SHARE CAPITAL DESIGN
CASE STUDY SOLUTIONS

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SHARE CAPITAL DESIGN
SOLUTIONS/ISSUES

Part A

- **Estate Freeze:** It is interesting to note, especially in the context of the CRA’s approach to “transfers of economic interests” (see Kieboom/Romkey/Shepp discussion below), that the CRA rules regarding estate freezes allow Mrs. X to freeze, and consequently retain the growth in value of, her common shares in Widgetco (i.e., the $4,000,000) even though she has made no direct contribution to that growth. Moreover, this is so even though, in economic terms, this growth in share value may be attributable at least in part to Mr. X having forgone a fair market value salary over the years and thereby shifted some economic value to Mrs. X’s shares. The CRA has indicated that subsection 74.1(2) will generally not apply to attribute, to a freezor, dividends paid on shares held by a trust for minor children as part of a typical estate freeze, provided the shares held by the trust are issued for an amount equal to their fair market value and are paid for with funds that are not obtained from the freezor. ¹ The CRA appears to have side-stepped any express pronouncement on the perhaps more difficult question of how one is to determine fair market value.

- **Discretionary/Exclusionary Dividends:** There is no subsection 56(2) attribution problem based on the Neuman decision (98 DTC 6297 (SCC)). The ability to use discretionary dividend shares effectively allows a corporation to be used as the economic equivalent of a discretionary trust, at least for those corporations which are in a start-up mode and whose shares accordingly have no accrued value.

- **Bowater v. Crain:** Arguably, the voting rights attached to Mr. X’s Class A shares give rise to a Bowater concern because those voting rights are determined by reference to the holder of those shares – i.e., Mr. X (if, as a result of his death, Mr. X no longer holds such shares, the shares cease to be voting). If this share provision were allowed, it could result in holders of the same class of shares having different rights with respect to their shares which is the very thing Bowater says is not permissible under corporate law. Note that this is a problem even if, as is

the situation in the case under discussion, there only happens to be one holder of that class of shares. The problem can, however, be avoided if the share terms are drafted slightly differently – *i.e.*, instead of providing that the shares owned by Mr. X cease to be voting on his death, the share terms should state that all the Class A shares cease to be voting on Mr. X’s death. This way, all the holders of Class A shares (whether there is one such holder or a number of such holders) are treated in the same manner on Mr. X’s death and *Bowater* should therefore not apply.

- **Price Adjustment Clauses**: See potential issues in the Price Adjustment Clauses paper found in the Programme materials.

- **No Acquisition of Control**: On Mr. X’s death, Widgetco becomes controlled by son as a result of the loss of the voting rights attached to the Class A shares. There is, however, no acquisition of control for tax purposes because of subparagraph 256(7)(a)(ii).

- **Kieboom/Romkey/Shepp**: ²

  (a) By exchanging her common shares of Widgetco (which are voting) for non-voting Class B shares, Mrs. X has, based on the CRA’s valuation approach in *Shepp* and on the “transfer of economic interest” theory set out in *Kieboom* and *Romkey* (and argued by the CRA in *Shepp*), transferred a portion of her economic interest in Widgetco to Mr. X. This is so because, prior to the share exchange, Mrs. X owned the same class of shares as the controlling shareholder of Widgetco (*i.e.*, Mr. X) so that she had a right to share rateably in the dividends declared on the class of shares held by such controlling shareholder. The Class B shares do not give her the same rateable sharing right since Mr. X can declare dividends on his own Class A shares without similarly declaring any dividends on Mrs. X’s Class B shares. Her new Class B shares are therefore arguably not as valuable as her old common shares. If this “transfer of economic interest” theory were to hold, Mrs. X would be deemed under subparagraph 69(1)(b)(ii) to have disposed of an economic interest in Widgetco to Mr. X for proceeds of disposition equal to the difference between the fair market value of her old common shares of Widgetco and the fair market value of her new Class B shares.
(b) By way of general comment, the *Kieboom* and *Romkey* decisions can lead to absurd results when read literally. For example, based on these cases, it would appear that every time a person acquires treasury shares from a corporation, and thereby dilutes the interests of the existing shareholders, the existing shareholders have arguably disposed of an economic interest in that corporation since they would be forgoing some of their rights to receive future dividends. This would be so notwithstanding the fact that the new shareholder may be dealing at arm’s length with the existing shareholders and may have paid fair market value for the treasury shares it acquires. This result can be avoided if *Kieboom* and *Romkey* are restricted to cases in which less than fair market value is paid for newly-acquired shares or for previously issued shares which have increased in value due to changed circumstances.

(c) Similarly, the valuation approach relied upon by the CRA in *Shepp*, when taken to its logical extreme, could be used by taxpayers as a simple basis upon which to income split with adult family members. For example, assume that Mr. and Mrs. X simply wish to income split with their son, rather than effect an estate freeze. Mr. and Mrs. X could accordingly each exchange their common shares of Widgetco for a separate class of new Widgetco shares, each of which would provide that dividends can be paid on one such class of shares to the exclusion of the other. Son would then subscribe for a third class of shares which would also carry an exclusionary dividend right but which would be non-voting. The price payable for such shares would be nominal. Based on *Kieboom* and *Romkey*, it is arguable that in these circumstances Mr. and Mrs. X have transferred an economic interest to their son by indirectly allowing him to share in the future dividends from Widgetco. Generally, such a transfer could give rise to two problems – attribution (as in *Kieboom* and *Romkey*) and subparagraph 69(1)(b)(ii) proceeds (as argued in *Shepp*). In these circumstances, however, attribution is not a problem because son is older than 18 years of age and the attribution rules therefore do not apply. Subparagraph 69(1)(b)(ii) should also not be a problem because, based on the CRA’s valuation approach in *Shepp*, the economic interest transferred to son would have no value and the income inclusion under subparagraph 69(1)(b)(ii) would therefore be nil.

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2 The cites for these cases are as follows: *Kieboom*, 92 DTC 6382 (FCA); *Romkey*, 2000 DTC 6047 (FCA); *Shepp*, 99 DTC 510 (TCC).
Note that the foregoing alternative structure probably doesn’t work for estate freezing purposes because, based on the CRA’s valuation approach in Shepp, it leaves father with all the valuable (and, arguably, growth) shares in Widgetco. On the other hand, since father’s shares cease to be voting on his death, maybe they have no value at such time, based on that same valuation approach (i.e., an arm’s length third party would likely not pay anything for shares that only have a discretionary dividend entitlement, if that arm’s length party cannot control the exercise of that discretion in his favour). If so, this means that this structure is a far better way to minimize taxes on death than is the traditional freeze because it allows for all the growth on father’s shares (including the growth prior to the share reorganization) to escape tax on father’s death.3 (Note that, technically, to avoid proceeds under subsection 70(5) regarding these shares, they would have to cease to be voting say, two days before Mr. X’s death4, since subsection 70(5) “kicks in” not on death, but rather immediately before death. The voting rights therefore, would have to cease before this latter time.) On the other hand, it may be arguable under Romkey that the cessation of voting control amounts to an transfer of an economic interest by father to son such that, while the deemed disposition under subsection 70(5) may not give rise to tax in father’s hands in the year of death, the transfer of the economic interest will give rise to

3 This complete escape from tax on death is not so remarkable when one considers that father could have caused a dividend to be paid to son one month before father’s death equal to almost all the value of the company and thereby reduce the value of father’s shares to a nominal amount on his death. The dividend paid to son could presumably have passed to a holding company owned by son without the imposition of tax which would have put son in the same position that he would have been in under the scenario in which the value of father’s shares is shifted to son as a result of a shift in voting rights (i.e., son would not currently be taxable under either scenario on the value shifted to him).

4 From a corporate law point of view, however, it is not clear whether such a retroactive change to voting rights is effective particularly because the change does not address the issue as to what is to be done with matters in respect of which father has voted his shares in that two-day period. One possible solution perhaps is to provide that to the extent that father has purported to vote his shares during such period in respect of a particular matter, the shares to which the voting control is deemed to have shifted during that period will be deemed to have been voted, in respect of that particular matter, in the same manner that father purported to vote his shares during that period. In TI 2001 – 0094085 (March 3, 2003) the CRA was asked whether the GAAR would apply to a series of transactions involving the use of shares which are automatically redeemed upon the death of the shareholder for a nominal amount. The CRA determined that although the GAAR could apply it would probably not be necessary since they did not accept the proposition that the redemption value of the shares as set forth in the Articles of Incorporation would necessarily be the fair market value of the shares for purposes of subsection 70(5). In reaching this conclusion they referred to Nussey Estate v The Queen where a shareholders’ agreement provided that the corporation was deemed to have redeemed all shares held by any shareholder as of the day immediately proceeding his death. The Court held that “to hold the shareholder agreement to be binding in this regard on the Minister would in effect permit the shareholders to negate the effect of subsection 70(5) of the Income Tax Act. The shareholders cannot by agreement amend the provisions of the Act as applicable to them”.

such tax. A possible rebuttal to this argument is that the “transfer” occurs pursuant to the terms of the shares and not as a result of anything father has done so that father cannot be said to have effected the transfer (although, in Shepp, the CRA argued that the subparagraph 69(1)(b)(ii) disposition occurred as a result of a special resolution (to which father was a party) which approved the amendment to the articles allowing for the convertibility of son’s shares into voting shares.)

(d) The “transfer of economic interest” theory set out in Kieboom and Romkey is suspect given the decisions of the Supreme Court of Canada in Shell and Will-Kare Paving. In Shell, the Court held that while “courts must be sensitive to the economic realities of a particular transaction rather than being bound to what first appears to be its legal form, there are at least two caveats to this rule.” First, economic realities cannot be used to re-characterize a taxpayer’s bona fide legal relationships – legal relationships must be respected in tax cases. Re-characterization is only permissible if the label attached by the taxpayer to the particular transaction does not properly reflect its actual legal effect. Second, a searching inquiry for economic realities cannot supplant a court’s duty to apply an ambiguous provision of the Act. The Court also held that absent a specific provision to the contrary, it is not the court’s role to prevent taxpayers from relying on the sophisticated structure of their transactions. In Shell, the Supreme Court specifically rejected the “economic realities” approach relied upon by the Federal Court of Appeal. Similarly, in Will-Kare Paving, the Supreme Court of Canada held that where words have an established and accepted legal meaning that meaning should be used. The technical nature of the Act does not lend itself to broadening the principal of plain meaning.

(e) One reason that it is so difficult to determine the appropriate consequences of issuing discretionary dividend shares is that there is an important legal distinction between a decision made qua shareholder and a decision made qua director. For example, in his capacity as a shareholder, Mr. X has agreed to the reorganization of capital of Widgetco. It is this reorganization that results in Mrs. X receiving her Class B shares and, therefore, it is arguably this transaction that results in a shift in value from Mr. X to Mrs. X. However, based on the valuation approach in Shepp, there is no shift in value from Mr. X to Mrs. X because the Class B shares are non-voting and are only entitled to discretionary dividends. But what if, say 5 years after the reorganization, the value of Widgetco has grown by $5,000,000 and Mr. X, as the sole director of Widgetco at that time, decides to pay a $5,000,000 dividend to Mrs. X?
Arguably, it is this dividend payment that gives rise to a shift in value from Mr. X to Mrs. X. However, this shift in value arises not as a result of a decision that Mr. X has made in his capacity as a *shareholder* of Widgetco but rather one that he has made in his capacity as a *director* of Widgetco. Consequently, it would be difficult for the CRA to argue that the dividend payment results in a transfer of an economic of interest from one shareholder to another.

- **Taxable Preferred Shares:** Mr. and Mrs. X’s shares are taxable preferred shares because they have a fixed liquidation entitlement. Dividends paid or deemed paid on such shares, however, will likely not give rise to Part VI.1 problems because of the substantial interest exemption and, depending on the amount of dividends or deemed dividends, the dividend allowance. Note, however, that the subsection 191(4) exception will not be applicable in the circumstances to deemed dividends arising on the redemption of the Class A or Class B shares because of the price adjustment clause attached to such shares. (See Preferred Share paper in Programme materials.)

**Part B**

- **Taxable Preferred Share Issues:**

  (a) *Dividend Entitlement:*

  - The Class D shares are clearly taxable preferred shares because of their 12% minimum dividend entitlement and their priority over the Equalization Dividend that may be paid on the Class C shares;

  - The Class C shares may or may not be taxable preferred shares:

    (i) The argument that they are taxable preferred shares is based on the fact that they have a minimum dividend entitlement (in the form of the Equalization Dividend) which has priority over the "fully participating" dividend to which the Class D shares are entitled;

    (ii) The argument that they are not taxable preferred shares is that the Equalization Dividend is not a priority dividend but rather a "catch-up" dividend. The Class C shares never receive anything more than do the Class D shares and therefore have no preference over the dividends that may be paid on the Class D shares. The "taxable
preferred share" definition provides that it must "reasonably be considered" that the Class C shares have a dividend entitlement and, in these circumstances, that is not the case.

(b) Retraction Right:

- The retraction right attached to the Class D shares causes such shares to have a liquidation entitlement because the shares are retractable for an amount that is fixed by formula;

- The fair market value exception is not applicable because it only applies if the retraction right is provided for in an agreement. Here the retraction right is found in the Class D share terms;

- The 5-year waiting period, however, avoids the short-term preferred share rules;

- The fact that the retraction right can only be exercised with respect to Class D shares owned by Ventureco gives rise to a Bowater problem because the ability of any holder of a Class D share to exercise the retraction right attached to such share will depend on the identity of the holder, and Bowater says that share rights cannot differ between holders of the same class of shares.

(c) Redemption Right:

- The redemption right attached to the Class D shares gives rise to a liquidation entitlement because of the minimum rate of return;

- There is no fair market value exception available (even if the redemption right were set out in an agreement) because the minimum rate of return could exceed fair market value.

(d) Put Right:

- The put right attached to the Class D shares will:

  (i) cause the shares to be taxable preferred shares under subparagraph (b)(iv) of the “taxable preferred share” definition if the purpose test set out therein is met; and
(ii) not cause the Class D shares to be short-term preferred shares because the put right is exercisable only after a retraction request remains unsatisfied. Since the retraction right is only exercisable after five years, the put right itself is only exercisable after five years and, therefore, would not be caught by the short-term preferred share rules.

(e) Tag Along and Drag Along Rights:

- Neither of these rights should cause the Class D shares to be taxable preferred shares.

(f) Right of First Offer:

- This right probably does not give rise to a contingent obligation to acquire the Class D shares that is caught by subparagraph (b)(iv) of the “taxable preferred share” definition.

(g) Exceptions:

- No substantial interest or subsection 191(4) exception will be available to Ventureco. (Subsection 191(4) will not apply because the redemption amount of the Class D shares (which would be the “specified amount” for subsection 191(4) purposes) may exceed the fair market value since it ignores any discount for illiquidity or for minority interests and guarantees a minimum 20% return;

- The dividend allowance, however, would still be applicable.

- The financial intermediary exception does not apply because Ventureco is not a prescribed venture capital corporation (see Regulation 6700).

- Term Preferred Share Issues:

(a) Ventureco is an SFI and therefore the term preferred share rules must be considered;

(b) The Class D shares are acquired in the ordinary course of Ventureco's business and therefore the subsection 112(2.1) exception for term preferred shares not acquired in the ordinary course of business does not apply;
(c) None of the dividend rights, redemption rights, drag along rights or first rights of offer cause the Class D shares to be term preferred shares;

(d) The retraction rights do cause the Class D shares to be term preferred shares;

(e) The tag along rights should not cause the Class D shares to be term preferred shares but the CRA might disagree with this conclusion. (See question 25, 1991 RCT Round Table regarding tag along rights).

• **Equity Kicker:**

  The issue with respect to this equity kicker is one of timing for recognition of income. There are two alternatives:

  (a) An income inclusion to Ventureco at the time of receipt of the Class D shares equal to the value of such shares *(i.e., $10,000).* This income inclusion will increase the cost of such shares to $10,000 under section 9. The entire outlay of $1,000,000 will be allocated to the cost of the debt. Widgetco arguably can claim a paragraph 20(1)(e) deduction aggregating $10,000 unless it can be argued that the issuance of the shares is not an expense.

  (b) No up front income inclusion. The $1,000,000 is allocated $10,000 to the cost of the Class D shares and $990,000 to the cost of the debt. The $10,000 difference between the $990,000 cost of debt and its $1,000,000 face amount will have to be included in income as it is paid. Widgetco should be entitled to a deduction for the $10,000 under paragraph 20(1)(f) when the debt is repaid.