2010 TAX LAW FOR LAWYERS

AMALGAMATIONS AND WIND-UPS

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Amalgamations

Overview

Amalgamation is one of the key tools available to lawyers in reorganizing and merging corporations. From a legal and commercial perspective, amalgamation has the advantage of being a relatively straightforward transaction in the sense that if the requisite conditions can be met, the assets and liabilities of the predecessor corporations automatically become assets and liabilities of the amalgamated corporation on the effective date of the amalgamation without the need for complicated conveyancing. From a tax perspective, if one is aware of certain pitfalls and traps, amalgamation can produce excellent results. On the amalgamation, tax deferrals will usually be available at both the shareholder and predecessor corporation levels, transfer taxes will not be exigible and there will be no doubling up of employer contributions to the Canada Pension Plan and employment insurance. These results flow automatically without the need to file tax elections.

Amalgamation can be considered in a wide variety of circumstances:

- Unrelated public corporations might decide to merge for reasons that include economies of scale, competitive advantages and tax efficiencies. A number of techniques to effect the merger would be available. The public corporations might simply amalgamate as in the amalgamation, pursuant to a plan of arrangement, of Suncor Energy Inc. and Petro-Canada described in their information circular of April 29, 2009. Or, one of the corporations might make a takeover bid for the other with a view, if the bid is successful, to merging with the acquired corporation by way of vertical amalgamation or wind-up. If the acquiring corporation elects to proceed by way of takeover bid but fails to acquire the requisite percentage of the shares (usually, 90% of the shares not previously owned by the acquiring group) to permit a force-out of the minority, it might then propose an amalgamation to squeeze out the minority. Alternatively, one of the corporations might seek to acquire the other by way of triangular amalgamation. That is, a wholly-owned subsidiary of the acquiring corporation might amalgamate with the target corporation and, on the amalgamation, shareholders of the target corporation would receive shares of the acquiring corporation rather than shares of the amalgamated corporation.

- Amalgamation might be used as a method to merge corporations within a related group of corporations. There may be non-tax reasons for mergers of this type, such as eliminating the costs of maintaining the separate existence of corporations when limited liability is not a concern, or, simply cleaning up the corporate chart. Merger might also be efficient from a tax perspective. Because consolidated tax returns are not permitted in Canada, a corporate group must be mindful not to have tax losses or excess tax accounts in one corporation while having taxable income in another. Reasonable inter-company charges such as management fees or interest may solve all or part of the problem. Merger by way of amalgamation or wind-up would provide a more lasting solution.

- Amalgamation might be used as a technique to gain access to tax losses and other tax accounts of an unrelated or unaffiliated corporation. In this context, the acquisition of control rules or the provisions of subsection 69(11) of the *Income Tax Act (Canada)*[1] may come into play but there is still considerable scope to achieve these tax objectives. For example, if a corporation with non-capital loss carryforwards from a business is amalgamated with a corporation that carries on the same or a similar business, it should be possible for the amalgamated corporation to use those loss carryforwards under subsections 87(2.1) and 111(5).

- If a corporation has borrowed money to acquire the shares of another corporation (in a private transaction, a leveraged buyout, a takeover bid or otherwise), it may find that it has interest expense that it cannot fully deduct. If the newly-acquired corporation is in a taxable position, there will be a strong incentive to merge the corporations by way of amalgamation or wind-up. As described below, the merger may result in additional capital tax liability but this is often more than offset by the income tax savings in being able to deduct the interest against the operating income of the newly-acquired subsidiary.

[1] R.S.C. 1985, c. 1 (5th Supp.), as amended (herein referred to as the "Act"). Unless otherwise noted, statutory references in this paper are to the Act.

- An amalgamation might be used to purify a corporation so that a shareholder who is an individual can take advantage of the capital gains exemption (as described in income tax ruling ATR-55).

- An amalgamation might be used to merge a Canadian holding company of a non-resident shareholder with a public subsidiary of the holding company in order to permit the non-resident to more efficiently proceed with a secondary offering and take advantage of a capital gains exemption under the applicable tax treaty (as seen in the Rothmans Inc. amalgamation of February 11, 2000).

It can be seen that amalgamation can be used to meet a wide range of tax and non-tax objectives. It must also be remembered, however, that amalgamation is just one of the techniques available in structuring a reorganization or merger. The role of the tax advisor is to sift through the advantages and disadvantages of all the available methods and recommend the technique that works best in the circumstances. For example, two unrelated corporate groups might each have a subsidiary that they wish to merge and operate jointly for commercial reasons. The structure that immediately comes to mind would be a simple amalgamation of the two subsidiaries. In certain circumstances, the parties may find that there would be greater tax efficiency if, instead, the merger were effected by way of partnership between the two subsidiaries.[2] Nevertheless, amalgamation will often prove to be the winning strategy.

Corporate Law

An amalgamation is a procedure provided under the various corporate statutes by which two or more corporations become one. In this paper, I will focus on amalgamations under the relatively modern corporate statutes such as the *Canada Business Corporations Act* ("CBCA") or the *Ontario Business Corporations Act* ("OBCA"), which provide for the continuity of existence concept of amalgamation. That is, by following the various required procedures and upon issuance of a certificate of amalgamation, the predecessor corporations continue as one amalgamated corporation, with the assets and the liabilities of each predecessor corporation becoming assets and liabilities of the amalgamated corporation. In language uncharacteristically poetic for corporate lawyers, an amalgamation has been likened to streams coming together to form a river.

Because amalgamations are governed by corporate statutes, an amalgamation can generally occur only if each of the predecessor corporations is governed by the same corporate statute.[3] In most jurisdictions (the notable exception being Quebec), however, it is possible for corporations to be continued to another jurisdiction. For example, a corporation governed by the OBCA can be continued under the CBCA, so that it can then amalgamate with another corporation governed by the CBCA.[4] If a non-Quebec corporation wishes to merge with a Quebec corporation, amalgamation would not be feasible under the current law. It will be feasible once the newly enacted *Business Corporations Act* (Quebec) comes into force, which is expected to be by January 2011. Until then, alternatives would be triangular amalgamation or acquisition of one of the corporations followed by a winding-up.[5]

To effect an amalgamation, approval of a specified proportion (2/3 under the CBCA and the OBCA) of shareholders is required, and dissenting shareholders are typically entitled to be paid the fair value of their shares if they so choose.

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2 Ronald M. Richler, "Merger by Way of Partnership – With a Comparison to Amalgamation", in Report of Proceedings of the Fifty-First Tax Conference, 1999 Conference Reports (Toronto: Canadian Tax Foundation, 2000) 25:1 - 30.

3 Exceptions are appearing in some of the provincial corporate statutes. For example, section 187 of the Alberta Business Corporations Act permits an Alberta corporation to amalgamate with an extra-provincial corporation provided that one is wholly-owned by the other and the extra-provincial corporation is authorized by the legislation in its home jurisdiction to so amalgamate. I'm not aware, however, of a jurisdiction (i.e., the home jurisdiction of the extra-provincial corporation) that would allow amalgamation in this way without first continuing to Alberta. For example, I understand that an amalgamation under a similar provision in the B.C. Business Corporations Act of a B.C. company and an Alberta extra-provincial corporation was denied because Alberta requires the Alberta corporation to continue before amalgamating with a non-Alberta corporation.

4 A continuance is not regarded by the Canada Revenue Agency (which together with the former Revenue Canada and the Canada Customs and Revenue Agency is referred to herein as the "CRA") as being a taxable event. See: Income Tax Ruling TR-1, June 24, 1974 (now withdrawn), CRA Document No. 2005-0147131R3, May 31, 2006 and Alan M. Schwartz, "Statutory Amalgamations, Arrangements, and Continuations: Tax and Corporate Law Considerations", in Report of Proceedings of the Forty-Third Tax Conference, 1991 Conference Reports (Toronto: Canadian Tax Foundation, 1992), 9:1-77, at 9:23.

5 There has been some suggestion that an amalgamation of a Quebec corporation with a CBCA or OBCA corporation might be possible pursuant to the arrangement provisions of the CBCA or OBCA but there are significant constitutional issues. See: Graham Turner, "Amalgamations and Continuations" (1988), vol. 36, no. 6 Canadian Tax Journal 1479-1499, at 1496.

Unless the short-form procedures on a vertical or horizontal amalgamation are used, an amalgamation agreement is required that must set out, among other things, the provisions that are usually included in articles of incorporation, such as the name of the amalgamated corporation and the share provisions. The agreement must also set out the consideration to be received by the shareholders of each of the predecessor corporations in exchange for their shares. Under the CBCA and the OBCA and most other modern corporate statutes, the consideration can consist of shares of a corporation other than the amalgamated corporation. This permits triangular amalgamations in which shares of the parent (or grandparent) of the amalgamated corporation are issued to shareholders of a predecessor corporation.

Articles of amalgamation are filed with the appropriate companies branch in order to receive a certificate of amalgamation. The articles must be accompanied by a statement of an officer or director of each predecessor corporation to the effect that there are reasonable grounds for believing that each predecessor corporation is, and the amalgamated corporation will be, able to pay its liabilities as they become due and that the realizable value of the assets of the amalgamated corporation will not be less than the aggregate of its liabilities and stated capital of all classes.

Both the CBCA and the OBCA provide short-form procedures in certain circumstances. A vertical short-form amalgamation is available for the amalgamation of a corporation and one or more of its wholly-owned subsidiary corporations. A horizontal short-form amalgamation is available for the amalgamation of two or more wholly-owned subsidiary corporations of the same corporation. Under these short-form procedures, an amalgamation agreement is not necessary and the vote of the shareholders is not required.

In a vertical short-form amalgamation, the shares of each predecessor subsidiary corporation are cancelled. The amalgamated corporation issues no securities and the articles are the same as the articles of the predecessor parent corporation.

In a horizontal short-form amalgamation, the shares of all but one of the predecessor subsidiary corporations are cancelled, the stated capital of the predecessor subsidiary corporations whose shares are cancelled is added to the stated capital of the predecessor subsidiary corporation whose shares are not cancelled and the articles of amalgamation are the same as the articles of the predecessor subsidiary corporation whose shares are not cancelled (subject to certain exceptions).

Recently, a Canadian parent corporation merged with a number of its Canadian subsidiaries pursuant to a plan of arrangement under the CBCA.[6] Under the plan of arrangement, the parties merged with the same effect as if they were amalgamated, including the continuance of all the corporations as one corporation, except that the separate legal existence of the parent corporation did not cease and the parent corporation survived the merger. The CRA ruled that the amalgamation provisions of section 87 would apply to the merger. The merger was structured in this way because one of the subsidiaries owned U.S. real property and this type of merger was eligible for a U.S. rollover under the *Foreign Investment and Real Property Tax Act* described below under the heading "Foreign Tax Implications".

Tax Considerations

Qualifying Amalgamation

Section 87 contains numerous provisions that essentially result in tax-deferred rollovers for shareholders and other security holders of the predecessor corporations and rollovers and continuity of tax accounts for the predecessor corporations.[7]

Not all amalgamations that can be done for corporate purposes qualify under section 87. In order to qualify as an amalgamation for the purposes of section 87, the following conditions must be met (and certain relevant points are noted in respect of these conditions):

1. There must be a merger of two or more corporations each of which was immediately before the merger, a "taxable Canadian corporation" to form one corporate entity.[8]

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[6] Gabrielle M. R. Richards, "U.S. Delaware Merger Imported to Canada" (2006), vol. X, no. 2 Corporate Structures and Groups (Federated Press) 552-553; CRA Document No. 2006-0178571R3, September 27, 2006.

[7] Checklists for amalgamations and wind-ups can be found in Catherine A. Brayley, "Merging Companies: A Practical Checklist for Amalgamations and Wind-Ups", in Report of the Proceedings of the Fifty-Second Tax Conference, 2000 Conference Reports (Toronto: Canadian Tax Foundation, 2001), 6:1-62.

[8] As in the merger described in footnote 6, a merger can be effected under a plan of arrangement rather than an amalgamation under the corporate statute. Section 87 also deals with mergers of foreign corporations but this topic is not covered in this paper.

- A "taxable Canadian corporation" is defined in subsection 89(1) to mean a corporation that is a "Canadian corporation" and not exempt from tax under Part I.

- A "Canadian corporation" is defined in subsection 89(1) to mean a corporation that is resident in Canada and either incorporated in Canada or resident in Canada since June 18, 1971. For this purpose, a corporation resulting from the amalgamation of Canadian corporations is considered to be incorporated in Canada.

- By virtue of subsection 250(5.1), a corporation continued into Canada from outside the country is considered after the time of continuation to have been incorporated in Canada.

2. All of the property (except amounts receivable from any predecessor corporation or shares of any predecessor corporation) of the predecessor corporations immediately before the merger must become property of the amalgamated corporation by virtue of the merger.

   - Under certain corporate statutes, it is permissible for cash to be given as consideration or partial consideration for the exchange of shares of a predecessor corporation. If the cash were to come from one of the predecessor corporations, the cash would not become property of the amalgamated corporation, thereby disqualifying the amalgamation under subsection 87(1). As will be seen in the discussion below regarding rollovers available at the shareholder level, it is possible to achieve the same result by using redeemable shares that are redeemed shortly after the amalgamation.

   - The CRA has taken the position that section 87 will apply where a shareholder receives cash or other property (having a value which does not exceed $200) in lieu of a fractional share.[9]

[9] Interpretation Bulletin IT-474R2, paragraph 37.

- The CRA has also taken the position that an amalgamation will not be disqualified when a leasehold or royalty interest of one predecessor corporation in the assets of another predecessor corporation is eliminated because the interests merge on the amalgamation.[10]

- Similarly, if one predecessor corporation has a right or option to acquire shares of another predecessor corporation, the amalgamation will not be disqualified even though the right or option terminates on the amalgamation.[11]

- Section 87 contemplates that one corporation may own shares of another predecessor corporation which will be cancelled on the amalgamation and the CRA has confirmed that no gain or loss will be realized on such cancellation;[12] but, as discussed below, gain can be realized by the parent predecessor corporation in respect of the shares of the subsidiary predecessor corporation that are cancelled on a vertical amalgamation, and, pursuant to the forgiveness of debt rules, gain can be realized if the adjusted cost base of the cancelled shares had previously been reduced under these rules.

3. All of the liabilities (except amounts payable to any predecessor corporation) of the predecessor corporations immediately before the merger must become liabilities of the amalgamated corporation by virtue of the merger.

4. All of the shareholders (except any predecessor corporation) who own shares of any predecessor corporation immediately before the merger must receive shares of the amalgamated corporation because of the merger.

   - In order to accommodate vertical and horizontal short-form amalgamations, subsection 87(1.1) deems shares of a predecessor corporation not cancelled on the amalgamation to be shares of the amalgamated corporation received by virtue of the merger provided that the amalgamation involves "subsidiary wholly-owned

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10 Ibid., paragraphs 4 and 21.

11 Ibid.

12 Ibid., paragraph 41. This position is to be codified under proposed amendments to paragraph (n) of the definition of "disposition" in subsection 248(1).

corporations". For this purpose, a "subsidiary wholly-owned corporation" does not have its usual definition in subparagraph 248(1) but rather means a corporation wholly-owned by another corporation, a subsidiary wholly-owned corporation of the other corporation or any combination of such persons.[13]

- In order to accommodate certain triangular amalgamations, paragraph 87(9)(a) provides that shares received by a shareholder of a predecessor corporation from a taxable Canadian corporation that controls the amalgamated corporation immediately after the merger (the "parent") are deemed to be shares of the amalgamated corporation received by the shareholder by virtue of the merger.

- If a dissenting shareholder asks to receive cash, there is an interesting theoretical issue, given that the only rights a dissenter has are to receive payment of the fair value of the dissenter's shares, as to whether the dissenter has ceased to be a shareholder of the predecessor corporation prior to the amalgamation or, if not, whether the dissenter became a shareholder of the amalgamated corporation. The CRA has taken the position that a dissenting shareholder ceases to be a shareholder and that the amalgamation is not disqualified in these circumstances.[14] The CRA also is of the view that the dissenter realizes a capital gain or loss on payment, rather than a deemed dividend, on the basis that payment is received from a corporation different from that in which the dissenter was a shareholder.[15]

- If on a squeeze-out amalgamation shareholders receive redeemable shares that are redeemed immediately following the amalgamation so that those shareholders cease to be shareholders of the amalgamated corporation, the CRA has taken the position that it would not apply the general anti-avoidance rule to, among other things, disqualify the amalgamation.[16]

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13 Subsection 87(1.4).

14 CRA Document No. 2001-0091465, July 30, 2001, and Interpretation Bulletin IT-474R2, paragraph 5.

15 1987 CRA Round Table, question 59 and 1993 CRA Round Table, question 56.

16 Information Circular 88-2, paragraph 28, and Interpretation Bulletin IT-474R2, paragraph 5.

5. The merger cannot be a result of the acquisition of property of one corporation by another corporation pursuant to the purchase of that property by the other corporation or as a result of the distribution of that property to the other corporation on the winding-up of the corporation.

If these conditions are met, the amalgamation will qualify under section 87 without the need for any elections to be filed.

If an amalgamation does not qualify under section 87, it is likely that the predecessor corporations would not be regarded as disposing of their assets on the amalgamation if, under the relevant corporate law, the predecessor corporation does not cease to exist but rather continues as part of the amalgamated corporation.[17] Nevertheless, it is usually considered desirable that an amalgamation qualify under section 87 because there would be considerable uncertainty about continuity of the various tax accounts and other tax attributes provided for at length in section 87 if that section were not applicable.[18] Further, the rollover at the shareholder level, described below, would not be available with the result that shareholders would be deemed to have a taxable disposition for capital gain and loss purposes.[19]

Rules Applicable to Shareholders

Rollover

The definition of "disposition" in subsection 248(1), which is relevant to shareholders who hold their shares of a predecessor corporation as capital property, provides that a disposition includes a transaction by which any share is converted by virtue of an amalgamation of merger.

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[17] 1992 CRA Round Table, question 26 and CRA Document No. 2002-0169775.

[18] The CRA has taken the position that the tax accounts and other tax attributes of the predecessor corporations would not flow through to the amalgamated corporation on a non-qualifying amalgamation: CRA Document No. 0003385, February 2, 2000. This principle was adopted by the Tax Court of Canada in *CGU Holdings Canada Ltd.* v. *The Queen*, 2008 DTC 3347 (TCC), affirmed for different reasons by the Federal Court of Appeal at 2009 DTC 5044.

[19] It has been suggested that the rollovers under subsection 85(1) or 86(1) may apply but there is considerable doubt in this regard. See Alan M. Schwartz, supra footnote 4, at 9:74 – 75.

Shareholders who hold their shares of a predecessor corporation as capital property will be entitled to a tax-deferred rollover under subsection 87(4) if the following conditions are met:

1. The amalgamation must be a qualifying amalgamation under section 87, as described above.

2. The shareholder must receive no consideration for the disposition of the shareholder's shares on the amalgamation other than shares of the amalgamated corporation.

    - That is, no non-share consideration (boot) is permissible but, as noted above, the CRA permits cash to be received in lieu of fractional shares and has taken the position that the general anti-avoidance rule will not be applied if a shareholder receives redeemable shares that are immediately redeemed for cash.

    - Because boot with even insignificant value would disqualify a shareholder from the rollover, one must be very careful that there are no related agreements that give the shareholder additional rights, such as rights to put the shares to another person or rights to vote the shares of another corporation.

    - An issue that caused consternation within the tax community a few years ago was a position of the CRA that rights under a typical shareholder rights plan do not form part of the bundle of rights that constitute a share and, therefore, might be considered to be boot. Many public corporations have shareholder rights plans that are designed to protect the corporation from an unfair takeover bid. Typically, the rights do not trade separately from the shares until the occurrence of certain defined events, at which point the rights permit shareholders to purchase shares at a significant discount. In fact, however, it is highly unlikely that the rights would ever be exercised. Instead, shareholder rights plans are designed to allow the directors a restricted amount of time to find a competing bidder. On an amalgamation, shareholders may receive such rights together with shares of the amalgamated corporation (or, on a triangular amalgamation, together with shares of the parent). Based on the CRA's position, there was concern that the rollover under subsection 87(4) (and other provisions such as subsections 51(1) and 85.1(1) that permit no boot) would not be available if shareholder rights were received together with shares. Fortunately, late in 2002, the CRA issued a favourable ruling that the rollover under subsection 87(4) would not be denied in these circumstances on the basis that the rights were received incidentally and not as "consideration" for the shares of the predecessor corporation.[20] The CRA was able to reach this conclusion because the shareholder rights plan could have been cancelled before the amalgamation, the existence of the plan at the time of the amalgamation was not a condition to the amalgamation occurring and rights were not promised to, or bargained for by, the shareholders.

- To accommodate certain triangular amalgamations, paragraph 87(9)(a) provides that shares received by a shareholder of a predecessor corporation from the parent are deemed to be shares of the amalgamated corporation received by the shareholder by virtue of the merger.

3. It must not be reasonable to regard the shareholder as desiring to confer a benefit on a related person in circumstances where the shares received by the shareholder on the amalgamation are worth less than the shares of the predecessor corporation held by the shareholder.

    - If this condition is not met, the shareholder can realize a gain under paragraph 87(4)(c).[21]

If all these conditions are met, the shareholder will be deemed to have disposed of the shareholder's shares of a predecessor corporation for proceeds equal to their adjusted cost base immediately before the amalgamation. Accordingly, the shareholder will not realize a capital gain. It would appear that a shareholder would realize a capital loss if the shareholder

[20] CRA Document No. 2002-017716, December 19, 2002. See also: Income Tax Technical News No. 28 which deals with shareholder rights plans in the context of section 86.1.

[21] In *Husky Oil Limited* v. *The Queen*, 2009 TCC 118 (under appeal), the Tax Court of Canada found that paragraph 87(4)(c) applied to deny a rollover on an amalgamation. See also: CRA Document 2007-0221331R3 for a ruling that paragraph 87(4)(c) did not apply in the circumstances.

had costs of disposition; however, it would be unusual in the context of an amalgamation for a shareholder to have any such costs.[22]

Under subsection 87(4), the shareholder is deemed to have acquired the shares of the amalgamated corporation at a cost equal to the shareholder's adjusted cost base of the shares of the predecessor corporation. If more than one class of shares of the amalgamated corporation are acquired by the shareholder, that cost is pro-rated between the classes based on their relative fair market values. The CRA has, however, taken the position that a shareholder who holds shares of two classes of a predecessor corporation that are each exchanged for shares of like classes of the amalgamated corporation can ignore the shift of cost between classes that would otherwise result and, instead, retain the same cost per class.[23]

Rollover on Short-Form Amalgamation

Notwithstanding that the amalgamated corporation does not issue shares on a vertical short-form amalgamation (the shareholders of the parent corporation continue as shareholders of the amalgamated corporation), the CRA takes the questionable position that the shares of the parent corporation are converted to shares of the amalgamated corporation and that there is a disposition of those shares for the purposes of the definition of "disposition" in subsection 248(1).[24] However, the CRA takes the position that the rollover under subsection

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22 Note that if the shareholder is subject to the conferral of benefit provisions, its capital loss is deemed to be nil under paragraph 87(4)(d).

23 Interpretation Bulletin IT-474R2, paragraph 38 which contains the following illustration:
For example, a shareholder might be in the following position:

	ACB of shares in predecessor corporations	FMV of shares in new corporation	Cost of shares of new corporation under 87(4)
preferred	$1,000	$1,000	$110
common	100	9,000	990
	$1,100	$10,000	$1,100

However, in a situation such as that described above, it is the practice of the CRA not to apply paragraph 87(4)(b) to reallocate the adjusted cost base of the shares of the new corporation where:

(c) the amalgamation agreement provides that the preferred and common shares of the predecessor corporation are to be converted into preferred and common shares, respectively, of the new corporation, or

(d) for a short-form amalgamation, the issued shares of one of the predecessor corporations becomes shares of the new corporation under the relevant corporate legislation.

Consequently, the cost of the preferred and the common shares of the new corporation will be $1,000 and $100, respectively.

24 CRA Document No. 2001-0104355, November 1, 2002.

87(4) applies and that if there was more than one class of shares of the parent corporation, it would not apply paragraph 87(4)(b) to shift the adjusted cost base among the classes.[25]

With respect to a horizontal short-form amalgamation, while there does not appear to be any statutory provision that permits the parent corporation to add its adjusted cost base of its shares of predecessor corporations that are cancelled to its adjusted cost base of the shares of the predecessor corporation that are not cancelled, the CRA has taken the position that subsection 87(4) permits the adjusted cost base of the shares of the predecessor corporations to be aggregated in determining the parent's adjusted cost base of the amalgamated corporation.[26]

Potential Capital Gain on Vertical Amalgamation

Until 1994, a wind-up of a subsidiary pursuant to subsection 88(1) had a distinct advantage over a vertical amalgamation under section 87 if the "bump" (that is, increase) in adjusted cost base of certain non-depreciable capital properties of the subsidiary was available under paragraph 88(1)(d). In order to permit this same advantage on a vertical amalgamation, subsection 87(11) was introduced. It applies when there is an amalgamation of a parent corporation and one or more other corporations each of which is a "subsidiary wholly-owned corporation" of the parent. This phrase does not have the broad meaning of subsection 87(1.4); rather, it is defined in subsection 248(1) to mean a direct wholly-owned (except for directors' qualifying shares) subsidiary.

While subsection 87(11) provides for the application of the bump provisions of subsection 88(1) on this type of vertical amalgamation (see below), it also introduces a tax trap that has applied to a wind-up under subsection 88(1) but had not previously applied to vertical amalgamations. Paragraph 87(11)(a) provides that the parent can realize a capital gain (but not a capital loss) in respect of the shares of the subsidiary pursuant to paragraph 88(1)(b) which is made to apply to this type of vertical amalgamation. The shares of the subsidiary are deemed to have been disposed of for proceeds equal to the lesser of the paid-up capital of those shares and the net tax value of the assets of the subsidiary as determined under subparagraph 88(1)(d)(i) (if that lesser amount is greater than the adjusted cost base of the shares of the subsidiary).

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25 CRA Document No. 9226095, September 23, 1992.
26 Interpretation Bulletin IT-474R2, paragraph 39.

I suspect that the tax policy reason for requiring the parent to realize a capital gain in these circumstances has been forgotten. If one is aware of this issue, there are some fairly simple procedures available to avoid it in advance of the amalgamation or wind-up. Perhaps, the simplest method is to reduce the paid-up capital of the shares of the subsidiary (without a payment of cash) to an amount equal to the parent's adjusted cost base of those shares prior to the transaction. This should not be regarded as an abusive transaction subject to the general anti-avoidance rule.[27]

Potential Gain on Shares Held by a Predecessor if Section 80 Previously Applied

Another way that a capital gain can arise in respect of shares of a predecessor corporation held by another that are cancelled on an amalgamation is if the adjusted cost base of those shares had been previously reduced pursuant to the forgiveness of debt rules of section 80. Pursuant to section 80.03, the holder will be deemed to realize a capital gain in these circumstances unless it elects to treat the gain as a forgiven debt under subsection 80.03(7). The same treatment applies on a wind-up.

Rollover on Triangular Amalgamation

On a triangular amalgamation, by virtue of paragraph 87(9)(a), the rollover rules of subsection 87(4) will apply to a shareholder of a predecessor corporation who receives shares of the parent corporation instead of shares of the amalgamated corporation.

A separate rule is provided in paragraph 87(9)(c) regarding the cost to the parent of shares of the amalgamated corporation. Typically, on a triangular amalgamation, the parent would receive shares in exchange for its shares of the predecessor corporations and would also receive shares from the amalgamated corporation as consideration for the parent issuing its own shares to the other shareholders of the predecessor corporations. Although the CRA never accepted it, there had been an argument that paragraph 87(9)(c) applied only to the first tranche of shares and that the parent should have a cost of the latter tranche of shares equal to the fair

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27 Joel Shafer, "Liquidation", in Report of Proceedings of the Forty-Third Tax Conference, supra footnote 4, 10:1–48, at 10:26; CRA Document No. 2006-0196011 C 6, October 6, 2006.

market value of the shares it issued.[28] This argument was eliminated with the adoption of paragraph 87(9)(a.4) which provides that *any* shares of the amalgamated corporation acquired by the parent on the amalgamation are deemed to be shares the cost of which is determined under paragraph 87(9)(c). Under that paragraph, the cost to the parent of the shares of the amalgamated corporation is equal to the adjusted cost base of its shares of the predecessor corporations, subject to a "bump" if the amalgamated corporation is wholly-owned by the parent following the amalgamation. The parent's cost can, generally, be bumped up to the amount of the net assets of the amalgamated corporation on a tax cost basis. The bump must be designated by the parent in its tax return for the taxation year in which the amalgamation occurred and cannot increase the cost of the shares above their fair market value immediately after the amalgamation.

It is interesting to compare the cost to the parent of shares of the amalgamated corporation on a triangular amalgamation with the cost it would have obtained on a share-for-share exchange takeover bid to which section 85.1 or subsection 85(1) applied. If section 85.1 applied, the parent's cost of shares acquired on the bid would be the lesser of their fair market value and their paid-up capital. If elections under subsection 85(1) were filed, the parent's cost of shares acquired on the bid would be the aggregate of the agreed amounts, each of which would likely equal the adjusted cost base of the tendering shareholder. The cost of shares under paragraph 87(9)(c) can be significantly different from the cost under section 85.1 or subsection 85(1) even though a triangular amalgamation and a successful share-for-share exchange takeover bid achieve exactly the same legal result: acquisition of a target corporation.

Non-Resident Shareholders

The concluding words of paragraph 87(4) provide that if the shares of a predecessor corporation were taxable Canadian property of a shareholder, the shares of the amalgamated corporation received in exchange will be deemed to be taxable Canadian property of that shareholder. This can be problematic for non-residents not entitled to treaty relief in respect of a subsequent capital gain because it appears that once the shares are deemed to be taxable Canadian property, they will always remain so even if the shares are subsequently

[28] Ronald M. Richler, "Triangular Amalgamations" in "The Taxation of Corporate Reorganizations" (1985), vol. 33, no. 2 Canadian Tax Journal 374 – 386, at 383.

listed.[29] Pursuant to an amendment proposed in the federal Budget of March 4, 2010, the shares will be deemed to be taxable Canadian property only during the 60-month period after the amalgamation.

A non-resident who exchanges shares that are taxable Canadian property on an amalgamation is not required by the CRA to comply with the reporting and certificate procedures under section 116 if subsection 87(4) is applicable.[30]

Comment [N1]: This is where we entered a custom footnote to force footnote on to correct page.

A special rule, contained in subsection 87(10), is provided to accommodate non-resident shareholders of a public corporation who are squeezed out on an amalgamation. If the non-resident held listed shares of a predecessor corporation and received redeemable shares of the amalgamated corporation that are redeemed shortly after the amalgamation, the redeemable shares are deemed to be listed for the purposes of subsection 115(1) and so that they will be "excluded property" for the purposes of section 116. A similar rule is contained in paragraph 87(9)(a.5) to accommodate squeeze-outs in the context of a triangular amalgamation. In both cases, the result is that the section 116 procedures are not applicable.

Needless to say, the tax implications of the amalgamation in the jurisdiction in which the non-resident shareholder is resident (or, notably for the U.S., of which the shareholder is a citizen) must be considered.

Paid-Up Capital

The paid-up capital of the shares of the amalgamated corporation could become relevant to a shareholder if those shares are subsequently redeemed or purchased for cancellation, if there is a return of capital or if the amalgamated corporation is wound up. In

[29] CRA Document No. 9601635, April 21, 1996.

[30] Interpretation Bulletin IT-474R2, paragraph 45. The CRA attempted to reverse this long-standing position with the original version of Interpretation Bulletin IT-474R2 released on December 17, 2007 but decided to stay with the status quo in the final version released on January 8, 2008.

these cases, a deemed dividend can result under section 84 if the amount paid on the shares exceeds their paid-up capital.[31]

On an amalgamation, the paid-up capital of the amalgamated corporation is deemed to be reduced under subsection 87(3) if it would otherwise exceed the total of the paid-up capital in respect of the shares of all the predecessor corporations (other than shares held by another predecessor corporation). If a reduction is required and if there is more than one class of shares in the amalgamated corporation, the reduction is made in proportion to the paid-up capital of each class.

For corporate purposes, the stated capital of the shares of the amalgamated corporation would normally equal the total of the stated capital of the shares of the predecessor corporations (other than shares held by another predecessor corporation), and that amount would also represent the paid-up capital for tax purposes as defined in subsection 89(1) (subject to the various downward adjustments referred to in that definition). If the stated capital of the shares of a predecessor corporation was higher than paid-up capital (for example, because of the previous application of a provision such as section 84.1, 85 or 212.1), the paid-up capital of the shares of the amalgamated corporation could be higher than the amount permitted under subsection 87(3), resulting in an automatic reduction in paid-up capital to the permitted amount. When the amalgamated corporation has more than one class of shares and if a reduction of paid-up capital under subsection 87(3) would result in an undesirable shifting of paid-up capital between classes[32], two alternatives are available. In very narrow circumstances, an election can be filed

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[31] Subsection 84(4.1) currently provides that *any* amount paid by a public corporation (and not just the amount in excess of paid-up capital) on a reduction of its paid-up capital (otherwise than by way of a redemption, acquisition or cancellation or a transaction described in subsection 84(2) or section 86) is deemed to be a dividend. A proposed amendment will add another exception: subsection 84(4.1) will not apply if the amount paid on the reduction of paid-up capital is derived from proceeds realized in a transaction that occurred outside of the ordinary course of business and within 24 months prior to the payment.

[32] For example, one predecessor corporation might have common shares with $200 stated capital and paid-up capital and preferred shares with stated capital, paid-up capital and a redemption amount of $1,000. The other predecessor corporation might have common shares with stated capital of $2,000 but, because of the operation of subsection 85(2.1) on a previous subsection 85(1) rollover, paid-up capital of only $800. On the amalgamation, common shares with $2,200 stated capital and preferred shares with $1,000 stated capital are issued. That is, the total stated capital is $3,200 and, but for subsection 87(3), this would also be the paid-up capital of the amalgamated corporation. However, subsection 87(3) does not permit paid-up capital to exceed $2,000. The required reduction of $1,200 is applied proportionately to the paid-up capital (pre-reduction) of the two classes so that the paid-up capital of the common shares is reduced to $1,375 and the paid-up capital of the preferred shares is reduced to $625. If the preferred shares were redeemed by the amalgamated corporation, a deemed dividend of $375 would – inappropriately – result.

under subsection 87(3.1) to avoid the application of subsection 87(3). A more practical solution is that under many corporate statutes, the stated capital of the amalgamated corporation can be set so as not to exceed the permitted amount under subsection 87(3), thereby avoiding a reduction under that subsection.

Prior to the introduction of the general anti-avoidance rule, the CRA appeared not to be concerned if a particular shareholder exchanged shares of a predecessor corporation for shares of the amalgamated corporation having a paid-up capital higher or lower than the paid-up capital of the exchanged shares.[33] Now, however, inappropriate shifting of paid-up capital from tax indifferent shareholders to other shareholders, including such shifting on an amalgamation, is one of the areas where the general anti-avoidance rule has been applied by the CRA.[34] For example, the CRA would likely be concerned if a corporation owned by a non-resident and having low paid-up capital and lots of cash amalgamated with an unrelated corporation with high paid-up capital and nominal assets so that the cash could be distributed to the non-resident shareholder free of Canadian withholding tax.

The CRA has stated, however, that it would not apply the general anti-avoidance rule when paid-up capital is shifted in a squeeze-out amalgamation.[35] Shifting paid-up capital among classes of the amalgamated corporation while ensuring that the total paid-up capital does not exceed the amount permitted under subsection 87(3) is often relied upon in the context of a squeeze-out amalgamation. It may be desirable that the shareholders receive (or at least have the choice to receive) capital gains rather than dividend treatment on the redemption of the redeemable shares received on the amalgamation. For this to happen, the paid-up capital of the redeemable shares must not be lower than their redemption amount. If there is sufficient paid-up capital, the stated capital and paid-up capital of the redeemable shares can be set at an amount equal to the redemption amount, with the balance of the paid-up capital being allocated to the remaining classes of shares. If the squeeze-out amalgamation is structured as an amalgamation between the target corporation and a special purpose subsidiary of the acquisition company, the cash needed to redeem the redeemable shares of the amalgamated corporation can be injected by

[33] Compare former Interpretation Bulletin IT-474R, paragraph 52 with Interpretation Bulletin IT-474R2, paragraph 47, but see 1980 CRA Roundtable, question 29.

[34] Income Tax Technical News No. 22, question 6, January 11, 2002.

[35] Information Circular IC-88-2, Supplement 1, paragraph 9.

the acquisition company into its special purpose subsidiary by way of subscription for common shares and, on the amalgamation, the paid-up capital of those common shares can be shifted to the redeemable shares of the amalgamated corporation.

When shares of a parent are issued on a triangular amalgamation, paragraph 87(9)(b) provides a similar rule to limit the paid-up capital of the class or classes of shares so issued. In summary, there is an automatic downward adjustment to ensure that the paid-up capital of the parent is not increased by more than the total of the paid-up capital of the shares of each predecessor corporation (except shares owned by the parent or another predecessor corporation or shares not exchanged for parent shares). The rules, described above, under subsection 87(3) would apply in determining the paid-up capital of the amalgamated corporation in a triangular amalgamation.

Shareholders that are Registered Plans

If a shareholder of a predecessor corporation is an entity, such as a registered retirement savings plan, that can hold only qualified investments, it will be important to know that the shares that will be received on the amalgamation will be qualified investments. Often, the shares of the predecessor corporation are a qualified investment due to the fact that the predecessor corporation is a public corporation.[36] Under paragraph 87(2)(ii), the amalgamated corporation will be deemed to be a public corporation if one of the predecessor corporations was a public corporation and, accordingly, the shares of the amalgamated corporation will be a qualified investment.

Rules Applicable to Other Security Holders

Option Holders

A rollover is provided under subsection 87(5) to a holder of an option to acquire shares of a predecessor corporation who holds the option as capital property if the option is exchanged solely for an option to acquire shares of the amalgamated corporation.

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36 Regulation 4900(1)(b).

On a triangular amalgamation, this rollover is extended to an exchange for an option to acquire shares of the parent by virtue of paragraph 87(9)(a.3).

If stock options were acquired as an employee incentive, they would not be capital property and, instead, would be subject to the rules of section 7. Rollovers are provided under subsection 7(1.4) for options exchanged on an amalgamation or a triangular amalgamation provided that the "in the money" amount of the new options immediately after the amalgamation does not exceed the "in the money" amount of the old options immediately before the amalgamation. If an employee exchanges options to acquire shares listed on a designated stock exchange for options to acquire shares of the amalgamated corporation (or, in the case of a triangular amalgamation, of the parent) and if the stock option deferral rules of subsection 7(8) would otherwise apply, those deferral rules will still be available when the new options are exercised (see subparagraph 7(9)(d)(ii)). The stock option deferral rules of subsection 7(8) are to be repealed pursuant to the federal Budget of March 4, 2010. Further, if an employee exercised options and acquired shares of a predecessor corporation which had been a Canadian-controlled private corporation when the option was granted such that the favourable rules of subsection 7(1.1) and paragraph 110(1)(d.1) apply, subsection 7(1.5) provides continuity of that favourable treatment if the shares received on the amalgamation are not worth more than the exchanged shares.

Debtholders

Holders of debt of a predecessor corporation who hold the debt as capital property are entitled to a rollover under subsection 87(6) provided that the amount payable on maturity does not change (the maturity date can change).

The rules regarding triangular amalgamations do not provide for a rollover when debt of a predecessor corporation is exchanged for debt of the parent. In fact, if this occurred, the amalgamation would not be a qualifying amalgamation because not all the liabilities of the predecessor corporations would become liabilities of the amalgamated corporation. In the case of a convertible debenture, however, the holder would, typically, want to receive a debenture of the parent convertible into shares of the parent rather than a debenture of the amalgamated corporation convertible into shares of the amalgamated corporation. In the (distant) past, this problem was accommodated through CRA rulings that permitted the debenture of the predecessor corporation to be exchanged on the amalgamation for a debenture of the amalgamated corporation (under subsection 87(6)) that was convertible into special shares of the amalgamated corporation (under section 51) that were exchangeable for shares of the parent (under section 85.1).

Prior to elimination of withholding tax on non-participating interest paid to arm's length non-residents, effective January 1, 2008, continuity of the exemption under paragraph 212(1)(b)(vii) was important. If a predecessor corporation had borrowed money from arm's length non-residents and interest on the debt was exempt from withholding tax under paragraph 212(1)(b)(vii), the exemption would have continued to be available following the amalgamation by virtue of subsection 87(7) if the amount payable on maturity did not change on the amalgamation and if the non-resident lender continued to deal at arm's length with the amalgamated corporation.

Rules Applicable at the Corporate Level

Subsection 87(2) contains over 70 rules applicable at the corporate level on a qualifying amalgamation, and other relevant provisions are scattered throughout the Act and the regulations. The purpose of most of these is to provide continuity of reserves, losses and other tax accounts and to avoid premature recognition of income. The following is a non-exhaustive review of these rules.

Year-End and Effective Time of Amalgamation

Paragraph 87(2)(a) provides that the amalgamated corporation is deemed to be a new corporation the first taxation year of which commences at the time of the amalgamation and that a taxation year of each predecessor corporation is deemed to have ended immediately before the amalgamation.

The CRA has stated that the effective date of amalgamation is governed by corporate law and is generally the date set forth in the certificate of amalgamation.[37] Further, the

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37 Interpretation Bulletin IT-474R2, paragraph 10.

time of the amalgamation is, according to the CRA, the earliest moment on that date in the absence of a particular time specified in the certificate of amalgamation.[38]

If, for example, the predecessor corporations have March 31 year-ends, by arranging for the certificate of amalgamation to be dated April 1, the deemed year-ends for the predecessor corporations will coincide with their normal year-ends, that is, the end of March 31. If the certificate of amalgamation were dated March 31, the deemed year-ends of the predecessor corporations would be the end of March 30. Worse, if the certificate of amalgamation were dated April 2, each of the predecessor corporations would be deemed to have a year-end at the end of April 1 resulting in a taxation year lasting only one day. In the latter case, the CRA suggests applying in advance for an extension of the year of each of the predecessor corporations to April 1 (a fiscal period can be up to 53 weeks).[39]

If a predecessor corporation has a short year-end, a number of tax implications will result. Certain deductions such as capital cost allowance, financing expenses and certain resource-related claims must be pro-rated. The timing of repayment of shareholder debt under subsection 15(2) or the payment of unpaid amounts subject to section 78 will be accelerated. The short taxation year will count as one of the years during which tax accounts with a limited life, such as non-capital loss carryforwards and investment tax credits, may be used by the amalgamated corporation.

The tax problems of short taxation years can be exacerbated if the amalgamation is one of a series of transactions involving deemed year-ends. For example, an acquisition of control of a corporation on Day 1 followed by its amalgamation on Day 2 will result in it having two deemed year-ends[40]. If, however, the amalgamation occurs on the same day as the acquisition of control, if no time is specified in the certificate of amalgamation and if an election has not been made pursuant to subsection 256(9), the CRA has confirmed that there is only a

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[38] Ibid. The CRA recognizes, however, that there can be exceptions to this general rule. For example, if a predecessor corporation carried out transactions on the day of, but before, the amalgamation, it – not the amalgamated corporation – should account for them in its taxation year deemed to have ended immediately before the amalgamation: CRA Document No. 2004-0086741C6.

[39] Ibid.

[40] With regard to the acquisition of control, if no election is filed under subsection 256(9), the taxation year will be deemed to have ended under subsection 249(4) immediately before Day 1. With regard to the amalgamation, the taxation year will be deemed to have ended immediately before Day 2 by virtue of paragraph 87(2)(a).

single deemed year-end ending immediately before the date of these transactions.[41] If the amalgamated corporation resulting from an amalgamation is party to a second amalgamation on the same day, a momentary taxation year would appear to result.[42] Or, if the amalgamated corporation elects not to be a public corporation and, as a result, becomes a Canadian-controlled private corporation, a deemed year-end would result under paragraph 249(3.1)(a).

As a general rule, a corporation is not permitted to change its taxation year unless it first obtains the consent of the CRA.[43] An amalgamation results in a deemed year-end and the amalgamated corporation is free to choose a new year-end without first obtaining the consent of the CRA. This gives rise to obvious planning opportunities but the CRA has stated that it would apply the general anti-avoidance rule if an amalgamation were undertaken solely for the purpose of changing the year-end.[44]

As will be seen, an amalgamation can result in an acquisition of control of a predecessor corporation and each of its subsidiaries. Unfortunately, the deemed year-end resulting on the acquisition of control is immediately before the deemed year-end resulting in the amalgamation so that the predecessor corporation in question would have two deemed year-ends. If a subsidiary of a predecessor corporation is not part of the amalgamation and instead becomes a subsidiary of the amalgamated corporation, it will not have a deemed year-end under paragraph 87(2)(a) but would have a deemed year-end if it was subject to the acquisition of control rules.

Tax Instalments

Because of the regulations that establish the instalment base of an amalgamated corporation,[45] there is continuity in the timing of payment of taxes.

New Corporation

As noted above, in addition to providing for a deemed year-end, paragraph 87(2)(a) states that "for the purposes of this Act, the corporate entity formed as a result of the amalgamation shall be deemed to be a new corporation…". Under the corporate law of most

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41 Interpretation Bulletin IT-474R2, paragraph 11.
42 Ibid., paragraph 12.
43 Subsection 249.1(7).
44 Information Circular 88-2, paragraph 21.

jurisdictions, however, the amalgamated corporation is not a new corporation but rather represents a continuation of each of the predecessor corporations. This dichotomy between the concept of a "new corporation" for tax purposes and a "continued corporation" for corporate purposes has caused considerable difficulty and has been the subject of three Federal Court of Appeal decisions.[46]

The first case, *Guaranty Properties*, involved the issuance of a notice of reassessment after an amalgamation but in respect of a taxation year of a predecessor corporation. The taxpayer claimed that the reassessment was invalid because it was addressed to the predecessor corporation rather than to the amalgamated corporation. The taxpayer argued that since the amalgamated corporation is deemed to be a new corporation for the purposes of the Act, the predecessor corporations must have ceased to exist under the Act. The Federal Court of Appeal held that the reassessment was valid. Mr. Justice MacGuigan, speaking for the Court, found that the purpose of paragraph 87(2)(a) was to give the predecessor corporations a deemed year-end and to give the amalgamated corporation a "deemed year-beginning". There was no intention on the part of Parliament to deem that the predecessor corporation ceased to exist or that it should be relieved of liability for its own income taxes prior to the date of amalgamation. Since under the relevant corporate law (the OBCA), the amalgamated corporation was a continuation of the predecessor corporations and was liable for their liabilities, a reassessment addressed to the predecessor corporation was valid.

The Federal Court of Appeal "clarified" its position in the *Pan Ocean Oil* case. That case dealt with the successor corporation rules applicable to resource expenditures. The successor corporation rules in question permitted certain resource expenditures incurred by one corporation to be deducted by a first successor and a second successor but not a third successor. One of the predecessor corporations was a second successor corporation and it was argued that the amalgamated corporation could deduct resource expenditures of the predecessor corporation because it was merely a continuation of the second successor and not a new corporation that

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45 Regulations 5301(4) and (5).

would have been a prohibited third successor. The trial judge found for the taxpayer, relying on the Federal Court of Appeal decision in *Guaranty Properties.* The Federal Court of Appeal allowed the appeal. Hugessen, J., speaking for the Court, restricted the application of the *Guaranty Properties* decision as follows:

> I do not think that the Court intended in the earlier parts of that passage to establish a general rule that the presumption of paragraph 87(2)(a) was limited solely to the timing of the new corporation's first taxation year; rather, the intention was to indicate that the presumption was one that is limited in scope and not applicable generally to the whole of the *Income Tax Act*….[47]

Then, referring to the Exchequer Court decision in *Palmer-McLellan (United) Ltd.* v. *M.N.R.*, 68 DTC 5304, he stated as follows:

> The underlined passages make it clear, in my view, that the provisions of paragraph 87(2)(a) are applicable only to the amalgamated company's computation of income under Division B (including the "deductions to which it may be entitled") and, where necessary as a consequence thereof, to its computations of taxable income (Division C) and of tax (Division E). That is, what this Court held in *Guaranty Properties* and the decision in that case should be limited to that holding. In particular, it should not be read as denying that the amalgamated corporation is to be deemed to be a new corporation for all purposes relating to the computation of its income.[48]

Based on the foregoing, the Court held that the amalgamated corporation was a new corporation for the purposes of computing income and was not the same as the predecessor corporation "whatever the situation may be under ordinary corporate law principles". Accordingly, it was a third successor and, as such, not entitled to the resource deductions.

The Federal Court of Appeal in the recent decision of *CGU Holdings* revisited its conclusion in the *Pan Ocean Oil* case. *CGU Holdings* involved the rules on non-resident-owned

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46 *The Queen* v. *Guaranty Properties Limited et al*, 90 DTC 6363 (FCA), leave to appeal to the Supreme Court of Canada denied January 17, 1991; *The Queen* v. *Pan Ocean Oil Ltd*., 94 DTC 6412 (FCA), leave to appeal to the Supreme Court of Canada denied November 17, 1994; *CGU Holdings Canada Ltd.* v. *The Queen*, supra footnote 18.

47 94 DTC 6412 at 6415.

48 Ibid., at 6415-6. This passage was quoted by the Court of Queen's Bench of Alberta in *Canadian Roxy Petroleum Limited* v. *Alberta*, 98 DTC 6313 which held that an amalgamated corporation is not a new corporation for the purposes of the Alberta Royalty Tax Credit. This principle was cited by the Tax Court of Canada in the *CGU Holdings* case, supra footnote 18.

investment corporations ("NROs") and the phasing-out of those rules in the 2000-2003 period. Three corporations, only one of which was an NRO, amalgamated in 1999. The predecessor corporation that was an NRO had a significant amount of allowable refundable tax on hand which, under the NRO rules, was refundable on payment of taxable dividends. The amalgamated corporation paid a taxable dividend in its first taxation year following the amalgamation and applied for the tax refund. Paragraph (g) of the definition of "NRO" in subsection 133(8) provides that a new corporation formed as a result of an amalgamation is not an NRO unless each of the predecessors was an NRO. The taxpayer relied on the phasing-out provision of section 134.1 which allows a corporation whose status as an NRO is phased out to file an election and obtain a refund of tax with respect to taxable dividends paid in its first non-NRO year. But section 134.1 applies only if a corporation was an NRO and then ceased to be an NRO. The Federal Court of Appeal held that the amalgamated corporation was not an NRO because some of the predecessor corporations were not themselves NROs. It agreed with the Tax Court that the allowable refundable tax on hand account of the predecessor corporation that was an NRO did not flow through to the amalgamated corporation because paragraph 87(2)(cc), which provides continuity for this account, applies only if the amalgamated corporation is itself an NRO. In this regard, it found that the deeming rule in subsection 134.1(2) could not be read as extending the meaning of paragraph 87(2)(cc).

This would have been enough to dispose of the case in favour of the Crown, but the Federal Court of Appeal went on to consider the conclusion of the Tax Court that the predecessor corporation that was an NRO had, following the amalgamation when it ceased to be an NRO, the standing to elect pursuant to subsection 134.1(1) on the basis that it was continued into the amalgamated corporation in accordance with corporate law principles. The Tax Court held that paragraph 87(2)(a) did not deem the appellant to be a new corporation for this purpose since based on the *Pan Ocean Oil* case, this provision has no application to Division F, where the NRO provisions are found, but rather applies only for the purposes of computing income (Division B), taxable income (Division C) and tax (Division E). The Federal Court of Appeal stated that this conclusion in the *Pan Ocean Oil* case is *obiter*. "The Court did not decide, let alone consider whether paragraph 87(2)(a) deems an amalgamated corporation to be a new corporation for the purpose of the NRO provisions in Division F."[49] Instead, the Federal Court of Appeal noted the new corporation rule in paragraph 87(2)(a) applies "for the purposes of the Act" and held that the amalgamated corporation was a new corporation for the purposes of Division F and in particular section 134.1.[50]

Following the *CGU Holdings* case, the extent to which the new corporation rule in paragraph 87(2)(a) will apply is unclear. Prior to this decision, the general principle was that it applies only for the purposes of computing the amalgamated corporation's income under Division B, taxable income under Division C and tax under Division E. Now, it is clear that it also extends to the NRO provisions in Division F. The NRO provisions in Division F deal with the computation of income, taxable income and tax in the special circumstance of an NRO and, accordingly, it is not surprising that the Federal Court of Appeal extended the *Pan Ocean* principle to these provisions. But now it appears open that a future decision of the Court will extend the new corporation rule to items other than income, taxable income or tax.

Other issues arising from the "new" versus "continued" corporation concepts are discussed below.

Characterization of Property of the Amalgamated Corporation

There are difficult theoretical issues regarding the proper characterization of property inherited by the amalgamated corporation. Will depreciable property of a predecessor corporation automatically be characterized as depreciable property of the amalgamated corporation? Can capital property of a predecessor corporation be regarded as inventory to the amalgamated corporation? As will be seen in the section dealing with wind-ups, the Supreme Court of Canada considered these issues, in not a particularly helpful manner, in the context of a wind-up under subsection 88(1) in two decisions.[51] In both cases, it was held that characterization to the parent of property acquired from its subsidiary was the same as the characterization to the subsidiary but it appears that this was based on factual determinations rather than on the basis that characterization automatically flowed through.

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[49] 2009 DTC 5044 at paragraph 40.

[50] Ibid., at paragraph 41.

[51] *Mara Properties Ltd.* v. *The Queen*, 96 DTC 6309 (SCC) and *Hickman Motors Limited* v. *The Queen*, 97 DTC 5363 (SCC).

In the case of an amalgamation, it is arguable that characterization does automatically flow through to the amalgamated corporation because the amalgamated corporation is, under corporate law, merely a continuation of the predecessor corporation and the "new corporation" rule of paragraph 87(2)(a) is not applicable for this purpose.[52] Support for this argument can be found in the passage from *Palmer-McLellan*, referred to earlier, that was quoted with approval by the Federal Court of Appeal in *Pan Ocean Oil*:

> Accepting that the statute requires that the appellant be treated as a new corporation for the purposes of the *Income Tax Act* such purposes, so far as relevant, are, as I see it, the measuring of its income for prescribed periods of time, including the determination of deductions to which it may be entitled, and the computation of its liability for tax. These purposes do not seem to me to require any inference to be made as to how the new corporation came into possession of whatever assets it had at the commencement of its fictitious existence. It is to be treated as a new corporation for the purposes I have mentioned but, as I see it, it is not to be treated as a new corporation for any other purposes and I see in section 85I [the predecessor to section 87] no basis for treating the assets of such a corporation as having been acquired in any other manner than that in which they were in fact acquired, that is to say, the manner in which they were acquired by the amalgamating corporations.
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> The new company contemplated by section 85I, simply starts off with certain assets and certain liabilities, that is to say, the assets and the liabilities of the amalgamating companies. With respect to such assets and liabilities nothing further is, as I see it, required for the purposes of the *Income Tax Act*; and if for the purpose of characterizing some item of assets or of liability, it becomes necessary to know its history that history, as I see it, is nought but its actual history. There is no need to take the further step of assuming some fictitious transaction or event conferring the asset on the fictitious new company or visiting it with the liability.[53]

Under this theory, the characterization of property would automatically flow through to the amalgamated corporation. But, as is true for any corporation, there could be a change of use based on the facts following this initial characterization. For example, property held in inventory by the predecessor corporation and, initially, by the amalgamated corporation might become depreciable property if the amalgamated corporation decided to hold it for long-term rental.

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[52] Daniel Sandler, "Character Rolls: Property Transfers and Characterization Issues" (1996), vol. 44, no. 3 Canadian Tax Journal 605-679, at 651.

[53] *Palmer-McLellan (United) Ltd.* v. *M.N.R.*, 68 DTC 5304 (Exchequer Court) at 5308.

The Federal Court of Appeal, in the *Pan Ocean Oil* case, however, confirmed that the "new corporation" rule of paragraph 87(2)(a) *is* applicable to the computation of income of the amalgamated corporation. The proper characterization of property to the amalgamated corporation would be relevant to the computation of its income. If the amalgamated corporation is a new corporation, it is arguable that the characterization of a property does not automatically flow through, even initially, and instead, must be retested. I doubt that the drafters of the Act intended that the amalgamated corporation be treated as a new corporation for the purpose of retesting the characterization of property because the various provisions dealing with the cost of property to the amalgamated corporation appear to operate only if the characterization of property remains the same. But even if it were necessary to retest the characterization of a property, in most cases, as a factual matter, the amalgamated corporation would continue to hold the property with the same intent and for the same use as was the case for the predecessor corporation. In these cases, there would be no recharacterization of the property on the facts even if an examination of the facts was necessary. There could be circumstances, however, when the intent and the use of a property change on the amalgamation (as is true even without an amalgamation). One might expect this to arise more often in situations where unrelated corporations amalgamate, and management of the amalgamated corporation has different views on the use of a property than did the predecessor corporation from which it was inherited. For example, the new management might decide that a building held in inventory by the predecessor corporation should be held from the time of the amalgamation for the purpose of long-term rental.

The characterization issue often arises when a capital property with an accrued gain is transferred (by amalgamation, wind-up or pursuant to subsection 85(1)) to a related corporation that has available tax shelter and then sold. If the first corporation had simply sold the property and realized the gain, it would not have been appropriate (although the CRA sometimes disagrees) to conclude that the decision to sell the property resulted in its recharacterization from capital property to inventory. As there is always a decision to sell before a sale, recharacterization would preclude a capital gain from ever being realized.[54] If, however, a related corporation acquired the property from the first corporation, or if an amalgamated

[54] Note that the change of use rules under subsection 13(7) and section 45 do not apply in these circumstances.

corporation is considered to have acquired the property, it might be concluded that the gain on sale is on income account because the property was acquired with a view to resale. The CRA has long taken the position that recharacterization would, generally, not occur in the context of subsection 85(1) transfers between related corporations.[55] Presumably, it would take the same position on an amalgamation or wind-up. In the *Continental Bank* case, Judge Bowman of the Tax Court of Canada said that assets that are not inventory in the transferor's hands do not become inventory in the parent's or transferee's hands simply because they are transferred on a winding up under section 88 or pursuant to a section 85 transfer for immediate resale.[56] But, as seen in the *Hickman Motors* case (which involved the transfer of depreciable property on a wind-up so that the parent could claim capital cost allowance prior to a quick resale), the CRA is not always consistent in applying this position. In the context of an amalgamation, if the continuity theory prevailed so that characterization as capital property automatically flowed through to the amalgamated corporation, it should not be open to the CRA to take the position that the decision by the amalgamated corporation to sell causes the property to become inventory (for the reasons stated above). Similarly, it should not be open to argue that the property was not acquired for the purpose of gaining or producing income, which is one of the conditions contained in regulation 1102(1) for property to qualify as depreciable property of a prescribed class.[57] If, however, the amalgamated corporation is regarded as a new corporation that acquired the property from the predecessor corporation, these arguments would be open to the CRA.

In summary, recharacterization of property is an unresolved issue which awaits jurisprudential or statutory developments.

No Disposition; Cost of Property to the Amalgamated Corporation

Generally speaking, section 87 does not contemplate that assets may have been disposed of by the predecessor corporations to the amalgamated corporation.[58] No rollover is provided to the predecessor corporations by deeming them to have received proceeds equal to

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55 1980 CRA Round Table, question 8, 1981 CRA Round Table, question 6 and 1983 CRA Round Table, question 24.

56 94 DTC 1858 at 1873-4. The Court of Appeal, 96 DTC 6355 at 6369, and the Supreme Court of Canada, 98 DTC 6501, agreed with this analysis.

57 This is one of the arguments raised by the CRA in *Hickman Motors*.

58 Paragraph 87(2)(e.4), which deals with mark-to-market property of a financial institution, and subsection 100(2.1), which deals with a partnership interest held by an unrelated predecessor corporation, are exceptions.

their tax cost. Instead, the assumption of the drafters appears to be consistent with the decision in the *Pan Ocean Oil* case. That is, the amalgamated corporation is deemed to be a new corporation only for the purposes of computing its own income, taxable income or tax; for the purposes of computing the income of a predecessor corporation, the corporate law concept of continuation governs so that there is no disposition of assets to the amalgamated corporation.

An exception exists if subsections 69(11) and (13) apply to the amalgamation. The tax policy concern behind these provisions is that losses and other tax accounts within an affiliated group of corporations should not be made available to an entity outside the group. Subsection 69(11) applies to various transactions (not just amalgamations) to deny a rollover in respect of property where it can reasonably be considered that one of the main purposes of the transaction is to obtain the benefit of losses or other tax accounts available to a non-affiliated person in respect of a subsequent disposition of the property, and where arrangements for the subsequent disposition are made within three years of the transfer. In order to make this provision applicable to amalgamations, subsection 69(13) deems a predecessor corporation to dispose of its property at cost (or, in the case of resource property, for nil proceeds). That is, a rollover (that is not required in section 87) is deemed to have occurred for the purposes of subsection 69(11). Then, if the conditions of subsection 69(11) are met, the predecessor corporation is deemed, notwithstanding any other provision of the Act, to have disposed of the property at the time of the amalgamation for proceeds equal to fair market value.

For example, if a predecessor corporation owned a capital property with a large accrued gain and amalgamated with a non-affiliated corporation with the purpose of selling the capital property within three years after the amalgamation and sheltering the capital gain with losses that the other predecessor corporation had, subsection 69(11) would deem the first predecessor corporation to have disposed of its capital property for fair market value proceeds at the time of the amalgamation.

Apart from these limited exceptions, the predecessor corporations are not regarded as disposing of their assets. Yet the drafters of the Act assume that the amalgamated corporation has acquired assets from the predecessor corporations. For example, paragraphs 87(2)(d) to (e.4) are premised on certain types of property having been acquired by the amalgamated corporation. In the *Pan Ocean Oil* case, however, the Federal Court of Appeal stated that:

> … the deemed "new" company, which, for tax purposes, came into being upon the amalgamation, did not "acquire" the property of the predecessor companies which were merged into it; rather, such property "simply became" the property of the new company upon amalgamation.[59]

I do not believe that the Court was suggesting that the provisions of subsection 87(2) that are premised on the amalgamated corporation having acquired certain property are not applicable. The Court seemed to believe that subsection 87(2) deems the property to have been acquired by the amalgamated corporation for tax purposes, as seen in the sentences that immediately follow the above quotation:

> Indeed, if it were otherwise the remaining paragraphs of subsection 87(2) would have little purpose; for the most part they deal in detail with such parts of the property, assets and liabilities of the predecessor companies which shall be deemed, for tax purposes, to have become part of the property, assets and liabilities of the new company and with the tax consequences thereof. Those provisions would be quite unnecessary if the Act were to regard the amalgamated company as being "new" solely for the purposes of establishing its first taxation year.

In fact, there are only a couple of provisions that deem the amalgamated corporation to have acquired property from a predecessor corporation (paragraph 87(2)(b) dealing with inventory and subsection 100(2.1) dealing with certain interests in partnerships). Nevertheless, unless there are further developments in the jurisprudence, it appears that the provisions of subsection 87(2) which assume an acquisition of property to have occurred are operative.

Inventory is deemed to have been acquired by the amalgamated corporation, pursuant to paragraph 87(2)(b), at an amount determined under section 10 as the value of the inventory at the end of the predecessor corporation's taxation year ending immediately before the amalgamation (subject to special rules for a farming business using the cash method). Under section 10, inventory (other than property held as an adventure or concern in the nature of trade) can be valued at the lower of cost or its fair market value at the end of the year or, pursuant to

59 94 DTC 6412 at 6416.

regulation 1801, all the inventories may be valued at fair market value. If the inventory of a predecessor corporation was valued at fair market value, paragraph 87(2)(b) does not contain a rule that carries forward the historic cost to the amalgamated corporation. Instead, the CRA has taken the position that the cost of the inventory is the amount at which it is deemed to have been acquired under paragraph 87(2)(b) rather than its historic cost to the predecessor corporation.[60]

The CRA has changed a previous position and now permits the amalgamated corporation to choose any inventory valuation method, even if different from the method used by the predecessor corporations, provided it is permitted under subsection 10(1) and yields a truer picture of its profit.[61]

If a predecessor corporation owns an interest in a partnership that becomes a property of the amalgamated corporation, special rules are required to deal with the situation where the predecessor corporation has a "negative" adjusted cost base in the partnership interest in the sense that the total deductions in computing the adjusted cost base under subsection 53(2) exceed the cost of the interest and the total additions to the adjusted cost base under subsection 53(1). A partner that is not a limited partner or a specified member of a partnership can have a "negative" adjusted cost base because the general rule that a capital gain is deemed to be realized in these circumstances under subsections 40(3) and (3.1) is not applicable. If, however, the predecessor corporation that owns the interest in the partnership is not related to the amalgamated corporation, it will be deemed to realize a capital gain on the amalgamation equal to the "negative" adjusted cost base through the combined operation of subsections 100(2) and (2.1). By virtue of a proposed amendment to add subsection 96(1.01), the CRA has taken the position that the predecessor corporation's share of the current year's income of the partnership can be added to its adjusted cost base, thereby alleviating the "negative" adjusted cost base problem.[62] If the predecessor corporation is related to the amalgamated corporation, this capital gain is not deemed to be realized and, by virtue of paragraph 87(2)(e.1), the "negative" adjusted cost base in the partnership interest is carried forward into the amalgamated corporation. For the purposes of determining whether a predecessor corporation is related to the amalgamated corporation, subsection 251(3.1) provides that the amalgamated corporation is deemed to have

60 CRA Document No. 942377, January 31, 1995.
61 CRA Document No. 1999-0010677, May 1, 2000; IT-474R2, paragraph 17.
62 CRA Document No. 2007-0251001E5, August 6, 2008.

been related to the predecessor corporation if the corporations would have been related immediately before the amalgamation had the amalgamated corporation been in existence at that time having the same shareholders it had immediately after the amalgamation. For example, if the controlling shareholder of a predecessor corporation became the controlling shareholder of the amalgamated corporation, the two corporations would be deemed to be related.

With regard to non-depreciable capital property (other than a partnership interest) acquired by the amalgamated corporation, paragraph 87(2)(e) provides that the cost of such property is equal to its adjusted cost base to the predecessor corporation immediately before the amalgamation (with exceptions for mark-to-market property relevant to financial institutions).

With regard to depreciable property, continuity in respect of capital cost allowance is generally provided by paragraph 87(2)(d). This is subject to two exceptions:

- The half-year rule of regulation 1100(2) will apply to the amalgamated corporation unless, by virtue of regulation 1100(2.2), the property is acquired from a non-arm's length person[63] that owned the property continuously during a period from a day that was at least 364 days before the end of the first taxation year of the amalgamated corporation until the amalgamation. As mentioned above, a predecessor corporation will be deemed to be related to the amalgamated corporation and, therefore, not dealing at arm's length, in the circumstances described in subsection 251(3.1). If a predecessor corporation has a significant amount of recently-acquired depreciable property and meets the condition of being non-arm's length with the amalgamated corporation, the 364 day holding period should be taken into account in determining the year-end of the amalgamated corporation. The longer the initial taxation year of the amalgamated corporation, the more recently-acquired assets of the non-arm's length predecessor corporation will be excluded from the half-year rule.

- The classification of depreciable property may change on an amalgamation because, for certain classes of depreciable property, the time of acquisition is relevant. An exception

63 See the anti-avoidance rule of regulation 1102(20).

to the requirement to reclassify is provided under regulation 1102(14) if a property was acquired from a non-arm's length person.[64]

Because capital cost allowance is permitted under regulation 1100(1) in respect of undepreciated capital cost as of the end of a taxation year, a predecessor corporation is entitled to claim capital cost allowance for the taxation year ending immediately before the amalgamation (pro-rated under regulation 1100(3) if it is a short taxation year). The "cost amount" of depreciable property of a class (which is defined in subsection 248(1) to mean the undepreciated capital cost) of the predecessor corporation immediately before the amalgamation is carried forward to the amalgamated corporation by virtue of subparagraph 87(2)(d)(ii).[65] By way of comparison, if a subsidiary distributes its depreciable property to its parent during its taxation year in the course of being wound up, it would not be entitled to capital cost allowance in that year as it would not own depreciable property at the end of the year.

It is not clear that paragraph 87(2)(d) provides for appropriate continuity in respect of recaptured depreciation when the amalgamated corporation disposes of the depreciable property. Recaptured depreciation is determined under subsection 13(1) by reference to certain components of the definition of "undepreciated capital cost" in subsection 13(21). One of these components is the total depreciation allowed to the taxpayer for property of the class before that time. There is no provision that deems depreciation taken by a predecessor corporation to have been allowed to the amalgamated corporation.[66] Accordingly, the amount of recapture would appear to be less than appropriate. The CRA does not, however, accept that there is a deficiency in the recapture provisions.[67]

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64 Ibid.

65 It is not clear that the amount of capital cost allowance claimed by a predecessor corporation in the taxation year ending immediately before the amalgamation is subtracted, as it should be, from the cost amount (undepreciated capital cost) that is carried forward to the amalgamated corporation. This is because the cost amount (undepreciated capital cost) is determined immediately before the amalgamation (that is, at the year-end of the predecessor corporation) but, pursuant to component E of the definition of "undepreciated capital cost" and the definition of "total depreciation" in subsection 13(21), the subtraction from undepreciated capital cost for that capital cost allowance claim does not occur until just *after* that time (that is, just after the year-end of the predecessor corporation). The CRA takes the position that this is not a problem: CRA Document No. 2009-0314801E5, January 4, 2010.

66 Alan M. Schwartz, supra footnote 4, at 9:59. Paragraph 87(2)(j.6) provides for continuity in respect of a different component of undepreciated capital cost.

67 Ibid., at 9:60.

Cost Bump on Vertical Amalgamation

As noted above, the amendment adding subsection 87(11) has put certain vertical amalgamations on an equal footing with a wind-up under subsection 88(1) in two respects. The first is the unfortunate implication that the parent may be deemed to realize a capital gain in respect of its shares of the subsidiary upon the vertical amalgamation of the parent and the subsidiary. The second implication of subsection 87(11) is that the advantageous cost bump rule of paragraph 88(1)(d) is now equally applicable to certain vertical amalgamations. To reiterate, section 87(11) applies when there is an amalgamation of a parent corporation and one or more other corporations each of which is a “subsidiary wholly-owned corporation” of the parent. For this purpose, “subsidiary wholly-owned corporation” is defined in subsection 248(1) to mean a corporation all the issued share capital of which (except directors’ qualifying shares) belongs to the corporation to which it is a subsidiary. The broader definition of subsection 87(1.4) is not applicable in this context.

By virtue of paragraph 87(11)(b), the cost to the amalgamated corporation of each capital property of the subsidiary predecessor corporation acquired on the amalgamation is calculated as if the property had been distributed to the parent on a winding-up of the subsidiary and subsections 88(1) and (1.7) had applied.

Accordingly, in the discussion that follows, one must imagine that property is distributed to the parent on a winding-up even though the transaction is a vertical amalgamation.

These provisions have become some of the most complex in the Act. In simplified terms, the bump in cost is available in respect of certain non-depreciable capital property (which I refer to as “eligible property”) that was owned by the subsidiary at the time the parent last acquired control of the subsidiary and thereafter without interruption until the amalgamation. Typical examples of eligible property are shares of other corporations and land. The CRA has confirmed that the characterization of property as capital property depends on a consideration of the facts surrounding the acquisition and holding of the property by the subsidiary rather than by the parent[68] (or the amalgamated corporation).

68 Interpretation Bulletin IT-488R2 (archived), paragraph 28(c).

The total potential bump is determined under paragraph 88(1)(d) to be the amount by which the adjusted cost base to the parent of its shares of the subsidiary exceeds the total of

(a) the net tax cost of the subsidiary's assets; and

(b) dividends received by the parent (or by a non-arm's length corporation[69]) on the shares of the subsidiary (or on shares for which the shares of the subsidiary were replaced, substituted or exchanged).

This total amount can then be allocated by the parent among the eligible properties acquired from the subsidiary provided that the adjusted cost base of any particular property may not be bumped above its fair market value at the time when the parent last acquired control of the subsidiary.

In this way, a parent which has a high cost of shares of a subsidiary (for example, because of a recent acquisition) can push down all or part of this cost of shares that will disappear on the vertical amalgamation (or winding-up) to eligible properties acquired from the subsidiary.

For example, a parent corporation might pay $1,000,000 cash to acquire all the shares of a holding company that, in turn, owns all the shares of two operating companies worth $400,000 and $600,000, respectively, but having nominal adjusted cost base. But for these bump provisions, on a subsequent vertical amalgamation of the holding company and the parent corporation (or wind-up of the holding company), the shares having $1,000,000 of cost would disappear and the amalgamated corporation (or the parent) would inherit the shares of the two subsidiaries at their nominal tax cost. If the bump provisions apply, the amalgamated corporation (or the parent) could increase the adjusted cost base of the shares of the operating companies to their fair market value at the time the holding company was acquired, namely, $400,000 and $600,000, respectively (assuming that the parent did not receive any dividends on the shares of the holding company prior to the vertical amalgamation or wind-up).

This bump in tax cost is a very useful tool when it is desirable to acquire a corporation with a view to keeping certain assets and divesting of others. In the above example, the amalgamated corporation could sell the second operating subsidiary and would realize a capital gain only if the sale price were higher than the bumped cost of $400,000.

It may be, however, that a target corporation carries on the business to be sold directly rather than in a subsidiary. The CRA has confirmed that the target would be permitted to transfer the business to a subsidiary before it is taken over by the parent corporation so that the cost bump will be applicable to the shares of the newly-created subsidiary when the target is subsequently merged with the parent.[70]

These rules apply only to eligible property that was owned by the subsidiary at the time the parent last acquired control of the subsidiary, and the cost of the property cannot be bumped to an amount higher than its fair market value at that time. Accordingly, the time when the parent last acquired control of the subsidiary is very significant. For this purpose, the acquisition of control rules of subsection 256(7) do not apply. Instead, the usual tests of de jure control[71] apply, subject to specific rules in paragraphs 88(1)(d.2) and (d.3) and subsection 88(4).

Comment [N2]: ditto

Under paragraph 88(1)(d.2), if control of a subsidiary was acquired from a non-arm's length person (ignoring paragraph 251(5)(b)), control is deemed to have last been acquired when that non-arm's length person acquired, or was deemed to have acquired, control (within the meaning of subsection 186(2)) of the subsidiary.

Subsection 88(4) provides that, for the purposes of paragraphs 88(1)(c), (c.2), (c.3), (c.8), (d), (d.2) and (d.3), control of a corporation is deemed not to have been acquired because of an amalgamation; provided, however, that in the case of a triangular amalgamation, control of a predecessor corporation that was not controlled by the parent is deemed to have been acquired by the parent immediately before the amalgamation. Subsection 88(4) goes on to provide that a corporation formed as a result of an amalgamation is deemed for these purposes to be a continuation of each predecessor corporation. The intention of this subsection is to prevent

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69 See subsection 88(1.7).

70 Information Circular 88-2, Supplement 1, paragraph 8.

71 See *Duha Printers (Western)* v. *The Queen*, 98 DTC 6334 (SCC) and *Silicon Graphics Limited* v. *The Queen*, 2002 DTC 7112 (FCA) for a review of these issues. The anti-avoidance rule in subsection 256(8) applies in this context only for the purpose of paragraph 88(1)(c.3).

a parent that controls a corporation to use an amalgamation to establish a new time at which the parent last acquired control. For example, if a controlled subsidiary were amalgamated with another corporation (not by a triangular amalgamation), the subsection would require the parent to ignore the amalgamation and look to the time when it acquired control of the subsidiary. This provision can, however, produce inappropriate results when the amalgamation is the event which results in the parent acquiring control of a corporation. For example, if the parent acquired control of a target corporation through a squeeze-out amalgamation in which a subsidiary of the parent amalgamated with the target, with the shareholders of the target receiving redeemable special shares of the amalgamated corporation (that are redeemed shortly after the amalgamation), subsection 88(4) would deem control of the target corporation and the amalgamated corporation not to have been acquired by the parent. Accordingly, a subsequent vertical amalgamation or wind-up of the amalgamated corporation into the parent would not permit a bump in the cost of eligible property that had been owned by the target corporation. The CRA, in confirming this conclusion in 1990, felt that it may not be an intended result and brought the matter to the attention of the Department of Finance, but the subsection has not been amended to fix this problem.[72]

Similarly, if the parent had been a party to an amalgamation, the amalgamation would not affect the time at which the parent last acquired control of its subsidiary; rather, the amalgamated corporation, being a continuation of the parent, would be considered to have acquired control of the subsidiary when the parent last acquired control of the subsidiary.

When control of a corporation is acquired as a consequence of the death of an individual, the acquiror is deemed under paragraph 88(1)(d.3) to have last acquired control of the corporation immediately after the death from a person who dealt at arm’s length with the acquiror. This provision can be very useful in estate planning because it permits a person who inherits the shares of a corporation having high tax cost (because of the deemed disposition on the death) to transfer the shares to a holding company, wind up (or amalgamate) the inherited

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72 CRA Document No. AC59195, March 8, 1990.

corporation into the holding company and step up the cost of eligible property of the corporation to the fair market value of the property at the time immediately after the death.[73]

Not all non-depreciable capital is eligible for the bump. Pursuant to paragraph 88(1)(c), property is ineligible if:

- it is transferred to the parent as part of a distribution to which the butterfly rules apply;
- it was acquired by the subsidiary from the parent (or non-arm's length person[74]) as part of a series of transactions or events in which the parent last acquired control of the subsidiary (the "anti-stuffing rule"); or
- it is subject to the so-called "back-door butterfly rule".

The back-door butterfly rule was introduced when the butterfly rules were tightened to prohibit purchase butterflies. A purchase butterfly was a transaction under which a purchaser would acquire shares of a corporation with a view to implementing a tax-deferred butterfly transaction in which it would acquire certain desired assets of the corporation. The back-door butterfly rule was designed to prevent the same results from being achieved through the use of the bump under paragraph 88(1)(d). For example, the purchaser might have acquired all the shares of the corporation with a view to doing a vertical amalgamation or a wind-up to bump the cost of the undesired assets to their fair market value which it would then sell back to the vendor without incurring a capital gain. The rule, contained in subparagraph 88(1)(c)(vi), provides that property is ineligible for the bump where as part of the series of transactions, the parent acquired control of the subsidiary and the property or "any other property acquired by any person in substitution therefor" is acquired by:

- a person (other than a specified person) that was a specified shareholder of the subsidiary before control was acquired;
- any number of persons (other than specified persons) that would, collectively, have been a specified shareholder of the subsidiary before control was acquired; or

73 See CRA Document Nos. 2002-0127013, May 29, 2002; 2002-0148283 and 2008-0288221R3, January 21, 2008.

74 See subsection 88(1.7).

- a corporation (other than a specified person or the subsidiary but including a partnership or trust deemed by subparagraph 88(1)(c.2)(ii) to be a corporation) of which the specified shareholder or the group referred to above was, or would have been, a specified shareholder.

For this purpose, a "specified person" is defined in paragraph 88(1)(c.2) to mean, essentially, the parent corporation and related persons. A "specified shareholder" is defined in subsection 248(1) and subparagraph 88(1)(c.2)(iii) to mean, essentially, a direct or indirect holder of not less than 10% of the shares of any class or series, counting shares held by non-arm's length persons and looking through trusts and partnerships.

The back-door butterfly rule started taking on a life of its own with technical amendments introduced in 1996 and 1997 that, among other things, expanded the definition of "property acquired by any person in substitution" for a property distributed to the parent on the winding-up. These provisions must be carefully reviewed because the back-door butterfly rule may deny the bump in less than obvious situations.[75]

Deemed Continuation

Many of the provisions in subsection 87(2) state that for a particular purpose, the amalgamated corporation "shall be deemed to be the same corporation as, and a continuation of, each predecessor corporation". That is, having deemed the amalgamated corporation to be a new corporation, the drafters then go back to the continuing corporation concept to provide continuity in respect of specific tax matters. For example, subparagraph 87(2)(f) provides that the amalgamated corporation is deemed to be the same corporation as, and a continuation of, each predecessor corporation for the purposes of determining any amounts relating to cumulative eligible capital, an eligible capital amount, an eligible capital expenditure or eligible capital property.

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75 See Income Tax Technical News No. 9; Marc N. Ton-That, "The Bump Denial Rules: In History and in Practice", in Report of Proceedings of the Fifty-Second Tax Conference, 2000 Conference Reports (Toronto: Canadian Tax Foundation, 2001), 27:1-66; and Judith Woods and Jerold Wortsman, "The Bump Denial Rule", in Report of Proceedings of the Fiftieth Tax Conference, 1998 Conference Reports (Toronto: Canadian Tax Foundation, 1999), 14:1-40.

One wonders whether it would not have been simpler to have confirmed that the amalgamated corporation is a continuation of each predecessor corporation, subject to exceptions (e.g., taxation years) when the continuation concept was not appropriate.

Reserves

Various provisions in subsection 87(2) provide continuity in respect of reserves. Paragraph 87(2)(g) provides that any amount that had been deducted as a reserve by a predecessor corporation for its last taxation year is deemed to have been claimed as a reserve by the amalgamated corporation for a taxation year immediately preceding its first taxation year. Other rules are provided in respect of specific types of reserves in order to ensure that the amalgamated corporation will be able to continue claiming them.

For example, if a predecessor corporation had claimed a reserve in respect of doubtful debts under paragraph 20(1)(l) in its last taxation year, the amalgamated corporation would be deemed to have claimed the reserve under paragraph 87(2)(g). Accordingly, that amount would be included in the income of the amalgamated corporation in its first taxation year under paragraph 12(1)(d). At the end of the first taxation year, the amalgamated corporation could claim a reserve under paragraph 20(1)(l) for debts that are still doubtful. The condition in that paragraph that the amount of the debt had been included in computing the income of the amalgamated corporation for a year would be met because paragraph 87(2)(h) deems the debts acquired from the predecessor corporation to have been included in the income of the amalgamated corporation for a preceding year.

It should be noted, however, that if the amalgamation results in an acquisition of control of a predecessor corporation, that corporation will be required by subsection 111(5.3) to claim a bad debt deduction for amounts that otherwise could have been claimed as a doubtful debt reserve in its last taxation year.

Other provisions providing continuity in respect of specific types of reserves are included in paragraphs 87(2)(i), (j), (m) and (ll).

Stop-Loss Rules

The Act contains a number of provisions (subsections 13(21.2), 14(12), 18(15) and 40(3.4)), known as the stop-loss or suspended loss rules, that, in simplified terms, deny a loss on a disposition of property to an affiliated person. Instead, the loss is "suspended" and can be claimed by the transferor once the property is no longer owned by an affiliated person or, in the case of a corporate transferor, immediately before control of the transferor is acquired. In the case of depreciable property, the transferor is deemed to continue to own depreciable property having a cost equal to the denied loss on which it may claim capital cost allowance and, once the property is no longer owned by an affiliated person or immediately before the acquisition of control of the transferor (if a corporation), a terminal loss. Similarly, in the case of eligible capital property, the "suspended" loss can continue to be amortized during the period.

The stop-loss rule in subsection 40(3.4) was recently considered by the Federal Court of Appeal in *The Queen* v. *Cascades Inc*., 2009 DTC 5093. Cascades sold the shares of a subsidiary ("PII") having a significant accrued capital loss to a newly-formed subsidiary (the "Corporation"). PII and the Corporation amalgamated 26 days later. Subsection 40(3.4) would have deemed the loss of Cascades on the sale of the PII shares to be nil only if, at the end of the 30-day period following the sale, the PII shares were owned by an affiliate. Here, the PII shares were not owned by anyone because they ceased to exist on the amalgamation. However, paragraph 40(3.5)(c) provides that for the purposes of subsections 40(3.3) and 40(3.4), "where subsections (3.3) and (3.4) apply" to the disposition by a transferor of a share of a corporation, and after the disposition the corporation is merged with one or more other corporations, the corporation formed on the merger is deemed to own the shares while it is affiliated with the transferor. The Tax Court had held that paragraph 40(3.5)(c) did not apply because it contains the words "where subsections (3.3) and (3.4) apply "and this was not the case since one of the conditions in subsection 40(3.3), that the PII shares be owned by an affiliate at the end of the 30-day period, was not met. The Federal Court of Appeal reversed this decision and held that the stop-loss rule did apply. It reasoned that the word "apply" means "pertain", "concern", "deal with". That is, the presumption in paragraph 40(3.5)(c) applies where subsections 40(3.3) and 40(3.4) "pertain to", "relate to" "concern" or "deal with" the case described in paragraph 40(3.5)(c): a disposition of a share of a corporation followed by an amalgamation of that corporation. Accordingly, the capital loss was deemed to be nil and "suspended" until the amalgamated corporation ceased to be affiliated with Cascades or there was an acquisition of control of Cascades.

If a predecessor corporation had been subject to these rules, the rules will continue to apply to the amalgamated corporation by virtue of paragraph 87(2)(g.3). If, however, there is an acquisition of control of the predecessor corporation by virtue of the amalgamation (see below), the predecessor corporation will be permitted to claim the "warehoused" loss in its last taxation year.

These stop-loss rules might be used as a planning tool if there were a concern that the characterization of property with a "pregnant" loss might change on an amalgamation.[76] For example, it may be desirable for a subsidiary having an accrued loss in respect of depreciable property to be amalgamated with its parent with a view to having the amalgamated corporation realize the loss on an arm's length sale shortly after the amalgamation. If there were concerns that the property would not be characterized as depreciable property to the amalgamated corporation (which, as argued earlier, would be less of a concern on an amalgamation than on a wind-up), the property might be sold by the subsidiary to an affiliated corporation prior to the amalgamation, thereby triggering the stop-loss rule in subsection 13(21.2). On the amalgamation, this "warehoused" loss would survive in the amalgamated corporation by virtue of paragraph 87(2)(g.3), permitting the amalgamated corporation to realize the loss when the property is sold by the affiliated corporation to a non-affiliated person.

Tax Status of the Amalgamated Corporation

If one of the predecessor corporations is a public corporation, the amalgamated corporation will be deemed to be a public corporation under paragraph 87(2)(ii). It should be kept in mind that a predecessor corporation whose shares are not listed would be a public corporation if its shares ever were listed (after June 18, 1971) on a designated stock exchange in Canada or if it had elected to be a public corporation and if it or the CRA had not taken steps to change this status. Among other implications (see above regarding whether the shares of the amalgamated corporation will be qualified investments for various registered plans), the amalgamated corporation, as a public corporation, would not qualify as a Canadian-controlled private corporation. Or, if a Canadian-controlled private corporation amalgamated with another corporation with the result that the amalgamated corporation were controlled by non-residents, the amalgamated corporation would not be a Canadian-controlled private corporation. In these situations, it might be advisable for the predecessor corporation to pay dividends from its capital dividend account or its refundable dividend tax on hand account prior to the amalgamation. It is also possible that a predecessor corporation that did not qualify as a Canadian-controlled private corporation might take part in an amalgamation resulting in an amalgamated corporation that does so qualify.

A CCPC may elect under subsection 89(11) not to be a CCPC for certain purposes set out in paragraph (d) of the definition of CCPC in subsection 125(7). This election does not survive an amalgamation.[77] Accordingly, if a predecessor corporation had made this election and it is desirable that the amalgamated corporation not be a CCPC for these purposes, the amalgamated corporation should make the election.

Status of a predecessor corporation as a "principal-business corporation" in the resource sector as defined in subsection 66(15) or as a corporation whose principal business is real estate related as described in regulation 1100(12) or leasing as described in regulation 1100(16) can be lost on an amalgamation if the other predecessor corporations carry on different businesses.

An amalgamated corporation might be a "specified financial institution", which would be relevant to dividends on term preferred shares under subsection 112(2.1), while a predecessor corporation was not. The exclusion from special taxes on taxable preferred shares available to a "financial intermediary corporation" or a "private holding corporation" under Part VI.1 could be lost on an amalgamation if the amalgamated corporation does not so qualify.

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[76] Andrew W. Dunn, "Corporate Consolidations: To Amalgamate or Not To Amalgamate?", in Report of the Proceedings of the Forty-Eighth Tax Conference, 1996 Conference Reports (Toronto: Canadian Tax Foundation, 1997), 13:1 – 25, at 13:15.

[77] CRA Document No. 2008-0285011C6 in which the CRA, in responding to a question at the 2008 APFF Conference, cited the *Pan Ocean Oil* case, supra footnote 48.

Status as an “investment corporation” for the purposes of section 130, a “mortgage investment corporation” for the purposes of section 130.1 or a “mutual fund corporation” for the purposes of section 131 can change on an amalgamation. There are numerous other examples of status changing because the facts on which that status is dependent change on an amalgamation.

Status as an entity subject to tax in a province as well as the level of taxation in a province can be affected by an amalgamation. Accordingly, when predecessor corporations carrying on business in various provinces amalgamate, the allocation of income and capital for provincial income and capital tax purposes should be considered.

GRIP and LRIP

Enhanced gross-up and tax credit rules are available in respect of “eligible dividends” paid by a corporation resident in Canada in taxation years that end after 2005. A Canadian-controlled private corporation or a deposit insurance corporation (a “CCPC”) would be subject to tax on excessive eligible dividend designations under Part III.1 if eligible dividends paid in a taxation year exceeded the “general rate income pool” (“GRIP”) at the end of the taxation year. A corporation that is not a CCPC would be subject to the tax on excessive eligible dividend designations to the extent of its “low rate income pool” (“LRIP”) at the time it pays an eligible dividend. Accordingly, continuity of the GRIP and LRIP accounts is necessary on an amalgamation.

If the amalgamated corporation is a CCPC, subsection 89(5) and paragraph 87(2)(vv) essentially provide that the GRIP of the amalgamated corporation is the total of the GRIP carried forward from any predecessor corporation that was a CCPC and a simulated amount of GRIP of a predecessor corporation that was not a CCPC. The simulated amount of GRIP is determined by a formula that calculates the surplus of the predecessor on a tax basis and subtracts out its LRIP.

If the amalgamated corporation is not a CCPC, subsection 89(9) and paragraph 87(2)(ww) provide that its LRIP is the total of the LRIP of each predecessor corporation that was not a CCPC and a simulated amount of LRIP of a predecessor corporation that was a CCPC.

The simulated amount of LRIP is determined by a formula that calculates the surplus of the predecessor corporation on a tax basis and subtracts out its GRIP.

If a public corporation is to amalgamate with a CCPC that has LRIP, it might be advisable for the predecessor corporation that is a public corporation to pay eligible dividends prior to the amalgamation. If this is not done, the amalgamated corporation, not being a CCPC, would be required to pay regular taxable dividends to clear out its LRIP before paying eligible dividends if it is to avoid the tax on excessive eligible dividends.

Resource Expenses

Exploration and development expenses in the resource sector are, generally, required to be pooled in accounts such as "cumulative Canadian exploration expense" ("CCEE") and "cumulative Canadian development expense" as defined in sections 66.1 and 66.2, respectively.

A predecessor corporation is permitted to claim deductions in respect of these accounts in the taxation year ending immediately before the amalgamation (on a pro-rated basis, pursuant to subsection 66(13.1), for accounts other than CCEE, if the taxation year is less than 51 weeks).

On a vertical amalgamation described in paragraph 87(1.1)(a) or an amalgamation of two or more corporations each of which is a subsidiary wholly-owned corporation of the same person (within the wider definition of subsection 87(1.4)), the balance of these resource-related accounts will flow into the amalgamated corporation because, under subsection 87(1.2), the amalgamated corporation is deemed to be the same corporation as, and a continuation of, each predecessor corporation.

On other types of amalgamation, the successor or "streaming" rules of section 66.7 will apply. Generally speaking, if an election is filed under paragraph 66.7(7)(c), the amalgamated corporation will be able to use the balance of these resource-related accounts of a predecessor corporation, but only to the extent of income from, or proceeds of disposition of, resource properties of the predecessor corporation that became property of the amalgamated corporation.

Interest Expense

The CRA has confirmed that where a predecessor corporation was entitled, under paragraph 20(1)(c), to deduct interest on borrowed money or on amounts payable for property, the amalgamated corporation can continue to deduct interest if the borrowed money or the property, as the case may be, continues to be used for income-producing purposes.[78] After the Supreme Court of Canada's decision in the *Bronfman Trust* case,[79] there was considerable uncertainty as to whether interest on money borrowed to buy shares of another corporation would continue to be deductible following a merger of the two corporations by way of amalgamation or by way of wind-up of the acquired corporation into the acquiring corporation. For example, an acquiring corporation might borrow substantial amounts of money in order to make a cash takeover bid for another corporation. If, following the successful bid, the two corporations amalgamated, the shares acquired with the borrowed money would disappear. Fortunately, the CRA confirmed shortly after the *Bronfman Trust* decision that its position in Interpretation Bulletin IT-315 would be maintained. Under that Bulletin, the CRA permitted the merged company to continue deducting interest if the property acquired as a result of the amalgamation or wind-up continued to be used for the purpose of gaining or producing income therefrom or from a business in respect of which the property is employed. Following the Supreme Court of Canada decisions in *Ludco Enterprises Ltd.* v. *The Queen*, 2001 DTC 5505, and *Singleton* v. *The Queen*, 2001 DTC 5545, the CRA announced that it had commenced a general review of its policies on interest deductibility. A preliminary report was released on October 1, 2002 in which the CRA, among other things, reconfirmed its position in Interpretation Bulletin IT-315. On October 31, 2003, the CRA released Interpretation Bulletin IT-533 which replaces a number of bulletins, including Interpretation Bulletin IT-315. In it, the CRA has again reconfirmed that position and stated that it applies even when the acquiring corporation did not deal at arm's length with the acquired corporation.

This position of the CRA is very helpful in the context of leveraged buy-outs or any other acquisition of a corporation where significant amounts of money are borrowed and the acquiring company does not have sufficient income to fully utilize the interest expense. In those situations, it will be desirable to merge the corporations if the acquired corporation has income

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[78] Former Interpretation Bulletin IT-474R, paragraph 31.

that can be offset by the interest expense. As noted below, this often gives rise to additional capital tax liability but, in many situations, the tax savings from being able to utilize the interest expense outweigh the capital tax disadvantage.

A non-tax reason for merging the two corporations is to permit lenders to perfect security interests in the assets of the borrower. In the absence of a merger, lenders to the acquisition company would have to rely on a guarantee by the target corporation secured by its assets. Under corporate law, there can be issues with upstream guarantees and lenders, generally, prefer to avoid these issues through a merger.

An alternative of not merging and, instead, having the recently acquired target corporation borrow money in order to subscribe for preferred shares, directly or indirectly, in the parent corporation so that the parent corporation can repay its own loans has been cast in doubt following the decision in *C.R.B. Logging Company Ltd.* v. *The Queen*.[80] The Court did not permit the deduction of interest on money borrowed by the target corporation to subscribe for preferred shares of the parent when the only source of funds that the parent had to pay dividends on those preferred shares was from the target corporation.

While the position of the CRA in Interpretation Bulletin IT-533 regarding deductibility of interest following a merger was welcomed, the saga is not quite over. On the same day that the Bulletin was released, the Department of Finance proposed amendments to the Act that would deny the recognition of a loss from a source if the taxpayer did not have a reasonable expectation of a “cumulative profit” from the source for the period that the taxpayer can reasonably be expected to carry on the business or hold the property. These proposals are to be effective for taxation years that begin after 2004. One particular concern that has been raised is that a corporation that borrows money to acquire a target corporation with a view to merging that target corporation into itself within, say, a year may expect that the acquired company will not pay any dividends prior to the merger. In this situation, can it be said that the necessary

[79] *The Queen* v. *Bronfman Trust*, 87 DTC 5059 (SCC).

expectation of cumulative profit exists prior to the merger? Following the merger, the expectation of a cumulative profit would usually exist because the relevant source is income from the business carried on by the merged corporation. Prior to the merger, when the relevant source is the shares of the target corporation, there may be considerably more doubt. The Department of Finance received considerable comment on these proposals. In the 2005 Budget, it was announced that an alternative proposal would be released at an early opportunity. No such proposal has been released to date.

Unpaid Amounts

Section 78 provides that if a deductible outlay or expense was owing by a taxpayer to a person with whom the taxpayer was not dealing at arm's length at the time the outlay or expense was incurred, and if that amount remains unpaid at the end of the second taxation year following the taxation year in which the outlay or expense was incurred, and if the parties are still not dealing with each other at arm's length at the end of that second taxation year, the unpaid amount must be included in the taxpayer's income for the third taxation year following the taxation year in which the outlay or expense was incurred (unless the parties elect to treat the amount as having been paid and loaned back to the taxpayer). In *The Queen* v. *Dow Chemical Canada Inc.*, 2008 DTC 6544, the Federal Court of Appeal held that section 78 applied following an amalgamation. While there is not a specific provision in section 87 referring to, and providing continuity for, section 78, the Court relied on paragraph 87(7)(d) which applies to obligations of a predecessor corporation and states that the provisions of the Act shall apply "as if" the amalgamated corporation had incurred the obligation at the time it was incurred by the predecessor corporation. This case involved a predecessor corporation that had deducted over $30 million of interest on a loan owing to a non-arm's length person. Control of the predecessor corporation and the creditor corporation was then acquired by Dow Chemical and the predecessor corporation was amalgamated with a subsidiary of Dow Chemical. The acquisition of control and the amalgamation created two short taxation years and the interest remained

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[80] 99 DTC 840 (TCC), affirmed 2000 DTC 6547 (FCA). The CRA has ruled favourably on these types of financing arrangements where the facts could be distinguished from the C.R.B. case, that is, where there are other sources of income to pay dividends on the preferred shares: CRA Document No. 2007-0252501R3 is one of many examples.

unpaid at the end of that second taxation year that ended immediately before the amalgamation. The Court concluded that at the end of the second taxation year (immediately before the amalgamation), the amalgamated corporation was not dealing at arm's length with the creditor relying on subsection 251(3.1) (which deems an amalgamated corporation to have been related to its predecessor corporation) and, presumably, subsection 251(3). The more difficult issue was whether the amalgamated corporation was not dealing at arm's length with the predecessor corporation at the time the interest expense was incurred. The Court stated that the "as if" principle in paragraph 87(7)(d) requires the amalgamated corporation to be placed in the shoes of the predecessor corporation at that time and, therefore, one must conclude that the amalgamated corporation was not dealing at arm's length with the creditor when the obligation to pay the interest was incurred. There is some question, however, whether the "as if" principle in paragraph 87(7)(d) can be extended this far. It is noted that where the drafters of the Act wish the amalgamated corporation to be treated as being the same corporation as a predecessor corporation, that is specifically provided for, as evidenced in the numerous paragraphs of section 87 that do so. Nevertheless, at least in the circumstances in the *Dow Chemical* case, continuity was found by the Federal Court of Appeal.

Capital Tax

In planning a merger, one should take into account any provincial capital tax implications, particularly the consequences of losing the investment allowance when one of the corporations owns shares of the other.

As noted above, this issue can be significant when a subsidiary is amalgamated with or wound up into its parent, particularly after a recent acquisition. For example, the subsidiary corporation may have $10,000,000 of capital for capital tax purposes but its shares may have been purchased by the parent for $20,000,000. To highlight the issue, assume that the parent corporation was a shell corporation that was funded with $20,000,000 to make the acquisition. After the shares are acquired, the subsidiary corporation would continue to pay the same amount of capital tax as it did before (that is, on $10,000,000 of capital), and the parent corporation would pay no capital tax because of the investment allowance (which provides a deduction in computing capital equal to the amount invested in shares of other corporations). If, however, the corporations were merged, the merged corporation would have $20,000,000 of capital subject to capital tax because the investment allowance would disappear.

Other capital tax issues to be considered include changes to the allocation of capital among provinces that impose a capital tax and avoiding duplication of payment of capital tax.[81]

Most of the provinces appear to be phasing out capital taxes. The federal capital tax, the large corporations tax, was eliminated as of January 1, 2006 pursuant to the 2006 Budget.

Acquisition of Control

An amalgamation can result in an acquisition of control of one or more of the predecessor corporations and their subsidiaries. One of the implications of an acquisition of control is a deemed year-end under subsection 249(4). As we have seen, a predecessor corporation will, in any event, have a deemed year-end by virtue of paragraph 87(2)(a). But the deemed year-end under subsection 249(4) will be immediately before the deemed year-end under paragraph 87(2)(a). To avoid having two deemed year-ends, the merger might be structured to result in a true acquisition of control of the predecessor (through an acquisition of its shares) followed by an amalgamation. As seen earlier under "Year-End and Effective Time of Amalgamation", the CRA has confirmed that this would result in only one deemed year-end (if an election under subsection 256(9) is not filed). If there is an acquisition of control of a predecessor corporation, each of its subsidiaries will also have a deemed year-end. There are many other implications of an acquisition of control which, generally speaking, involve restrictions or prohibitions on the use of loss carryforwards, certain unrealized losses and certain tax accounts following the acquisition of control. For example, if there were an acquisition of control of a predecessor corporation that had non-capital loss carryforwards from a business, those losses could be used following the acquisition of control (that is, following the amalgamation, by the amalgamated corporation) only if the business were continued with a

81 For the capital tax implications of mergers, see Graham Turner, Corporation Capital Tax in Canada (CCH Canadian Limited, 1999), chapter 14.

reasonable expectation of profit and then only to the extent of income from that business or a similar business, as prescribed in subsection 111(5).

Whether or not there is an acquisition of control on an amalgamation is determined by paragraph 256(7)(b). This complicated but elegant provision provides a decision tree. An acquisition of control of a predecessor corporation will be deemed to occur only if subparagraph 256(7)(b)(ii) or (iii) applies.

Under subparagraph (ii), there will be an acquisition of control of a predecessor corporation and each of its subsidiaries if a person or group of persons that controls the amalgamated corporation immediately after the amalgamation did not control the predecessor corporation immediately before the amalgamation. This rule does not apply, however, if the person or group of persons would not have acquired control of the predecessor corporation if the person or group of persons had acquired all the shares of a predecessor corporation (for example, if the person or group of persons was related to the predecessor corporation). For example, if Mrs. A controls Corporation A and does not control and is not related to Corporation B, there will be an acquisition of control of Corporation B on its amalgamation with Corporation A if Mrs. A controls the amalgamated corporation.

Under subparagraph (iii), control of a predecessor corporation and its subsidiaries is deemed to have been acquired immediately before the amalgamation by a hypothetical person unless one of three exceptions applies. The first exception applies if the predecessor corporation was related to each of the other predecessor corporations. The second exception applies if the shareholders of the predecessor corporation receive more than 50% of the votes of the amalgamated corporation. The third exception is directed primarily at an amalgamation of two predecessor corporations of equal value where the shareholders of each predecessor corporation acquire exactly 50% of the shares of the amalgamated corporation. If none of these exceptions applies, there will be an acquisition of control. If an exception does apply and if subparagraph (ii) does not apply, there will not be an acquisition of control.

Under the foregoing rules, if there is an amalgamation of predecessor corporations under common control and the amalgamated corporation is controlled by the same person, there will not be an acquisition of control. If there is an amalgamation involving unrelated corporations, there will be an acquisition of control of at least one of the predecessor corporations unless the third exception of subparagraph (iii) applies, such as an amalgamation of two unrelated corporations where the shareholders of each end up with exactly half the voting shares of the amalgamated corporation.

Paragraph 256(7)(b) will also determine whether there is an acquisition of control of a predecessor corporation on a triangular amalgamation. In the typical situation where the parent creates a subsidiary to amalgamate with an unrelated target corporation, there will be an acquisition of control of the target corporation. The paragraph is deficient, however, in that it will result in an acquisition of control of the target corporation even if a person or group of persons who controlled the target corporation obtain sufficient votes of the parent to control the parent following the amalgamation; in this situation, there would be a deemed acquisition of control under subparagraph 256(7)(b)(iii) because clause (B) does not deem shares of the parent to be shares of the amalgamated corporation.

There could be an acquisition of control of the parent if the shares issued by the parent on the triangular amalgamation represented more than 50% of the votes of all the shares of the parent (pursuant to paragraph 256(7)(c)).[82]

Loss Carryforwards and Carrybacks

Subject to the acquisition of control rules, loss carryforwards of a predecessor corporation can be used by the amalgamated corporation, by virtue of subsection 87(2.1), as if the amalgamated corporation were the same corporation as, and a continuation of, the predecessor corporation.

As mentioned in the previous section, if there is an acquisition of control of a predecessor corporation, its business loss carryforwards can be used by the amalgamated corporation if certain conditions are met. Capital loss carryforwards and non-capital loss

[82] It was the intention of the Department of Finance (as per its December 1997 Technical Notes) that paragraph 256(7)(c) might apply on a triangular amalgamation but query whether that is inconsistent with subparagraph 256(7)(b)(i). The CRA takes the position that paragraph 256(7)(c) could apply on a triangular amalgamation notwithstanding subparagraph 256(7)(b)(i): Interpretation Bulletin No. IT-474R2, paragraph 29 and CRA Document No. 2001-006494, January 7, 2002.

carryforwards arising from property of a predecessor corporation cannot be used by the amalgamated corporation if there was an acquisition of control of the predecessor corporation.[83]

Non-capital losses that become available to the amalgamated corporation can be used by it to shelter income earned from the time of the amalgamation. This can be compared with a wind-up under subsection 88(1) where losses of a subsidiary cannot be used by the parent until the commencement of its first taxation year following the wind-up. The amalgamated corporation will be able to continue using the non-capital losses, subject to the acquisition of control rules if applicable, for the balance of the loss carryforward years (increased to twenty years under the 2006 Budget). As noted above, if the predecessor corporation from which the loss was inherited had a short taxation year because of the amalgamation, that taxation year will count as one of the available loss carryforward years.

The general rule is that losses realized by an amalgamated corporation may not be carried back before the amalgamation for use by a predecessor corporation. The only exception is provided by subsection 87(2.11) which applies to a vertical amalgamation. For this purpose, the definition of "subsidiary wholly-owned corporation" is the wider version in subsection 87(1.4) rather than the narrower version of subsection 248(1). Subsection 87(2.11) was enacted to put a vertical amalgamation on an equal footing with a wind-up under subsection 88(1). On a wind-up, because the parent corporation is not deemed to be a new corporation, losses it realizes subsequent to the wind-up can be carried back the usual three taxation years to shelter income earned by it in taxation years before the wind-up. Subsection 87(2.11) provides the same result on a vertical amalgamation; losses realized by the amalgamated corporation can be carried back to shelter income of the parent corporation in the three taxation years preceding the amalgamation.[84] Losses of the amalgamated corporation cannot be carried back to shelter income of the subsidiary prior to the amalgamation.

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[83] Under subsection 111(4), it is possible to make certain designations to increase the cost of capital property having an accrued gain by the amount of capital losses, including accrued capital losses deemed to be realized immediately before the acquisition of control, that would otherwise expire on the amalgamation.

[84] Subsection 87(2.11) also provides for the carryback of other tax accounts, including investment tax credits and the deduction of surtax against the large corporations tax.

If sister corporations are to be amalgamated, consideration should be given to first transferring one below the other. This would allow a vertical amalgamation to be done which would leave open the possible use of loss carrybacks under subsection 87(2.11).

Forgiveness of Debt Rules

Indebtedness owing by one predecessor corporation to another is deemed to be settled, under subsection 80.01(3), before the amalgamation at an amount equal to the creditor's cost amount of the indebtedness. That subsection modifies the usual definition of "cost amount" in subsection 248(1) by adding unpaid interest on the debt that had been included in the creditor's income but not written off as a bad debt. If, for example, a predecessor corporation had purchased debt of another predecessor corporation which it held as capital property at an amount less than the principal amount and issue amount of the debt, the debtor will be deemed to have settled the debt at an amount equal to the adjusted cost base of the debt to the creditor, resulting in forgiveness of the balance (assuming that there was no unpaid interest and that the debt was not deemed to have been settled under the debt parking rules of subsections 80.01(6) to (8) when the creditor purchased the debt).[85]

Foreign Tax Implications

If a predecessor corporation holds property or carries on business in a foreign jurisdiction, the tax implications in that jurisdiction should be considered.

Because of the magnitude of Canadian investment in the U.S., an issue that often arises on an amalgamation of Canadian corporations is U.S. taxation of U.S. real property interests under the *Foreign Investment in Real Property Tax Act* ("FIRPTA"). For example, a predecessor corporation that owns a U.S. subsidiary carrying on a real estate or resource business in the U.S. will likely find that the shares of that subsidiary constitute a U.S. real property interest. For U.S. tax purposes, the predecessor corporation may be regarded as disposing of those shares on the amalgamation. It may be that the disposition qualifies for a rollover under

[85] See: CRA Document Nos. 2008-0267831E5, May 8, 2008 and 2008-0269971R3 dealing with gains or losses due to foreign exchange fluctuations when debt denominated in a foreign currency is deemed to be settled under subsection 80.01(3).

U.S. domestic tax law.[86] If not, an application for deferral can be made under paragraph 8 of Article XIII of the *Canada-United States Income Tax Convention*, 1980. An application for relief under this provision of the Convention would usually be a last resort because the process can be time consuming and the granting of relief is discretionary and, in more complicated reorganizations, not necessarily predictable.

Transfer Taxes, Canada Pension Plan and Employment Insurance

On an amalgamation, no land transfer tax or retail sales tax in respect of assets that become assets of the amalgamated corporation is payable in Ontario, and it is understood that the same is true in other provinces that impose such taxes. Goods and services tax is not payable on an amalgamation because the transfer of property by a predecessor corporation to an amalgamated corporation is deemed not to be a supply.[87] There is no doubling up of the employer's share of Canada Pension Plan or Employment Insurance contributions because the CRA takes the position that the amalgamated corporation is not a new employer.[88]

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[86] See the merger described in footnote 6.

[87] *Excise Tax Act* (Canada), R.S.C. 1985, c. E-15, as amended, section 271.

[88] Interpretation Bulletin IT-474R2, paragraph 35. The Department of Finance announced on February 27, 2004 and in the Budget of March 23, 2004 amendments to eliminate the doubling up problem for other types of merger and business acquisitions. These amendments were made by sections 15 and 27 of the *Budget Implementation Act*, 2004, c.22.

<u>Wind-Ups</u>

Overview

From a tax planning perspective, there are two main categories of corporate wind-ups. The first, and the focus of this portion of the paper, is the wind-up of a subsidiary that is at least 90% owned by the parent and that qualifies for the rollover provisions of subsection 88(1). The second, which will be briefly described for comparison purposes, is a taxable wind-up.

A wind-up under subsection 88(1) can be considered as an alternative to a vertical amalgamation under section 87 in that it can result in tax deferrals and continuity of tax accounts. A wind-up is a more difficult transaction from a legal and commercial perspective than an amalgamation because it involves, among other things, conveyancing of assets, consents of third parties, the potential for liability for certain transfer taxes and a continuing process following the general conveyance of assets to the parent to obtain articles of dissolution. For these reasons, a vertical amalgamation is usually the preferred route if it is available.

In the past, there were two tax advantages available on a wind-up under subsection 88(1) that were not available on a vertical amalgamation, namely, the ability to bump up the cost of certain non-depreciable capital property of the subsidiary and the ability to carry back losses realized after the merger to shelter income of the parent before the merger. As seen in the previous section, vertical amalgamations have been put on an equal footing with wind-ups in these two respects. Accordingly, there are now even fewer occasions where a wind-up under subsection 88(1) would be preferred to a vertical amalgamation. Nevertheless, there are a number of situations where a wind-up would be considered:

- A wind-up could be used to merge a subsidiary with its parent in circumstances where an amalgamation is not possible under the relevant corporate law. For example, a subsidiary incorporated under the laws of Quebec could not be amalgamated with a CBCA parent and could not first be continued under the CBCA. It could, however, be wound up into the CBCA parent. The corporate law governing wind-ups does not require that the parent be governed by the same corporate statute as the subsidiary. As noted under

"Amalgamations: Corporate Law" above, it will be possible to continue corporations in and out of Quebec once the *Business Corporations Act* (Quebec) comes into force.

- Because a wind-up does not give rise to a deemed year-end of the parent (or the subsidiary), a wind-up might be considered if the merger could not take place at the time of the normal year-end of the parent and if it is undesirable to have a deemed year-end of the parent.

- Timing in respect of use of loss carryforwards inherited from a subsidiary differs depending on whether the merger is by way of wind-up or amalgamation. The fact that a parent does not have access to such losses until its first taxation year following the wind-up is often considered a disadvantage but, as will be seen, there are certain circumstances where a wind-up can extend the life of such losses.

- A wind-up of a subsidiary that is a public corporation would not result in the parent being deemed to be a public corporation whereas an amalgamation would result in the amalgamated corporation being a public corporation.

- Subsection 88(1) applies to certain wind-ups where minority shareholders dealing at arm's length with the parent own up to 10% of the shares of the subsidiary. While an amalgamation of the parent and the subsidiary could occur in these circumstances with the minority shareholders receiving shares of the amalgamated corporation (or shares of the parent on a triangular amalgamation), a vertical amalgamation could not. Therefore, the tax advantages of a vertical amalgamation, including the two noted above and the continuity of resource expenditures without streaming under subsection 87(1.2), would not be available. Having said this, doing a wind-up under subsection 88(1) when there are minority shareholders gives rise to a number of issues. Under general corporate law principles, shareholders must be treated alike; accordingly, it may not be possible to distribute cash or property of one type to the minority shareholders while transferring a business or property of another type to the parent. Also, as will be seen, the distribution of property to the minority shareholders is a taxable transaction to the subsidiary and to the minority shareholders. In my experience, minority shareholders are usually dealt with through mandatory force-out provisions of the relevant corporate statute or squeeze-out transactions rather than through wind-up procedures.

Corporate Law

Corporate law provides various procedures for both voluntary and involuntary wind-ups of a corporation. Because we are considering tax planning for mergers, only voluntary wind-ups will be considered. One must, of course, look to the corporate law in the jurisdiction in which the corporation was incorporated or continued. The following deals with corporations governed by the CBCA, but provincial law is similar.

The CBCA provides two distinct methods to voluntarily wind-up a corporation. The simpler procedure, and the one most often used in the context of a wind-up of a wholly-owned subsidiary, is subsection 210(3) of the CBCA. Under this procedure, a corporation that has property or liabilities or both may be dissolved by special resolution of the shareholders (or, if it has more than one class of shares, by special resolution of the holders of each class whether or not they are otherwise entitled to vote) if:

(a) by the special resolution the shareholders authorize the directors to cause the corporation to distribute any property and discharge any liabilities; and

(b) the corporation has distributed any property and discharged any liabilities before it sends articles of dissolution to the Director.

The usual practice, in the case of a wholly-owned subsidiary, is to execute a general conveyance of assets to the parent and an assumption of liabilities by the parent shortly after passage of the special resolution. The subsidiary then proceeds to obtain any necessary third party consents and registers specific conveyances of assets in much the same manner as on a sale of assets. The checklist of items to be completed would include transferring employees and considering implications under any union agreements, reviewing contracts for assignability, ensuring that intellectual property rights are properly transferred and considering whether filing articles of dissolution must be deferred until any litigation involving the subsidiary is completed. With regard to liabilities, subsection 210(3) requires that these be discharged before filing the articles of dissolution. The assumption of liabilities by the parent at the time of the general conveyance would not, generally, result in a discharge of the liability. Accordingly, it is necessary to proceed to either have the parent pay the liabilities in the normal course or have the creditors consent to a novation of the debt so that only the parent is liable thereon.

If a tax-clearance certificate under subsection 159(2) is not obtained prior to the distribution of property, the directors of the subsidiary may be liable for the payment of taxes owing by the subsidiary up to the value of the property distributed. As a practical matter, the certificate is usually not requested in the case of a wholly-owned subsidiary. Instead, the parent would assume liability for taxes and indemnify the directors. This avoids the often lengthy delays in obtaining a subsection 159(2) certificate and permits the distribution of property to occur shortly after the passage of the special resolution.

In the case of a wind-up under provincial corporate law (for example, the OBCA), the consent of the provincial revenue authorities may be required before articles of dissolution can be filed.

Often, a considerable period of time will pass between the passage of the special resolution and the general conveyance until the corporation is in a position to file articles of dissolution. Once the articles are filed, the Director must issue a certificate of dissolution and, pursuant to subsection 210(6), the corporation ceases to exist on the date shown in the certificate of dissolution.

A more involved procedure is provided under section 211 of the CBCA. This procedure also commences with the passage of a special resolution but requires filing a statement of intent to dissolve with the Director, at which point the corporation must cease to carry on business except to the extent necessary for the liquidation. The corporation must take reasonable steps to give notice of its intent to dissolve in each province where it carried on business and must notify each of its creditors. The corporation must adequately provide for the payment or discharge of all of its obligations. It then distributes any remaining property to its shareholders. At this point, it can file articles of dissolution and receive a certificate of dissolution. Under subsection 211(16), the corporation ceases to exist on the date shown in the certificate of dissolution.

The section 210 procedure would usually be used in preference to the section 211 procedure on the wind-up of a wholly-owned subsidiary. If, however, the more complicated section 211 procedures are used, the subsidiary would, in practice, enter into a general conveyance of its assets to its parent and assumption of liabilities by the parent and follow the same checklist of steps to properly convey its assets to the parent.

In respect of either procedure, subsection 226(2) of the CBCA provides, among other things, that a civil, criminal or administrative action or proceeding may be brought against a corporation that has been dissolved within two years after its dissolution as if the corporation had not been dissolved. Subsection 226(4) goes on to provide that a shareholder to whom any property has been distributed is liable to a person claiming under subsection 226(2) to the extent of the amount received by that shareholder on the distribution, and an action to enforce such liability may be brought within two years after the date of the dissolution. The Federal Court – Trial Division held that the Minister could assess tax against a corporation that had been dissolved and the corporation could object to the assessment under the analogous provision of the OBCA.[89]

Tax Considerations

Wind-Up Where Subsection 88(1) Not Applicable

To understand the implications of subsection 88(1), it is first necessary to describe the tax implications of a wind-up not eligible for the rollover provisions of that subsection.

The main provisions that apply to a wind-up not eligible for the rollovers of subsection 88(1) are subsections 69(5), 84(2) and 88(2).[90]

Under subsection 69(5), on the wind-up of a corporation, the corporation is deemed to have disposed of the property appropriated to, or for the benefit of, a shareholder for proceeds of disposition equal to its fair market value immediately before the wind-up, and, the

89 *460354 Ontario Limited*, 95 D.L.R. (4th) 351; confirmed by the Federal Court of Appeal in *The Queen* v. *Sarrif*, 94 DTC 6229. But see *510492 BC Limited* v. *The Queen*, 2001 DTC 124 in which the Tax Court of Canada held that a corporation that had been assessed prior to dissolution could not appeal the assessment following its dissolution because the corporation was governed by the *BC Company Act* which did not have a provision analogous to subsection 226(2) of the CBCA.

90 For a detailed summary of these rules, see: Shafer, "Liquidation", supra footnote 27, at 10:15-19.

shareholders are deemed to have acquired the property at a cost equal to the same amount. If the corporation realizes a loss on property disposed of on the wind-up, paragraph 69(5)(d) provides that the various “stop-loss” rules referred to therein are not applicable.

Under subsection 84(2), a dividend will be deemed to have been paid by a corporation resident in Canada when it distributes or otherwise appropriates property to or for the benefit of its shareholders on the “winding-up, discontinuance or reorganization of its business”. The amount of the dividend is the value of the funds or property distributed or appropriated less the amount, if any, by which the paid-up capital in respect of the shares of the corporation is reduced.

As pointed out in Interpretation Bulletin IT-126R2, the term “winding-up” is used in the Act in connection with both the winding-up of a business and the winding-up of a corporation’s existence. Subsection 69(5) applies only when there is a winding-up that involves the termination of the corporation’s existence whereas subsection 84(2) applies on either the winding-up of a business or the winding-up of a corporation’s existence. For inexplicable reasons, the Bulletin refers to subsections 84(2), 88(1) and 88(2) but not to subsection 69(5). The Bulletin contains a number of useful interpretations which do not clearly apply to subsection 69(5). For example, the CRA takes the position that subsections 88(1) and (2) will be considered to apply even if the formal dissolution of a corporation is not complete but there is substantial evidence that the corporation will be dissolved within a short period of time. In particular, if a corporation is not dissolved because of the existence of outstanding litigation, the CRA will apply subsections 88(1) and (2) even though the rights and obligations under the outstanding lawsuits were retained by the corporation because they could not be transferred without prejudice to the corporation.[91] The CRA also deals with the issue that properties may be distributed at various times throughout the winding-up period. In the context of paragraph 88(1)(a) which refers to rollovers at tax cost “immediately before the winding-up”, the CRA takes the position that this term will be considered to mean immediately before a particular disposition. Because the Bulletin is silent with respect to subsection 69(5), it is not clear whether this interpretation is applicable for the purposes of determining the fair market value of property “immediately before

[91] Interpretation Bulletin IT-126R2, paragraph 5.

the winding-up". In the context of subsection 69(5), this phrase might be found to refer to the time immediately before the passing of the winding-up resolution.[92]

If there is a deemed dividend under subsection 84(2), subsection 88(2) permits the corporation to make use of various tax accounts, including the capital dividend account and the pre-1972 capital surplus on hand account, to reduce the impact of the dividend on its shareholders (and also permits these accounts to be increased by gains of the corporation arising on its wind-up). In order for subsection 88(2) to apply, all or substantially all of the property owned by the corporation must be distributed to its shareholders at a particular time; accordingly, the subsection operates properly only if there is a single such distribution as opposed to a series of distributions over the winding-up period.

In addition to being deemed to receive a dividend, a shareholder of a corporation will be regarded as disposing of the shares of the corporation when they are cancelled on the wind-up.[93] The shares of a corporation that is being wound up would not, generally, be cancelled until a certificate of dissolution is issued. The CRA takes the position, however, that there is a disposition of the shares when subsection 88(1) or (2) applies to the corporation in circumstances where the dissolution has not yet occurred but there is substantial evidence that the corporation will be dissolved within a short period of time.[94] If the disposition of the shares does not occur until after the shareholder receives the winding-up distribution, the shareholder would be required to reduce the adjusted cost base of the shares, under subparagraph 53(2)(a)(ii), by the amount of the reduction of paid-up capital on the distribution.

For example, a shareholder who receives $100 as a winding-up distribution in respect of shares having $20 of paid-up capital and $30 of adjusted cost base will be deemed to receive a dividend of $80 at the time of the distribution (assuming the distribution represents a return of $20 of capital and a liquidating distribution of $80) and the adjusted cost base will be deemed to be reduced by $20. When the shares are cancelled, or otherwise regarded as disposed of, the shareholder will realize a capital loss of $10 (proceeds of nil less adjusted cost base of $10), subject to the stop-loss rules of subsection 112(3).

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[92] This was the position of the CRA in Interpretation Bulletin IT-126R, the previous version of Interpretation Bulletin IT-126R2, which also did not refer to subsection 69(5).

Qualifying Wind-Up Under Subsection 88(1)

If a wind-up of a subsidiary qualifies under subsection 88(1), the subsidiary will not be deemed to realize a gain in respect of its assets and the parent will acquire these assets at their tax cost plus, in certain circumstances, the bump in respect of certain non-depreciable capital properties. The parent will not be deemed to receive a dividend, will not realize a capital loss in respect of its shares of the subsidiary and, in most cases, will not realize a gain thereon. Moreover, various provisions would apply to provide continuity in respect of loss carryforwards and other tax accounts of the subsidiary.[95]

In order to qualify under subsection 88(1), the following conditions must be met:

1. Both the subsidiary and the parent must be taxable Canadian corporations.

   - This condition also applies to an amalgamation under section 87. See the comments in the discussion on qualifying amalgamations regarding the definitions of "taxable Canadian corporation" and "Canadian corporation".

2. Not less than 90% of the issued shares of each class of the capital stock of the subsidiary must be owned, immediately before the winding-up, by the parent and all of the shares that were not owned by the parent must be owned by persons with whom the parent was dealing at arm's length.

   - As noted above, the CRA has commented on the meaning of "immediately before the winding-up" in Interpretation Bulletin IT-126R2. The previous version of this bulletin stated that this phrase means "that point in time that directly precedes the implementation of the winding-up procedures".[96] As mentioned above, the current version deals with this phrase only in the context of distributions of property taking place at various times throughout the winding-up period in the context of paragraph 88(1)(a). This position was taken to minimize problems

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93 See paragraph (b)(i) of the definition of "disposition" in subsection 248(1).
94 Interpretation Bulletin IT-126R2, paragraph 9.
95 For checklists, reference should be made to footnote 7.

with a series of such distributions and it is understood that the general position of the CRA, as stated in the prior version of the bulletin, has not changed. Because the implementation of the winding-up procedures generally commences with the passing of a special resolution of the shareholders, the 90% ownership threshold should be tested immediately before the passing of this resolution. Accordingly, subsection 88(1) would appear not to apply if the parent held less than 90% immediately before the passage of the shareholders' resolution but subsequently acquired additional shares to hold more than 90%.

- As is generally true for the purposes of the Act, ownership means beneficial ownership. For example, if a share is registered in the name of a director but is held in trust for the parent (that is, a director's qualifying share), the CRA would regard the share as owned by the parent for these purposes.[97]

- The arm's length tests are contained in section 251 and following. It will be necessary to determine that each minority shareholder is not related to the parent and, on the facts, deals with the parent at arm's length.

3. The subsidiary "has been wound up".

- Unfortunately, the past tense is used in this phrase. This might be taken to imply that all the steps to wind up the corporation have been completed, including the issuance of a certificate of dissolution. The CRA has, however, taken a more liberal position in Interpretation Bulletin IT-126R2 in which it states that a corporation is considered to have been wound up for the purposes of subsection 88(1) where the formal dissolution of a corporation is not complete but there is substantial evidence that the corporation will be dissolved within a short period of time. As noted above, an example is where the corporation delays obtaining the formal dissolution because it is involved in litigation. Another example is where a tax assessment received by the subsidiary results in a delay in applying for its

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96 Interpretation Bulletin IT-126R, paragraph 6.
97 Interpretation Bulletin IT-488R2 (archived), paragraph 3.

dissolution.[98] As a practical matter, if the subsidiary has followed the appropriate procedures to commence the wind-up, has dealt with its liabilities and has distributed its remaining property to its shareholders, the CRA will regard the corporation as having been wound up provided it can be shown that it is proceeding with the remaining steps leading to a certificate of dissolution.[99] (As discussed below under “Loss Carryforwards and Carrybacks”, the CRA has taken a different position on when a corporation has been wound up for the purposes of loss utilization under subsection 88(1.1).)

If these conditions are met, the wind-up will qualify under subsection 88(1) without the need for any elections to be filed.

The many rules in subsection 88(1) will apply “notwithstanding any other provision of this Act other than subsection 69(11)”. As noted previously, subsection 69(11) is an avoidance rule designed to deny a rollover in respect of property where it can reasonably be considered that one of the main purposes of the transaction is to obtain the benefit of losses or other tax accounts available to a non-affiliated person in respect of a subsequent disposition of the property, where arrangements for the subsequent disposition are made within three years of the transfer. Although a subsidiary will be affiliated with the parent, subsection 69(11) requires that the series of transactions be examined; and the relevant time to determine whether the subsidiary was affiliated is immediately before the series began. For example, if the parent acquired all the shares of a non-affiliated corporation that owned a capital property with a large accrued gain and wound up the corporation with the purpose of selling the capital property within three years after the wind-up and sheltering the capital gain with losses of the parent, subsection 69(11) would deem the subsidiary to have disposed of that capital property for fair market value proceeds at the time of the wind-up.

Disposition of Property by the Subsidiary

By virtue of paragraph 88(1)(a), each property, other than a partnership interest, a resource property or a specified debt obligation, distributed to the parent on the wind-up is

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[98] Ibid., paragraph 20.

deemed to have been disposed of by the subsidiary for proceeds equal to its cost amount immediately before the winding-up. That is, the subsidiary will be eligible for a rollover unless, as described above, subsection 69(11) applies. The CRA takes the generous position that all property transferred to the parent by the subsidiary on the wind-up is considered to be property distributed to the parent on the wind-up even if certain of these properties might reasonably be considered to have been transferred to the parent in satisfaction of debt owing to the parent by the subsidiary or as consideration for the parent's assuming the liabilities of the subsidiary.[100]

The relevant time to determine the cost amount of property is "immediately before the winding-up". As noted above, property may be distributed at various times throughout the winding-up period. To avoid potential difficulties, the CRA takes the position that "immediately before the winding-up" in respect of a particular disposition is considered to mean immediately before that particular disposition.[101] Were it not for this position, the subsidiary might be deemed to realize a capital gain if between the time of the commencement of the wind-up and the distribution of a property the adjusted cost base of that property was reduced. For example, if the subsidiary owned a share of a corporation and received cash as a return of capital thereon after the commencement of the wind-up but before the share was distributed by the subsidiary, its adjusted cost base would have been reduced under subparagraph 53(2)(a)(ii) but the proceeds of disposition to the subsidiary would be deemed to be the higher adjusted cost base immediately before the commencement of the wind-up procedures. Under the CRA's administrative position, however, the subsidiary is deemed to have disposed of the share at its adjusted cost base immediately before the distribution of the share so that no gain results. If the amounts involved are significant, it would be advisable to confirm this administrative position through an advance tax ruling.

If a partnership interest is distributed, paragraph 88(1)(a.2) provides that it is deemed not to have been disposed of (except for the purposes of paragraph 98(5)(g)). Accordingly, if the subsidiary has a "negative" adjusted cost base in the partnership interest, it

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99 CRA letter of February 25, 1991 referred to in "Window on Canadian Tax" (CCH Canadian Limited, 1991) (looseleaf), paragraph 1126.

100 Interpretation Bulletin IT-488R2 (archived), paragraph 14.

101 Interpretation Bulletin IT-126R2, paragraph 7 and IT-488R2 (archived), paragraph 13.

will not be deemed to realize a capital gain. Instead, the negative adjusted cost base will flow through to the parent because paragraph 87(2)(e.1) will apply by virtue of paragraph 88(1)(e.2).

Resource property is deemed to have been disposed of for proceeds equal to nil under subparagraph 88(1)(a)(i), resulting in no gain or loss to the subsidiary. The resource-related tax accounts, such as cumulative Canadian exploration expense and cumulative Canadian development expense flow through to the parent by virtue of subsection 88(1.5). As in the case of vertical amalgamation, the successor or "streaming" rules of section 66.7 will not apply to restrict the parent in the use of those accounts.

Cost of Property to Parent

The cost of each property distributed to the parent on the winding-up is determined under paragraph 88(1)(c). The general rule is that the parent's cost of each property is equal to the proceeds of disposition to the subsidiary of the property. As we have seen, the amount of the proceeds of disposition to the subsidiary is, generally, the cost amount of the property immediately before the wind-up.

Paragraph 88(1)(c) provides that if there had been a reduction to the cost amount to the subsidiary of the property because of the application of the forgiveness of debt rules of section 80 on the wind-up, the amount of the reduction must be subtracted from the proceeds of disposition to the subsidiary, and the net result becomes the cost to the parent. This is a reasonable rule if the proceeds of disposition to the subsidiary had not already been reduced under section 80. Under section 80, and by virtue of the timing rule in paragraph 80.01(4)(d), the reduction in cost amount to the subsidiary would occur immediately before the distribution of the property to the parent. As we have seen, however, the administrative position of the CRA with regard to determining the proceeds of disposition is that the cost amount to the subsidiary is determined immediately before the distribution of the property rather than immediately before the commencement of the winding-up procedures. Under this administrative position, the proceeds of disposition would already be reduced by amounts under section 80 and it would be inappropriate to reduce the cost to the parent by this amount a second time. I am not aware of the CRA having considered this issue. In any event, as discussed below, an election is available under subsection 80.01(4) to avoid the application of section 80 in cases where the parent has full tax cost in the debt of the subsidiary.

It should also be noted that if the avoidance provision of subsection 69(11) applied to deem the subsidiary to have received fair market value proceeds of disposition, the cost to the parent will, nevertheless, be the cost amount to the subsidiary.

As we have seen, in the case of a partnership interest, the parent inherits the adjusted cost base of the subsidiary including any negative adjustments that, in effect, give rise to a "negative" adjusted cost base.

Most significantly, paragraph 88(1)(c) permits the cost of certain non-depreciable capital property to be bumped by the amount determined under paragraph 88(1)(d). These rules were discussed in the previous section dealing with vertical amalgamations.

Taxation Year

Unlike an amalgamation, a wind-up does not give rise to a deemed year-end of the subsidiary (or the parent). Rather, the normal year-end will continue until articles of dissolution are issued, at which point, the final year-end of the subsidiary will occur.

Stop-Loss Rules

If the subsidiary had been subject to one of the stop-loss rules (under subsection 13(21.2), 14(12), 18(15) or 40(3.4)) on a prior transfer of property to an affiliated corporation, the loss that is "suspended", as discussed in the earlier discussion on amalgamations, will be carried forward to the parent by virtue of paragraphs 87(2)(g.3) and 88(1)(e.2).

As described in that earlier discussion, this can be used as a planning tool in situations where there is concern that property with a "pregnant" loss may be recharacterized in the hands of the parent following a wind-up such that the loss would not be available to the parent. In these circumstances, instead of having the property transferred to the parent on the wind-up, the subsidiary might transfer it to an affiliated corporation prior to the wind-up, thereby triggering the stop-loss rule. The "suspended" loss would flow to the parent on the wind-up and the parent would realize the loss when the property is sold by the affiliated corporation to a non-affiliated person. This might be preferable to having the subsidiary selling the property to a non-affiliated person prior to the wind-up and relying on the parent being able to use the loss carryforwards of the subsidiary because, as described below, these loss carryforwards would not be available to the parent until its first taxation year commencing after the commencement of the wind-up. Also, a "suspended" loss realized by the parent could be carried back by it to a prior year but a loss carried forward from its subsidiary could not.[102]

Capital Cost Allowance Claims by the Subsidiary

One implication of there not being a deemed year-end at the time of a wind-up is that the subsidiary will not be entitled to claim capital cost allowance in its taxation year in which it distributed its depreciable property. Under the capital cost allowance rules, capital cost allowance is available only in respect of the undepreciated capital cost to a taxpayer at the end of a taxation year. By way of contrast, capital cost allowance can be claimed (pro-rated if in a short taxation year) by a predecessor corporation in the taxation year that ends on an amalgamation.

Reserves

By virtue of paragraph 88(1)(e.1), the subsidiary may, in the taxation year during which its assets were transferred to, and its obligations were assumed by, the parent on the wind-up, claim any reserve that would otherwise have been allowable. If the subsidiary continues to exist in a following taxation year, it is not required to include in its income any reserve that it chose to claim in the year of the winding-up distribution. Continuity in respect of reserves is provided under paragraph 88(1)(e.2) which would require any such reserves to be included in the income of the parent. For example, a reserve for doubtful debts under paragraph 20(1)(l) could be claimed by the subsidiary in its taxation year during which its assets were distributed to the parent; the parent would, under paragraph 88(1)(e.2) which refers to paragraphs 87(2)(g) and (h), include such reserves in its income in its taxation year during which it received the assets of the subsidiary and could claim an appropriate reserve for debts that are doubtful at the end of that taxation year.

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102 Andrew W. Dunn, supra footnote 76, at 13:16.

Application of Specific Amalgamation Rules

Paragraph 88(1)(e.2) provides that a long list of specific rules in section 87 apply equally to a wind-up under subsection 88(1) (with appropriate wording changes). Generally speaking, these rules are designed to flow-through various tax accounts of the subsidiary to the parent and provide continuity. Examples referred to previously include rules regarding partnership interests and reserves.

In the context of an amalgamation, it is arguable (though not accepted by the CRA) that continuity is available without specific rules because the predecessor corporations are deemed to continue as the amalgamated corporation. On a wind-up, however, it is clear that specific rules are needed to provide such continuity as there is no equivalent corporate concept of the subsidiary continuing as part of the parent.

Characterization of Property Distributed to Parent

As discussed in the context of an amalgamation, it is possible that the characterization of property acquired by the parent on a wind-up may differ from that of the subsidiary. On an amalgamation, there are good arguments that characterization automatically flows through, at least initially, to the amalgamated corporation based on the corporate law concept that there is no acquisition of property on an amalgamation and the apparent assumption of the drafters of the Act (evidenced in the rules establishing cost of property to the amalgamated corporation) that characterization would be preserved on an amalgamation. In the case of a wind-up, the argument for automatic flow-through of the characterization of properties is not as strong because there clearly is an acquisition of property by a separate legal entity, the parent.

The Supreme Court of Canada considered the characterization issue in the context of a wind-up in two cases: *Mara Properties* and *Hickman Motors.*[103] *Mara Properties* involved a series of steps undertaken purely for tax purposes. Mara Properties purchased all the shares of an arm's length corporation that had been in the land development business and which held one remaining property in inventory having a large "pregnant" loss. On the day of the acquisition, that corporation was wound up into Mara Properties pursuant to subsection 88(1) and the

[103] Supra footnote 51.

property inherited on the wind-up was immediately sold. Mara Properties, which was also in the land development business, claimed the loss as a loss in respect of inventory and used it to shelter its income. These transactions occurred before the enactment in 1987 of various rules designed to stop trading of tax losses. Counsel for Mara Properties put it, quaintly, as follows:

> Now let's be clear, Your Honour. We make no bones about the fact this was an entirely tax-motivated transaction. We make no bones about the fact that there was no reasonable expectation of profit in property where we acquired it at noon and sold it by dusk for a loss of four and a half million dollars.[104]

The CRA argued that the land acquired by Mara Properties on the wind-up was not inventory to it because Mara Properties did not acquire it for use in its ordinary course of business and never intended to gain or produce income therefrom. Mara Properties was successful at the Tax Court of Canada but its appeal was allowed, with a dissent by McDonald, J. A., by the Federal Court of Appeal.

The Supreme Court restored the judgment in favour of Mara Properties of the Tax Court. In a short, oral decision the Supreme Court simply stated that it agreed with the conclusion reached by the Tax Court and Mr. Justice McDonald and that "In our view, in the circumstances, of this case, the property retained its character as inventory in the hands of the Appellant."[105] Because the Court did not provide its reasons for this decision and did not state that it agreed with the reasoning of the Tax Court or Mr. Justice McDonald, its decision is not particularly helpful. Its use of the words "in the circumstances of this case" suggests, however, that the characterization of the property did not flow through automatically on the wind-up but, rather, retained its character as inventory based on the facts. Mr. Justice McDonald had stated the following:

> Upon winding up, a subsidiary automatically distributes its assets to its parent (subsection 88(1)) and those assets should be grouped with assets of the parent of the same character. Here, both companies are in the same business and consider land as an item of inventory. Consequently, on the winding up of a Fraserview, its inventory should have merged with Mara's inventory for income tax purposes.[106]

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[104] *Mara Properties Limited* v. *The Queen*, 93 DTC 1449 (TCC) at 1451.
[105] 96 DTC 6309 at 6310.
[106] 95 DTC 5168 at 5174.

In the later decision of the Supreme Court of Canada in *Hickman Motors*, the only reference to *Mara Properties* was by Justice L'Heureux-Dubé who said the following:

> In so far as its interrelation with the present case is concerned, in my opinion *Mara* stands for the following proposition: upon winding-up, a subsidiary automatically distributes its assets to its parent pursuant to s. 88(1), and those assets should be grouped with the parent's assets of the same character.[107]

For what they are worth, these comments, too, suggest a factual analysis rather than an automatic flow-through of characterization.

Hickman Motors was a case that involved the characterization of depreciable property acquired on a wind-up pursuant to subsection 88(1). The parent, Hickman Motors, was a profitable automobile and truck distributor. Its sister corporation ("Equipment") sold and leased heavy equipment. Equipment had substantial undepreciated capital cost of depreciable property but did not need to claim capital cost allowance because of loss carryforwards. Accordingly, Hickman Motors acquired all the shares of Equipment and Equipment was wound up into Hickman Motors on December 28, 1984. On January 2, 1985 (that is, only five days later), the assets acquired on the wind-up were sold by Hickman Motors to another related corporation. In its December 31, 1984 tax return, Hickman Motors claimed capital cost allowance of approximately $2,000,000 in respect of the assets it had received from Equipment. This capital cost allowance claim was disallowed by the CRA.

Hickman Motors lost at both the Federal Court - Trial Division and the Federal Court of Appeal. Those courts concluded that the property was not depreciable property of a prescribed class because the condition in regulation 1102(1)(c), that the property be acquired for the purpose of gaining or producing income, was not met. Hugessen, J.A., speaking for the Court of Appeal, also held that subsection 88(1) merely effects a flow-through of the cost of property from subsidiary to parent but "In and of itself, the subsection creates no rights to any deductions at all."[108] The Federal Court of Appeal rejected Hickman Motors' argument that regulation 1102(14) superseded the application of regulation 1102(1)(c). As we have seen, regulation 1102(14) provides that when property of a prescribed class is acquired from a non-arm's length person, it is deemed to be property of the same prescribed class of the acquiror.

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107 97 DTC 5363 at 5367.

The Federal Court of Appeal held that the purpose of regulation 1102(14) is to prevent a shift of depreciable property from one prescribed class to another; it did not automatically allow the taxpayer to claim capital cost allowance simply because the transferor of the property could do so.[109]

When the case reached the Supreme Court of Canada, the Crown abandoned the argument that the property did not constitute depreciable property of a prescribed class to the parent. Instead, it argued that Hickman Motors did not have a business source of income from which to claim capital cost allowance, as required by the opening words of subsection 20(1). This awkward change in position was, apparently, caused by the concern that if property did not retain its character as depreciable property of a prescribed class on a wind-up, recapture of capital cost allowance might be avoided.

The Supreme Court found for Hickman Motors but was deeply divided. Justice McLachlin (La Forest and Major JJ, concurring) found in favour of Hickman Motors and held that the characterization of the property as depreciable property of a prescribed class automatically flowed through by virtue of regulation 1102(14):

> In this case, Hickman Motors Ltd. is deemed to have acquired the assets for the purpose of gaining or producing income under Regulation 1102(14), which states that where property is acquired as a result of the winding-up of a Canadian corporation under s. 88(1) of the Act, and the property, immediately before it was so acquired, was property of a prescribed class, the property shall be deemed to be the property of that same prescribed class. Since the property was depreciable property in the hands of Hickman Equipment just prior to the winding up, it is deemed to be acquired by Hickman Motors Ltd. as depreciable property – i.e., for the purpose of gaining or producing income.
>
> So long as Hickman Motors Ltd. did not commence to use the property for some purpose other than the production of income (s. 13(7)(a)), the property remains eligible for capital cost allowance deduction. There is no evidence that this occurred.[110]

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108 95 DTC 5575 at 5577.
109 Ibid., at 5578.

110 97 DTC 5363 at 5364.

Justice L'Heureux-Dubé wrote a separate and long judgment in favour of Hickman Motors. She summarized her reasoning as follows:

> Section 88(1)(c) does not create any right for the parent company to claim a CCA deduction as a result of the winding-up of a subsidiary. This right is to be found in s. 20(1)(a), read concurrently with the applicable Regulations. The Appellant has discharged its burden of proving that the property was held for the purpose of producing income from its business. The Appellant proved that between December 28, 1984, and January 2, 1985, it did in fact carry on an integrated car, truck and equipment business. The Appellant proved that the equipment-related property produced revenue from that business during that period. Accordingly, the requirements of Regulation 1102(1)(c) and s. 20(1)(a) are met. Therefore, the CCA deduction is allowable.[111]

More to the point, she stated the following:

> The nature of the property and the nature of its income are not forever fixed as a result of a s. 88(1) rollover.[112]

Justice Iacobucci wrote the dissent (Sopinka and Cory JJ, concurring). He agreed with Justice L'Heureux-Dubé that "s. 88(1) creates no right in a taxpayer to claim capital cost allowance."[113] He went on to state as follows:

> All that s. 88(1) does is to displace the normal rules applying to the disposition of property: it turns the transfer from subsidiary to parent into a tax-free transaction. What s. 88(1) does not do is to fix the character of the transferred property immutably, nor does it fix the nature of the income produced by that property.[114]

On the facts, the dissenting judges held that Hickman Motors could not claim capital cost allowance because it did nothing at all with the assets acquired on the wind-up during the five-day ownership period. It did not use the assets in a business and the rental income it received during the five-day period was income from property. As the point was not argued, they felt it unnecessary to discuss whether Hickman Motors could claim capital cost allowance on the basis that it was applicable to income from property. Instead, they held that capital cost allowance could not be claimed as there was no source of business income.

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111 Ibid., at 5377.
112 Ibid., at 5368.
113 Ibid., at 5381.
114 Ibid., at 5385.

In the result, while Hickman Motors won the appeal, a majority of the judges (L'Heureux-Dubé, J. and the three dissenting judges) held that subsection 88(1) did not result in an automatic flow-through of the characterization of property.

In summary, it appears that property acquired on a wind-up will not necessarily retain the same character it had in the hands of the subsidiary. As discussed in the context of amalgamations, a determination based on the facts will not result in recharacterization in the usual situation in which the parent continues to use the inherited assets in the same manner as did the subsidiary. In other situations, however, recharacterization may be necessary and, as seen in the division of views of the Supreme Court in *Hickman Motors*, reasonable judges can reach very different conclusions based on the same set of facts.

Capital Cost Allowance Claims by the Parent

Assuming that a property is properly characterized as depreciable property to the parent, continuity in respect of capital cost allowance claims by the parent will be available subject to the possible application of the half-year rule of regulation 1100(2). The half-year rule will apply unless, by virtue of regulation 1100(2.2), the subsidiary owned the property continuously during a period from a day that was at least 364 days before the end of the taxation year of the parent during which it acquired the property until the distribution to the parent.[115] The classification of the property will be the same as applied to the subsidiary by virtue of regulation 1102(14).[116]

Forgiveness of Debt Rules

Subsection 80.01(4) contains rules dealing with the forgiveness of debt owing by the subsidiary to the parent or by the parent to the subsidiary that is settled as a consequence of a wind-up under subsection 88(1). If the payment on the debt is less than the creditor's cost amount of the debt, the parent is permitted to file an election to deem the debt to have been settled at the cost amount. For this purpose, the cost amount is increased by adding unpaid

[115] The condition that the property be acquired from a non-arm's length person would be met in these circumstances unless the anti-avoidance rule of regulation 1102(20) applied.

[116] Ibid.

interest that had been included in the income of the creditor and not deducted as a bad debt by the creditor.

If the creditor's cost amount of the debt is equal to the amount of the debt, filing this election will result in no forgiveness of debt to the debtor and no gain to the creditor.[117]

If the creditor's cost amount is less than the amount of the debt, filing the election will result in the debt being settled at the cost amount and, therefore, forgiveness equal to the excess of the amount of the debt over that cost amount. Alternatively, the debtor could satisfy the debt with full payment, in which case, the forgiveness of debt rules would not apply but the creditor would realize a gain in respect of the debt.

If the creditor is the parent and if the subsidiary distributes property on the wind-up in settlement of the debt, it is the CRA's position, as noted previously, that such property is nevertheless distributed on the wind-up and, therefore, eligible for rollover treatment under subsection 88(1).

If there is a forgiveness of debt of the subsidiary on the wind-up, the settlement is deemed, by virtue of paragraph 80.01(4)(d), to have occurred "immediately before the time that is immediately before the time of the distribution" for the purposes of applying section 80. For example, section 80 can result in, among other things, a reduction in the adjusted cost base of capital property owned by the subsidiary pursuant to subsection 80(9). Under subsection 80(9), the reduction in adjusted cost base occurs immediately after the time of the forgiveness. Accordingly, the reduction would occur immediately before the distribution of the property to the parent. Given the CRA's administrative position that the amount of proceeds of disposition of property to the subsidiary is determined immediately before the distribution, rather than immediately before the commencement of the winding-up procedures, the subsidiary should not realize a gain in respect of property the cost of which has been reduced under section 80.

[117] See: CRA Document No. 2009-0313921R3 dealing with gains or losses due to foreign exchange fluctuations when debt of the parent held by the subsidiary is denominated in a foreign currency and the election under subsection 80.01(4) is made.

Potential Capital Gain to Parent

As discussed in the context of a vertical amalgamation under subsection 87(11), the parent can realize a capital gain (but not a capital loss) in respect of its shares of the subsidiary on a wind-up under subsection 88(1). Under paragraph 88(1)(b), the shares of the subsidiary are deemed to have been disposed of for proceeds equal to the lesser of the paid-up capital of those shares and the net tax value of the assets of the subsidiary as determined under subparagraph 88(1)(d)(i) (if that lesser amount is greater than the adjusted cost base of the shares of the subsidiary).

In the earlier discussion, a method of dealing with this tax trap is described.

As is true on an amalgamation, if the adjusted cost base of the shares of the subsidiary had been previously reduced pursuant to the forgiveness of debt rules of section 80, the parent will be deemed by section 80.03 to realize a capital gain unless it elects under subsection 80.03(7) to have the gain treated as a forgiven debt.

Rules Applicable to Debtholders

Holders of debt of the subsidiary would be considered to have disposed of the debt when it was assumed by the parent and if there was a novation. In this event, a rollover is available under subsection 87(6), which is made applicable by virtue of paragraph 88(1)(e.2), provided that the amount payable on maturity does not change.

Of mostly historical interest now that we have a general withholding tax exemption for interest paid to arm’s length non-residents, if the subsidiary had borrowed from arm’s length non-residents and interest on the debt was exempt from withholding tax under paragraph 212(1)(b)(vii), the exemption continued to be available following the assumption by the parent of the debt on the wind-up by virtue of subsection 87(7), which is made to apply by virtue of paragraph 88(1)(e.2), if the amount payable on maturity was not changed.

Tax Status of the Parent

It was noted previously that an amalgamated corporation will be deemed to be a public corporation if one of the predecessor corporations was a public corporation. As there is no such rule in the context of a wind-up, a wind-up of a public corporation will not cause the parent to become a public corporation. In certain circumstances, this may lead to choosing to merge by way of wind-up rather than amalgamation, particularly if it is not possible for the subsidiary to elect not to be a public corporation prior to the merger. Consider the following example (which can arise more often than one might first think). Corporation A (not a public corporation) created a special purpose subsidiary, Corporation B, to make a takeover bid for Corporation C, a public corporation whose shares were listed on a designated stock exchange. Following the successful bid, and without having first elected that Corporation C cease to be a public corporation, Corporation B and Corporation C were amalgamated in a short-form vertical amalgamation to form Amalco. Many years later, Corporation A decides to merge with Amalco. At this point, because of a technical flaw in the drafting of regulation 4800(3), it is not possible for Amalco to elect not to be a public corporation.[118] In these circumstances, unless a favourable ruling is obtained, it may be preferable to wind-up Amalco rather than amalgamate it with Corporation A so that the merged corporation is not deemed to be a public corporation.

The status of the parent as a "principal business corporation" in the resource sector as defined in subsection 66(15) or as a corporation whose principal business is real estate related as described in regulation 1100(12) or leasing as described in regulation 1100(16) can change on a wind-up if the subsidiary had been carrying on a relatively significant business in another industry.

Status of the parent as an entity subject to tax in a province as well the level of taxation in a province can be affected by a wind-up. Accordingly, the allocation of income and capital for provincial income and capital tax purposes following the wind-up should be considered.

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[118] David Smith, "Acquiring, Holding, and Financing Canadian Businesses by Non-Residents: A Canadian Perspective", in Income Tax and GST Planning for the Purchase, Sale, and Canada-U.S. Expansion of a Business, 1996 Corporate Management Tax Conference (Toronto: Canadian Tax Foundation, 1996), 19:1-42, at 19:4. One of the conditions under regulation 4800(2) to make the election is that insiders of Amalco must hold more than 90% of the issued shares of each class that was, at any time after Amalco last became a public corporation, listed on a designated stock exchange or was a class designated in an election to become a public corporation. Regulation 4800(3) provides that shares of an amalgamated corporation are deemed to be of a class so designated if they were issued on the conversion of shares of a public predecessor corporation. On the vertical short-form amalgamation, however, shares of Amalco were not issued and the shares of Corporation C simply disappeared. Accordingly, it appears, technically, impossible to meet the conditions of regulation 4800(2). Fortunately, the CRA appears willing to provide favourable rulings in this type of situation: CRA Document 2000-0004783, May 10, 2001 and 2008-0268961R3.

Interest Expense

As would be the case if the merger were by way of amalgamation, interest on loans incurred by the parent to acquire shares of a subsidiary which is subsequently wound up under subsection 88(1) will be considered by the CRA to be deductible if the property acquired as a result of the wind-up continues to be used by the parent for the purpose of gaining or producing income from a business or property.[119] As noted in the context of amalgamations, this position is very helpful in situations where the parent has borrowed money to acquire shares of a profitable subsidiary but does not have sufficient income to offset the interest expense. Although the wind-up of the subsidiary may result in additional capital tax liability, the tax savings from being able to utilize the interest expense often outweigh the capital tax disadvantage. We will, however, need to watch the progress of the October 31, 2003 proposals, or any revised proposals, of the Department of Finance on the non-recognition of losses when there is not a reasonable expectation of "cumulative profit".

GRIP and LRIP

In much the same way that subsections 89(5) and (9) and paragraphs 87(2)(vv) and (ww) provide continuity for the GRIP and LRIP accounts in the case of an amalgamation, subsections 89(6) and (10) and subparagraph 88(1)(e.2)(ix) provide continuity on a wind-up pursuant to subsection 88(1).

Capital Tax

As noted in the context of amalgamations, the capital tax implications of a merger, including a wind-up, should always be considered if the amalgamated corporation will be subject to capital tax in a province that still imposes capital tax. In particular, a wind-up of a subsidiary can result in increased capital tax liability because of the loss of the investment allowance.

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[119] Interpretation Bulletin IT-533, paragraph 21, and Interpretation Bulletin IT-488R2 (archived), paragraph 39.

Loss Carryforwards and Carrybacks

Non-capital and capital loss carryforwards of the subsidiary may be used by the parent, pursuant to subsections 88(1.1) and (1.2), respectively, commencing with the first taxation year of the parent that begins after the commencement of the winding-up. This differs from an amalgamation where the amalgamated corporation can begin to use losses of the predecessor corporations from the time of the amalgamation. On the other hand, because of the way subsections 88(1.1) and (1.2) are drafted, there can be circumstances in which the period of time in which losses may be utilized is extended pursuant to a wind-up.

The two subsections apply in conditions that are identical to those necessary for the application of subsection 88(1) except that the parent and the subsidiary need to be merely "Canadian corporations" under the former whereas they must be "taxable Canadian corporations" under the latter. A "Canadian corporation" can be a tax-exempt corporation but it is not clear when this distinction would be significant in the context of loss carryforwards.

As is true for subsection 88(1), subsection 88(1.1) applies where the corporation "has been wound up". The CRA has taken the position[120] that, for the purposes of subsection 88(1.1), a corporation will not be considered wound-up until it has been formally dissolved. That is, the position taken in Interpretation Bulletin IT-126R2 in respect of when a corporation has been wound up for the purposes of subsection 88(1) is not operative for this purpose. If the subsidiary is not formally dissolved until after the parent has filed a tax return for a taxation year in which the loss would have been used but for this interpretation, the CRA states that the parent can file an amended return. Hopefully, the CRA will reconsider having two different meanings for the phrase "has been wound up" for the purposes of section 88. The requirement that the corporation "has been wound up" does not apply to subsection 88(1.2) which requires only that the winding-up has "commenced".

In simplified terms, these subsections operate by deeming a loss of the subsidiary realized in a taxation year of the subsidiary ("the subsidiary's loss year") to be a loss of the parent for the taxation year of the parent in which the subsidiary's loss year ended, provided that (not surprisingly) the subsidiary has not deducted the loss and that the loss would have been

[120] CRA Document No. 2001-0067105, March 19, 2001.

deductible in computing the taxable income of the subsidiary for any taxation year beginning after the commencement of the winding-up (on the assumption that it had such a taxation year and that it had sufficient income for that year). For example, assume that a subsidiary is on a calendar year basis and its parent has a June 30 year-end. In 2003, the subsidiary realized a non-capital loss that would expire on December 31, 2010 (a seven-year carryforward period applied then). However, on June 30, 2010 it is wound up. Because the subsidiary would not have been permitted to use the loss for any taxation year beginning after June 30, 2010 (that is, its year commencing January 1, 2011), the parent will not be permitted to use the loss.

Because these subsections deem a loss of the subsidiary to have been realized by the parent in the taxation year of the parent in which the subsidiary's loss year ended, the life of a loss can be extended following a wind-up in circumstances where the subsidiary had one or more short taxation years caused, for example, by acquisitions of its control. Assume, for example, that both the subsidiary and the parent have calendar year-ends. The subsidiary realized a non-capital loss in 2003 but then had two short taxation years because of successive acquisitions of control (the last one being by the parent) so that the loss would expire on December 31, 2009. The subsidiary has continued to carry on the loss business as required by the acquisition of control rules, described below. The subsidiary was wound up in 2007 (and the loss became available to the parent because the subsidiary could have used the loss in its taxation year that would have commenced on January 1, 2008). Because the loss was deemed to have been realized by the parent in its 2003 taxation year, and assuming that the parent did not have any short taxation years, the loss may be used by the parent until December 31, 2010. Subject to the general anti-avoidance rule, the wind-up eliminates the timing impact of the two acquisitions of control. The usefulness of this technique has been lessened since the carryforward period was extended to twenty years in the 2006 Budget.

An election is provided under paragraphs 88(1.1)(f) and 88(1.2)(d) for cases where a loss of the subsidiary would otherwise be deemed to be a loss of the parent for a taxation year beginning after the commencement of the winding-up. For example, assume the subsidiary has a calendar year-end while the parent has a June 30 year-end. The subsidiary is wound up on May 31, 2009 and realizes a loss for its year ended December 31, 2009. That loss will be deemed to be a loss realized by the parent for its year ending June 30, 2010, a taxation year that commenced after the commencement of the winding-up. In these circumstances, the parent can elect to treat the loss as realized in its immediately preceding taxation year, allowing it to carry forward the loss for use in its first taxation year commencing after the commencement of the winding up, that is, in its taxation year ending June 30, 2010. If the election is not made, the parent would have to wait and carry forward the loss for use commencing in its taxation year ending June 30, 2011.

Subsections 88(1.1) and (1.2) contain acquisition of control rules that parallel those of subsections 111(4) and (5). Pursuant to a proposed amendment to paragraph 88(1.1)(e), if there was an acquisition of control of the subsidiary at any time, or an acquisition of control of the parent after the commencement of the winding-up, a non-capital loss from a business may be used by the parent only if the business was carried on by the subsidiary or the parent with a reasonable expectation of profit and, then, to the extent of the parent’s income from the loss business or a similar business. With regard to a net capital loss, the parent may not use the loss following an acquisition of control of the parent or the subsidiary.

If the parent realizes a loss, it can carry it back the normal three taxation years unaffected by a wind-up of its subsidiary. As noted in the discussion on amalgamations, a vertical amalgamation has been put on the same footing in that the amalgamated corporation can carry back a loss to offset income of the parent in the three taxation years prior to the amalgamation. Here too, there can be subtle timing differences. Assume that both parent and subsidiary have calendar year-ends. If they are amalgamated on June 30, 2010 and the amalgamated corporation chooses a December 31 taxation year, losses realized by the amalgamated corporation in its taxation year ended December 31, 2010 may be carried back to shelter income of the parent in the parent’s taxation year ended December 31, 2008. The short taxation year caused by the amalgamation counts as one of the three carryback years. If, instead, the subsidiary were wound up on June 30, 2010, losses realized by the parent in its year ended December 31, 2010 could be carried back to its taxation year ended December 31, 2007.

Tax Implications on Distribution to Minority Shareholders

If there are minority shareholders within the 10% threshold permitted under subsection 88(1), the subsidiary will not be entitled to a rollover in respect of property distributed on the wind-up to the minority shareholders. Instead, the subsidiary will be deemed to receive fair market value proceeds under paragraph 69(5)(a).

The minority shareholders will not be deemed to receive a dividend under subsection 84(2) because it is deemed not to apply by virtue of paragraph 88(1)(d.1). The CRA takes the position that the minority shareholders will receive proceeds of disposition for their shares equal to the fair market value of the property so distributed.[121] The minority shareholders would acquire the distributed property at a cost equal to its fair market value by virtue of paragraph 69(5)(b).

Foreign Tax Implications

As is true on an amalgamation, foreign tax implications must be considered on a wind-up if the subsidiary holds property or carries on business in a foreign jurisdiction. In particular, if the subsidiary holds real estate or resource properties in the U.S., the implications under FIRPTA must be considered.

Transfer Taxes, Canada Pension Plan and Employment Insurance

A distribution of tangible personal property on a wind-up is not considered to be a sale for retail sales tax purposes in Ontario if the subsidiary had paid the tax when it acquired the property, if the property is acquired by the parent for the purpose of resale or if the property was exempt from retail sales tax (for example, qualifying production equipment).[122] Ontario is moving from a retail sales tax to a harmonized sales tax effective July 1, 2010. It is understood that similar rules apply in other provinces that impose a retail sales tax.

Goods and services tax is not payable on a wind-up when property is distributed to a corporation that owns at least 90% of the issued shares of each class of the subsidiary.[123]

In previous years, if employees of a subsidiary became employees of the parent on the wind-up, the parent was a new employer for purposes of Canada Pension Plan and

[121] Interpretation Bulletin IT-488R2 (archived), paragraph 46. It may be, however, that the minority shareholders do not have a disposition until their shares are cancelled on the dissolution of the corporation.

[122] Paragraph (i) of definition of "sale" in subsection 1(1) of the *Retail Sales Tax Act (Ontario)*, R.S.O., 1990, c. R.31, as amended.

[123] *Excise Tax Act (Canada)*, supra footnote 87, paragraph 272(b).

employment insurance contributions. Accordingly, if the subsidiary had already paid the maximum contribution for a calendar year and the employees were transferred during that year, additional Canada Pension Plan and employment insurance contributions were payable by the parent resulting in a doubling up of employer contributions. This doubling up problem was eliminated with amendments announced on February 27, 2004 and in the Budget of March 23, 2004.[124]

In Ontario, there is no exemption from land transfer tax when land is transferred on a wind-up. The Ontario rules impose land transfer tax not only on the registration of a conveyance but also on a transfer of a beneficial interest. It would appear possible to avoid land transfer tax by having the subsidiary transfer legal title, but not the beneficial interest, for nominal consideration to an affiliated corporation prior to the wind-up. On the wind-up, the beneficial interest would be distributed to the parent and an application for exemption would be made. A deferral is available on a transfer of a beneficial interest to an affiliate (that is, the parent) if the affiliate undertakes not to dispose of the property within three years and if security for the tax is given.[125] If the parent holds the beneficial interest for the three-year period, the liability for the land transfer tax in respect of the transfer to the parent would be cancelled and the security would be returned.[126]

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[124] Supra footnote 88.

[125] Subsection 3(9) of the *Land Transfer Act (Ontario)*, R.S.O. 1990, c. L.6, as amended. The undertaking can be met, notwithstanding the wind-up, by virtue of subsection 3(12).

[126] Ibid., subsection 3(11).