DIVISIVE REORGANIZATIONS
Or "Butterfly Transactions"

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DIVISIVE REORGANIZATIONS

Introduction

The provisions of the *Income Tax Act* (the “Act”)[1] and the related administrative positions applicable to divisive reorganizations or colloquially, “butterflies”, have grown up over time. In the past, I have discussed the provisions of the Act and the related administrative positions through a review of the historical development of the butterfly, taking the advice of the King to the rabbit in the following extract from Alice in Wonderland:

"The White Rabbit put on his spectacles. 'Where shall I begin, please your Majesty?' he asked. 'Begin at the beginning,' the King said gravely, 'and go on till you come to the end: then stop.'[2]

However, in this version of the paper, I have decided to review the general provisions of the Act relating to butterflies (what I refer to as the building blocks of the Act applicable to butterflies) before considering the specific provisions of the Act relating to butterflies.

I have in the past been asked to approach this topic from the “30,000 foot level”. Consequently, before considering any of the provisions of the Act, I will outline two simple factual situations which illustrate the objective of a butterfly transaction.

In Diagram I below, Mr. A and Ms. B own 60% and 40% respectively of the shares of Corporation X. Corporation X in turn owns two Subsidiaries, Corporations Y and Z. Corporation Y has a value equal to 60% of the value of Corporation X and Corporation Z has a value equal to 40% of the value of Corporation X.
The shareholders wish to "divide" Corporation X into its constituent parts, Subsidiary Y and Subsidiary Z, so that Mr. A acquires Subsidiary Y and Ms. B acquires Subsidiary Z as illustrated in Diagram II.

This form of a butterfly is called a “split-up” since Mr. A and Ms. B have interests in different assets after the butterfly. I have intentionally chosen the relative values of the subsidiaries to be proportional to the shareholding of the shareholders who wish to acquire those subsidiaries. We will discuss more fully below the issues that arise when the relative values of the shareholdings of Mr. A and Ms. B do not match the relative values of Subsidiary Y and Subsidiary Z.
Another example, which illustrates the objective of a butterfly, is the reorganization of CP Limited. A much simplified corporate organization of CP Limited as it existed before the reorganization is illustrated in Diagram III below:

![Diagram III](image)

In the foregoing diagram, I have assumed that CP Limited is worth $100 and the subsidiaries have the values that are set out in the diagram and that aggregate $100. (In the investment world, the theory is that one carries out a butterfly of this form because the constituent parts will trade at an aggregate amount greater than the amount at which the one bundled entity will trade. In the investment community, this is frequently referred to as “unlocking shareholder value”.)

CP owned five subsidiary corporations. The object of the divisive reorganization was to give each shareholder that shareholder's pro rata interest in each of the five subsidiaries of CP. The completed divisive reorganization gave rise to the corporate organization in Diagram IV.
Each shareholder owns directly that portion of the property that the shareholder previously owned “indirectly”. From a 30,000 foot view, all that we have done is eliminate CP Limited and handed each shareholder the indirect interest that the shareholder previously had in the 5 subsidiary corporations.

This form of butterfly is called a "spin-off" since after the butterfly, every shareholder has an interest in the same property.

The foregoing examples illustrate the purpose of a butterfly reorganization, which is to divide the assets of a corporation among two or more corporations so that

(i) in a spin-off, each of the shareholders prior to the butterfly owns, through a corporation, his, her or its proportionate share of the corporation's assets which existed prior to the butterfly, and

(ii) in a split-up, one group of shareholders owns, through a corporation, one constituent part of the assets of the corporation which existed prior to the butterfly and another group of shareholders owns, through a corporation, another constituent part of the assets of the corporation.

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**The Missing Provision**

There are provisions of the Act, such as subsection 85(1) and section 85.1, which permit a taxpayer to transfer property on a tax-deferred basis to a corporation. Under subsection 85(1), a transferor and a transferee corporation can make a joint election in which they elect an amount that will be deemed to be the transferor’s proceeds of disposition and the transferee’s cost of the property. Section 85.1 allows a taxpayer who holds shares of a taxable Canadian corporation as capital property to dispose of them to a second Canadian corporation in exchange for shares of the transferee corporation on a tax-deferred basis. From the point of view of the taxpayer making the disposition, this results in a tax-deferred transfer of the shares.

There is no analogous provision which permits a corporation to distribute property on a tax-deferred basis directly to its shareholders.

What is needed is an expanded domestic equivalent of section 86.1. Section 86.1 provides for a tax-deferred transaction to Canadian resident shareholders where a publicly-traded foreign corporation (the “distributing corporation”) whose shares are widely held undertakes a transaction whereby it distributes to its common shareholders common shares of another foreign corporation (the “distributed corporation”) owned by the distributing corporation. Where section 86.1 applies, the Canadian shareholders are not required to include any amount in income. The adjusted cost base to each shareholder of the distributing corporation immediately before the distribution is allocated to the adjusted cost base to the shareholder of the distributing corporation and of the distributed corporation after the distribution in proportion to the fair market values of the distributing corporation and of the distributed corporation.

The domestic equivalent would have to apply not only to public corporations, but also to private transactions. It would also be necessary for such section to provide that the corporation would not realize any gain on the distribution of shares of a subsidiary.

The following example illustrates the missing provision of the Act and the need for the butterfly.

Consider the corporate organization illustrated in Diagram V below.
Although Mr. A and Ms. B get along amicably, they have developed different business theories and wish to go their own way.

As described above, the objective of a butterfly is to distribute the assets of a corporation on a *pro rata* basis to the shareholders of a corporation. Unfortunately, the Act does not contain a single provision pursuant to which such result may be accomplished. Consider what would happen if Corporation X distributes the shares of Subsidiary Z to Ms. B by repurchasing its shares from her. Corporation X will realize gain of $160 and pay tax. In addition, Ms. B will receive a dividend to the extent the fair market value of what she receives exceeds the paid-up capital attributable to her shares and pay income tax in respect of the dividend\(^3\) to the extent that it is not paid out of the capital dividend account. (In Diagram V, because of integration, the total tax payable would be approximately equivalent to what the corporation would pay as tax if it sold Subsidiary Z to a third party and kept the proceeds.)\(^4\)
The foregoing result is not particularly attractive.

The foregoing tax consequences might be ameliorated if Ms. B were to incorporate a holding corporation as in Diagram VI and Corporation X repurchased its shares held by Corporation B.

**DIAGRAM VI**

In such circumstances, the taxable dividend would not be subject to Part I tax by virtue of subsection 112(1) and would be exempt from Part IV tax (except to the extent that Corporation X receives a refund of Part IV tax) since Corporation B owns more than 10% of the shares of Corporation X. However, Corporation X would still realize gain of $160 on the distribution of its assets.
It was this problem that tax planners faced in the late 1970s\(^6\) when they developed the butterfly.

A reorganization (or butterfly) which satisfies the provisions of paragraph 55(3)(b) and related provisions of the Act permits a corporation to transfer property on a tax-deferred basis to its corporate shareholders and consequently substitutes for the missing provision in the Act. However, the butterfly rules are unlike either subsection 85(1) or section 85.1 in that they do not present a complete code specifying how to implement a butterfly. They provide a code of “don’ts” and indicate when a transaction may not be carried out on a tax-deferred basis.

The complexity of these transactions arises because of the limitations of the provisions of the Act and because of anti-avoidance provisions of the Act that have been implemented to ensure that the reorganizations cannot be used to achieve inappropriate income tax consequences.

This paper will outline the relevant butterfly provisions of the Act. It will also describe the administrative practices of the Canada Revenue Agency (the "CRA", formerly Revenue Canada) relating to butterflies. The provisions of the Act and the administrative provisions have grown up over time.\(^7\) However, as I stated above, before I proceed with a discussion of this development and of the specific butterfly rules, I will review the following specific provisions of the Act that are relevant to the implementation of a butterfly transaction, which are:

(a) subsection 85(1);
(b) subsection 85(2.1)
(c) subsection 112(1);
(d) section 84(3);
(e) subsection 52(2).
(f) section 85.1;
(g) section 86; and
(h) subsection 55(2)
I have not considered in this paper in detail the applications of the following provisions of the Act:

(i) Part IV;

(j) Part IV.1; and

(k) Part VI.1.

Relevant Provisions

Subsection 85(1)

Subsection 85(1) of the Act permits a taxpayer to transfer “eligible property” to a taxable Canadian corporation property on a tax-deferred basis by making an election. This is illustrated in Example 1 below.

EXAMPLE 1

Corporation X owns all the shares of Corporation A. Corporation A owns (in addition to other assets) shares of CIBC with a current fair market value of $1,000 and an adjusted cost base of $600. Corporation A wishes to isolate all of its investment assets in one corporation. The first step in the transaction is for Corporation X to incorporate Corporation B.

Corporation A can transfer the CIBC shares to Corporation B in consideration for preferred shares of Corporation B which are redeemable and retractable for $1000. Such a transfer can take place on a tax-deferred basis provided that Corporation A and B elect pursuant to subsection 85(1) at $600. In such circumstances, subsection 85(2.1) deems the paid-up capital of the preferred shares to be $600. In any event, before subsection 85(2.1) was enacted, in order to implement a butterfly, the stated capital was set at $600 for corporate law purposes and consequently the paid-up capital became $600 for purposes of the Act. The transaction is illustrated in Diagram VII below.
Subsection 85(2.1)

Subsection 85(2.1) applies where subsection 85(1) or (2) applies to a disposition of property. (It does not apply where section 84.1 or 212.1 applies.) The effect of subsection 85(2.1) is to limit the paid-up capital of the shares issued on a subsection 85(1) or subsection 85(2) election to the amount by which the elected amount exceeds any non-share consideration. Subsection 85(2.1) exists primarily for historical reasons. The May, 1985 budget proposed a lifetime capital gains exemption of $500,000. The Department of Finance was concerned that taxpayers would transfer property to a corporation for shares on a tax-deferred basis and then redeem those shares and recognize a capital gain. In these circumstances, ordinary income would be converted to a capital gain which would be exempt from tax. The lifetime capital gains concept was later phased out. However, subsection 85(2.1), which is an anti-avoidance section, is quite beneficial in the butterfly context; by virtue of its application, the shares issued on a transaction that is subject to a subsection 85(1)
election will have a paid-up capital equal to the elected amount where there is no non-share consideration and any amount above the elected amount will be a deemed dividend. The advantage of receiving a deemed dividend is explained under the heading Section 112 below.

By way of historical background, prior to the existence of subsection 85(2.1), the paid-up capital could be made equal to the elected amount by adding to the corporate capital at an amount less than the full fair market value of the property transferred. This result can still be achieved pursuant to the relevant provisions of the corporate statutes. Such provisions were inserted into the corporate statutes to assist in implementing butterfly transactions. Before such provisions were inserted in the corporate statutes, butterflies were carried out through the use of par value preferred shares which had a par value that was considerably less than their redemption amount.

In Diagram VII, there is still a cross-shareholding with Corporation A holding shares of Corporation B. In order to achieve the corporate structures referred to in Diagrams II and IV, it is necessary to eliminate such cross-holdings. This is usually carried out by having Corporation B redeem its shares with a promissory note. The relevant provisions relating to such redemption are subsection 52(2), 84(3) and 112(1).

**Subsection 84(3)**

Subsection 84(3) provides that where a corporation redeems a share for an amount in excess of the paid-up capital of the share, the amount in excess of the paid-up capital is deemed to be a dividend. Such deemed dividend is not considered to be proceeds of disposition of the share for purposes of computing any capital gain or capital loss realized by the shareholder on the redemption of the share. This is illustrated in Example 2 below.

**EXAMPLE 2**

Assume the facts set out in Example 1 with Corporation A holding preferred shares of Corporation B with a fair market value of $1,000 and a paid-up capital of $600. Corporation B redeems its preferred shares held by Corporation A and Corporation B issues a promissory note in the amount of $1,000 in payment of the redemption amount. On the redemption of the preferred shares, Corporation A would receive a deemed dividend of $400. Consequently, the proceeds of disposition to Corporation A of the shares of Corporation B acquired by it would be $600, so that Corporation A realizes no capital gain on the disposition of the shares of Corporation B. The
foregoing transactions give rise to the organization described in Diagram VIII.

**Diagram VIII**

![Diagram VIII](image)

**Section 112**

A dividend paid by a taxable Canadian corporation to another corporation is included in the income of the recipient corporation pursuant to paragraph 82(1)(a). A recipient taxable Canadian corporation is entitled to deduct the amount of the dividend in computing its taxable income pursuant to the provisions of subsection 112(1). As a result, the general rule in the Act is that dividends flow free of tax from corporation to corporation. As a result, in the foregoing example, Corporation A does not realize any income tax consequences on the redemption of the shares.

**Subsection 52(2)**

Subsection 52(2) provides that where any property has been received by a shareholder as, on account or in lieu of payment or satisfaction of a dividend, the shareholder is deemed to have acquired the property at a cost to the shareholder equal to the fair market
value at that time. As a result, the cost of the note of Corporation B to Corporation A in Diagram VIII is $1,000.11

The cost of the note is relevant when it comes to carrying out a transaction designed to eliminate the note. In Diagram VIII, the most appropriate way to eliminate the note would be to have Corporation A purchase a portion of its shares held by Corporation X which have a fair market value equal to the $1000 note of Corporation B. Provided that the paid-up capital of the shares of Corporation A is less than the adjusted cost base of the shares, Corporation X will realize a deemed dividend and no capital gain on the purchase for cancellation of a portion of shares of Corporation A. Corporation X can then transfer the note of Corporation B to Corporation B for shares of Corporation B having a fair market value of $1000. On the transfer of the note of Corporation B to Corporation B, the note will merge and cease to exist. The note can be transferred from Corporation A to Corporation X and from Corporation X to Corporation B without either Corporation A or Corporation X realizing any adverse income tax consequences on the transfer of the note.

Section 85.1

Section 85.1 permits a taxpayer to transfer on a tax-deferred basis shares of a taxable Canadian corporation to another Canadian corporation (the “transferee corporation”) in exchange for shares of the transferee corporation.

As illustrated in the first 4 diagrams of this paper, a butterfly transaction is one in which the assets of a corporation are divided among two or more corporations. As a result, the shareholders of the corporation that is to be “butterflied” must become shareholders of at least one other corporation. Section 85.1 is used to accomplish this result in certain circumstances.

We want to create the corporate organization referred to in Diagram VII where there are two corporations, one of which holds the shares of CIBC and one of which holds the remaining assets of the corporation. Our starting point is the corporate organization outlined in Diagram IX.
In a private transaction, the shareholders could create Corporation B and enter into an agreement to transfer some of their shares of Corporation A to Corporation B for shares of Corporation B and elect pursuant to subsection 85(1). In a public transaction, it is necessary to implement such transfer by way of a plan of arrangement and it is usually most convenient to arrange for the shareholders to obtain a tax-deferral through the provisions of section 85.1. Pursuant to section 85.1, the shareholders of Corporation A will transfer a portion of their shares of Corporation A to Corporation B in exchange for common shares of Corporation B.

As discussed more fully below with respect to the meaning of “distribution”, the definition of distribution requires that the shareholders transfer to Corporation B that proportion of the shares of Corporation A that the fair market value of the shares of CIBC to Corporation A are of all of the assets of Corporation A. This gives rise to the corporate organization in Diagram X.
Section 86

Frequently, the transaction can also be carried out using a combination of the provisions of section 85.1 and section 86. Section 86 applies where there is a reorganization of the capital of the corporation. In such circumstances, the common shares of Corporation A can be converted into Class A and Class B shares. The value of the Class B shares as a percentage of the aggregate value of the Class A and Class B shares will be that proportion that the fair market value of the shares of CIBC are of the fair market value of all of the assets of Corporation A. The shareholders will then transfer, in accordance with the plan of arrangement, the Class B shares to Corporation B for common shares of Corporation B, giving rise to the same corporate structure as in Diagram X, except that Corporation B will own Class B shares of Corporation A and not common shares. The transaction referred to in Diagram VII above can then be carried out, giving rise to the corporate organization referred to in Diagram XI.
This leaves us to “eliminate” the Class B or common shares of Corporation A and the preferred shares of Corporation B. I will deal more fully with those issues below. Looking at this solely from an overview basis, upon elimination of the cross-shareholdings, the diagram will appear as in Diagram XII, which is a simplified version of the corporate organization in Diagram IV.
Subsection 55(2)

Subsection 55(2) was inserted into the Act to prevent abuses that could arise through the use of subsection 85(1) and subsection 112(1). Example 3 illustrates such abuse.

EXAMPLE 3

Corporation A wishes to sell a division which has a value of $1,100,000. A sale of the assets for cash consideration and other non-share consideration would result in recapture on the sale of the depreciable property, an income inclusion as a result of the sale of goodwill and a capital gain as a result of the sale of capital assets such as land. In this example, let us assume that the tax cost of the assets is $600,000 and that a sale of the assets would result in taxes of $175,000. Instead of selling the assets for cash and other non-share consideration, Corporation A sells the assets to Corporation B for redeemable preferred shares of Corporation B. The parties agree that the shares will be redeemed immediately after their issue. The parties make an election pursuant to subsection 85(1) of the Act in which the parties agree that the proceeds to Corporation A and the cost to Corporation B of each property is the tax cost of that property to Corporation A. As a result,
the adjusted cost base to Corporation A of the shares of Corporation B is the tax cost of the assets which it sold. Because Corporation B is giving up some of the value of the "tax shield" by agreeing to acquire the assets at their tax cost to Corporation A, the parties will arbitrage the tax savings from the transaction and will negotiate a purchase price that is less than the purchase price of a cash sale. Let us assume that the parties negotiate a purchase price of $1,000,000. The attributes of the shares of Corporation B issued to Corporation A are such that the shares have a redemption amount equal to the negotiated purchase price of $1,000,000 and a paid-up capital equal to the tax cost of the assets sold of $600,000. On the redemption of Corporation A's preferred shares of Corporation B, Corporation A receives a dividend which, but for subsection 55(2) is not subject to tax.

This transaction is illustrated in Diagram XIII below.

**DIAGRAM XIII**

When the Department of Finance became aware of this abuse, it introduced subsection 55(2) into the Act. Subsection 55(2) sets out a general anti-avoidance rule that prevents corporations from converting proceeds of disposition which would be taxed as a capital gain into an intercorporate dividend that is received free of tax.

Frequently, butterfly presentations state that the butterfly rules are an exception to the anti-avoidance rules set out in subsection 55(2). While this is technically accurate, it is historically inaccurate. Butterflies existed prior to subsection 55(2). Only when practitioners were able to develop transactions of the form described above which relied on the utilization of subsection 85(1) and subsection 112(1) to avoid corporate level tax did Department of Finance introduce subsection 55(2).
Subsection 55(2) generally applies where a corporation receives a dividend as part of a series of events or transactions, one of the purposes of which is to effect a significant reduction in the portion of the capital gain that, but for the dividend, would have been realized. (In *Her Majesty the Queen v. Placer Dome Inc.*,\(^{12}\) the Court discussed the tests to be applied in determining whether it was the purpose of the taxpayer to effect a significant reduction in the portion of a capital gain that would have been realized but for the dividend). If, however, there is a deemed dividend pursuant to subsection 84(3), subsection 55(2) will apply where one of the results of the dividend is a significant reduction in the portion of the capital gain that, but for the dividend, would have been realized.

The rules in subsection 55(2) do not apply to income earned or realized by a corporation after 1971 and before the safe income determination time. This income is colloquially referred to as "safe income". A discussion of what is considered safe income is beyond the scope of this paper.\(^{13}\) The computation of safe income is complicated by the fact that each share has a different proportion of safe income attributable to it. It is only income earned by a corporation after 1971 and before the safe income determination time while the share was held by the shareholder that is considered to be safe income that is attributable to the share.\(^{14}\) The leading case on the meaning of safe income is that of *The Queen v. Brelco*\(^{15}\) (The Court remitted the case back to the Tax Court of Canada for a determination of safe income.\(^{16}\)) See also *The Queen v. Kruco Inc.*,\(^{17}\) *Lamont Management Limited v. The Queen*\(^{18}\) and *VIH Logging Ltd. v. The Queen*.\(^{19}\) *The Queen v. Nassau Walnut Investments Inc.*,\(^{20}\) is another case in which the Court discussed the calculation of safe income, although that issue was not central to the decision. “Safe income determination time” is defined in subsection 55(1) to be the earlier of

(a) the time that is immediately after the earliest disposition or increase in interest described in any of subparagraphs 55(3)(a)(i) to (v) that resulted from the transaction, event or series; and

(b) the time that is immediately before the earliest time that a dividend is paid as part of the transaction, event or series.\(^{21}\)
Prior to the insertion of this definition into the Act, the Act referred to safe income arising prior to the commencement of the relevant series of transactions. There was always some uncertainty as to the time at which any particular series commenced.

Subsection 55(2) also does not apply to that portion of the dividend that is subject to Part IV tax and is not refunded as a consequence of the payment of a dividend to a corporation where the payment is part of the series of transactions or events.\(^{22}\)

Where subsection 55(2) applies, the amount of the dividend that can reasonably be considered attributable to anything other than income earned by a corporation after 1971 and before the safe-income determination time

(a) is deemed not to be a dividend received by the corporation;

(b) where the corporation has disposed of the shares, is deemed to be proceeds of disposition of the share except to the extent that it is otherwise included in computing such proceeds; and

(c) where the corporation has not disposed of the share, is deemed to be a gain of the corporation for the year in which the dividend was received from the disposition of a capital property.

The consequences of the application of subsection 55(2) can be illustrated by Example 3 above.

Paragraph 55(2)(a) provides that the deemed dividend of $400,000 that would otherwise arise on the redemption of the preferred shares is deemed not to be a dividend.

Paragraph 55(2)(b) provides that where the shares are redeemed, the amount of the deemed dividend is considered to be proceeds of disposition. Therefore, Corporation A’s proceeds of disposition of the shares is $1,000,000 and Corporation A realizes a capital gain of $400,000.

It is paragraph 55(2)(c) that is the most difficult to understand. Paragraph 55(2)(c) contemplates a situation in which instead of redeeming the preferred shares, the purchaser corporation, Corporation B in this example, pays a dividend. One could contemplate a transaction which Corporation A and B could carry out but for paragraph 55(2)(c) in which Corporation A and Corporation B provide that Corporation B will reduce
the paid-up capital of the preferred shares by $599,999 and pay a dividend of $400,000. Upon completion of these transactions, the preferred share provisions would be amended so as to reduce the value of the preferred shares. For example, the preferred shares might be entitled to a preference on the payment of dividends of an aggregate of $.01 and be entitled to no voting rights. Such a transaction would avoid the provisions of paragraph 55(2)(a). Paragraph 55(2)(c) prevents this avoidance of paragraph 55(2)(a) and deems the dividend of $400,000 to be a gain from the disposition of a capital property of the corporation for the year in which the dividend was received. As a result, Corporation A would realize a capital gain of $400,000.

Application of Building Blocks

Using the foregoing building blocks, I will outline the transactions required so that the corporate organization in Diagram I becomes the corporate organization in Diagram II and the corporate organization in Diagram III becomes the corporate organization in Diagram IV. As I indicated above, the butterfly rules provide a code of “don’ts” and indicate when a transaction may not be carried out on a tax-deferred basis. I will describe how to implement a butterfly before coming back to the detailed rules which complicate the implementation of a butterfly.

Split-Up

I will take you through one version of the transactions required so that the corporate organization in Diagram I becomes the corporate organization in Diagram II and then outline a manner in which a simpler version can be implemented.

The first step is for Ms. B to incorporate a holding corporation, Corporation B, and for her to transfer her shares of Corporation X to Corporation B. Such a transfer can be carried out on a tax-deferred basis if Ms. B and Corporation B make an appropriate election pursuant to subsection 85(1) of the Act. This transfer gives rise to the organization referred to in Diagram XIV:
The next step is for Corporation B to incorporate its own subsidiary, Subco B.
After the incorporation of Subco B, the corporate organization is as in Diagram XV.
The next step is for Corporation X to transfer the shares of Subsidiary Z to Subco B in exchange for voting preferred shares of Subco B. Such a transfer can be carried out on a tax-deferred basis provided that Corporation X and Subco B make appropriate elections. In most circumstances, Corporation X and Subco B would elect at the adjusted cost base to Corporation X of the shares of Subsidiary Z, which in this case is $240. As a result, the preferred shares issued by Subco B to Corporation X would have a paid-up capital of $240 and a fair market value of $400. The preferred shares are voting to ensure that no Part IV tax is exigible on the redemption of the preferred shares described below. This transfer gives rise to the corporate organization in Diagram XVI below.
The preferred shares of Subco B held by Corporation X are redeemed for a note of Subco B having a value equal to the value of Subsidiary Z being $400. Since the paid-up capital of the shares is $240, $160 of the redemption amount will be deemed to be a dividend so that the proceeds of disposition of the shares will be $240. This is the adjusted cost base of the shares and therefore, Corporation X will not realize any gain on the redemption of the shares. The cost of the note to Corporation X will be $400. The redemption of the shares gives rise to the corporate reorganization referred to in Diagram XVII.
Subco B is then wound up into Corporation B so that the obligation of Subco B under its note becomes the obligation of Corporation B. (It is necessary to wind-up Subco B and not to amalgamate Corporation B with Subco B. The traditional position of the CRA has been that the distributed assets must be transferred either directly or indirectly to a transferee. The transferee, as we will discuss more fully below, in this Diagram is Corporation B. The position of the CRA is that a amalgamation of Corporation B and Subco B would result in a new corporation and therefore if there were an amalgamation, Subsidiary Z would not be distributed directly or indirectly to a transferee.) The common shares of Corporation X held by Corporation B will be purchased for cancellation by Corporation X using the note of Subco B. On the transfer of the note of Subco B to Corporation B, the note
is extinguished. On the purchase for cancellation of the shares of Corporation X held by Corporation B, $160 will be deemed to be a dividend and Corporation B will not realize any capital gain on the purchase of its shares of Corporation X since the paid-up capital of the shares of Corporation X held by Corporation B does not exceed the adjusted cost base in Corporation B of the shares of Corporation X. (If the paid-up capital were greater than the adjusted cost base, the paid-up capital of the common shares of Corporation X could be reduced to permit the shares of Corporation X held by Corporation B to be purchased for cancellation so as to not result in any capital gain to Corporation B.) These transactions will give rise to the corporate organization in Diagram XVIII.

**DIAGRAM XVIII**

```
Mr. A
  ↓
Corporation X
  ↓
Subsidiary Y

Ms. B
  ↓
Corporation B
  ↓
Subsidiary Z
```

It would be possible to merge Corporation X with Subsidiary Y and Corporation B with Subsidiary Z to give rise to the corporate organization set out in Diagram II.

A simpler way of carrying out the butterfly in the foregoing example would be for Corporation X to transfer the shares of Subsidiary Z directly to Corporation B for
preferred shares of Corporation B and to elect pursuant to subsection 85(1). This is illustrated in Diagram XIX.

**DIAGRAM XIX**

Since Corporation B owns only 40% of the shares of Corporation X, this transaction will not violate the corporate laws of those jurisdictions which provide that a corporation cannot hold shares of its body holding corporate.

Corporation B will redeem its preferred shares held by Corporation X for a note with a face amount of $400 resulting in the corporate organization set out in Diagram XX.
Corporation X will redeem its shares held by Corporation B and use the promissory note of Corporation B as consideration for the redemption proceeds. The note of Corporation B will disappear on its acquisition by Corporation B. Corporation B will realize no gain on the purchase for cancellation by Corporation X of the shares of Corporation X held by Corporation B provided that the adjusted cost base to Corporation B of the shares of Corporation X is equal to or greater than the aggregate paid-up capital of those shares. As a result of these transactions, the corporate organization outlined in Diagram XXI will result.
The one potential impediment to this form of transaction is that inappropriate Part IV consequences may arise where Corporation X has previously paid Part IV tax. As indicated above, it would be possible to merge Corporation X with Subsidiary Y and Corporation B with Subsidiary Z to give rise to the corporate organization set out in Diagram II.

**Implementation of Spin-Off**

Set out below is a simplified version of the transaction necessary to convert the corporate organization illustrated in Diagram III to that referred to in Diagram IV. For these purposes, we will assume that CP Limited held only two subsidiaries, Canadian Pacific Railway Company and CP Ships. The corporate organization is illustrated in Diagram XXII below.

![Diagram XXII](image-url)

The transaction will be carried out by way of a plan of arrangement. The first step in the plan might be for the common shares of CP Limited to be exchanged for Class A and Class B shares of CP Limited pursuant to the provisions of section 86 of the Act. The Class A Shares would have a value equal to one-quarter of the value of CP Limited and the Class B Shares would have a value equal to three-quarters of the value of CP Limited. (This
could be accomplished by creating equal numbers of Class As and Class Bs but providing that the holders of the Class B Shares receive a dividend per share equal to three times dividend paid on the Class A shares and by providing that on the dissolution of the Corporation, the holders of the Class B Shares receive three-quarters of the value of the assets and the holders of the Class As receive only one quarter of the value of the assets.) The next step in the plan of arrangement would be for the shareholders to transfer their Class A shares to a newly incorporated Newco for common shares of Newco. Such a transfer would be implemented pursuant to the provisions of subsection 85.1(1) of the Act so that the shareholders would not realize any gain or loss on the transfer of their shares. As a result of such transfer, the corporate organization in Diagram XXIII would result.

The next step in the transaction would be for CP Limited to transfer CP Ships to Newco for preferred shares of Newco. Such a transfer would be the subject of an election by CP Limited and Newco pursuant to subsection 85(1) of the Act. As a result, the paid-up capital and ACB of the preferred shares would be equal to the elected amount. Such a transfer would give rise to the corporate organization referred to in Diagram XXIV below.
Finally, the preferred shares of Newco would be redeemed by the issuance of a note by Newco and the Class A shares of CP Limited would be purchased for cancellation by the issuance of a note by CP Limited. This will give rise to the corporate organization referred to in Diagram XXV.
The notes would then be set off against one another. Newco could then be amalgamated with CP Ships Limited and CP Limited could be amalgamated with Canadian Pacific Railway Limited giving rise to the corporate reorganization in Diagram XXVI

**DIAGRAM XXVI**

![Diagram XXVI](image)

The fair market value of the Class A shares of CP Limited held by Newco may not be equal to the value of the shares of CP Ships transferred to Newco. As a result, the Notes may not have equal values. The CRA accepts that the notes can be set off against one another without the application of section 80 on the basis that the *pro rata* test is the paramount requirement in a butterfly.\(^{23}\)

**Development of Abuses**

So far I have proceeded on the basis that the butterfly can be carried out. I will now proceed to discuss the rules that limit in many instances, or prohibit the implementation of a butterfly.

No sooner did the butterfly appear on the scene than what were viewed by the Department of Finance to be abuses developed.

The first perceived abuse was that shareholders who owned a corporation containing both business and investment assets were using a butterfly reorganization to transfer the business assets to one set of shareholders and the investment assets to a different set of shareholders. For example, assume that the assets of Corporation X in Diagram XXVII below consisted of a combination of portfolio investments and business assets.
The butterfly would be carried out so that Mr. A through Corporation A would end up with all the investment assets and Ms. B through Corporation X would end up with all the business assets. The result of such butterfly is set out in Diagram XXVIII below:
The CRA referred to such a transaction as a “cashing-out” by Mr. A. One might say that the first administrative position developed by the CRA was simply, “Thou shall not cash out”. Even in hindsight, it is difficult to perceive just why the CRA considers cashing out to be so inappropriate. After all, the assets remain in “corporate solution” and the individual shareholders have not received directly any property from Corporation X. In any event, the principle that butterflies cannot be used to cash out has remained fundamental to the CRA. This principle in turn has led to a number of other principles which are described below.

The second abuse is the abuse referred to above which led to the insertion of subsection 55(2) into the Act, the utilization of subsection 85(1) and 112(1) to transfer properties between corporations on a tax-deferred basis. As I have indicated, this form of abuse was not limited to butterfly-form transactions.

**Exceptions to Subsection 55(2)**

As I have stated above, although the butterfly reorganization is an exception to subsection 55(2), the butterfly came first and subsection 55(2) was a response to the abuse of the techniques utilized in the butterfly. However, once subsection 55(2) was inserted into the Act, it was necessary to provide rules for the implementation of a butterfly if the government was going to permit butterflies to be implemented after the introduction of subsection 55(2). This led to the implementation of subsection 55(3).  

Subsection 55(3) contains two exceptions to the anti-avoidance rule set out in subsection 55(2). Paragraph 55(3)(a) applies to internal reorganizations while paragraph 55(3)(b) applies to reorganizations involving one or more arm's length persons. The term "butterfly" is usually used to refer to a divisive reorganization of the form described in paragraph 55(3)(b).

**Internal Reorganizations**

Paragraph 55(3)(a) permits an internal reorganization where:

(a) either there is no transfer of property to a person who is not at arm’s length with the corporation, or

(b) the transfer of property to the arm's-length person is at fair market value.
The purpose of paragraph 55(3)(a) is to permit a corporation to move properties around within a corporate group without the necessity of complying with all the butterfly provisions. In particular, it allows a transfer of properties internally in contemplation of a sale provided that sale is at fair market value, i.e., not carried out on a tax-deferred basis. The need for paragraph 55(3)(a) is illustrated by the following example:

EXAMPLE 4

Corporation A owns all the issued and outstanding common shares of Corporation B. There are no other shares of Corporation B issued and outstanding. Corporation B has three divisions, Division I, II and III. The corporate organization is illustrated in Diagram XXIX.

DIAGRAM XXIX

Corporation A wants Corporation B to sell Division I. Such a sale would produce recaptured capital cost allowance and capital gains. Corporation B has no shelter and the sale by Corporation B of Division I would result in Corporation B paying tax on the sale. Corporation A has non-capital losses. Therefore, the sale by Corporation A of Division I would allow Corporation A to utilize its losses against income arising on the sale of Division I. It is possible to “merge” Corporations A and B either by winding-up Corporation A or amalgamating Corporations A and B. However, it may not be appropriate to carry out a merger for a number of business reasons. For example, Corporation B may be carrying on business in a regulated industry and subject to regulation while Corporation A is not subject to any such regulation.

One can accomplish the requisite tax result by means of an "internal" butterfly. This can be accomplished if Corporation A incorporates a new
corporation, Newco, and transfers that portion of its common shares of Corporation B to Newco equal to the portion that the value that Division I is of the net value of all the assets of Corporation B. Corporation B then transfers Division I to Newco in consideration for preferred shares of Newco. On the transfer, Corporation B and Newco will elect pursuant to subsection 85(1) so that the tax cost to Newco of the Division I assets is equal to the tax cost to Corporation B of the Division I assets. The relevant corporate reorganization will be as in Diagram XXX.

**DIAGRAM XXX**

The common shares of Corporation B held by Newco will be purchased for cancellation by Corporation B and Corporation B will pay the purchase amount by means of a promissory note. Newco will redeem the preferred shares which it had issued to Corporation B and pay the redemption amount by means of a promissory note. The notes may be set off against one another. This gives rise to the corporate reorganization referred in Diagram XXXI.

**DIAGRAM XXXI**

Corporation A can wind-up or amalgamate with Newco and sell Division I to an arm's length third party.
The transaction is not considered offensive by the Department of Finance because the sale of Division I takes place at fair market value and therefore there is no deferral of tax, simply a utilization by Corporation A of existing tax shelter which could have been utilized had Corporations A and B been able to merge.

**Divisive Reorganizations – Butterflies**

By virtue of paragraph 55(3)(b), subsection 55(2) does not apply if the dividend was received in the course of a reorganization in which:

(i) a distribution was made by a distributing corporation\(^{25}\) to one or more transferee corporations, and

(ii) the distributing corporation was wound up or all of the shares of its capital stock owned by each transferee corporation immediately before the distribution were redeemed or cancelled otherwise than on an exchange to which subsection 51(1), 85(1) or 86(1) applies.

The shares of the distributing corporation held by the transferee corporations must disappear and not be replaced by other shares.

Divisive reorganizations have two common features:

(i) a transfer of a corporate asset on a tax-deferred basis (using a subsection 85(1) election) to a transferee which is a corporation in return for shares of the transferee corporation; and

(ii) a redemption or purchase for cancellation of the shares of both the transferor corporation and the transferee corporation resulting in deemed dividends under the Act to the shareholder rather than a capital gain.

Paragraph 55(3)(b) requires a distribution. The term "distribution" is defined to be a direct or indirect transfer of property of a corporation (the "distributing corporation") to one or more corporations (each of which is a "transferee corporation") where, in respect of
each type of property owned by the distributing corporation immediately before the transfer, each transferee corporation receives property of that type the fair market value of which is equal to or approximates the amount determined by the formula

\[ \frac{A \times B}{C} \]

Where

\( A \) is the fair market value, immediately before the transfer, of all property of that type owned at that time by the distributing corporation,

\( B \) is the fair market value, immediately before the transfer, of all the shares of the capital stock of the distributing corporation owned at that time by the transferee corporation, and

\( C \) is the fair market value, immediately before the transfer, of all the shares of the capital stock of the distributing corporation.

In the butterfly referred to in Diagrams XIV to XVIII, there was an \textit{indirect} transfer of property from the distributing corporation to the transferee corporations whereas in the butterflies described as Diagrams XIX to XXII there was a \textit{direct} transfer of property from the distributing corporation to the transferee corporation. An indirect transfer is implemented where the cross-holding of shares which would arise from a direct transfer of property would result in a corporation owning shares of its holding body corporate, which frequently is not acceptable for corporate law purposes. In the corporate organization described in Diagram XIX, Corporation X can transfer assets directly to Corporation B (so that Subsidiary B does not have to be incorporated) in consideration for shares of Corporation B. Most corporate statutes would not permit Corporation X to hold shares of Corporation B if Corporation B held more than 50\% of the shares of Corporation X.
**Limitations**

**Overview**

Subsection 55(3.1) contains rules which limit the application of the paragraph 55(3)(b) exemption. If subsection 55(3.1) applies, paragraph 55(3)(b) will not apply and subsection 55(2) will apply to the intercorporate dividends. By virtue of subsection 55(3.1):

(i) In contemplation of the distribution in which the dividend was received, there is a general prohibition on property becoming property of the distributing corporation, a corporation controlled by it or a predecessor corporation of any such corporation. Subparagraphs 55(3.1)(a)(i) to (iv) provide for exceptions to the general prohibition on the property becoming property rule;

(ii) with limited exceptions, the transfer by a specified shareholder of a distributing corporation or of a transferee corporation of any shares of such corporations to an unrelated person or to a partnership renders the paragraph 55(3)(b) exemption inapplicable;

(iii) with limited exceptions, an acquisition of control of a distributing corporation or of a transferee corporation renders the paragraph 55(3)(b) exemption inapplicable;

(iv) restrictions are imposed on the acquisition of shares of the distributing corporation in contemplation of a butterfly to ensure that a purchase butterfly cannot be implemented where there is no acquisition of control of a distributing corporation or of a transferee corporation and no disposition of property by a specified shareholder; and

(v) the shareholders of the distributing corporation are required to maintain some continuity of interest in the property of the distributing corporation for the paragraph 55(3)(b) exemption to be applicable.
Administrative Practices

As the legislation governing butterflies evolved, no attempt was made to codify the rules which permitted the implementation of a butterfly transaction. There was simply a codification of those rules which indicate when a divisive reorganization will attract undesired income tax consequences. Nowhere in the Act can one find a description of how to implement a butterfly or the relevant rules that govern a butterfly.26

Because the legislation permitting a butterfly is an exception to an anti-avoidance rule and not a complete codification of the divisive reorganization rules, the CRA has developed a number of administrative practices. It must be emphasized that notwithstanding the complexity of the rules in the Act, the implementation of a butterfly in a manner that is acceptable to the CRA depends very much on the CRA's administrative practices. From the practitioners' perspective, the ground is always shifting and the practitioner is never certain of what the rules are. As a result, it is always advisable to obtain an advance income tax ruling from the CRA. If a butterfly does not satisfy the provisions of paragraph 55(3)(b) and if each transferee corporation and the distributing corporation receives a dividend, that dividend will be treated as a capital gain. In such circumstances, the resulting income tax consequences will likely be quite significant.27

As described above, in order for there to be a distribution, the transferee corporation must receive its pro rata share of each type of property. This begs the question, “What are the types of property contemplated by the Act?” The Act does not, subject to my comments below about spin-offs involving public corporations, define types of property. These administrative practices include the categorization of all property of a particular corporation into three types: (i) cash or near cash, (ii) investment property and (iii) business property. The starting point for the categorization is the balance sheet of the distributing corporation. Current assets are categorized as cash or near cash. Business assets are those assets used to earn income that is regarded as business income rather than property income. Business assets will be considered to be one type of property regardless of the number of different businesses or the different nature of the businesses involved. Investment assets are those used to derive property income and that are not used in the business of the distributing corporation.
In determining the fair market value of each type of asset, the liabilities of a corporation are deducted from the fair market value of the assets. Current liabilities reduce current assets. Where current liabilities exceed current assets, the corporation will have no net cash or near cash assets. Any indebtedness incurred to acquire a specific asset will reduce the value of that asset and if there is any excess debt, it will be applied to reduce assets of a similar type. The liabilities that pertain to a type of property, but not to a particular property, will then be allocated to that type of property, but not in excess of the net fair market value of such type of property after the allocation of the liabilities to a particular property. If any liabilities remain after the allocations described above are made ("excess unallocated liabilities"), such excess unallocated liabilities will then be allocated to the cash or near cash property, investment property and the business property based on the relative remaining net fair market value of each type of property determined prior to the allocation of such excess unallocated liabilities.

The CRA has developed a consolidated look-through approach pursuant to which the distributing corporation and each of the transferee corporations looks through corporations over which it has a significant influence to determine the categorization of all properties held by the distributing corporation. A corporation is considered to have significant influence where the distributing corporation has the ability to exercise significant influence within the guidelines provided by section 3051.05 of the CICA handbook, which reads as follows:
"An investor may be able to exercise significant influence over the strategic operating, investing and financing policies of an investee even though the investor does not control or jointly control the investee. The ability to exercise significant influence may be indicated by, for example, representation on the board of directors, participation in policy-making processes, material intercompany transactions, interchange of managerial personnel or provision of technical information. If the investor holds less than 20 percent of the voting interest in the investee, it is presumed that the investor does not have the ability to exercise significant influence, unless such influence is clearly demonstrated. On the other hand, the holding of 20 percent or more of the voting interest in the investee does not in itself confirm the ability to exercise significant influence. A substantial or majority ownership by another investor would not necessarily preclude an investor from exercising significant influence."

The objective of the consolidated look-through approach is to determine the types of property that would exist in the distributing corporation and each transferee corporation if a preliminary butterfly of each of its subsidiary corporations were undertaken. In using the consolidated look-through approach, the CRA does not consider some shares to be one type of property and other shares to be another type of property but considers the consolidated result and considers each share of a look-through corporation to represent the types of property owned by the corporation. This concept is illustrated by example 5 below.

**EXAMPLE 5**

Corporation X has two shareholders, Corporations A and B, each of which holds 50% of the shares of Corporation X. Corporation X owns two divisions, Division 1 and Division 2, the net values of which are $45 and $55, respectively. In addition, Corporation X owns 10 of the 20 issued and outstanding shares of Corporation Y. The assets of Corporation Y consist of business assets with a net value of $100 and investment assets with a net value of $20. Consequently, on a consolidated look-through approach, Corporation X holds business assets with a net value of $150 and investment assets with a net value of $10.

The diagram illustrating this corporate organization is set out in Diagram XXXII below.

It is desired to butterfly Division 1 to Corporation A. Since Corporation A is a 50% shareholder of Corporation X,
Corporation A must receive 5 shares of Corporation Y so that it receives $5 of the $10 of the investment property of Corporation X. As a result of the receipt of such shares, it will receive $25 of business property. In the aggregate, it must receive $75 of business property. Since it receives only $45 of business property as a result of the transfer of Division 1 to it, it must also receive $5 of the business assets of Division 2. It could then sell the $5 of business assets back to Corporation X upon the completion of the distribution of the assets of Division 2 which it receives. (The restrictions on the subsequent sale of assets is discussed below under the heading, "Post-Butterfly Restrictions").

While the categorization described above appears straightforward enough, significant difficulties may be encountered in practice in categorizing the assets of a corporation. Such difficulties arise out of the practical problems of implementing a butterfly. As stated above, each transferee corporation must obtain its pro rata share of each type of property of the distributing corporation. Therefore, if a transferee corporation owns 30% of the shares of a distributing corporation, that transferee corporation must obtain 30% of the cash or near cash assets, 30% of the investment property and 30% of the business property of the distributing corporation. It is easiest to implement a butterfly if all property of a distributing corporation consists of one type of property so that all property of the corporation is fungible. It is more difficult if there are two or more types of property. It may not be easy to divide investment assets such as land into the portions required; in addition, because of the
consolidated look-through approach, there may be some problems in transferring cash assets in the appropriate portions. Consequently, there is a desire on the part of taxpayers who attempt to categorize to the extent possible all assets as business assets. (Today, most butterflies involve operating corporations; however, the butterfly started its history as a method of segregating investments in an investment corporation; as described *infra*, public corporations in a spin-off transaction may categorize all property as one type of property.) At the same time, as described *supra*, the CRA has a concern that a butterfly not be used to "cash out" a shareholder. As a result, it wants to ensure that the butterfly is not used to distribute to any particular shareholder assets which will not be used in the business and which have a high tax cost in comparison to their fair market value so that the shareholder can convert to cash the assets it receives without realizing significant income tax consequences.

This concern has complicated the CRA’s administrative positions. For example, while receivables, inventories and prepaid expenses are initially categorized as cash or near cash to determine whether the corporation has any cash or near cash assets, such assets are subsequently categorized as business assets and not as cash or near cash assets for purposes of determining the fair market value of each type of asset to be distributed on the butterfly. 28

This position can be illustrated in the following example in which the assets of the distributing corporation are distributed in an acceptable and an unacceptable manner to two equal corporate shareholders, Corporations A and B.
**EXAMPLE 6**

**Balance Sheet of Distributing Corporation**

<table>
<thead>
<tr>
<th>Current Assets</th>
<th>Acceptable</th>
<th>Unacceptable</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>75</td>
<td>1150</td>
</tr>
<tr>
<td>Accounts Receivable</td>
<td>100</td>
<td>350</td>
</tr>
<tr>
<td>Inventories</td>
<td>150</td>
<td></td>
</tr>
<tr>
<td>Prepaid Expenses</td>
<td>25</td>
<td></td>
</tr>
<tr>
<td>Land</td>
<td>500</td>
<td></td>
</tr>
<tr>
<td>Building</td>
<td>300</td>
<td></td>
</tr>
<tr>
<td><strong>Total Current Assets</strong></td>
<td>1150</td>
<td></td>
</tr>
<tr>
<td><strong>Total Current Liabilities</strong></td>
<td>400</td>
<td>550</td>
</tr>
<tr>
<td><strong>Total Liabilities</strong></td>
<td>400</td>
<td>550</td>
</tr>
<tr>
<td><strong>Total Equity</strong></td>
<td>300</td>
<td>350</td>
</tr>
</tbody>
</table>

**Balance Sheet of Transferee Corporation A**

<table>
<thead>
<tr>
<th>Current Assets</th>
<th>Acceptable</th>
<th>Unacceptable</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>50</td>
<td>75</td>
</tr>
<tr>
<td>Accounts Receivable</td>
<td>100</td>
<td>100</td>
</tr>
<tr>
<td>Inventories</td>
<td>50</td>
<td>150</td>
</tr>
<tr>
<td>Prepaid Expenses</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Land</td>
<td>250</td>
<td>200</td>
</tr>
<tr>
<td>Building</td>
<td>200</td>
<td>150</td>
</tr>
<tr>
<td><strong>Total Current Assets</strong></td>
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<td>675</td>
</tr>
<tr>
<td><strong>Total Current Liabilities</strong></td>
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<td>200</td>
</tr>
<tr>
<td><strong>Total Liabilities</strong></td>
<td>200</td>
<td></td>
</tr>
<tr>
<td><strong>Total Equity</strong></td>
<td>300</td>
<td>375</td>
</tr>
</tbody>
</table>

- 45 -
It is the CRA's administrative position that in determining whether the pro rata test is met, the positions of the distributing corporation and transferee corporations must be considered after the butterfly. If, because the current liabilities exceed the current assets of the distributing corporation before the butterfly, the distributing corporation has no net cash prior to the butterfly, each of the transferee corporation and the distributing corporation cannot have any net cash after the butterfly. If this is not the case, the CRA takes the position that there has been a distribution of cash on the butterfly and there has not been an appropriate pro rata distribution of each type of asset on the butterfly.

Where the distributing corporation holds a financial instrument such as a mortgage, any portion of the instrument due within the current year is treated as cash whereas any amount due in a subsequent year is treated as an investment property.

Where the distributing corporation acquires a property for one purpose but subsequently alters its plans, the categorization of the property may change. For example, the corporation may acquire land with the purpose of building a factory thereon. At the time of the acquisition of the land, the land will be considered to be business property. If, for some reason, the factory is not built but the corporation continues to hold the land, the CRA may categorize the land as investment property.

Not all of the CRA’s administrative positions present difficulties for the taxpayer; in some circumstances, the CRA’s administrative positions facilitate the use of
butterflies. In one published ruling, the CRA ruled that cash or near cash committed to fund the acquisition of business property that would be acquired in the ordinary course of the distributing corporation’s business would be classified as business property.

A transfer by a particular corporation of the pro rata share of all of one or two types of property but not all three types of property to each shareholder is commonly referred to as a "partial butterfly". In these circumstances, the shareholder retains some interest in the shares of the particular corporation.

A "purchase butterfly" consists of the purchase of shares of a particular corporation by a person in contemplation of a butterfly or the purchase by a person immediately after the butterfly of shares of a transferee corporation. Such a transaction occurs when a purchaser wants to buy certain assets of a corporation but does so by way of the purchase of shares. In this manner, the transaction is carried out on a tax-deferred basis at the corporate level.

The Department of Finance became concerned about the loss of revenue which resulted from the use of the purchase butterfly since a purchase butterfly permitted a corporation to sell its assets without the imposition of any tax at the corporate level. The Department of Finance also became concerned about the abuses that were possible with partial butterflies. The changes made to the Act by the budget of February 22, 1994 were designed primarily to eliminate the use of purchase butterflies and partial butterflies.

As discussed above, one of the fundamental principles of the CRA has been that a butterfly cannot be used to cash out a shareholder. Such reasoning developed early on in the history of butterflies at a time when most butterflies involved private investment corporations. It is doubtful whether such reasoning has much application to large public corporations. As a result, the Act was amended so that the “type of property” rules no longer have application to a public corporation (or a wholly-owned subsidiary of a public corporation) carrying out a spin-off. The type of property rules continue to apply to a public corporation carrying out a split-up and to all transactions in which the distributing corporation is a private corporation.
The amendment consisted of the insertion into the Act of the definitions of “specified corporation” and “specified wholly-owned corporation” in subsection 55(1) and of subsection 55(3.02) which provides that a public corporation carrying out a spin-off is considered to have only one type of property. As described above, where a corporation has only one type of property, a butterfly can be implemented with considerably less difficulty.

**Detailed Analysis**

**Property Becoming Property**

The preamble to paragraph 55(3.1)(a) provides that the exception referred to in paragraph 55(3)(b) does not apply if, in contemplation of a transfer of property by the distributing corporation, property becomes property of the distributing corporation, of a corporation controlled by it or of a predecessor corporation of any such corporations unless the property is acquired in an excepted transaction.

This rule does present significant difficulties in practice. Where an operating corporation is the subject of a butterfly transaction, one cannot suspend operations for the several months it takes to obtain an income tax ruling and implement the transaction. Quite obviously, therefore, property will become property of the corporation during the period of time commencing with the decision to implement a butterfly and the actual implementation of the butterfly. The CRA interprets the words "in contemplation of" a transfer of property to mean "but for"; that is, the acquisition of property does not render the paragraph 55(3)(b) exemption inapplicable unless the property would not have become property but for the butterfly. As a result, the rule does not apply where property is acquired as part of the ongoing commercial activities of the corporation.

The rule is intended to prevent corporations from circumventing the butterfly rules and accomplishing a sale of assets by transferring assets to the distributing corporation. The following example illustrates the abuse to which this provision was aimed.

**EXAMPLE 7**

Corporation A has two divisions, Division 1 and Division 2. Division 1 has a value of $30 and Division 2 has a value of $70. Corporation A would like to sell Division 1 to Corporation X. However, such a transaction would result in Corporation A recognizing gain. Instead, Corporation X
subscribes for shares of Corporation A. (The subscription price is equal to the aggregate of the purchase price of Division 1 and 30% of the injected cash which Corporation X receives on the butterfly. Mathematically, Corporation A is entitled to 70% of the cash which must be equal to $30, the sale price of Division 1. Therefore, Corporation X must tender as the subscription price the amount determined by the formula $(70\%) \times (X) = $30$ where X is the subscription amount. Based on this formula, $X = $42.85$.) As a result, Corporation A now has the two divisions plus cash of $42.85. This is illustrated in Diagram XXXIII below.

**DIAGRAM XXXIII**

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CORPORATION A               CORPORATION X

Division 1                  Division 2

$30                         $70

$42.85
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A butterfly is implemented pursuant to which Corporation X receives Division 1 and $12.85 of cash in exchange for its shares of Corporation A. From the perspective of the Department of Finance, this result was no different than the transaction described in example 3 above and was just as unacceptable.

**Exceptions to Rule**

The subparagraphs of paragraph 55(3.1)(a) contain a number of specific exceptions to the prohibition referred to in the preamble of paragraph 55(3.1)(a). (Each such exception implicitly assumes that the transaction would not satisfy the property becoming property rule but for the specific exemption.) These subparagraphs permit the following transactions:
(i) an amalgamation of two or more corporations related to the distributing corporation (subparagraph 55(3.1)(a)(i));

(ii) an amalgamation of a corporation and one or more corporations controlled by that corporation to form a distributing corporation (subparagraph 55(3.1)(a)(ii));

(iii) the receipt by a corporation pursuant to a butterfly transaction of property which it distributes on a subsequent butterfly transaction (subparagraph 55(3.1)(a)(iii)). Without subparagraph 55(3.1)(a)(iii), there could be no serial butterflies.

(iv) the disposition of property by the distributing corporation, a corporation controlled by the distributing corporation or a predecessor of any such corporation to a corporation controlled by the distributing corporation or a predecessor corporation of the distributing corporation (clause 55(3.1)(a)(iv)(A));

(v) the disposition of property by a corporation controlled by the distributing corporation or by a predecessor corporation of the distributing corporation to the distributing corporation or to a predecessor corporation of the distributing corporation (clause 55(3.1)(a)(iv)(B)); and

(vi) the disposition of property by the particular corporation, a corporation controlled by it or a predecessor corporation of any such corporation for consideration that consists only of money or indebtedness that is not convertible into other property, or any combination thereof (clause 55(3.1)(a)(iv)(C)).

Continuity of Share Ownership

Paragraph 55(3.1)(b)

Paragraph 55(3.1)(b) provides that if there is not a continuity of share ownership in the distributing corporation and in the transferee corporation, the exception
provided by paragraph 55(3)(b) is not available. This continuity of share ownership is one of the mechanisms designed to prohibit the use of a purchase butterfly.

Paragraph 55(3.1)(b) describes three situations in which the exception in paragraph 55(3)(b) does not apply.

**Subparagraph 55(3.1)(b)(i)**

The first situation occurs where, as part of the series of transactions that includes the distribution, a person or partnership (referred to as the "vendor") who is a specified shareholder of either a distributing corporation or a transferee corporation disposes of a particular property to certain persons. The particular property includes (i) a share of the distributing corporation, (ii) a share of the transferee corporation or (iii) property 10% or more of the fair market value of which was, at any time during the course of the series of transactions, derived from one or more such shares (e.g. a holding corporation). Subparagraph 55(3.1)(b)(i) applies if the described property, or any property acquired by any person or partnership in substitution for that property, was acquired by a partnership or by a person (other than the vendor) who either was not related to, or as part of the series ceased to be related to, the vendor. Excepted from the ambit of this rule is property acquired on a permitted acquisition, permitted exchange or permitted redemption. (In general, a permitted acquisition, a permitted exchange or a permitted redemption is a transaction needed to carry out a butterfly.) Moreover, substituted property does not include property received by the transferee corporation on the distribution.

Technically, the disposition by a specified shareholder of a single share of a distributing corporation or of a transferee corporation, where it is not part of a permitted acquisition, permitted exchange or permitted redemption and is to a person not related to the vendor, will render the exception in paragraph 55(3)(b) inapplicable.

Subparagraph 55(3.1)(b)(i) applies only where the vendor (which can be a person or a partnership) is a specified shareholder (as defined in subsection 248(1)) at any time during the course of the series of transactions.
Specified Shareholder

Put in its most basic terms, a person is a specified shareholder of a corporation if the person owns, directly or indirectly, at any time in the taxation year not less than 10% of the issued shares of any class or series of the corporation or of any other corporation related to the corporation. Investors who hold less than 10% of the common shares of a corporation will not normally make subparagraph 55(3.1)(b)(i) applicable. (Conceivably, on a split-up butterfly, a person who held, say 8% of the distributing corporation's shares, will hold more than 10% of the shares of a transferee corporation. In those circumstances, the person will be a specified shareholder of the transferee corporation. In addition, the very expansive definition of specified shareholder may result in a shareholder who owns less than 10% of the shares of a corporation being a specified shareholder.) Subject to the specific exceptions in subparagraph 55(3.1)(b)(i), any sale by a specified shareholder of shares of a distributing corporation or of a transferee corporation as part of the series of transactions that includes the butterfly would make the provisions of subparagraph 55(3.1)(b)(i) applicable.

In practice, when applying for an advance income tax ruling, the CRA will request information as to whether there are persons who are specified shareholders and ask for undertakings with respect to their intention.

Paragraph 55(3.2)(h) provides that each corporation that is a shareholder and specified shareholder of a distributing corporation at any time during the course of a series of transactions or events, a part of which includes a distribution, will be treated as a transferee corporation in relation to the distributing corporation. Subsection 55(3.3) ensures that in determining whether a person is a specified shareholder of a particular corporation for the purposes of subparagraph 55(3.1)(b)(i) and paragraph 55(3.2)(h), only Holdings “above” the particular corporation and not “below” it are to be considered.

Subparagraph 55(3.1)(b)(ii)

Subparagraph 55(3.1)(b)(ii) provides that paragraph 55(3)(b) does not apply where any person or group of persons has acquired control of a distributing corporation or of a transferee operation. (For these purposes, an acquisition of control is acceptable if it occurs
as a result of a permitted acquisition, permitted exchange or permitted redemption in relation to the distribution.) Paragraph 55(5)(e) contains a number of deeming rules for purposes of section 55, one of which (subparagraph 55(5)(e)(iv)), provides that for purposes of determining whether control has been acquired, the Act is to be read without reference to subsection 251(3) and paragraph 251(5)(b). Subsection 251(3) provides that if two persons are related to the same person, they are related to each other. As a result of subparagraph 55(5)(e)(iv), two persons will not be related to each other for purposes of section 55 solely by virtue of being related to a third party. Paragraph 251(5)(b) provides that for the purposes referred to in that paragraph, a person who holds certain rights is in the same position as if that person exercised the rights. By virtue of subparagraph 55(5)(e)(iv), the mere acquisition of a right will not result in the acquisition of control for purposes of section 55.

**Subparagraph 55(3.1)(b)(iii)**

Subparagraph 55(3.1)(b)(iii) makes paragraph 55(3)(b) inapplicable where shares of the distributing corporation are acquired by certain persons in contemplation of the distribution.

The target of subparagraph 55(3.1)(b)(iii) is a situation in which there is no sale of shares of the distributing corporation by a specified shareholder and in which the only acquisition of control of the distributing corporation or of a transferee corporation occurs on a permitted acquisition or permitted exchange. Subparagraph 55(3.1)(b)(iii) contemplates two factual situations.

In the first situation (described in clause 55(3.1)(b)(iii)(A)), a transferee corporation acquires shares of the distributing corporation from unrelated persons who are not specified shareholders. The transferee corporation then receives property of the distributing corporation on the distribution. This is illustrated in example 8 below:

**EXAMPLE 8**

Corporation X has three 20% shareholders, A, B and C, who are related, and a significant number of shareholders none of whom is a specified shareholder of Corporation X. Corporation Y purchases all of the shares of Corporation X other than those held by A, B and C so that it owns 40% of the shares of Corporation X. The organization is set out in Diagram XXXIV below.
Corporation X then undertakes a butterfly transaction pursuant to which Corporation Y acquires 40% of the assets of Corporation X.

The series of transactions set out in example 8 is not encompassed by the provisions of subparagraph 55(3.1)(b)(i) because no specified shareholder of the distributing corporation (Corporation X) or of the transferee corporation (Corporation Y) disposes of shares on any transaction other than on a permitted redemption. The series of transactions is not encompassed by the provisions of subparagraph 55(3.1)(b)(ii) because there is no acquisition of control of Corporation X or Corporation Y. However, the series clearly constitutes a classic purchase butterfly that from a policy perspective should be denied the exemption provided in paragraph 55(3)(b).

The prohibition extends to an acquisition of distributing corporation shares by a person or partnership with whom the transferee corporation does not deal at arm's length. This is designed to preclude such a person or partnership from acquiring shares of the distributing corporation and subsequently transferring them to the transferee corporation on a permitted exchange.
The restriction in clause 55(3.1)(b)(iii)(A) is in respect of shares acquired from a person to whom the acquiror (i.e. the transferee corporation or someone with whom it does not deal at arm's length) was not related or from a partnership. Therefore, a transferee corporation may acquire shares from a related person in order to carry out a butterfly.

Clause 55(3.1)(b)(iii)(B) contemplates a situation that is the mirror image to that contemplated by clause 55(3.1)(b)(iii)(A). The acquisition of shares of a distributing corporation, in contemplation of a distribution, by a person or any member of a group of persons that acquires control of the distributing corporation as part of the series of transactions will deny the paragraph 55(3)(b) exemption even where control is acquired as a consequence of a permitted redemption. This restriction is illustrated by example 9 below.

**EXAMPLE 9**

Corporation X has a 30% shareholder (Corporation A), a 50% shareholder (Corporation B) and a number of shareholders none of whom is a specified shareholder of Corporation X. All of the shareholders of Corporation X deal with each other at arm's length. Corporation A acquires all the shares of Corporation X not held by Corporation B.

**DIAGRAM XXXV**
Corporation X then undertakes a butterfly transaction so that Corporation A is the sole remaining shareholder of Corporation X.

This transaction is not one to which subparagraph 55(3.1)(b)(i) applies because no shares are sold by a specified shareholder. The transaction is not one to which subparagraph 55(3.1)(b)(ii) applies because the acquisition of control of the distributing corporation by Corporation A occurs as a consequence of a permitted redemption. However, this is a classic purchase butterfly which is beyond what the Department of Finance views as acceptable tax policy. By virtue of clause 55(3.1)(b)(iii)(B), the exemption contained in paragraph 55(3)(b) does not apply to the transaction described in example 9.

**Post-Butterfly Restrictions**

**Paragraphs 55(3.1)(c) and (d)**

The stated purposes of paragraphs 55(3.1)(c) and (d) are to ensure that:

(i) the shareholders maintain some continuity of interest in the property retained by the distributing corporation after the distribution and transferred to a transferee corporation on the distribution; and

(ii) a sale of the distributing corporation's assets cannot be used to "cash out" a corporate shareholder by distributing assets on a butterfly prior to the sale of those assets to a third party.

(If each transferee corporation and the distributing corporation are related immediately after the butterfly, neither paragraph 55(3.1)(c) nor (d) will apply.) Reference should be made to the special deeming rules in paragraph 55(5)(e) which deem certain persons to be or not to be related to others. (In particular, siblings are not related. In addition, as described above, subparagraph 55(5)(e)(iv) provides that, for purposes of section 55, in determining whether persons are related to each other or whether control of a corporation has been acquired, the Act is to be read without reference to subsection 251(3) and paragraph 251(5)(b).) If all such corporations are not related, a determination must be made as to whether either or both of paragraphs 55(3.1)(c) and (d) apply. Although their purpose is the same, one provision may apply independently of the other. Where paragraph 55(3.1)(c) applies to a transferee corporation, the exemption contained in paragraph 55(3)(b) will not apply to dividends.
received by the transferee corporation. Where paragraph 55(3.1)(d) applies, the exemption contained in paragraph 55(3)(b) will not apply to dividends received by a distributing corporation from any transferee corporation not related to the distributing corporation.

Paragraph 55(3.1)(c) applies where, as part of the series of transactions that includes the butterfly, more than 10% of the property received by a transferee corporation on a distribution is acquired by a partnership or by a person that is not related to the transferee corporation. Paragraph 55(3.1)(d) applies where, as part of the series of transactions that includes the butterfly, more than 10% of the property retained by a distributing corporation after a distribution is acquired by a partnership or by a person that is not related to the distributing corporation. Each of paragraphs 55(3.1)(c) and (d) excepts certain acquisitions of property.

Property that is money, indebtedness that is not convertible into other property, shares of the transferee corporation or of the distributing corporation, or property more than 10% of the fair market value of which is attributable to one or more such shares is not relevant for purposes of these rules.

Each transferee corporation and the distributing corporation is examined on an independent basis. For each corporation, the aggregate fair market value (determined at the time of the acquisition) of each of its relevant properties must be determined. Where the corporation is a transferee corporation and the aggregate fair market value of all relevant properties exceeds 10% of the fair market value, determined at the time of the distribution, of all the property (other than money and indebtedness that is not convertible into other property) received by it on the butterfly, paragraph 55(3.1)(c) will apply. Where the corporation is the distributing corporation and the aggregate fair market value of all relevant properties exceeds 10% of the fair market value, determined at the time of the distribution, of all the property (other than money and indebtedness that is not convertible into other property) retained by it after the butterfly, paragraph 55(3.1)(d) will apply.

Where paragraph 55(3.1)(c) applies, the paragraph 55(3)(b) exception will be inapplicable only in respect of the dividends received by the particular transferee corporation. The exemption will continue to apply in respect of any dividends received by the distributing corporation or by any other transferee corporation. Where paragraph 55(3.1)(d) applies, the
paragraph 55(3)(b) exception will be inapplicable only in respect of dividends received by the distributing corporation from each transferee corporation to which the distributing corporation was not related.

Paragraphs 55(3.1)(c) and (d) will have a significant effect in circumstances where the shareholdings do not closely correspond to the asset groupings. This principle is illustrated by example 10 and the variation thereon described below.

**EXAMPLE 10**

Corporation X has two Divisions, 1 and 2, whose fair market values are $30,000,000 and $70,000,000, respectively. Corporations A and B own 25% and 75%, respectively, of the shares of Corporation X. This corporate organization is illustrated in Diagram XXXVI below.

**DIAGRAM XXXVI**

![Diagram](image-url)
A butterfly transaction is undertaken pursuant to which Corporation A receives $25,000,000 of the assets of Division 1 (25% of the assets of Corporation X). After the butterfly, Corporation A wishes to acquire the assets of Division 1 retained by Corporation X.

Since such assets ($5,000,000) represent less than 10% of the assets retained by Corporation B ($75,000,000), such sale would not result in the application of paragraph 55(3.1)(c).

Assume instead in example 10 that Divisions 1 and 2 have a value of $25,000,000 and $75,000,000, respectively, and that Corporations A and B own 30% and 70%, respectively, of the shares of Corporation X. It is intended that Corporation A acquire Division 1. On the butterfly, Corporation A would acquire Division 1 and $5,000,000 of the assets of Division 2 (30% of the assets of Corporation X) and Corporation X would retain $70,000,000 of the assets of Division 2 (70% of the assets of Corporation X). In order to effect the correct business result, Corporation A would be required to transfer the $5,000,000 of assets of Division 2 to Corporation X. Since such assets ($5,000,000) represent more than 10% of the assets received by Corporation A ($30,000,000), such sale would result in the application of paragraph 55(3.1)(c).
Appendix A


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

From Alice in Wonderland, Chapter XII, "Alice's Evidence".

Subsection 84(3).

The proceeds of disposition of the shares is reduced by the amount of the dividend pursuant to paragraph (j) of the definition of proceeds of disposition in section 54.

Ms. B can transfer her shares to her holding corporation on a tax-deferred basis by making an election under subsection 85(1) of the Act.

In Robert J. Dart, "Demergers," in Report of Proceedings of the Forty-Third Tax Conference, 1991 Conference Report (Toronto: Canadian Tax Foundation, 1992), 13:1-38, at 13:3, Dart indicates that the term "butterfly" was first used at the 1977 annual conference of the Canadian Tax Foundation in reference to spinouts. Arthur Scace presented a paper in which he described a schematic diagram for a complex private corporation spinout. The diagram was nicknamed a "butterfly" by P.N. Geer, a co-panellist of Scace's at the conference. See A.R.A. Scace, "Going Private and Deconglomeration," in Report of Proceedings of the Twenty-Ninth Tax Conference, 1977 Conference Report (Toronto: Canadian Tax Foundation, 1978), 569-84, at 578. According to Dart, the term "butterfly" was used in Scace's remarks but did not appear in the text of his paper. While Scace's article is the first paper of record that describes a butterfly transaction, it is understood that practitioners in addition to Scace contributed to the initial development of the butterfly. In particular, it is understood that both Howard Kellough and P.N. Geer contributed significantly to the development of the butterfly.

Appendix A lists a number of papers that have been presented over the years and that describe the historical development of the rules and analyze the technical provisions of the rules. Notwithstanding the evolution of the law relating to butterflies, most of the administrative positions outlined by the officials of the CRA in their papers referred to in the Appendix continue to be relevant. Reference should also be made to Understanding Section 55 and Butterfly Reorganizations by Vance Sider and Marc Ton-That (CCH, 1999) for a discussion of the current butterfly rules.

"Eligible property" is defined in subsection 85(1.1). An election can be made pursuant to subsection 85(1.1) only in respect of property that is eligible property.

Paragraph (j) of the definition of proceeds of disposition in section 54.

Any such dividend may be subject to tax pursuant to Part IV or Part IV.1.

The promissory note is composed of two parts. $600 represents the payment of a return of capital and since it is received in exchange for property which has a value of $600, it has a cost of $600. The other portion represents the part of the note paid as a dividend. By virtue of subsection 52(2), this part of the note has a cost of $400. The total cost of the note is therefore $1000.

96 D.T.C. 6562 (F.C.A.).

See Robertson's paper, item 3 in Appendix A, at page 8:3 and following for a discussion of safe income.

Generally, when a person acquires shares, the "safe-income" attributable to those shares forms part of the purchasing adjusted cost base. There are exceptions, such as where shares are transferred pursuant to subsection 85(1). In such circumstances, the safe-income becomes safe-income to the transferee holder. See Robertson's paper, item 3 in Appendix A, at page 85.
The decision of the Tax Court is found at 2000 D.T.C. 1482.


The Queen v. Canadian Utilities Limited and Canutilities Holdings Limited, 2004 DTC 6475 (F.C.A), rev’g in part 2003 DTC 1029 (TCC); leave to appeal to Supreme Court denied March 3, 2005.

See Harris’ paper, No. 9 in Appendix A at page 14:7, infra.

Subsection 55(3) has gone through a number of amendments since it was first introduced. A number of amendments to subsection 55(3) are discussed in the following part of this paper.

Diagrams XIV to XVIII outline a classic butterfly. In that butterfly, Corporation X is the distributing corporation and Corporation B is the transferee corporation.

As described above, butterfly transactions in general require the application of a number of the corporate reorganization rules contained in the Act. There may be an initial reorganization of the distributing corporation that is subject to the provisions of section 86. The transfer of shares of the distributing corporation by shareholders of the distributing corporation to one or more transferee corporations may be subject to the provisions of either subsection 85(1) or section 85.1. The subsequent cross-redemption of shares will give rise to intercorporate dividends that may be deducted from taxable income of each recipient corporation in accordance with the provision of subsection 112(1). For a more detailed discussion of the relevant technical issues involved in a butterfly in addition to the application of subsection 55(3) discussed below, see Robert J. Dart’s paper referred to in item 8 of Appendix A at page 13:30 and following.

For a very unsophisticated approach to a butterfly reorganization which was not thought out, see Northern Hot Oil Services Limited v. The Queen, 97 D.T.C. 1210 T.C.C.

See Hiltz’s paper, number 6 in Appendix A, at page 20:33. See paragraph 35(b)(ii) of advance income tax ruling 2006-0215751R3 in which the CRA stated that any remaining net fair market value of any accounts receivable, trade receivables, inventories and prepaid expenses of the distributing corporation after allocation of the current liabilities would be classified as business property and excluded from the cash or near-cash property.

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