Corporate Reorganizations – An Update on Recent Issues

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Our selected topics bear no relation to one another, except that each is fairly recent and broadly falls under the rubric of "Corporate Reorganizations". Our comments are intentionally brief, in the hope that they may be read in advance of our 30-minute presentation.

1. Price adjustment clauses – Are they effective?

a. Case causing a stir

Readers will know that *St. Michael Trust Corp*. (also known as *Garron Family Trust)*[2] has – for the time being – changed the law on the tax residence of a trust. Leave to appeal has been granted by the Supreme Court of Canada, so the story has not been fully told. Perhaps a lesser-known issue (to arise from this case) stems from the following comment of Sharlow, J.A. at paragraphs 37 and 38:

> 37 Justice Woods concluded, for reasons that are well explained, that the Minister's assumption had not been rebutted, but she did not consider it necessary to determine the value. Therefore, for purposes of this appeal, it must be taken as a fact that the pre-reorganization value was substantially more than $50 million.
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> 38 As a practical matter, that means that the redemption value of the Freeze Shares was fixed at an amount, $50 million, that was less than their actual value, resulting in a shift in the value of PMPL from the holders of the Freeze Shares (Garron Holdings and Dunin Holdings) to the holders of the New Common Shares (the Trusts). The articles of incorporation of PMPL contain a provision that would have adjusted the

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2 *Garron Family Trust (Trustee of) v. The Queen*, 2010 FCA 309; affirming *Garron Family Trust (Trustee of) v. The Queen*, 2009 TCC 450; leave to appeal to SCC granted June 23, 2011 (under the style of cause *St. Michael Trust Corp., as Trustee of the Fundy Settlement* and *St. Michael Trust Corp., as Trustee of the Summersby Settlement*).

> redemption value of the Freeze Shares upon a determination by a taxing authority or a court that the fair market value of the Freeze Shares was some amount other than $50 million, but that clause was never in play because no such determination was made. (emphasis added)

The "Freeze Shares" referred to in the excerpt were garden-variety, fixed-value, preferred shares issued in the course of a relatively standard freeze of a Canadian company's existing common shares – *except* that the freeze was in favor of new family trusts established in Barbados (the residence of which became a central issue in the case). The new common shares issued to the trusts were sold two years following the freeze, at a substantial gain. The trusts argued that the gain escaped Canadian taxation entirely. They lost on the ground that the trusts were resident in Canada for tax purposes.

The Canada Revenue Agency ("CRA") argued, and the Tax Court found, that the value of the common shares of the Canadian company at the time of the freeze was *greater than* the value as determined by the company, meaning that there was a value shift from the Canadian shareholders to the (Barbados) trusts immediately following the freeze. No determination of the *specific* value of the common shares was required for this purpose.

b. Relevance of the value shift

The value shift was relevant primarily to the contribution test in old s. 94(1): i.e., whether the new trusts had acquired property "directly or indirectly in any manner whatever" from a Canadian resident beneficiary or a person related to that beneficiary.[3] In applying (and arguably extending) the reasoning in *Kieboom*,[4] Sharlow, J.A. found there was such an acquisition. The common shares of the company (i.e., prior to the freeze) had a value *greater than* the preferred shares issued on the freeze, meaning there was a shift of the excess value from the original common shareholders to the (Barbados) trusts. This finding was sufficient to result in a transfer of property that engaged s. 94(1). Further, as just noted, this finding could be made without having to "determine" any *specific* value for the common shares at the time of the freeze (i.e., it was sufficient that, in the court's opinion, the actual value was at least *higher than* the transaction value).

[3] All statutory references are to the *Income Tax Act* (Canada), as amended, unless noted otherwise.

[4] *The Queen v. Kieboom*, 92 DTC 6382.

c. PAC was not engaged

The "price adjustment clause" ("PAC") in the Canadian company's articles (referred to in the opening excerpt above in connection with the freeze) read as follows:

> The fair market value of the Common Shares shall be determined by the Corporation as of the close of business on the day before the Director appointed under the Act has certified these Articles of Amendment. In the event that any taxing authority or court of competent jurisdiction makes a determination (to which the Corporation acquiesces or from which there is no further right to object or appeal) that the fair market value of the common shares is an amount other than the amount determined by the Corporation, then the fair market value of the Common Shares for the purposes of determining the Redemption Amount of a Class A [freeze] share shall be such other amount. (emphasis added)

A PAC can only operate if the conditions that it specifies actually occur. Here, as there was no actual "determination" of a specific value (amount) *at any time* by a tax authority or a court, the clause was simply not engaged – on its *own* terms. That is, at no point in the history of the case did either the CRA or a court make a specific "determination" that the value of the common shares was "an amount" different than the amount determined by the corporation at the time of the freeze, so the PAC "was never in play". Because the PAC was inapplicable in preventing the value shift described above, the court held that s. 94(1) was applicable.[5]

The failure of the PAC to operate (leading to the application of s. 94(1)) did not, in the end, affect the final outcome in the case. As mentioned above, the taxpayers ultimately lost because the trusts were found to be resident in Canada (on common law principles) and were fully taxable in Canada on that basis.

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[5] An interesting historical point may be made here. The minority judgment of Sheppard, DJ, in the landmark decision of *Guilder News Co. v. M.N.R.*, [1973] C.T.C. 1, makes a similar point in respect of a virtually identical price adjustment clause. After finding the price adjustment clause to be a sham, Sheppard, DJ went on to say that:

> There was no finding by the Minister of the fair market value within the meaning of clause 4. There was at the most an assessment by the Minister under the power of the *Income Tax Act*, and not a valuation pursuant to clause 4. [emphasis added]

The CRA's helpful response to *Guilder News* – in Interpretation Bulletin IT-169 - Price Adjustment Clauses (August 6, 1974) – may have been prompted in part by the above statement; IT-169 uses the same "determination" language. This IT Bulletin was not discussed by either the Tax Court or the Federal Court of Appeal in *St. Michael Trust Corp*.

d. Implication - broader triggering language for PACs?

In the course of argument on s. 68, the taxpayers in *St. Michael Trust Corp*. actually relied on the *non*-application of the PAC to support the view that s. 68 could not apply to the freeze shares on the sale two years following the freeze.

This point is made at paragraph 397 of the Tax Court decision, where Woods, J. says:

> The appellants submit that the allocation of the proceeds on the sale to Oak Hill was reasonable. Even if the value of PMPL at the time of the 1998 reorganization was greater than $50,000,000, the preference shares were redeemable for only $50,000,000 at the time of the sale because the adjustment mechanism had not been triggered at that point. (emphasis added)[6]

The Minister did not make full submissions on this point, and Woods, J. simply decided that "in all the circumstances it would be preferable to defer a consideration of section 68 for another day".

In most cases, taxpayers will naturally want their PACs to be "in play" in the event of a proposed assessment or reassessment that is, in some fashion, *based on* the tax authority not agreeing with their chosen values. A PAC is intended to prevent the adverse application of various deemed FMV rules, benefit conferral rules, and attribution rules: i.e., s. 69, s. 15, s. 74 to s. 74.3, s. 85(1)(e.2), s. 86(2), and the like.

In many cases (for example, deemed FMV and benefit conferral cases), one would think it necessary for the CRA to first "determine" a *specific* value to support the assessment. This may then engage a PAC that employs "determination" language. However, and notwithstanding the "determination" language used in IT-169, one lingering (and perhaps renewed) concern may be the comment in the *dissenting* judgment of Sheppard, DJ, in *Guilder News*: i.e., "There was at the most an assessment by the Minister under the power of the Income Tax Act, and not a valuation" (emphasis added).[7]

In order to meet such an argument head on – and further to guard against the possible application of attribution rules in circumstances discussed above – it would be prudent to employ a sufficiently

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[6] The emphasized words raise a further question as to whether the comments from Sharlow, J.A. above (i.e., that the clause "was not in play") were intended to mean *only* that no reassessment action had been initiated *by the time of the sale*, and that after the sale any PAC (as between the parties) would be quite irrelevant. The problem with this suggestion, however, is that no such time reference was made by Sharlow, J.A., who is a careful and thoughtful judge. Had Sharlow, J.A. intended a time reference, it is quite likely she would have used words to this effect.

[7] See footnote 4.

broad PAC that clearly contemplates an assessment or proposed assessment (or reassessment) as the triggering event.

One such clause, in the context of a s. 85(1) transfer for example, might read as follows:

> If:
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> (a) the Minister of National Revenue or any other competent authority at any time questions or proposes to issue or issues any assessment or reassessment that would impose or imposes any liability for tax of any nature or kind on any of the parties or on any other person on the basis that the fair market value of the Property at the date of this Agreement is greater or less than the Estimated Value[8]; and
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> (b) the Vendor and the Purchaser agree or a competent tribunal finally adjudges that the fair market value of the Property is a greater or lesser amount (the "Adjusted Value") than the Estimated Value;
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> then
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> (c) the redemption amount in respect of the class • shares in the capital of the Purchaser, as that term is defined by reference to the articles of the Purchaser, will be determined by reference to the Adjusted Value to the exclusion of the Estimated Value; and
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> (d) the Vendor and the Purchaser will do all such things and perform all such acts as may be necessary to revise the redemption amount accordingly. [emphasis added]

Such "if…then" language could be modified for all manner of non-arm's length transactions.[9] Of course, all other aspects of PACs – which we have come to know well – must be carefully observed. Not the least of these are (1) that the evidence must disclose a *bona fide* intention of the parties to transfer the property at fair market value ("FMV"), and (2) the parties must arrive at that FMV by a fair and reasonable method.[10]

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8 The Estimated Value would be defined earlier in the agreement. Typically, the property is sold "at fair market value", which is determined in the first instance by a fair and reasonable valuation. The number so determined is the Estimated Value.

9 See Joan E. Jung, "Price Adjustment Clauses Under Attack?", vol. 11, no. 2 Tax for the Owner-Manager (Toronto: Canadian Tax Foundation, April 2011); Douglas Ewens, "Use of Adjustment Clauses in Non-Arm's-Length Reorganizations" (1981), vol. 29, no. 5 Canadian Tax Journal 718 - 30 at 723.

10 See *Krauss v. Canada,* 2010 FCA 284, affirming 2009 TCC 597 (PAC ineffective: partnership interest was not retractable by the holder, so PAC that adjusted the redemption value with reference to the property value could not evidence an intention to transact at FMV); *Leung et al. v. MNR*, 92 DTC 1090, at page 1097 (PAC valid: value supported by evidence that addressed the matter, noted historical sales, noted earnings of the company,

e. Brief Comment on Rectification

Before leaving this topic, we offer a brief word on rectification. If a PAC is not operative in a particular circumstance, or there is some other defect that the PAC does not address, rectification may be a good option to eliminate or mitigate any adverse tax consequence. A recent (and helpful) example is the Alberta Court of Queen's Bench decision in *S&D International.*[11] Graesser, J. exercised his equitable jurisdiction to reduce the consideration given under an agreement where the parties had assigned a FMV to the consideration that was significantly less than the FMV assigned by the Minister. The agreement did not contain a PAC, so the taxpayers were forced to seek a court-ordered rectification.

The court granted the relief sought, and in so doing, provided an excellent overview of the law in this area. The court's equitable jurisdiction was engaged by a fundamental mistake as to the tax effect of the transactions, as disclosed by the (self-evident) fact that the parties would have done something else had they been aware of the adverse tax consequences of their documented transaction. The case is also an important reminder that transaction documents should, where possible and appropriate, expressly mention the intended tax results of the transaction (assuming such intentions are held by the parties at the time of the transaction).[12]

2. "Kiddie tax" extended to certain capital gains

The rules in s. 120.4 – otherwise known as the "kiddie tax" – limit income-splitting structures that result in certain types of income being shifted (economically) from a higher-income earner to a lower-income child.

The kiddie tax applies at the highest marginal tax rate (currently 29% at the federal level) and is applied to "split income". Split income includes (i) dividends from private companies and (ii) income

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and noted effects of a fire – all to arrive at a value the taxpayers thought was reasonable); *Wagner v. Canada,* 2001 FCA 319 (PAC ineffective: sale of real estate implemented on basis of 2-plus year-old appraisal, updated orally, prior sale proposals ignored, value $200,000 less than taxpayers' own expert at trial). For additional information on PACs, see the following: "Revenue Canada Round Table" in Report of Proceedings of the Forty-Second Tax Conference, 1990 Conference Report (Toronto: Canadian Tax Foundation, 1991), 50:1-33, question 58; CCH-Tax Window Files Document number 9805487 dated July 30, 1998; Information Circular IC 01-1 "Third Party Civil Penalties," paragraph 71; Vancouver District Office, 1991 BC Tax Study Group round table, question 15, referred to in John L. Carlin and Robert R. Jason, Section 85 Rollovers (Toronto: CCH Canadian 2001)at 64.

[11] *S&D International Group Inc. v. Attorney General of Canada*, 2011 A.B.Q.B. 230.

[12] On October 13, 2011, the Supreme Court of Canada granted leave on a rectification case out of Quebec: *34235 Agence du Revenu du Québec (formerly the Deputy Minister of Revenue of Quebec) v. Services Environnementaux AES Inc., Centre Technologique AES Inc.* The decision in this case will be an important addition to the growing body of case law in this area.

from a partnership or trust if such income is derived from providing property or services to, or in support of, a business carried on by a person related to the child (i.e., management partnership or trust structures).

Prior to the 2011 federal budget, the kiddie tax did not apply to capital gains realized by the child. Naturally, various techniques developed to exploit this omission, including structures resulting in gains being realized, for the benefit of the child, on a sale of shares of a company to a family member or related person (or vehicle). In 2005,[13] the CRA advised the tax community that the general anti-avoidance rule ("GAAR") was "a concern" with respect to using stock dividends to avoid the kiddie tax.

The 2011 federal budget proposed to extend the kiddie tax to capital gains realized by, or included in the income of, a minor from a disposition of *shares* of a corporation[14] to a person who does not deal at arm's length with the minor, if taxable dividends on those shares would have been subject to the kiddie tax. Such capital gains will be treated as ineligible dividends. As a result, they will not be subject to the capital gain 50% inclusion rate and will not qualify for the capital gain exemption (for qualified small business corporation shares). Further, the corporation will be considered not to have paid a dividend.

On August 16, 2011, draft legislation was released to implement the budget announcement. New subsection 120.4(4) provides that if a specified individual (generally an individual under 18 years of age) would have a taxable capital gain (other than an excluded amount) from a disposition of *shares* (other than shares of a class listed on a designated stock exchange or shares of a mutual fund corporation) that are transferred, "either directly or indirectly, in any manner whatever", to a person with whom the specified individual does not deal at arm's length, then the amount of that taxable capital gain is deemed not to be a taxable capital gain. Rather, twice the taxable capital gain is deemed to be received by the specified individual in the year as a taxable dividend that is not an eligible dividend. It is clear the use of the phrase "directly or indirectly, in any manner whatever" is intended to cast a wide net around transfers ultimately to a non-arm's length person.

New s. 120.4(5) provides that if a specified individual would be required under s. 104(13)(a) or s. 105(2) to include an amount in computing the specified individual's income for a taxation year (i.e., amounts payable from a trust), then to the extent that the amount can reasonably be considered to be

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13 Income Tax Technical News No. 34 (General Anti-Avoidance Rule and Audit Issues/Concerns).

14 The tax does not, however, extend to dispositions of trust or partnership interests where income from the partnership or trust is derived from providing property or services to, or in support of, a business carried on by a person related to the child.

attributable to a taxable capital gain (other than an excluded amount) of a trust from a disposition of *shares* (same exclusions as above) that are transferred (same direct or indirect language as above) to a person with whom the specified individual does not deal at arm's length, then s. 104(13)(a) and s. 105(2) do not apply in respect of the amount, and twice the amount is deemed to be received by the specified individual in the year as a taxable dividend that is not an eligible dividend.

As a result, the federal 29% kiddie tax (and applicable provincial rate) will apply to this *deemed* taxable dividend. Further, the taxable dividend is not an "eligible dividend", such that the rules relating to eligible dividends (i.e., the favorable rate of dividend tax credit) do not apply. However, these deeming rules will not result in a dividend having been *paid by* the corporation. This is sensible in that the corporation would (typically) not be involved in the sale; the rule merely changes the character of the gain realized into an amount on income account.

The definition "excluded amount" in s. 120.4(1) describes income that is excluded from the split income of an individual. There currently are two types of income that qualify as an excluded amount: (1) income from property inherited by the individual from a parent of the individual, and (2) income from property inherited by the individual from anyone, if the individual is, in the year in which the income is required to be reported, either a full time student enrolled at a post-secondary educational institution as defined in s. 146.1(1) or eligible for the disability tax credit.

The definition "excluded amount" is amended to include a taxable capital gain from the disposition of a property inherited in the circumstances described above. This amendment is concurrent with the introduction of new s. 120.4(4) and s. 120.4(5), to ensure that a taxable capital gain of an individual from such a property is not included in split income.

These amendments apply to dispositions that occur on or after March 22, 2011.

3. Amalgamations & Liquidations

a. Broken Amalgamation

In *Envision Credit Union*,[15] two credit unions (corporations) structured their amalgamation under the British Columbia *Credit Union Incorporation Act* to avoid the amalgamation rules in s. 87. They purported to do this by transferring certain assets to a subsidiary at the exact moment of the

[15] *Envision Credit Union v. The Queen*, 2010 DTC 1399.

amalgamation.[16] When the credit unions reviewed the amalgamation transactions, they concluded that one of the results of the transactions was to regenerate their *original* depreciable property cost accounts without recognizing recaptured income for prior depreciation claims.[17]

The Tax Court agreed that the amalgamation was technically not governed by the rules in s. 87 (because of the transfer of the property to the subsidiary at the precise moment of the amalgamation), but then held that the same tax result arose under the (well-known) principle in *Black & Decker* ([1975] 1 SCR 411): i.e., that "the amalgamating companies continued *without subtraction* in the amalgamated company, with all their strengths and their weaknesses, their perfections and imperfections, and their sins, if sinners they be". This meant that the amalgamated credit union inherited the full *tax* history of the predecessor companies, such that the amalgamated company began its life with the lower depreciated tax cost balances of the predecessors.

The taxpayer argued that if the tax accounts flowed through on an amalgamation that was not governed by s. 87, then many aspects of section 87 were superfluous. In response to this argument, the Tax Court said:

> Since Parliament included paragraph 87(2)(a) in the [Act] (which deems the amalgamated corporation to be a new corporation), as noted above, the principles as set out in *Black and Decker* will not apply to a merger that is an amalgamation as defined in subsection 87(1) of the Act. Therefore, it is necessary to identify which accounts will flow through to this "new corporation". The fact that the net result in relation to particular tax accounts such as UCC of assets of particular classes of property, may be the same by applying the principles in *Black and Decker* and the provisions of paragraph 87(2)(d) of the [Act] simply means that this was the desired result. In *Black and Decker*, Justice Dickson (as he then was) faced a similar argument. He stated as follows:

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[16] S. 87(1)(a) excludes from the amalgamation rules, any amalgamation that does not result in the amalgamated corporation receiving all of the property of its predecessors. It provides as follows:

"87. (1) Amalgamations — In this section, an amalgamation means a merger of two or more corporations each of which was, immediately before the merger, a taxable Canadian corporation (each of which corporations is referred to in this section as a "predecessor corporation") to form one corporate entity (in this section referred to as the "new corporation") in such a manner that

(a) all of the property (except amounts receivable from any predecessor corporation or shares of the capital stock of any predecessor corporation) of the predecessor corporations immediately before the merger becomes property of the new corporation by virtue of the merger…" [emphasis added]

[17] The tax position of the *shareholders* of the two credit unions was not in issue. An amalgamation results in a disposition of the shares of the predecessor corporations (definition of "disposition" in s.248(1)). Accordingly, any accrued gain would be realized on the amalgamation because the rollover rule in s.87(4) would not have applied. The decision does not disclose whether the shareholders attempted to rely on s.85 or s.86. In addition, if the shares could simply have been redeemed by the predecessor corporations for their original subscription price, it is likely no gain had accrued on the shares.

> It was also submitted that if the amalgamating companies continue in amalgamation in all their plenitude, then ss. 137(13)(b) and 137(14) are mere surplusage. I would not so regard them. These sections spell out in broad language amplification of a general principle, a not uncommon practice of legislative draftsmen.

The Tax Court also noted that not *all* tax consequences would be the same under the *Black & Decker* principle. For example, s. 87(2)(e.4) provides, in the circumstances set out in that provision, that the cost to the new corporation of a "mark-to-market property" will be its fair market value, which would not be the same result if the principles as set out in *Black & Decker* were applied. A similar example would be the bump rule in s. 87(11): the increased tax cost of property potentially available under that provision would not be available if the principles in *Black & Decker* were applied.

The decision has been appealed to the Federal Court of Appeal.

b. Amalgamations on closing day

In paragraph 11 of IT-474R2, the CRA accepts that a Target company ("Target") will generally have only *one* deemed year end where on the *same* day ("Transaction Day") Target is both acquired and amalgamated with the acquiring company ("Parent") or a related company, *provided* no election is made under s. 256(9) and no time is specified in the certificate of amalgamation. In these circumstances, both the acquisition of control *and* the amalgamation with Target would generally be considered to occur on the first moment of the Transaction Day,[18] resulting in simultaneous deemed year ends immediately *before* that time (under s. 249(4) and s. 87(2)(a)).[19]

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[18] S. 256(9) provides that:

> "For the purposes of this Act, other than for the purposes of determining if a corporation is, at any time, a small business corporation or a Canadian-controlled private corporation, where control of a corporation is acquired by a person or group of persons at a particular time on a day, control of the corporation shall be deemed to have been acquired by the person or group of persons, as the case may be, at the beginning of that day and not at the particular time unless the corporation elects in its return of income under Part I filed for its taxation year that ends immediately before the acquisition of control not to have this subsection apply." [emphasis added]

Further, in paragraph 10 of IT-474R2, the CRA says:

> "The effective date of amalgamation is governed by corporate law and is generally the date of issuance of letters patent or the date shown or set forth in the certificate of amalgamation, as the case may be. The time of the amalgamation is generally the earliest moment on that date in the absence of a particular time specified in the certificate of amalgamation." [emphasis added]

[19] This result does not appear to be possible, as a technical matter, under the British Columbia *Business Corporations Act*. Section 279 of that Act says in part that the companies are amalgamated on the date and time that the amalgamation application is filed with the registrar. The remainder of the section says that you may specify a date and time in the future (i.e., after it has been filed), or simply a date after it has been filed and in this latter case the will be effective at the beginning of that specified date. No such constraints would appear to arise

In 2010-0388081E5, the CRA clarified that it would apply this position *only* where the acquisition of Target and subsequent amalgamation are "the only transactions outside of the normal course of business" that occur on the Transaction Day. In this regard, the CRA said that transactions "outside the normal course of business" would include any other "transactions specifically described, for example, in a closing agenda or other document setting out the logical order of specific transactions that must occur before the amalgamation".

This position means that, for many transactions, Target would be deemed to have not one but *two* year ends: one immediately before the Transaction Day (arising from the acquisition of control) and a second immediately before the amalgamation *during* the Transaction Day (as sequentially contemplated in the closing agenda, for example). This may be a helpful interpretation where, for example, it was intended that certain transactions were to occur *during* the Transaction day *before* the amalgamation (i.e., in the predecessors) and the certificate of amalgamation does not refer to a specific time of the amalgamation on the Transaction Day.

c. Debt-continuity rule on amalgamation

In 2010-0387601E5, the CRA adopted a favorable view of the debt-continuity rule for amalgamations. A company ("Target") was acquired and subsequently amalgamated with another entity in the purchaser's corporate group. For its taxation year that was deemed to end on the acquisition of control, Target elected to realize an accrued foreign currency (FX) gain on certain foreign currency debt (under ss. 111(4)(e) and 111(12)). An election under s. 111(4)(e) is typically made to use certain losses of the Target that would otherwise expire following the acquisition of control. The CRA was asked to confirm whether the amalgamated entity ("Amalco") could *also* be viewed as having realized this prior elected FX gain (under s. 40(10) and s. 40(11)), so that no double taxation of the same FX gain would arise when *Amalco* actually repaid the debt. No provision in the amalgamation rules (in s. 87) specifically addresses this point.

The CRA, however, adopted an expansive reading of the debt-continuity rule in s. 87(7)(d) in this context, which provides simply that the *Income Tax Act* applies as if Amalco had issued the (foreign currency) debt at the time that debt was issued by Target. Applying the *reasoning* in *Dow Chemical*,[20] the CRA concluded that Amalco could be considered to have elected to realize the prior

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under the federal *Canada Business Corporations Act*. Continuance under that Act may be appropriate in some cases.

[20] *Dow Chemical Canada Inc. v. The Queen*, 2007 DTC 1701(Federal Court of Appeal examined s. 87(7)(d) in a different context).

FX gain under s. 111(12). This broad (purposive) interpretation of the debt-continuity rule ensured that no double tax arose upon *Amalco's* actual repayment of the foreign currency debt (under s. 40(10) and s. 40(11)).

d. Liquidation following acquisition – the loss business

In *S.T.B. Holdings*,[21] the taxpayer ("STB") acquired another company ("Newport") that had significant losses. STB wound up Newport and thereafter sheltered its income with Newport's losses. In order to succeed in such a transaction, Newport had to be carrying on a business that generated the loss (the "loss business"), STB would have to continue to carry on *that business* with a reasonable expectation of profit, and STB's sheltered income would have to be earned (broadly) in the same or similar business[22] as Newport's loss business (s. 88(1.1)(e)).

In finding that all these conditions were met on the facts, the court usefully commented that a business of buying and selling real estate (i.e., a pure speculator) could be considered the same business as buying real estate for *development and* sale (i.e., a developer). Both of these activities involved dealing with real estate as *items of inventory*. The court also usefully commented that, in the context of these loss acquisition rules, a corporate partner of a partnership can be considered to be directly carrying on the business of the partnership.

4. Share Reorganizations

a. S. 85 and s. 51 – timing of share issuances

Section 85 is of course a commonly-used elective provision that can permit a rollover (tax-deferral) where property is transferred to a taxable Canadian corporation "for consideration that includes shares" of the corporation. In 2010-0373231C6, the CRA released (in written form) its comments made at the 2010 APFF Round Table, where the CRA said that a rollover under s. 85 could be available even if, at the time of the transfer, the shares to be issued are not legally authorized in the articles of the company. The CRA cited the decision of Bowman, J. in *Dale*[23], who said: "The expression consideration that includes shares does not, as counsel suggests, imply that the share

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21 *S.T.B. Holdings Ltd. v. The Queen*, 2011 TCC 144.

22 The actual wording of s. 88(1.1)(e) provides that where "properties were sold, leased, rented or developed or services rendered in the course of carrying on that [loss] business before that time", then the similar business is a "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".

23 *Dale v. The Queen*, 94 DTC 1100 (TCC).

must necessarily be issued simultaneously with the transfer of property to the company or indeed within the same taxation year. What is essential is that there be either an actual issuance of shares or a binding obligation to do so at the time of transfer and that the shares be issued within a period of time that, in all the circumstances, is reasonable" (emphasis added).

The CRA helpfully expressed the view that the Federal Court of Appeal "upheld the decision by Bowman, J. on this point". The CRA could *not*, however, take the same expansive view of the rollover under s. 51(1) because the wording of that provision is different. Pursuant to the share-for-share exchange rule in s. 51(1), the actual shares of the corporation must be acquired by the shareholder/transferor *in exchange for* the property transferred to the corporation. In the CRA's view, this wording requires that the shares be issued at the time of the "exchange".

b. Fractional shares on outbound roll

CRA recently extended its favorable position on domestic share-for-share exchanges to foreign share-for-share exchanges. By way of brief background, the acquisition of a Canadian public company ("Target") by another Canadian public company ("Acquirer") is often undertaken by way of a share-for-share exchange (i.e., the shareholders of Target transfer their Target shares to Acquirer for shares of Acquirer). Such a transaction is generally a rollover (tax-deferred transaction) to the Target shareholders under s. 85.1(1), provided that they do not receive any consideration other than shares of Acquirer on the exchange.

One technical issue in these transactions has involved the fact that often a Target shareholder cannot exchange all of their Target shares for a whole number of Acquirer shares, such that the Target shareholder becomes entitled to a fractional share in the Acquirer. In this circumstance, and in lieu of such fractional shares, a Target shareholder is typically entitled to receive cash or other non-share consideration from the Acquirer. The CRA has said (IT-450R, paragraph 6) that the s. 85.1(1) rollover will *not* be lost in these circumstances (i.e., even though the transaction is not solely share-for-share).

In 2011-0392891I7, the CRA said this favorable administrative position will be extended to transactions where the Target and the Acquirer are both *foreign* corporations, such that the equivalent rollover in s. 85.1(5) would similarly *not* be lost. The capital gain or loss from the receipt of the non-share consideration (received in lieu of fractional shares) would have to be reported by the Target shareholder, unless the value of the non-share consideration is $200 or less, in which event the value of the consideration may be considered to reduce the tax cost of the Acquirer shares received on the exchange.

c. Tuck-under (or summersault) transactions

In 2010-0370551E5, the CRA commented on the Federal Court of Appeal's decision in *Tremblay*.[24] While only a French version of the CRA's document was released, based on the summary in English, the CRA considered a situation similar to that in *Tremblay*. A Canadian holding company ("Holdco") owned 40% of the shares of a Canadian operating corporation ("Opco"). A non-resident ("Non-Resident") owned all the shares of Holdco, as well as the other 60% of the shares of Opco.

The Non-Resident wanted to "simplify the corporate structure" by holding, directly, all the shares of Opco. One method of achieving this would be simply to amalgamate Holdco and Opco. For administrative (non-tax) reasons, such an amalgamation was not desired. Instead, the Non-Resident sought to transfer his Holdco shares to Opco, in exchange for equivalent-value preferred shares of Opco (being the tuck-under or summersault transaction). At this point, Holdco would be a wholly-owned subsidiary of Opco, and Opco could proceed to liquidate Holdco under s. 88(1).

In *Tremblay*, a similar transaction (in contemplation of the shareholders emigrating from Canada) was undertaken and the CRA reassessed the transaction as giving rise to a deemed dividend under s. 84(2). That provision deems a taxable dividend in the case of certain distributions by Canadian resident corporations. It operates to prevent corporations, upon the "winding up, discontinuance, or reorganization of their business", from issuing to shareholders what should be taxable earnings in the form of (an ostensibly) tax-free return of paid-up capital – by deeming any amounts distributed in excess of paid-up capital ("PUC") to be taxable dividends. The CRA said that the tuck-under transaction amounted to a "distribution" of the actual underlying common shares of the operating company (in that case). The majority agreed with the Tax Court Judge that s. 84(2) could not apply because "the property received by the respondents was never the property of 8855 [the equivalent of Holdco]".

In its document, the CRA commented (again, only the summary is available in English) that *Tremblay* "contains a strong dissent" based on the *Smythe* decision of the Supreme Court of Canada.[25] The minority in *Tremblay* found Smythe to be applicable because, "Although *Smythe* involved the appropriation of undistributed income on hand to shareholders, the assets were transformed through various transactions which involved the incorporation of a new company and unrelated companies as

[24] *Tremblay v. The Queen*, 2010 FCA 119.

[25] *Smythe v. Minister of National Revenue* [1970] S.C.R. 64.

well as bank loans until the assets in the desired form were back into the appellants' hands" (emphasis added).[26]

Furthermore, the CRA commented that the GAAR was not raised in the *Tremblay* case. Consequently, despite the (favorable) majority decision in *Tremblay*, the CRA said it "…will continue to challenge abusive surplus stripping arrangements, including those taking the form of tuck under transactions" (emphasis added). The CRA further said - suggesting what would not be considered abusive in this context - that "in appropriate circumstances" the GAAR and s. 84(2) would not apply where a "tuck under" transaction is carried out solely for "safe income extraction".[27]

The (cryptic) summary in the CRA's document strongly suggests that the CRA would have no objection to a tuck-under transaction that either (1) does not increase the basis (PUC and adjusted cost base) in the shares of the corporation received on the exchange when compared to the shares given up – i.e., there is no surplus strip, or (2) does result in an increase to such basis but only to the extent of underlying "safe income" (presumably for the purposes of s. 55(2)) attributable to the shares exchanged.

Given the cryptic nature of these comments, it may be advisable to seek an advance ruling from the CRA (or at least discuss the above with the CRA) before any proposed tuck-under transaction is undertaken.

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[26] It is a fact that, in *Smythe*, a surplus strip *was* achieved because the taxpayer's had full tax basis their investment in the new company. In *Tremblay*, no such increase in tax basis (PUC or adjusted cost base) arose because the rollover rule in *Tremblay* (s. 85.1) ensured this result.

[27] The CRA issued a favorable ruling in a version of a tuck-under (or summersault) transaction in Advance Income Tax Ruling 9727743 dated May 22, 1998.