified that while Balaclava was in the solid waste recycling business, it did not have experience operating an oil recycling plant. Balaclava was willing to acquire the Residual Assets in order to allow the broader transaction to proceed. Mr. Lindsay explained that this was a better alternative to a failed transaction in which Balaclava would be left holding a significant interest in a company whose stock was thinly traded at prices significantly below what Mr. Lindsay believed was Mohawk Canada's inherent value.

[16] Mr. Lindsay testified that as a board member he was well aware of his fiduciary duties to maximize value for all shareholders. In light of that, he delegated the role of negotiating the transaction for Balaclava to Mr. Gordon Pow, the CFO of Balaclava. He expected that Mr. Pow would consult with him only if he had a problem negotiating the terms of the transaction with the independent committee and its advisors. He did not get involved in the design of the structure nor in the details leading to its implementation. His CFO turned to Balaclava's legal counsel, Ladner Downs, for commercial and tax advice. KPMG, Balaclava's auditors also played a role in the transaction.

Mr. Kopstein's Evidence

[17] Mr. Kopstein testified that his firm was approached by Mr. Pow to advise Balaclava on how a joint bid could be structured between Balaclava and Husky using a transaction structure which would allow Husky to acquire the Retail Business and Balaclava the Residual Assets.

[18] Mr. Kopstein testified that Husky's initial proposal to acquire the Retail Business through an asset purchase was unacceptable to the Mohawk Board. An asset-based transaction would have given rise to a significant tax liability resulting in a significant corporate tax liability for Mohawk Canada. The financial and tax model showed that with such a transaction structure the shareholders of Mohawk Canada would end up with a net cash purchase price significantly below Mr. Sutherland's desired price of $7.25 per share.

[19] Mr. Kopstein explained that Balaclava was unwilling to surrender part of its interest in Mohawk Canada for the Residual Assets as this would lead to capital gains tax. Since Balaclava was to receive significantly less cash than the public and Mr. Sutherland, he was instructed to come up with a transaction structure which would allow Balaclava to defer its gain.

[20] The first part of the transaction structure (the "Initial Transaction") called for Balaclava to sell its interest in Mohawk Canada for the consideration described in paragraph 24 of the Statement of Agreed Facts, consisting of 9,565,402 common shares of HB Acquisition, cash in the amount of $5,193,436 and a non-interest-bearing promissory note issued by HB Acquisition in the amount of $5,934,598 (the "HB Acquisition Promissory Note"). The second leg of the transaction structure called for Balaclava or an authorized subsidiary of Balaclava to acquire Mohawk Lubricants and the other Residual Assets for $15.5 million payable through the issue of two non-interest-bearing promissory notes in the amounts of $9,565,403 (the "First Promissory Note") and $5,934,598 (the "Second Promissory Note") respectively, payable in 25 years. This transaction step would be concluded only after the takeover bid was completed. The HB Acquisition Promissory Note and the Second Promissory Note would be offset and cancelled, leaving Balaclava (or its subsidiary) holding 9,565,402 common shares in HB Acquisition and Mohawk Canada holding the First Promissory Note. To complete the transaction, Balaclava would exchange the common shares of HB Acquisition for preferred shares of a Husky affiliate. While the preferred shares were retractable at the option of the holder, Husky could cause Balaclava (or its subsidiary) to accept the First Promissory Note in full and final payment of the redemption price.

[21] Mr. Kopstein testified that at that point he believed he had completed his main tax mandate. Under the Initial Transaction structure, Husky would have paid $103 million for all of the common share interest in Mohawk Canada. Balaclava would own the Residual Assets as well as 9,565,402 preferred shares in a Husky affiliate. The capital gain on Balaclava's interest in Mohawk Canada would be deferred until Balaclava asked for a retraction of the preferred shares, and HB Acquisition and Mohawk Canada could be amalgamated with Husky. While the

sale of the Residual Assets to Balaclava would take place in a taxable transaction, Mr. Kopstein was told that Mohawk Canada would have a sufficient tax shelter to offset the gain.

[22] The Initial Transaction structure was reflected in the Joint Bid Agreement signed between Husky and Balaclava, and in the purchase and sale agreement and the Option and Put Agreement, both appended as schedules to the Joint Bid Agreement. The Option and Put Agreement and the purchase and sale agreement were to be executed by Mohawk Canada after completion of its takeover, as the Board was not responsible for overseeing potential post-closing transactions. These post-closing transactions would be approved by the new board of directors controlled by Husky. Husky Oil and Balaclava provided, in the Joint Bid Agreement, undertakings to give effect to each of the aforementioned agreements.

[23] Mr. McNair called Mr. Kopstein in early July, after the offering circular had been mailed to the Mohawk Canada shareholders, to tell him that Mohawk Canada was more profitable than expected and that Mohawk Canada would incur tax liability on the sale of the Residual Assets. Mr. Kopstein testified that Mr. McNair was frustrated with the fact that Mohawk Canada was going to have to pay tax on the sale, which was an outcome that Husky had not bargained for. Mr. Kopstein suggested to Mr. McNair that the capital gain could be avoided by simply substituting preferred shares for the promissory notes that Mohawk Canada was to receive under the Initial Transaction structure. However, Mr. Kopstein explained that he needed his client's approval to begin work on a revised plan. Mr. Kopstein called Mr. Pow of Balaclava, who approved the new initiative provided it would not prejudice Balaclava's position.

[24] Mr. Kopstein worked with his corporate and securities partners to come up with the details of the revised plan. After completing their analysis of the tax, corporate and securities law considerations, a revised structure was proposed (the "Revised Structure") under which Mohawk Lubricants, the owner of the Residual Assets, would amalgamate with 347, an indirect subsidiary of Balaclava. Mohawk Canada would receive preferred shares of Lubes Amalco as described in paragraph 41 of the Statement of Agreed Facts. The Revised Structure called for the redemption of the 7,338,740 Class A preferred shares received by Mohawk Canada for a non-interest-bearing promissory note in the amount of $7,338,740 payable on June 1, 2023. Following this redemption, Mohawk Canada was left holding 8,161,260 Class B preferred shares and one Class C preferred share in Lubes Amalco. The Revised Structure was reflected in the Amended Option and Put Agreement executed after completion of the sale of Mohawk Canada and was fully implemented after the completion of the planned amalgamation.

Mr. McNair's Testimony

[25] Mr. McNair testified that he was part of the Husky team involved in the Mohawk Canada transaction. His primary responsibility was quarterbacking the tax due diligence and reviewing the plans for the acquisition of Mohawk Canada and the disposition of the Residual Assets by this corporation. He was not involved in the preparation of the tax plan as this was Mr. Kopstein's responsibility. Initially, his tax due diligence showed that Mohawk Canada would not be taxable on the sale of the Residual Assets in light of the information obtained from Mohawk Canada's tax advisors, Ernst and Young.

[26] By early June, as summarized in his memorandum of June 3, 1998[1], Mr. McNair had discovered that Mohawk Canada was more profitable than expected and would pay approximately $1.5 million in tax as a result of the sale of the Residual Assets. He corroborated Mr. Kopstein's testimony on the circumstances leading to the Revised Structure. His understanding of the Revised Structure is that both Mohawk Canada and BAI would be able to defer tax until the preferred shares they hold are redeemed. This event would likely occur only in 2023, which is the maximum deferral period built into the terms and conditions of the preferred shares.

Ms. Pereversoff's Evidence

[27] Ms. Pereversoff testified that she was asked to review the Mohawk Canada transaction by the CRA large case auditor assigned to the Husky audit. She found it peculiar that two unrelated parties could avoid capital gains tax by taking back similar preferred shares. She concluded that the amalgamation violated the exception in subsection 87(4) of the *Act* (the "87(4) Exception").

[28] The admissibility of her testimony was challenged by Mr. Crump, counsel for the Appellant, on the grounds that she was not qualified to give an opinion on the fair market value of the shares of Mohawk Lubricants and Lubes Amalco. She acknowledged that she was not qualified to do so but pointed out during her testimony that the value that she ascribed to the shares of Mohawk Lubricants was the value used by the parties to the transaction.

Mr. Weevers' Evidence

[29] Mr. Weevers testified that he disagreed with Ms. Pereversoff's basis for denying rollover treatment to Mohawk Canada for the purposes of subsection 87(4)

[1] Tab 25, Joint Book of Exhibits.

of the *Act*. He believed that Ms. Pereversoff had wrongly concluded that a "benefit" had been conferred on HB Acquisition within the meaning of the 87(4) Exception because she believed that HB Acquisition had been relieved of an obligation to pay cash for the shares disposed of by BAI. Apparently, she wrote this in a letter that was not provided in evidence. Mr. Weevers believed that rollover treatment should be denied on the grounds that Mohawk Canada received non-share consideration on the amalgamation. Mr. Weevers had difficulty explaining his position on this issue during his cross-examination. He finally agreed that the non-share consideration that he identified when he reviewed the file was BAI's agreement to accept common shares of HB Acquisition which were subsequently exchanged by BAI for preferred shares of HMLT.

[30] Mr. Weevers' decision to add subsections 56(2) and 69(4) as alternative grounds for his confirmation of the reassessment was made because he had received directions from a CRA department in Ottawa to do so.

## III. Issues to be decided by the Court

[31] The issues for determination in this appeal were framed by the pleadings as follows:

> (i) Whether the FMV of the shares of Lubes Amalco received by Mohawk Canada on the amalgamation of Mohawk Lubricants and 347 was less than the FMV of the Mohawk Lubricants shares prior to their disposal by Mohawk Canada and whether it is reasonable to regard all or a part of the excess . . . as a benefit which Mohawk Canada wished to confer on HB Acquisition so that the exception in s. 87(4) of the *Act* applies to deny rollover treatment;
>
> (ii) Whether Mohawk Canada received non-share consideration for its disposition of its shares of Mohawk Lubricants on the amalgamation of Mohawk Lubricants and 347 so that the rollover provision in s. 87(4) of the *Act* does not apply;
>
> (iii) Whether property owned by Mohawk Canada represented by its shares of Mohawk Lubricants, was appropriated for the benefit of HB Acquisition with Mohawk Canada receiving consideration in the form of preferred shares of Lubes Amalco having a FMV less than the shares of Mohawk Lubricants, so as to engage the provisions of s. 69(4) of the *Act*; and

(iv) Whether Mohawk Canada intended to confer a benefit to HB Acquisition when BAI's shares of Mohawk Canada were transferred to HB Acquisition so as to engage the provisions of s. 56(2) of the *Act*.

## IV. Positions of the parties

### Appellant's position

*Evidentiary objections*

[32] The Appellant objects to the testimony of both Mr. Weevers and Ms. Pereversoff on the grounds that their testimony was inadmissible because both witnesses were being asked to provide expert valuation evidence on the fair market value of the shares of Mohawk Canada and Lubes Amalco. The Appellant also argues that Mr. Weevers and Ms. Pereversoff were being asked to provide lay opinions on the application of the law to the facts herein, a matter that should be dealt with only in argument and ruled on by me in my judgment. Lastly, the objection was raised that the witnesses' testimony violated the parol evidence rule insofar as their evidence constituted an invitation to the Court to conclude that Mohawk Canada and Balaclava made mutual promises to exchange worthless shares for the benefit of being able to defer their respective taxable capital gains for 25 years. Mr. Crump argues that the agreements that give effect to the transactions were unambiguous and the parol evidence rule bars the witnesses from inferring that so-called mutual promises existed.

87(4) Exception

[33] Mr. Crump submits that in order for me to find that the 87(4) Exception applies to the facts herein, I must conclude that all of the following conditions have been met, which the Appellant disputes:

a) The fair market value of Mohawk Canada's shares in Mohawk Lubricants exceeded the fair market value of Mohawk Canada's shares in Lubes Amalco. On this point, the Appellant argues that the evidence of Mr. Lindsay in examination-in-chief and in cross-examination is sufficient to make out a *prima facie* case that the Respondent's assumption that the shares in Lubes Amalco were worth less than $15.5 million is wrong. As the Respondent failed to call an expert witness, I must conclude, according to Mr. Crump, that the Respondent has failed to make its case on this point.

b) It is reasonable to conclude that Mohawk Canada intended to confer a benefit on HB Acquisition as alleged by the Respondent in its pleadings. On this point, counsel argues that Ms. Pereversoff identified the benefit as the removal of HB Acquisition's obligation to pay BAI $7.25 in cash per share. Ms. Pereversoff's analysis on this point is contradicted, says counsel, by documentary evidence that clearly establishes that no such obligation existed.

c) Mohawk Canada was related to HB Acquisition at the time that the benefit was conferred. The Appellant's submission on this point is that the benefit was conferred when Mohawk Canada signed the support agreement on June 1, 1998, as that agreement set in motion the transactions which gave rise to the amalgamation. At that time, HB Acquisition and Mohawk Canada were not related.

Only share consideration was received

[34] The Appellant submits that the Respondent's allegation that non-share consideration was received by Mohawk Canada on the amalgamation is summarized in the read-in from the Appellant's examination for discovery of Mr. Weevers, as follows:

> The non-share consideration received by Mohawk Canada Limited in the course of disposing of Mohawk Lubricants Ltd. shares was BEL Acquisition Inc.'s promise to accept 9,565,402 common shares and a promissory note bearing a face value of $5,934,598 from HB Acquisition Inc. in the course of BEL Acquisition Inc.'s disposition of Mohawk Canada's [*sic*] Limited shares.[2]

[35] Furthermore, Mr. Crump points out that Mr. Weevers admitted in cross-examination that the non-share consideration identified by him was provided for under an agreement that took effect on July 7, 1998 pursuant to which BAI transferred its shares in Mohawk Canada to HB Acquisition. This agreement predates the execution of the amalgamation on July 8, which took effect on August 1. Counsel argues that Mohawk Canada received only shares in Lubes Amalco on August 1 and that past consideration, if any exists, cannot be considered to be consideration received on the amalgamation. Moreover, Mr. Crump further submits that the plain words of subsection 87(4) require that the non-share consideration be received from the corporation resulting from the amalgamation and not from a third party.

No appropriation under subsection 69(4)

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[2] Transcript of Mr. Weevers' examination for discovery at page 90, lines 5 to 12.

[36] The Appellant argues that subsection 69(4) does not apply to the facts herein because the Respondent failed to identify the appropriator in its pleadings and Ms. Pereversoff wrongly concluded that the benefit received by HB Acquisition was the removal of an obligation to pay BAI $7.25 in cash for each of its shares in Mohawk Canada.

Subsection 56(2) not applicable

[37] Counsel points out that the Minister failed, for the reasons mentioned earlier, to establish that HB Acquisition received a benefit. A benefit is an essential condition for the application of subsection 56(2).

**Respondent's position**

*Evidentiary objections*

[38] Mr. Gibson, counsel for the Respondent, rejects the Appellant's argument that the testimony of Ms. Pereversoff and Mr. Weevers is inadmissible. These witnesses were called to explain why the CRA denied tax-free rollover treatment and reassessed Husky in respect of the disposition by Mohawk Canada of shares in Mohawk Lubricants. Counsel also argues that the parol evidence rule does not apply to third parties, such as the Respondent, who are not parties to the documents signed by the parties to the transaction. What the parol evidence rule is designed to do is stop one party to a contract in written form from introducing evidence other than the written contract that is inconsistent with the wording of that written contract.

87(4) Exception

[39] Mr. Gibson argues that the only way the Appellant could rebut a technical assumption as to the fair market value of the shares of Mohawk Lubricants and Lubes Amalco was to call a recognized expert in the valuation field. The Appellant's witnesses were not qualified to provide expert testimony, in much the same way that the Respondent's witnesses were not qualified to do so. Therefore, the Minister's assumption as to the fair market value of the shares made in the pleadings must stand. Secondly, Mr. Gibson argues that Ms. Pereversoff used the value agreed to by the parties for the Mohawk Lubricants shares, as evidenced by the reference in the offering circular to the fact that the Residual Assets were to be purchased for $15.5 million.

[40] Mr. Gibson also takes issue with the allegation that Ms. Pereversoff concluded that the benefit conferred on HB Acquisition was the removal of its obligation to pay

$7.50 per share. Ms. Pereversoff did not testify on this point in her examination-in-chief. In addition, counsel for the Respondent did not cross-examine her on the point. All that counsel for the Respondent did was read an excerpt from Mr. Weevers' examination for discovery that established what Mr. Weevers believed Ms. Pereversoff had identified as being the benefit for the purposes of the 87(4) Exception. Mr. Weevers concluded that Mohawk Canada could be reassessed on a different basis: he believed that Mohawk Canada received non-share consideration for the shares it gave up in Mohawk Lubricants.

Non-share consideration

[41] Mr. Gibson argues that there were mutual promises given by BAI on the one hand and Mohawk Canada on the other to exchange shares for worthless shares and that these mutual promises constitute non-share consideration received by Mohawk Canada on the amalgamation of Mohawk Lubricants.

Subsection 69(4)

[42] Mr. Gibson submits that Husky, through its control of HB Acquisition, caused HB Acquisition to direct Mohawk Canada to enter into the amalgamation in order to fulfil a promise made to Balaclava that it would end up owning the Residual Assets when the transactions were finally completed. He argues that there was nothing for Mohawk Canada in the amalgamation; it gave up shares in Mohawk Lubricants worth $15.5 million for preferred shares in Lubes Amalco that were worthless. This constituted an appropriation by HB Acquisition, or Husky Oil for that matter, of property belonging to its subsidiary in much the same way that the Appellant in *Boardman v. R.*, 1985 CarswellNat 452, appropriated property, although the property was not transferred to him.

Subsection 56(2)

[43] The Crown argues that the actions that trigger the application of subsection 69(4) of the *Act* are the same actions that trigger the application of subsection 56(2).

## V. Analysis

*Evidentiary objections*

[44] I allowed Ms. Pereversoff and Mr. Weevers to testify subject to the reservation that I would rule on the admissibility of their testimony, and on the

weight, if any, I should give to it, prior to dealing with the substantive matters at issue.

[45] On cross-examination, both witnesses admitted that they were unqualified to give expert opinion on the fair market value of the shares of Mohawk Lubricants and Lubes Amalco. However, this does not mean that I must discard all of their testimony. Ms. Pereversoff testified that she believed that the shares of Mohawk Lubricants were worth $15.5 million based on the value used in the transaction documents by the parties. She also testified that she assumed the preferred shares taken by Mohawk Canada in Lubes Amalco were worthless in view of the terms and conditions of the shares. In addition, Ms. Pereversoff believed that Mohawk Canada intended to confer a benefit on HB Acquisition in accepting the worthless shares. These findings are the assumed facts that are listed in subparagraphs 17 (bbb), (ccc) and (ddd) of the Respondent's Reply to the Notice of Appeal. These were the facts that prompted Ms. Pereversoff to issue the reassessment on the basis that the amalgamation violated the 87(4) Exception.

[46] I admit the witnesses' testimony for the purpose only of establishing the facts that the Appellant has the initial burden of demolishing by presenting a *prima facie* case to the contrary. I also find that Mr. Weevers, in confirming the reassessment, believed that Mohawk Canada received non-share consideration for the disposition of its interest in Mohawk Lubricants and that property of Mohawk Canada, being the shares in Mohawk Lubricants, was appropriated for the benefit of HB Acquisition.

[47] I do not agree with Mr. Crump that the parol evidence rule prohibits the Respondent from alleging that Balaclava and Husky entered into mutual promises to transfer property for shares of much less value as a scheme to avoid capital gains tax. Mr. Justice Hugessen, writing for the Federal Court of Appeal in *Urichuk v. Canada*, [1993] 1 C.T.C. 226, dismisses the application of this rule as follows:

> . . . We also reject the Appellant's attempt to invoke the parol evidence rule to object to evidence of the circumstances leading up to the making of the agreement; **the Minister, not being a party to that agreement, is entitled to rely on any available evidence** to support his characterization of the payments in a manner different from that employed by the former spouses in the agreement itself. In our view the trial judge correctly examined the agreement and all its surrounding circumstances and applied thereto the proper criteria . . . .
>
> [Emphasis added.]

[48] Mr. Crump argues that the onus of proof as regards the question of the value of the shares had shifted to the Respondent. He bases this on the testimony of

Mr. Lindsay and on his analysis of the Supreme Court of Canada's decision in *Hickman Motors Ltd. v. Canada*, [1997] 2 S.C.R. 336.

[49] What exactly did Mr. Lindsay say during his examination-in-chief and on cross-examination? Mr. Lindsay said that Husky initially was interested only in Mohawk Canada's Retail Assets. Balaclava had identified five assets that Husky was unwilling to take. Mr. Sutherland, for this part, was interested in an all-cash bid. After extensive negotiations, Husky agreed to take two of the Residual Assets, namely the Minnedosa Ethanol Plant and a life insurance policy, and increased its initial offer from $90 million to $103 million. Following the amalgamation of Mohawk Lubricants, Balaclava would end up owning the Residual Assets consisting of the Pound-maker shares, the Jade Inventory and the oil refinery in British Columbia. On cross-examination, Mr. Lindsay testified as follows:

> Q MR. GIBSON: So, the figure of 15.5 million that we've heard about and that you were asked about by Justice Hogan earlier, how did that figure come about?
> A Which 15.5 number are you talking about?
> Q 15.5. The value of residual assets, portion of the residual assets.
> A Is that all the residual assets? The number would be a lot bigger that that.
> JUSTICE HOGAN: I said it was 103 plus 15.5 was the residual that you took, minus debt, and that give you a full share value, because in the 103 Husky was picking up the other residuals.
> A Yeah, they'd already picked up Minnedosa, that was the second most valuable asset after - -
> JUSTICE HOGAN: Plus the insurance policy.
> A Yeah. I mean, that number, you know . . .
> Q MR. GIBSON: The Crown thinks that Mohawk Lubes was worth 15.5 million.
> A I'm not sure if that's correct or if that included jade and the Poundamaker [*sic*]. Are you sure of that? Someone would have to show me the breakdown. I believe, and I stand to be corrected, is would it not be more like 13 million and two and a half million?
> JUSTICE HOGAN: 15.5 was for all the residual that they bought - -
> A All three of them. Well, you know, I believe the numbers were something like 13, 2.2 and a million or something, you know, to get to 15.5, but I'm somewhat guessing from recollection on that make of 15.5.[3]

[50] As Mohawk Lubricants owned all of the Residual Assets acquired indirectly by BAI at the time of Mohawk Lubricants' amalgamation, the value of its shares should be $15.5 million based on Mr. Lindsay's recollection. It would be hard for Mr. Lindsay to recollect otherwise. In the offer to purchase mailed to the Mohawk

[3] Volume 2, transcript, page 315, line 19 to page 316, line 23.

Canada shareholders, the parties declare that shares of Mohawk Lubricants are to be acquired for a purchase price of $15.5 million as follows:[4]

> ***Option Agreement***
>
> . . .
>
> Under the Option Agreement, BAI will be granted an option (the "Option") to purchase all of the issued and outstanding shares of Lubricants (the "Lubricants Shares"). BAI or any of its affiliates or associates will be entitled to exercise the Option at any time during a 20 day period (the "Option Period") following the date of the Option Agreement. Mohawk will have the right at any time during the Option Period to require the exercise of the Option by BAI. If the Option is exercised, the purchase price for the Lubricants Shares will be $15.5 million, subject to a working capital adjustment. The purchase price for the Lubricants Shares will be evidenced by the issuance by the purchaser of a promissory note, and BAI will be required to surrender its common shares of the Offeror in exchange for non-voting preferred shares of the Offeror.

[51] Mr. Crump presents a novel argument. He submits that a reasonable person apprised of the fact that the Amended Option and Put Agreement had been entered into would reduce the value of the Mohawk Lubricants shares to nil. I do not accept this argument. Mohawk Canada is a shareholder of Mohawk Lubricants. The fact that it has entered into the Amended Option and Put Agreement does not affect the value of the shares of its subsidiary, Mohawk Lubricants. Mohawk Canada could be compelled to give effect to the agreement or face a lawsuit for damages, both being actions that can be directed against it and not its subsidiary, Mohawk Lubricants. I note that the Amended Option and Put Agreement may affect the value of Mohawk Canada's shares as it is giving up Mohawk Lubricants, worth $15.5 million according to the Respondent, to accept shares of Lubes Amalco, which the Respondent says are worthless. It does not, however, affect the value of Mohawk Lubricants.

[52] If I were to accept Mr. Crump's submission on this point, *bona fide* estate freezes would no longer need to be implemented with the protection of valid price adjustment clauses. For example, based on this argument, a father could cause his holding corporation to grant a long-term option, for example, to his son to purchase assets from the corporation at their current price or a lower price. On his death, the father's estate could claim that the holding corporation's value is impaired because of the option, thus avoiding, for both the shareholder and the entity, tax on shares that have since increased in value.

[53] After review of the evidentiary objections raised by the Appellant, I conclude that the Minister's assumption that the shares of Mohawk Lubricants are worth $15.5

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[4] HB Acquisition's offer to purchase dated June 3, 1998, page 19.

million must stand. Equally, the Appellant has failed to make a *prima facie* case rebutting the Minister's assumption that the preferred shares of Lubes Amalco were worthless. To rebut this assumption the Appellant would have had to call an expert witness to provide the Court with an opinion on the fair market value of the Lubes Amalco preferred shares.

## Analysis of the substantive issues

### 87(4) Exception

[54] Rollover treatment may be disallowed under the 87(4) Exception, which reads as follow:

> . . . except that, where the fair market value of the old shares immediately before the amalgamation exceeds the fair market value of the new shares immediately after the amalgamation and it is reasonable to regard any portion of the excess (in this subsection referred to as the "gift portion") as a benefit that the shareholder desired to have conferred on a person related to the shareholder, the following rules apply . . .

[55] When this exception applies, the shareholder of the predecessor corporation is deemed to have disposed of the shares (the "Old Shares") of the predecessor corporation for an amount equal to the lesser of (i) the total of the adjusted cost base of the Old Shares and the gift portion, defined in that subsection as the amount by which the value of the Old Shares exceeds the value of the new shares, and (ii) the fair market value of the Old Shares immediately before the amalgamation.

[56] In order for the 87(4) Exception to apply in the instant case, I must find that all of the following conditions are met:

a) the fair market value of Mohawk Canada's shares of Mohawk Lubricants exceeded the fair market value of Mohawk Canada's shares of Lubes Amalco;
b) it is reasonable to regard any portion of the excess as a benefit that Mohawk Canada desired to confer on HB Acquisition; and
c) Mohawk Canada was related to HB Acquisition at the time the benefit was conferred.

[57] The preferred shares held by Mohawk Canada in Lubes Amalco give no dividend entitlement. The redemption price of the shares can be paid by Lubes Amalco through the issuance of a non-interest-bearing promissory note maturing on June 1, 2023. It is incontrovertible that an arm's length purchaser of the preferred shares would place a significant discount on the principal amount of the note. The Appellant failed to lead evidence on this point. As a result, the Minister's assumption that the Lubes Amalco preferred shares had a nil value must stand.

[58] Why did Mohawk Canada agree to accept the preferred shares in Lubes Amalco in exchange for the shares it gave up in Mohawk Lubricants? The short answer is that Mohawk Canada had no independent say in the matter. The evidence shows that Husky wanted the Retail Business. It was unwilling to purchase the Residual Assets. Balaclava wanted to liquidate its position in Mohawk Canada and was willing to accept the Residual Assets in lieu of an additional cash payment of $15.5 million provided that the Residual Assets could be acquired on a pre-tax basis. Mohawk Canada was compelled to give effect to the amalgamation and exchange its shares in Mohawk Lubricants for the preferred shares in Lubes Amalco, because the amalgamation was the means by which the Residual Assets could be transferred to Balaclava, supposedly on a tax-free basis. The amalgamation was a condition *sine qua non* that paved the way for HMLT's and Husky's acquisition of Mohawk Canada. Both of these entities gave undertakings to Balaclava that they would cause Mohawk Lubricants to amalgamate with 347 and Mohawk Canada gave effect to this promise for the benefit of HB Acquisition and Husky. In my opinion, the 87(4) Exception is designed to prevent this very result by providing that the shareholder of the predecessor corporation must act in its own interest and not for the benefit of a related party, such as a controlling shareholder.

[59] It should also be noted that the amalgamation benefited HB Acquisition and Husky in another way. Under the Amended Option and Put Agreement, HB Acquisition could have been compelled to acquire the securities it issued to BAI for $15.5 million if the Residual Assets were not transferred to Balaclava through the completion of the amalgamation on or before September 29, 1998. HB Acquisition's obligation to pay this amount was supported by a guarantee given by Husky. Both of these contingent obligations were terminated on completion of the amalgamation. Following the amalgamation, BAI was compelled to exchange its common shares of HB Acquisition for preferred shares in HMLT, which have terms and conditions similar to securities held by Husky in Lubes Amalco. I infer from the fact that BAI exchanged the shares in HB Acquisition for preferred shares in HMLT that provided no annual return to it that it was satisfied that it had received the $15.5 million of value attributable to the Residual Assets through the completion of the amalgamation.

[60] Mr. Crump argues that Mr. Weevers failed to properly identify the benefit required to trigger the application of the 87(4) Exception. He makes his point in a roundabout way by referring me to Mr. Weevers' testimony on discovery. Mr. Weevers testified that Ms. Pereversoff invoked the 87(4) Exception because she had wrongly concluded that HB Acquisition was relieved from paying $7.50 per share in cash only with respect to the shares disposed of by BAI in favour of HB Acquisition. The evidence shows that HB Acquisition did not have an immediate obligation to make an additional $15.5 million cash payment to BAI. This obligation would arise only if HB Acquisition failed to cause Mohawk Canada to complete the amalgamation on or before September 29, 1998. I am not sure whether Ms. Pereversoff grasped this distinction. The question was not put to her when she testified. In any event, what Ms. Pereversoff believed is not important, as my review of the evidence has led me to conclude that Mohawk Canada gave up shares worth $15.5 million for worthless preferred shares because its shareholders, HB Acquisition and Husky, agreed to these terms as part of their bargain with Balaclava. As a result, a benefit was conferred on HB Acquisition and, indirectly, on Husky.

[61] That being said, there is nothing offensive, in my view, about the parties ending up with cross-shareholdings allowing a potential 25-year deferral of capital gains tax. Mohawk Canada, however, could not benefit from a rollover under subsection 87(4) because it ran afoul of the 87(4) Exception.

[62] I suspect that Mr. Kopstein faced a significant quandary in designing the terms and conditions of the preferred shares issued by Lubes Amalco to Mohawk Canada. His client, Balaclava, had instructed him that it was prepared to accommodate Husky's desire that Mohawk Canada not pay taxes in connection with the disposition of the Residual Assets provided that Balaclava's commercial objectives were not prejudiced thereby. To make the tax plan more robust from a rollover standpoint, the preferred shares could have been made retractable for fair market value consideration. An annual dividend entitlement could have been added to the shares. These features would have been consistent with what the CRA generally demands in the case of an estate freeze. I assume that the former feature was inconsistent with Balaclava's desire to benefit from a 25-year deferral. If the Lubes Amalco shares had been made redeemable for fair market value consideration, Husky could have demanded the immediate redemption of these shares. This meant that BAI would have been compelled to do the same for its shares in HMLT, otherwise it would assume the risk associated with a continued investment in HMLT, while at the same time having no return on its investment. I assume that this consideration prompted Mr. Kopstein to design the terms and conditions of the Lubes Amalco preferred shares so as to ensure that Husky would retain its investment for as long as BAI

desired to benefit from a rollover. I infer from the evidence that this was achieved by providing that the redemption price would be paid through the issue of a non-interest-bearing note maturing in June 2023. I suspect that the annual dividend feature was also rejected because Lubes Amalco would incur Part VI.1 tax if it paid a dividend to Husky. HMLT would incur the same tax when it paid a matching dividend back to BAI. It seems that Balaclava's legitimate commercial considerations prevailed over Husky's desire for a tax-free rollover. This is an understandable result in the circumstances.

[63] The Appellant argues that the words "reasonable to regard" used in the 87(4) Exception require an objective review of the evidence. I agree with this proposition and I believe that this is what I have done. However, I do not agree with Mr. Crump's second proposition that I must consider the overall impact of all of the transactions entered into by the parties. This is what Mr. Crump is inviting me to do in arguing that Mr. Lindsay testified that from an overall standpoint each party ultimately ended up owning what that party bargained for.

[64] The 87(4) Exception is designed to prevent related parties from shifting equity values around, much as paragraph 85(1)(*e.3*) does in the case of a rollover of property for shares, and subsections 86(2) and 51(2) do in the case of an exchange of securities of an issuer for new shares of the same issuer. Without these provisions it would be easy for related parties to avoid personal tax or corporate tax by directing the shareholder of an amalgamating corporation to take back securities of lesser value. A butterfly transaction structured to comply with subsection 55(2) or a bump transaction structured to comply with paragraph 88(1)(*c*) can lead to the avoidance of tax by the corporate entity, but neither of these provisions could have been made to work in the case at bar. In my opinion, the 87(4) Exception must be tested solely at the level of Mohawk Canada and not by reference to the overall result of all of the transactions as suggested by Mr. Crump. The words of the 87(4) Exception limit one, in identifying the benefit conferred, to a search conducted at the level of the disposing shareholder. This is clear from the reference in that provision to the fair market value of the shares before and after the amalgamation.

[65] The last point in the Appellant's argument is that the benefit arose as a result of agreements entered into at a time when HB Acquisition (and Husky for that matter) and Mohawk Canada were not related. Therefore, the 87(4) Exception cannot apply. I find nothing in the agreement that supports this view. The Joint Bid Agreement was entered into by Husky and Balaclava. The Option and Put Agreement is attached as a schedule to the Joint Bid Agreement. Husky and Balaclava were committed to execute the Option and Put Agreement after the takeover closed. Mohawk Canada, being the object of the Joint Bid Agreement, was

not obliged to give effect to the Option and Put Agreement. Mohawk Canada did sign the support agreement, but there is nothing in that agreement that deals with the transfer of the Residual Assets to Balaclava. The board of Mohawk Canada could not agree to the transfer of the Residual Assets without knowing whether its shareholders would agree to tender their shares pursuant to HB Acquisition's offer. The Amended Option and Put Agreement was executed by the new board after the takeover transaction closed and at a time when HB Acquisition, Husky and Mohawk Canada were related. This is consistent with what happens after a takeover is completed. A new board is appointed to allow the new owners of the corporation to implement their plans for the target entity, including post-closing reorganizations. Therefore, I conclude that the 87(4) Exception applies to the disposition by Mohawk Canada of its shares of Mohawk Lubricants that occurred on amalgamation.

Non-share consideration

[66] As noted earlier, Mr. Weevers took issue with the basis on which Ms. Pereversoff concluded that the 87(4) Exception applied so as to deny rollover treatment. He recommended an alternative basis for the reassessment under subsection 87(4) of the *Act*. Mr. Weevers concluded that Mohawk Canada received non-share consideration, which violated the prohibition in the preamble to that subsection. Subsection 87(4) also denies rollover treatment if the shareholder of the predecessor corporation receives non-share consideration for the shares of the predecessor corporation.

[67] I disagree with Mr. Weevers' analysis. Mohawk Canada received only preferred shares of Lubes Amalco on the amalgamation. Balaclava received more than the securities of HB Acquisition when it agreed to transfer to that entity the shares of Mohawk Canada. Balaclava got an undertaking by Husky and HB Acquisition to cause Mohawk Canada to complete the amalgamation. This may be consideration to Balaclava. It is not, however, consideration received by Mohawk Canada. Mohawk Canada simply gave effect to the amalgamation; this freed HB Acquisition from the risk of having to pay cash to BAI for the securities that it held in HB Acquisition and released Husky from its guarantee of this obligation. The amalgamation also removed the risk, for both parties, of a claim by BAI for damages if the amalgamation was not completed as agreed.

Subsection 69(4)

[68] The Respondent also argues that the amalgamation gives rise to the application of subsection 69(4) of the *Act*. That subsection reads as follows:

> **69(4) Shareholder appropriations** — Where at any time property of a corporation has been appropriated in any manner whatever to or for the benefit of a shareholder of the corporation for no consideration or for consideration that is less than the property's fair market value and a sale of the property at its fair market value would have increased the corporation's income or reduced a loss of the corporation, the corporation shall be deemed to have disposed of the property, and to have received proceeds of disposition therefor equal to its fair market value, at that time.
>
> [Emphasis added.]

[69] This provision is much broader than the 87(4) Exception. Property can be appropriated in many ways outside the case of a rollover. For example, a shareholder could cause property of a corporation to be transferred to it for consideration less than fair market value. A controlling shareholder could cause a corporation to transfer property to someone else to relieve that corporation of an obligation or, in this case, to free HB Acquisition, or Husky for that matter, from the risk of having to pay cash to BAI for the securities issued by HB Acquisition.

[70] The transactions carried out by Husky, HB Acquisition, Balaclava and BAI in the present case are a more sophisticated version of the following basic plan presented here to illustrate the application of subsection 69(4):

a) Seller A owns a subsidiary corporation (Target Corporation) that it wants to sell.
b) Purchaser B wants to acquire the Target Corporation.
c) Both parties wish to reduce their respective tax bills.
d) Seller A agrees to reduce the purchase price it is willing to receive for the Target Corporation on condition that Purchaser B will cause the Target Corporation to transfer an asset to it at a discount equal to the agreed-upon reduction in the purchase price for the Target Corporation.
e) Seller A pays less tax, Purchaser B conserves cash and the Target Corporation pays less tax.

[71] In the present case, a similar result occurs under a more sophisticated plan. HB Acquisition agreed to cause Mohawk Canada (Target Corporation) to transfer Mohawk Lubricants for consideration worth less than the fair market value of the Mohawk Lubricants shares. As a result, HB Acquisition conserves cash. Following the amalgamation, HB Acquisition could no longer be compelled to buy back for $15.5 million the securities it issued to BAI. To complete the transaction, BAI, having obtained the full present value of the Residual Assets, transferred the shares it held in HB Acquisition in exchange for preferred shares in HMLT that had a similar impaired value. I am of the opinion that, in the instant case, Mr. Kopstein's plan was designed to defer tax while the plan described above is aimed at avoiding tax. Subsection 69(4) prevents both plans from working by providing that the Target

Corporation must pay tax on the full value that has been appropriated for the benefit of its shareholder HB Acquisition.

[72] The Appellant argues that the Respondent did not properly identify the appropriator in its Reply to the Notice of Appeal. The documentary evidence submitted to me in the Joint Book of Documents has enabled me to conclude that the appropriators are HB Acquisition and Husky, the parties that directed Mohawk Canada to enter into the amalgamation for their benefit. The transactions that give rise to the application of subsection 69(4) are the very same ones that give rise to the application of the 87(4) Exception.

Subsection 56(2)

[73] The Respondent invokes subsection 56(2) as an alternative basis for the reassessment. That provision reads as follows:

> **56(2) Indirect payments** — A payment or transfer of property made pursuant to the direction of, or with the concurrence of, a taxpayer to some other person for the benefit of the taxpayer or as a benefit that the taxpayer desired to have conferred on the other person (other than by an assignment of any portion of a retirement pension pursuant to section 65.1 of the *Canada Pension Plan* or a comparable provision of a provincial pension plan as defined in section 3 of that *Act* or of a prescribed provincial pension plan) shall be include in computing the taxpayer's income to the extent that it would be if the payment or transfer had been made to the taxpayer.
>
> [Emphasis added.]

[74] In *Neuman v. M.N.R.*,[5] the Supreme Court of Canada reduced the application of subsection 56(2) to its essential characteristics as follows:

> (1) the payment [transfer of property] must be to a person other than the reassessed taxpayer;
>
> (2) the allocation must be at the direction or with the concurrence of the reassessed taxpayer;
>
> (3) the payment [transfer of property] must be for the benefit of the reassessed taxpayer or for the benefit of another person whom the reassessed taxpayer wished to benefit; and
>
> (4) the payment [transfer of property] would have been included in the reassessed taxpayer's income if it had been received by him or her.

[5] [1998] 1 S.C.R. 770, at p. 782.

[75] Mr. Weevers testified that someone in the head office suggested that subsection 56(2) should be thrown into the mix in the event that the Court concluded that the amalgamation qualified for rollover treatment under subsection 87(4) and that subsection 69(4) did not apply. The four conditions listed above require that a person other than the transferor direct that the transfer take place, thus making that person taxable provided that the person would otherwise be taxable if the transfer was made directly to him or her. Subsection 56(2) could have applied to HB Acquisition, the party that benefited from the amalgamation, in much the same way that subsection 15(1) could have been invoked. The amalgamation was not carried out for the benefit of Mohawk Canada, as it gave up shares that had a greater value than the Lubes Amalco shares it received. Finally, subsection 56(2) cannot be applied to the owner of the transferred property, Mohawk Canada, because it would not have been subject to tax on property that it already owned and thus the requirement of the fourth condition is not met. For these reasons, subsection 56(2) does not apply to the transactions herein.

[76] For all of these reasons, the Appellant's appeal is dismissed, with costs to the Respondent.

Signed at Ottawa, Canada, this 24th day of February 2009.

"Robert J. Hogan"

Hogan J.

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