TAX LAW FOR LAWYERS

PURCHASE AND SALE OF A BUSINESS - SHARE TRANSACTIONS

INCLUDING TAX ISSUES IN DOCUMENTATION

Douglas A. Cannon
Mario Abrioux
McCarthy Tétrault LLP

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PART ONE: TAX ISSUES

This paper[1] addresses some common income tax issues that arise in connection with the purchase and sale of shares of a Canadian corporation.[2] The first part deals with the tax issues in general and the second part addresses tax issues in the documentation of a share purchase agreement.

PART ONE: TAX ISSUES

Basic Principles

A. Time of Disposition

Identifying the time that a disposition of shares occurs is important for a number of reasons. For instance, the time of the disposition will determine in which taxation year a gain or loss must be reported. In addition, where the vendor of the shares is a non-resident, and the shares constitute "taxable Canadian property" to the vendor, it will also "start the clock" on certain reporting and tax payment obligations of the vendor that arise as a result of the disposition and which must be satisfied within certain time frames.[3]

The time of a disposition is determined by reference to the provisions of the *Income Tax Act* (Canada) ("ITA")[4] as well as by the case law. The ITA defines a disposition of property to include, *inter alia*, any transaction or event entitling a taxpayer to proceeds of disposition of property. "Proceeds of disposition" is, in turn, defined in the ITA to include, *inter alia*, the sale price of property that has been sold.[5] The ITA generally excludes from the concept of a "disposition", subject to certain exceptions, any transfer of property that does not result in a change in beneficial ownership.[6] It follows from the foregoing that a disposition of shares will only arise for income tax purposes upon the latest of three events, being (i) the date that the property has been, as a legal matter, "sold", (ii) the date that the vendor becomes "entitled" to the proceeds of disposition, and (iii) the date that beneficial ownership of the property has been transferred to the purchaser.[7]

Canadian case law has established that, in order to determine when property has been sold, reference must be made to the relevant governing private law.[8] Canadian case law has also established that a disposition of shares generally occurs upon delivery of the securities to the purchaser following the fulfillment of any conditions precedent, and not on the date of execution of the agreement of purchase and sale itself.[9]

An obligation subject to a true condition precedent is not effective and, thus, beneficial ownership is not transferred, until the condition has been satisfied.[10] Accordingly, where a sale of shares is subject to a true condition precedent, a disposition of the shares for tax purposes will not occur until the condition is fulfilled, even if this occurs at a time subsequent to their delivery.[11]

The views of the CRA on the effect of a condition precedent are consistent with the foregoing principles and are set out at paragraph 5 of Interpretation Bulletin IT-170R:

> [I]t is the Department's view that the sale price of any property sold is brought into income for tax purposes when the vendor has an absolute but not necessarily

> immediate right to be paid. As long as a condition precedent remains unsatisfied, a vendor does not have an absolute right to be paid … the fact that a contract of sale is subject to ratification is of no consequence in determining the date of disposition unless it is made a condition precedent of the agreement."

While entering into an agreement to sell shares on a future date will generally not result in a disposition of the shares at that time,[12] it may give rise to other tax consequences. Paragraph 251(5)(b) provides that for the purposes of the "related persons" rules and the "Canadian-controlled private corporation" ("CCPC") definition, a person who has a right to acquire shares of the capital stock of a corporation, whether immediately or in the future and whether absolutely or contingently, is deemed to be in the same position as if the person owned such shares. Consequently, if a non-resident person or a public corporation has a right under a contract to acquire shares that will give it 50% or more of the votes attached to the shares of a corporation and that corporation would otherwise qualify as a CCPC, the corporation will cease to be a CCPC at the time of the entering into of the agreement.[13] Where a corporation ceases to be a CCPC otherwise than because of an acquisition of control, subsection 249(3.1) deems the corporation's taxation year to end immediately before that time.

B. Nature of the Gain

A taxpayer's disposition of shares will generally be on capital account unless the taxpayer holds the shares in the course of carrying on a business of trading or dealing in securities or the shares were acquired in a transaction or transactions considered to be an adventure in the nature of trade. As a general rule, in the context of a sale of a business implemented through a sale of the shares of a corporation that owns the business, the vendor's shares should be capital property such that their disposition will result in a capital gain or loss.[14]

If the shares are held on income account, any gain realized on the disposition will be fully includable in income. Most taxpayers will be able to elect, in prescribed form, in the year of a disposition of a Canadian security to deem every Canadian security owned in that year and all subsequent years to be capital property.[15]

Shares may also be deemed to be capital property pursuant to section 54.2. Section 54.2 applies where a person has disposed of property that consisted of all or substantially all of the assets used in an active business to a corporation for consideration that includes shares. In these circumstances, the acquired shares will be deemed to be capital property. The CRA considers "all or substantially all" to mean 90% or more. If a person has more than one business operation and not all of the operations are to be transferred to the corporation, it will be critical to determine whether the transferred operations transferred constitute a separate business.[16] If they do not, section 54.2 will not apply to deem the acquired shares to be capital property. A recent case that considered this issue is *Dupont Canada Inc. v. The Queen*.[17]

From the purchaser's perspective, if the acquisition is on capital account then the purchase price will be included in computing the adjusted cost base of the shares which will be used in calculating the purchaser's capital gain or loss on a subsequent disposition of the shares. If the shares are inventory to the purchaser then the purchase price will be added to the cost of the purchaser's inventory.

Preparing the Target Corporation

A. Safe Income Dividends

On a disposition of shares held on capital account, the vendor will realize a capital gain to the extent that the proceeds of disposition exceed the adjusted cost base of the shares and any reasonable costs of disposition.

The gain realized on a share disposition may arise, in part, because the target corporation has undistributed retained earnings, being the income remaining after the payment of taxes at the corporate level. To the extent that a shareholder would realize a gain on the disposition of shares because of undistributed after-tax income in the corporation, the shareholder may be able to realize such amount without incurring a tax liability.

This opportunity arises because, as a general rule, inter-corporate dividends received by a taxable Canadian corporation from a "connected" corporation are not subject to Canadian income tax.[18] If a corporation receives a dividend before selling the shares it holds in the dividend paying corporation, generally the proceeds and, therefore, the capital gain realized will be reduced by the amount of the dividend.[19] As a result, a portion of the tax that would otherwise have been paid on the sale will have been avoided since no tax will be paid on the dividend.

There is a limit, however, on the amount of tax-free dividends which may be extracted from a corporation prior to a sale of shares. Subsection 55(2) is an anti-avoidance rule which will recharacterize a dividend as a capital gain, or as proceeds of disposition, if the dividend is received as part of a transaction or event (or series of transactions or events) one of the purposes of which (or results of which, in the case of a deemed dividend) is to reduce a capital gain that would otherwise be realized on a fair market disposition of the shares. Notably, subsection 55(2) will not apply to the extent that the dividend is reasonably attributable to income earned or realized by the corporation after 1971 and before the "safe-income determination time"[20] for the particular transaction, event or series of which the dividend is a part.

A corporation's income that has been earned or realized after 1971 and before the "safe-income determination time" is known as "safe income."[21] The ITA does not define "safe income", nor does it contain an exhaustive code for the calculation and allocation of safe income among different classes of shares of a corporation. Until recently, there was limited jurisprudence on safe income issues. Accordingly, tax practitioners generally relied on articles, technical interpretations and rulings published by the CRA in determining the amount of "safe income" that could be extracted without triggering a re-characterization under subsection 55(2). Although a detailed description of the CRA's administrative approach is beyond the scope of this paper, a basic premise of the approach is that only "safe income on hand" - that is, safe income which is actually on hand and available for distribution as a dividend - should be permitted to be extracted without triggering the application of subsection 55(2). While recent case law has affirmed certain components of the CRA's administrative approach to computing safe income on hand,[22] it has also rejected

certain other components of that approach. The most notable of these cases is the Federal Court of Appeal decision of *Kruco* v. *The Queen*.[23]

In *Kruco*, the CRA argued, in accordance with its long held administrative position, that a negative adjustment should be made to the taxpayer's safe income computation to reflect the taxpayer's "phantom income" – that is, amounts which were technically included in computing the taxpayer's income under Division B of Part I of the ITA but which were not supported by a corresponding cash inflow. The Federal Court of Appeal rejected the CRA's argument, and in doing so, noted that the ITA specifically deems a taxpayer's safe income to be its income as otherwise computed under the ITA, subject to certain exceptions.[24] Although in the Court's view this deemed starting point could be reduced by cash outflows (such as dividends and taxes) which are no longer "on hand" and which therefore cannot contribute to the gain that otherwise would be realized on a fair market value disposition of the shares, the Court concluded that reducing the starting point by amounts that were never on hand to begin with would be inconsistent with the deeming rule.

The CRA has accepted the *Kruco* decision and has advised that for any taxable dividend received after 2006, the safe income attributable to a particular share will need to be determined in accordance with the approach mandated by the Federal Court of Appeal in *Kruco*. Although the CRA originally took the view that the *Kruco* method did not require taxpayers to reduce safe income by the amount of any non-deductible expenditures other than taxes and dividends, it recently reversed this position.[25] In the authors' view, this revised position is consistent with the Court of Appeal's comments in *Kruco* and other existing case law.

If the amount of a dividend paid, or deemed to be paid, on a share exceeds the safe income attributable to the share, the whole amount of the dividend will be deemed to be proceeds of disposition or a capital gain under the anti-avoidance rule. However, paragraph 55(5)(f) allows a corporation that has received a dividend to make a series of designations deeming it to have received separate dividends.[26] By making such designations the dividend recipient can obtain the benefit of the safe income through deemed separate dividends up to the amount of the safe income. An alternative to making paragraph 55(5)(f) designations is to actually pay a series of separate dividends.

Safe income may be accessed through the declaration and payment of actual dividends. Where actual dividends are paid, the value of the target corporation will be reduced, and as a consequence, the capital gain realized on the sale of the shares will be reduced.[27]

Historically, taxpayers have also realized safe income through the payment of stock dividends and through increases in the stated capital of the shares that are the subject of the sale transaction, each of which will give rise to deemed dividends.[28] However, proposed amendments to paragraphs 53(1)(b) and 52(3)(a) will, if reintroduced and enacted, likely impair the ability to realize safe income through stated capital increases and will eliminate the ability to do so through the payment of stock dividends.[29] If a stock dividend is paid, the value of the corporation is not reduced (as would be the case with an actual dividend) and under existing paragraph 52(3)(a), the shareholder is deemed to have acquired the share or shares received as a stock dividend at a cost equal to the amount of the stock dividend.[30] As

a consequence, the gain on a subsequent disposition of the shares will be reduced and the shareholder should be in the same after-tax position as if an actual dividend had been received. Under proposed paragraph 52(3)(a), however, the shareholder will be deemed to have acquired the share or shares received as a stock dividend at the amount by which the amount of the stock dividend exceeds the amount of the dividend that the shareholder may deduct under subsection 112(1). The amendment thus effectively eliminates the ability to realize safe income through the payment of stock dividends.

Under current legislation, if a dividend is deemed to have been paid as a result of an increase in the capital of the shares, paragraph 53(1)(b) will increase the adjusted cost base of the shareholder's shares by the amount of the dividend deemed by subsection 84(1) to have been received. The effect is thus similar to that of a stock dividend under the existing legislation in that the gain on a subsequent disposition of the shares is reduced. However, under proposed paragraph 53(1)(b), the increase to the adjusted cost base of the shareholder's shares will be reduced by the amount of the deemed dividend that arose, directly or indirectly, as a result of a conversion of contributed surplus into paid-up capital and which the taxpayer was permitted to deduct under subsection 112(1). Accordingly, although a stated capital increase may still be used to realize safe income in cases where the increase involves a conversion of retained earnings into paid-up capital, it cannot be so used where it involves a conversion of contributed surplus into paid-up capital.

Given that the proposed changes to paragraphs 52(3)(a) and 53(1)(b) (which, if reintroduced and enacted will apply to dividends received after November 8, 2006), taxpayers selling shares may pursue other methods of capitalizing safe income. For example, a corporation could borrow under a daylight loan in order to pay a safe income dividend to its shareholder. The shareholder would then reinvest the funds as a contribution of capital (thereby increasing the cost base of its shares) and the corporation would use such contribution to repay the daylight loan.[31] Alternatively, the corporation could pay a dividend to its shareholder and issue a promissory note as payment therefor. The vendor would then sell the note, together with the shares, to the purchaser.[32]

If an individual owns the shares of a target corporation, it is still possible to take advantage of "safe income" dividends by transferring the shares of the target to a holding company on a rollover basis and having the holding company receive a safe income dividend. Once the safe income dividend has been paid by the target, the shares of the target could be sold by the holding company for reduced proceeds.

If an individual, other than a trust, holds "qualified small business corporation shares", additional planning may be desirable. Subsection 110.6(2.1) entitles an individual who was resident in Canada throughout the year and who disposed of a share of a qualified small business corporation to a $750,000 capital gains deduction in computing income for a taxation year.[33] However, if all the shares of the target corporation are transferred to a holding company on a rollover basis as part of a transaction to strip out safe income, the capital gains exemption could not be used on a sale of the shares of the target since the exemption only applies on a disposition by an individual. It is, however, possible to further reduce the tax payable on the transaction if the shares of the target corporation held by the individual are exchanged for two separate classes of shares with only one class being

transferred to the holding company. A dividend equal to the pro-rata share of safe income attributable to the class of target shares held by the holding company could then be paid. On the subsequent sale of the shares held directly by the individual, the capital gains exemption may be applied against the gain realized on the sale of those shares.

B. Capital Dividends

A private corporation may pay, or be deemed to pay, a dividend which it elects to be a capital dividend under subsection 83(2). Such a dividend will be received free of tax by a Canadian resident shareholder.[34]

A private corporation's capital dividend account, at any particular time, includes the non-taxable portion of capital gains realized by it immediately before the particular time and is reduced by the amount of its capital losses (other than the portion that is an allowable capital loss) realized immediately before the particular time. On an acquisition of control of a corporation, accrued capital losses are deemed to have been realized by the corporation "immediately before the time that is immediately before" the acquisition of control.[35] These deemed realized losses will reduce the balance in the capital dividend account.

Accordingly, if control of the target corporation will be acquired by the purchaser and the target corporation has both a positive balance in its capital dividend account and accrued losses on its capital assets, the capital dividend should be paid sufficiently far in advance of the sale in order to avoid the grind in the capital dividend account that will occur because of the acquisition of control. On the other hand, if the target corporation has net capital loss carryforwards and the acquisition of control rules will be used to trigger capital gains to use up such losses, the capital dividend should be timed to take advantage of the resulting increase in the capital dividend account.

C. Sale of Division

A corporation with a number of divisions may undertake a spin-off "butterfly" reorganization pursuant to which it transfers one or more of its divisions to separate corporations owned by its shareholders. Following such a reorganization, the shares of the separate corporations would be available for sale at a future time by the shareholders.

Generally, such a transaction would involve the following steps:

(i) the shareholders of the corporation that owns the several business divisions (the transferor corporation) would transfer a portion of their shares in the transferor corporation, on a tax deferred basis under subsection 85(1), into a new sister corporation (the transferee corporation). The transferred shares would have a fair market value equal to the value of the transferor corporation's shares multiplied by the value of the division to be transferred over the value of all of the corporation's assets;

(ii) the assets comprising the division would then be transferred, again on a tax deferred basis under subsection 85(1), into the transferee

corporation in return for retractable preferred shares with a fixed value equal to the fair market value of the assets transferred;

(iii) the cross-shareholdings between the transferor corporation and the transferee corporation would then be repurchased or redeemed with promissory notes; and

(iv) the promissory notes would then be set-off against each other and cancelled.

On the share repurchases and redemptions, subsection 84(3) would deem dividends to be paid to the extent that the amounts paid exceeded the paid-up capital of the repurchased or redeemed shares.[36] The deemed dividends should not be recharacterized as capital gains under subsection 55(2) provided that the conditions of paragraph 55(3)(b) are satisfied. However, paragraph 55(3)(b) will not apply (and subsection 55(2) will apply) if any of the prohibited transactions described in subsection 55(3.1) are undertaken as part of the "series of transactions or events" that includes the butterfly reorganization. The transactions described in subsection 55(3.1) are commonly referred to as the "butterfly denial rules". Included among these is a requirement that there must not have been "as part of the transaction or event or series of transactions or events" that included the payment of the dividends, an acquisition of control of either the transferor corporation or the transferee corporation.

If the spin-off occurs once a potential buyer has been identified and negotiations for the sale of the division have commenced, then subsection 55(2) will clearly apply to recharacterize the deemed dividends arising on the redemptions as capital gains. It is less clear that subsection 55(2) will apply if the spin-off occurs at an earlier time. The issue that must be addressed in each case is whether the spin-off is part of the same series of transactions as the sale of the transferee corporation shares.[37]

A series of transactions may be found to exist at common law,[38] or alternatively, as a result of the application of the deeming rule in subsection 248(10) of the ITA. Subsection 248(10) provides that a reference in the ITA to a "series of transactions or events" is deemed to include "any related transactions or events completed in contemplation of the series." Where the spin-off occurs prior to identifying a potential buyer and the commencement of any negotiations, generally the concern is not that the sale forms part of the same common law series as the spin-off, but rather, that subsection 248(10) may apply to deem it to be part of that common law series.[39]

Subsection 248(10) has been considered in a number of Canadian decisions, most notably *OSFC Holdings Ltd.* v. *The Queen*,[40] *Canada Trustco Mortgage Co.* v. *The Queen*,[41] *MIL Investments (SA)* v. *R*[42] and *Copthorne Holdings* v. *R*.[43]

In *OSFC*, Standard Trust became insolvent and E&Y was appointed as liquidator. At the time it became insolvent, Standard Trust held a number of mortgages which were in arrears and E&Y sought to maximize the amount that could be recovered from these assets. If the mortgages had been sold directly to arm's length purchasers, the accrued losses on the

mortgages would have been realized by Standard Trust, which could not have used the losses for tax purposes given that it was not profitable. Accordingly, E&Y devised a plan to preserve Standard Trust's losses and make them available to third parties. To achieve this, Standard Trust's mortgages were transferred to a partnership on a basis that resulted in the mortgages having a high cost to the partnership. The Federal Court of Appeal considered, among other issues, whether subsection 248(10) should apply to deem the acquisition of the partnership interest by the third party taxpayers to be part of the common law series that included the packaging transactions. In concluding that it should, the Court made the following comments in relation to subsection 248(10):

> Subsection 248(10) required three things: first, a series of transactions within the common law meaning; second, a transaction related to that series; and third, the completion of the related transaction in contemplation of the series.
>
> Thus, before applying subsection 248(10), "series" must be construed according to its common law meaning, which I have found to be pre-ordained transactions which are practically certain to occur. To that is added "any related transactions or events completed in contemplation of the series". Subsection 248(10) does not require that the related transaction be pre-ordained. Nor does it say when the related transaction must be completed. As long as the transaction has some connection with the common law series, it will, if it was completed in contemplation of the common law series, be included in the series by reason of the deeming effect of subsection 248(10). Whether a related transaction is completed in contemplation of the common law series <u>requires an assessment of whether the parties to the transaction knew of the common law series such that it could be said that they took it into account when deciding to complete the transaction</u>. If so, the transaction can be said to be completed in contemplation of the common law series. [emphasis added]

In *Canada Trustco*, the Supreme Court of Canada considered whether a particular series of transactions should be caught by the general anti-avoidance rule in section 245. Although the application of subsection 248(10) was not a central issue in the case, the Supreme Court took the opportunity to expand on the Federal Court of Appeal's conclusion in *OSFC* that the parties to a transaction must have knowledge of the common law series in order for that transaction to be considered to be completed "in contemplation" of that series:

> We would elaborate that "in contemplation" is read <u>not in the sense of actual knowledge but in the broader sense of "because of" or "in relation to" the series.</u> The phrase can be applied to events either before or after the basic avoidance transaction found under s. 245(3). [emphasis added]

Two recent decisions have attempted to clarify the Supreme Court of Canada's comments in *Canada Trustco*. In *MIL Investments*, the Tax Court of Canada considered whether subsection 248(10) should apply to deem a sale of shares by a corporate taxpayer, which were exempt from Canadian tax under the *Canada-Luxembourg Tax Treaty*, to be part of an earlier common law series of transactions which included the continuation of the taxpayer into Luxembourg. The Tax Court concluded that subsection 248(10) should not apply, noting that at the end of the common law series the directing mind of the taxpayer had no intention of selling the shares, and that the sale could not be included in that series because of a mere possibility of a future sale. In coming to its conclusion, the Tax Court introduced

the requirement that a "strong nexus" exist between transactions in order for them to meet the "because of" or "in relation to" standard referred to in *Canada Trustco*, stating:

> There must be a strong nexus between transactions in order for them to be included in a series of transactions. In broadening the word "contemplation" to be read in the sense of "because of" or "in relation to the series", the Supreme Court cannot have meant mere possibility, which would include an extreme degree of remoteness. Otherwise, legitimate tax planning would be jeopardized, thereby running afoul of that Court's clearly expressed goals of achieving "consistency, predictability and fairness". [emphasis added]

The "strong nexus" requirement was subsequently considered in the case of *Copthorne Holdings*, and although initially adopted by the Tax Court, was later rejected by the Federal Court of Appeal. At the Tax Court level it was determined that a redemption of shares, which had the effect of accessing PUC that had been preserved through an earlier series of transactions, had a sufficiently strong nexus with that series notwithstanding that the parties involved had no precise knowledge that the redemption would occur at the time the series was entered into and notwithstanding that the event that led to the redemption (a change to the ITA's FAPI rules) was unrelated to the series. The Tax Court emphasized that the redemption was in contemplation of the initial series, within the meaning of subsection 248(10), because the appellant had knowledge of the prior preservation of PUC and took this into account when completing the redemption.

Although the Federal Court of Appeal upheld the decision of the Tax Court, it rejected the notion that a "strong nexus" must exist in order for the *Canada Trustco* standard to be met. Instead, it indicated that a transaction will be included in a prior series, pursuant to subsection 248(10), if the series is a "motivating factor" with respect to the completion of that transaction:

> I am satisfied that Bell J. [in MIL] was correct in concluding that the language of the Supreme Court of Canada in paragraph 26 of *Canada Trustco* that broadens the meaning of "in contemplation", as used in subsection 248(10), does not lead to the conclusion that the "mere possibility" of a connection between a series of transactions and a related transaction is sufficient to include the transaction in the series. On the other hand, I am not persuaded that the indicated broadening of "in contemplation" could, as Bell J. suggests with his phrase "strong nexus", require an even closer connection between the transaction and the series than was required under the interpretation offered by Rothstein J.A. in *OSFC*.
>
> In my view, if a series is a motivating factor with respect to the completion of a subsequent transaction, the transaction can be said to have been completed "in contemplation of the series" and a direct causal relationship between the series and the transaction, as argued by the appellant, need not be established. In my opinion, this standard is reconcilable with the test stated in *OSFC* and as broadened in *Canada Trustco*.

Leave to appeal was granted in *Copthorne Holdings* in January 2010. The Supreme Court of Canada will therefore soon have the opportunity to address any uncertainty created by the different approaches taken by the Tax Court of Canada in *MIL*, on the one hand, and the Federal Court of Appeal in *Copthorne Holdings*, on the other.

D. Inside vs. Outside Basis

There is often a difference between the tax cost of the shares of the target corporation ("outside basis") and the tax cost of the assets owned by the target corporation ("inside basis"). A higher outside basis and a desire to ensure capital gains treatment will generally cause the vendor to prefer a sale of shares. However, a share purchase may be less desirable to a purchaser since the purchase price will be reflected in the cost of the acquired shares and not in the target corporation's underlying assets.

Where the parties proceed by way of a share sale, a purchaser may, following the sale, and so long as it owns 90% or more of the target corporation's shares, take steps to increase or "bump" its cost in any underlying non-depreciable capital property of the target corporation to reflect the higher purchase price paid by it for the target corporation's shares. The corporate transactions that must be carried out to effect such a "bump" are relatively straightforward.[44] Where the purchaser corporation owns 90% or more of the issued shares of each class of the target corporation, the target corporation may be wound-up in a transaction to which subsection 88(1) applies. Alternatively, if the purchaser corporation wholly owns the target corporation, then the purchaser corporation and target corporation may be merged by way of a vertical amalgamation to which section 87 applies. In either transaction, provided the specific provisions of the ITA are satisfied, a designation may be made in the corporate tax return to step up the adjusted cost base of the non-depreciable capital assets of the target corporation owned by it at the time of the acquisition of control, unless the assets are "ineligible property."[45]

The aggregate amount of the increase in the adjusted cost bases of the assets of the target corporation generally cannot exceed the excess of the adjusted cost base of the target shares over the sum of the net tax bases of the target corporation's assets plus the amount of money on hand in the target corporation immediately before the merger. Further, the adjusted cost base of any particular non-depreciable capital asset of the target cannot be increased beyond its fair market value at the time the purchaser corporation acquired control.[46]

To a certain extent, steps can be taken prior to a sale of shares of a corporation to allow for a future internalization of the excess outside basis. In particular, it is possible to convert otherwise ineligible assets into assets eligible for the bump. For example, non-eligible assets may be rolled into a new subsidiary of the target corporation prior to the sale. The shares of the subsidiary taken back as consideration for the transfer of the ineligible assets will be non-depreciable assets and will not, by virtue of such a transaction, be "ineligible property." The usual concern with this type of planning is to ensure that the shares of the subsidiary are non-depreciable capital property to the target corporation. Section 54.2, discussed above, may apply to deem the acquired shares to be capital properties. If it does not apply because the transferred assets do not represent all or substantially all the assets used in an active business,

common law principles will have to be relied upon to support a capital property characterization of the shares.[47]

Assets may also be transferred on a rollover basis into a partnership under subsection 97(2). The partnership interest should be a capital asset to the transferor based on common law principles provided that the partnership is established for a limited period prior to the sale of the shares of the target corporation. Accordingly, the purchaser should be able to bump the adjusted cost base of the partnership interest following its acquisition of control of the target. Recently, however, the CRA has expressed the view that the general anti-avoidance rule in subsection 245(2) may apply where assets are transferred to a partnership under subsection 97(2) followed by a sale of the partnership interest to a tax exempt entity or an income fund.

E. Taxable Preferred Shares

The existence of an agreement to purchase shares, even common shares, may cause such shares to become "taxable preferred shares" or "short-term preferred shares."[48] A corporation that pays, or is deemed to pay, dividends on "taxable preferred shares" or "short-term preferred shares" may be liable for Part VI.1 tax. Part VI.1 tax is a form of advance corporation tax and is generally recoverable to the extent that a corporation pays tax under Part I of the ITA at normal corporate rates.

Specifically, under subsection 191.1(1), a taxable Canadian corporation paying taxable dividends (other than excluded dividends) will be liable for Part VI.1 tax equal to:

(i) 50% of the amount by which dividends paid by it in a year on "short-term preferred shares" exceeds its dividend allowance for the year;[49]

(ii) 40% of the amount by which dividends paid by it in a year on "taxable preferred shares" that are not "short-term preferred shares" and in respect of which it elects under subsection 191.2(1), exceeds the amount, if any, by which its dividend allowance for the year exceeds the dividends referred to in (i); and

(iii) 25% of the amount by which such dividends paid by it in a year on "taxable preferred shares" that are not "short-term preferred shares" and in respect of which it does not elect under subsection 191.2(1), exceeds the amount, if any, by which its dividend allowance for the year exceeds the dividends referred to in (i) and (ii).

Part VI.1 tax is not payable in a year if the aggregate amount of dividends paid in the year by a corporation on both taxable preferred shares and short-term preferred shares does not exceed its annual dividend allowance. A corporation's dividend allowance in a particular year cannot exceed $500,000 and it is shared among associated corporations.

Part VI.1 tax is not payable by a corporation in respect of a particular dividend where the dividend is paid to a shareholder that has a "substantial interest" in the corporation at the time the dividend is paid. Subject to the specific rules in subsections 191(2) and (3), a shareholder will have a substantial interest in a corporation at a particular time if, at that

time, (i) the shareholder is related to the corporation (otherwise than by virtue of paragraph 251(5)(b)) or (ii) the shareholder, together with related persons (otherwise than by virtue of paragraph 251(5)(b)), owns shares of the corporation representing 25% or more of the votes and value of the corporation plus either 25% or more, by value, of the shares of each class of the corporation or 25% or more, by value, of all non-taxable preferred shares.

A "short-term preferred share" includes a share where under the terms and conditions of the share, or any agreement relating to the share, the corporation or a specified person in relation to the corporation is, or may, within five years from the date of issuance of the share be required to acquire the share. It also includes a share that is exchangeable or convertible, unless the right is to exchange for, or convert into, a share that would not be a short-term preferred share. Subject to the 60-day or fair market value exceptions described below, a share will also be deemed to be a short-term preferred share if at any particular time an agreement is entered into to which the corporation or a specified person in relation thereto is a party, and as a consequence the corporation, or such a person, may reasonably be expected to acquire the share within five years of that time.

A "taxable preferred share" includes a share where, under the terms or conditions of the share or any agreement in respect of the share to which the corporation or a "specified person" in relation to the corporation is a party, (i) it may reasonably be considered that the amount of the dividends that may be paid on the share is, by way of formula or otherwise, fixed, limited to a maximum or established to be not less than a minimum where there are preferential dividend rights in respect of such minimum entitlement, or (ii) it may reasonably be considered, having regard to all of the circumstances, that the amount that the shareholder is entitled to receive in respect of the share on the dissolution of the corporation or on the redemption, acquisition or cancellation of the share is, by way of a formula or otherwise, fixed, limited to a maximum or established to be not less than a minimum. The taxable preferred share definition also includes a share that is exchangeable or convertible unless it is only exchangeable or convertible for a share that would not be a taxable preferred share.

A "specified person" in relation to a corporation is defined, in paragraph (h) of the definition of taxable preferred share, to mean a person with whom the corporation is not dealing at arm's length. Related persons are deemed not to deal at arm's length with each other. For the purposes of determining whether a person is related to a corporation, if the person has any rights to acquire shares of the corporation, paragraph 251(5)(b) deems the person to be in the same position as if the person owned those shares. Therefore, any person who is to purchase the shares of a corporation under an agreement which has not closed will be a "specified person" in relation to the corporation if the person will acquire control of the corporation on closing.

The breadth of the definitions of "taxable preferred shares" and "short-term preferred shares" coupled with the definition of a "specified person" can result in shares being so characterized when they become the subject matter of an agreement of purchase and sale. Three examples follow:

(i) Shares will become short-term preferred shares if an agreement is entered into by the vendor and a purchaser who becomes a "specified

person" in relation to the corporation by virtue of the agreement, unless the agreement provides that the shares are to be acquired (i) within 60 days of the agreement being entered into for an amount that does not exceed the greater of the fair market value of the shares at the time the agreement was entered into and their fair market value at the time of acquisition, or (ii) for an amount that does not exceed the fair market value of the shares at the time of the acquisition (or an amount which is intended to be fair market value that is computed by reference to assets or earnings).

(ii) Shares will become taxable preferred shares if the corporation is a party to the agreement and under the agreement the vendor is entitled to extract a specified amount of dividends prior to the sale of the shares. In such a case, the divided entitlement on the shares would be a fixed amount resulting in the shares being "taxable preferred shares".

(iii) Once a share purchase agreement has been entered into, it is arguable that the shares of the corporation have become "exchangeable" for the consideration payable under the agreement. The "taxable preferred share" and "short-term preferred share" definitions do not define the term exchangeable. The term may be considered to apply where shares are being disposed of (i.e. exchanged) for other securities (such as notes) and arguably, at its broadest, it would extend to shares being disposed of for cash. While both the "taxable preferred share" and "short term preferred share" definitions have exclusions for agreements that satisfy the 60 day/fair market value requirement referred to above, in the case of the "short-term preferred share" definition, the exclusion does not apply to an exchangeable share. Nevertheless, having regard to the purpose of these rules, a court should conclude that a share purchase agreement will not cause a share to be an exchangeable share and that the term must be confined to shares that are exchangeable for assets of the issuing corporation.[50]

If shares of the target corporation become "short-term preferred shares" or "taxable preferred shares", the target corporation may become liable to Part VI.1 tax on dividends paid on the share unless the vendor has a "substantial interest", as discussed above.

The rules will continue to be a concern post-closing if the vendor(s) maintain a share interest in the target corporation and either dividends are paid on those shares or they are ultimately redeemed giving rise to a deemed dividend under subsection 84(3).[51]

F. Dividend Tax Credit Rules

In February 2007 the federal government enacted legislation containing rules, generally applicable to taxation years ending after 2005, which in certain circumstances permit

corporations to designate dividends paid to Canadian residents as "eligible dividends", with the result that individual Canadian resident recipients of such dividends may receive enhanced dividend gross-up and tax credit treatment. However, since the rules are only intended to provide enhanced treatment for income of the dividend paying corporation that does not benefit from other preferential tax rates, any "excessive" dividend designations made by the dividend paying corporation are subject to a penalty tax. For CCPCs, this penalty tax applies where the CCPC declares eligible dividends in excess of its "general rate income pool" (or "GRIP"). GRIP is calculated at the end of the tax year in which the dividend is paid, and is generally made up of taxable income that has not benefited from the section 125 small business deduction or any of certain other special tax rates. For non-CCPCs, the penalty tax applies where the non-CCPC pays dividends at a time that it has a "low rate income pool" balance (or "LRIP"). LRIP is generally made up of taxable income that benefitted from the small business deduction, either in the hands of a CCPC that paid an ineligible dividend to the non-CCPC or, if the non-CCPC had previously qualified as a CCPC, in its own hands.

Careful consideration should be given to the new enhanced dividend tax credit rules when proceeding with a purchase and sale of a business by way of a share sale. For example, where a vendor and purchaser enter into an agreement of purchase and sale in respect of the future sale of the shares of a target CCPC, the new dividend tax credit rules may have the unintended effect of creating an additional taxation year-end, and consequently an additional short taxation year, for the CCPC. Subsection 249(3.1), which deems a CCPC to have a taxation year-end immediately before the time that it becomes or ceases to be a CCPC, specifically excludes from its application a change in status caused by an acquisition of control - and thus presumably was not intended to apply in the context of the sale of a controlling interest in a corporation.[52] However, where the purchaser of a controlling interest in a CCPC is a non-resident of Canada or a public corporation, the entering into of an agreement of purchase and sale prior to the actual acquisition will generally itself cause the target corporation to lose its CCPC status.[53] In these circumstances, subsection 249(3.1) would appear to be triggered and the CCPC would have two deemed year ends – one resulting from entering into the agreement of purchase and sale and a second resulting from the actual sale of the shares. Although the first of these was perhaps not intended by Finance when it drafted the enhanced dividend tax credit rules, the CRA does not appear to be prepared, at this time, to grant administrative relief in these circumstances.[54]

The new rules may also be relevant to, and impact the planned timing of, any dividends (including dividends arising as part of a safe income transaction, as discussed above) that the vendor is proposing to cause the target to declare and/or pay prior to the sale. If the parties enter into an agreement of purchase and sale and the purchaser is not a non-resident or a public corporation, the target CCPC will generally not undergo a change in status upon entering into the agreement of purchase and sale. In these circumstances, the target's GRIP balance as of the year-end caused by the acquisition of control will govern whether dividends paid prior to the acquisition, and which are designated as "eligible dividends", are excessive and therefore subject to penalty, whereas the target's GRIP balance as of the next year-end following the acquisition of control (which could be up to twelve months following the acquisition of control) would govern this determination for dividends declared prior to, but paid following, the acquisition. Similarly, if the agreement of purchase and sale does result

in a change of the target CCPC's status, the target's GRIP balance at the time of the change of status would determine whether dividends paid prior to the change of status are excessive, but it would be the existence of an LRIP balance at the time of payment that would govern this determination for dividends paid after the change of status.
The possible outcomes under each of the foregoing scenarios should therefore likely be considered by a vendor when planning the timing of any dividends that it is proposing to cause the target to declare and pay.

Purchase Price Planning

In the simplest scenario, the vendor and purchaser will have agreed on a fixed price payable on closing. The vendor will recognize a capital gain in the year of the disposition and the purchaser's adjusted cost base for the shares acquired will be equal to the purchase price plus certain costs of acquisition. More likely, the purchase price will not be payable in its entirety on closing and the price itself may be subject to adjustment for post-closing events or based on a formula which may take into account the future earnings of the corporation.

A. Capital Gains Reserve

If a fixed purchase price is payable in instalments, the taxable capital gain otherwise includable in income in the year of disposition may be reduced through the claiming of a reserve.

The capital gains reserve is provided in subparagraph 40(1)(a)(iii), pursuant to which the vendor may claim the lesser of (i) a reasonable amount as a reserve in respect of such part of the proceeds of disposition that are payable after the end of the year as can reasonably be regarded as a portion of what would otherwise be the capital gain, and (ii) 80% of the gain in the year of disposition, 60% in the year following the year of disposition, 40% in the third year following the year of disposition and 20% in the fourth year following the year of disposition. The amount of the reserve claimed in one year is added to the vendor's income for the following year.[55] The effect of the reserve provision is to require the entire taxable capital gain to be included in income within a five-year period (including the year of disposition).

If a significant portion of the purchase price will be payable over a period longer than five years and the purchaser is a corporation, consideration should be given to the possible use of a rollover to defer recognition of the purchase price. Subject to the detailed rules in the ITA, a vendor could exchange some or all of the target corporation shares, on a tax-deferred basis, for redeemable shares of the purchaser or of the target corporation itself. In the year of sale, the only gain that would be realized by the vendor would be on the shares not transferred on a rollover basis. Gains on the shares received as consideration on the rollover would only be realized in the year in which they were disposed of by the vendor.

If the purchase price under the agreement of purchase and sale is deferred through instalments and it can reasonably be regarded as being in part interest and in part capital, subsection 16(1) could apply to deem part of the purchase price to be a payment of interest

on a debt obligation. To the extent that this occurs, it would result in a full income inclusion for the vendor and a possible deduction of the amount by the purchaser.[56]

B. Earnout Provisions

If the amount of the final purchase price is determined in whole or in part by reference to future earnings of the corporation then the proceeds of disposition will not be determinable at the time of sale and may not be known for several years.[57]

In these circumstances, the question arises as to how to report the gain or loss on sale. One approach would be to estimate the proceeds of disposition in the year of sale. Another would be to bring the proceeds into income pursuant to paragraph 12(1)(g), which requires a person to include in income any amount received in the year that was dependent on the use or production from property, regardless of whether the amount was an instalment of the sale price of the property. This provision arguably applies to a sale of shares subject to an earn-out even though the earn-out amount would be based on the use of or production from the underlying assets of the corporation and not the use or production from the shares themselves. The CRA acknowledges that each of these approaches produces unsatisfactory results.[58]

Accordingly, the CRA accepts the "cost recovery method" for reporting the gain (or loss) from the sale of shares where the price is subject to an earnout provision, provided the following conditions are met:[59]

(a) The vendor and purchaser are dealing with each other at arm's length.

(b) The gain or loss on the sale of shares of the capital stock of a corporation is clearly of a capital nature.

(c) It is reasonable to assume that the earnout feature relates to underlying goodwill the value of which cannot reasonably be expected to be agreed upon by the vendor and purchaser at the date of the sale.

(d) The earnout feature in the sale agreement must end no later than 5 years after the date of the end of the taxation year of the corporation (whose shares are sold) in which the shares are sold. For the purposes of this condition, the CRA considers that an earnout feature in a sale agreement ends at the time the last contingent amount may become payable pursuant to the sale agreement.

(e) The vendor submits, with his return of income for the year in which the shares were disposed of, a copy of the sale agreement. The vendor must also submit with that return a letter requesting the application of the cost recovery method to the sale, and an undertaking to follow the procedure of reporting the gain or loss on the sale under the cost recovery method as outlined below.

(f) The vendor is a person resident in Canada for the purpose of the ITA.

The cost recovery method requires the vendor to reduce the adjusted cost base of the shares as amounts on account of the price (i.e. earnout payments) become determinable. To the extent that an amount would reduce the adjusted cost base below zero, a capital gain is realized at the time such amount is determinable and the adjusted cost base remains nil. Further earnout amounts would be included in the vendor's income as capital gains in the year they become determinable. An amount is only determinable when it can be calculated with certainty. Where a minimum amount is payable on closing, it will reduce the adjusted cost base of the shares in the year of disposition and it will result in a capital gain in the year of disposition to the extent that the minimum amount exceeds the vendor's adjusted cost base.

An agreement that merely determines when amounts are to be paid is not considered an earnout agreement for purposes of using the cost recovery method. The capital gain reserve discussed above can apply to amounts that become determinable but are not payable until a subsequent taxation year.

C. Holdbacks/Adjustments/Warranties

The purchase price may be subject to adjustment for a variety of reasons. The price may be adjusted based upon the outcome of litigation claims by, or against, the target corporation or part of the stated purchase price may be held in escrow pending the determination of shareholders' equity at closing which may not be known for several months. When the sale is closed in one taxation year and the purchase price is altered or released from escrow in a subsequent taxation year, the issues to be considered are the extent to which the vendor should recognize a gain in the year of sale and the treatment of the adjustment when it is known in a subsequent taxation year. Since any adjustments will not be for future earnings, but in respect of events occurring on or before closing, the CRA's position on earn-outs would not appear to be applicable.

Upon closing there will have been a disposition of the shares. The types of adjustments and holdbacks that are typically made should not void the contract *ab initio*, but go to the quantum of the purchase price payable under the contract. Accordingly, the vendor will have disposed of the shares and have an entitlement to proceeds, although the actual amount of the proceeds may not be determinable at the time of disposition.[60]

In the case of holdbacks that depend on the calculation of shareholders' equity as at closing, the vendor is entitled at closing to an amount the determination of which will be made, for the most part, based on events or transactions that have occurred by closing. In these situations, generally, the full amount of the holdback should be included in computing the vendor's proceeds of disposition and a reserve for a portion of the amount not payable until a subsequent year may be claimed. If, for any reason, an amount is never paid, then the vendor should be able to claim a capital loss on that portion of the receivable.

There may be instances, however, where adjustments are made to shareholders' equity as at closing which take into account events which occur after closing and perhaps after a year-end. In such circumstances, it is arguable that the holdback pending these adjustments

should not be included in the vendor's proceeds of disposition until the year the amount becomes determinable.

Where an amount is held back by the purchaser to satisfy warranties given by the vendor in relation to the shares, it is arguable that separate consideration has been identified for the warranties, such that the tax treatment of the amount is governed by section 42.[61] Assuming proposed amendments to section 42 are enacted as proposed, section 42 will provide:

> For the purposes of this subdivision
>
> (a) an amount received or receivable by a taxpayer in a taxation year as consideration for a warranty, a covenant or another conditional or contingent obligation given or incurred by the taxpayer in respect of a property disposed of, at any time, by the taxpayer
>
> > (i) is, if the amount is received or becomes receivable on or before the taxpayer's filing-due date for the taxpayer's taxation year in which the taxpayer disposed of the property, to be included in computing the taxpayer's proceeds of disposition of the property, and
> >
> > (ii) is, if the amount is received or becomes receivable after that filing-due date, deemed to be a capital gain of the taxpayer from the disposition, by the taxpayer of the property, that occurs at the time when the amount is received or becomes receivable; and

If a vendor has an outlay or expense in a taxation year under a warranty, covenant or another conditional or contingent obligation given or incurred by the taxpayer in respect of property disposed of by the taxpayer, proposed paragraph 42(b) provides that if the amount is paid or becomes payable on or before the taxpayer's filing-due date for the taxpayer's taxation year in which the taxpayer disposed of the property, the outlay or expense is to be deducted in computing the taxpayer's proceeds of disposition of the property, and if the amount is paid or becomes payable after that filing-due date, the amount is deemed to be a capital loss of the taxpayer from the disposition, by the taxpayer of the property, that occurs at the time when the amount is paid or becomes payable.

D. <u>Retiring Allowances/Consulting Fees</u>

If the vendor provides consulting services to the target corporation and the purchase price for the shares represents the fair market value of the shares, then the fees paid for the consulting services should be deductible to the payer and should not be considered to be additional proceeds of disposition. On the other hand, the target corporation will have conferred a shareholder benefit on the purchaser if the target corporation pays consulting fees to the vendor where the fee is disguised consideration for the shares. If the agreement requires that payments be made to the vendor whether or not services are rendered to the corporation this may be an indication that the payments are, in fact, additional consideration for the acquired shares.[62]

Generally, one would expect a vendor to prefer additional proceeds to consulting fees because only one-half of the capital gain will be included in income as opposed to the full

amount of the fees. However, as consulting fees are only included in income in the year that they are earned, this could extend the income recognition period beyond the five year period over which taxable capital gains must be included in income.

Upon a sale of a corporation, executive level employees or officers may depart and receive compensation payments. The payments will typically be retiring allowances. This term is broadly defined in the ITA to include an amount received by a taxpayer on or after retirement from an office or employment in recognition of the taxpayer's long service or in respect of a loss of an office or employment.[63] A deduction should be allowed to the corporation for a retiring allowance to the extent that the amount of the payment is reasonable.

Within certain limits, the retiring allowance may be rolled into the employee's RRSP for pre-1996 years of employment.[64] The rollover is limited to $2,000 for each calendar year, or part year, of employment with the employer paying the retiring allowance (or a related person) before 1996, plus $1,500 for each such year before 1989 in respect of which the employer's pension contributions have not vested.

E. Restrictive Covenants

The purchaser of a corporation may insist on a covenant in the agreement of purchase and sale that the vendor not compete in the same business as the corporation for a certain time period following the purchase and within a certain geographical area. As a general rule, the restrictive covenant is intended to protect the value of the goodwill of the corporation's business from potentially detrimental competition by the selling shareholders.

Two decisions from the Federal Court of Appeal, *Manrell* and *Fortino*, held that non-competition payments could be received tax-free by shareholders of a target corporation in certain circumstances.[65] The Department of Finance responded with a proposal to tax non-competition payments as ordinary income, subject to certain exceptions. The new rule, which is found in proposed section 56.4, applies to amounts received or receivable by a taxpayer after October 7, 2003, other than to amounts received by the taxpayer before 2005 in connection with a restrictive covenant entered into in writing before October 7, 2003 between arm's length persons.[66]

Proposed subsection 56.4(2) provides that where in a taxation year an amount is received or receivable by the taxpayer or a person not dealing at arm's length with the taxpayer in respect of a restrictive covenant of the taxpayer, the amount is to be included in the taxpayer's income for the year. The definition of a "restrictive covenant" clearly includes non-competition agreements made in connection with the sale of a business. A "restrictive covenant" of a taxpayer is defined in the draft legislation as:

> an agreement entered into, an undertaking made, or a waiver of an advantage or right by the taxpayer (other than an agreement or undertaking for the disposition of the taxpayer's property …), whether legally enforceable or not, that affects, or is intended to affect, in any way whatever, the acquisition or provision of property or

> services by a taxpayer or by another taxpayer that does not deal at arm's length with the taxpayer.

There are a number of exceptions to the application of the general income inclusion rule.[67]

Proposed paragraph 56.4(3)(c) contains one such exception. The exception applies for amounts received or receivable in respect of a restrictive covenant of a taxpayer that directly relates to the particular taxpayer's disposition of property that is, at the time of the disposition, an "eligible interest" in the corporation or partnership that carries on the business to which the restrictive covenant relates. This exception enables the parties to elect to treat the amount in respect of a restrictive covenant as additional proceeds of disposition from the disposition of the eligible interest, effectively subjecting the restrictive covenant amount to a capital gains tax rate. The definition of the term "eligible interest" is found in proposed subsection 56.4(1). "Eligible interest" of a taxpayer means capital property of a taxpayer that is either a partnership interest in a partnership that carries on a business, a share of the capital stock of a corporation that carries on a business, or a shares in the capital stock of a corporation 90% or more of the fair market value of which is attributable to eligible interests in one other corporation.

Proposed paragraph 56.4(3)(c) applies where the conditions found in subparagraphs 56.4(3)(c)(i) to (vii) are satisfied.[68] These include that the restrictive covenant may reasonably be considered to have been granted to maintain or preserve the value of the eligible interest sold to the purchaser. In addition, subsection 84(3) must not apply to deem a dividend to have been paid upon the redemption, acquisition or cancellation of the shares of the capital stock of the corporation and the transfer of the eligible interest cannot be effected on a rollover basis under either section 85 or subsection 97(2). The selling taxpayer and the purchaser must jointly elect in prescribed form to have subsection 56.4(3) apply.

Proposed subsection 56.4(4) contains provisions designed to ensure that, to the extent one of the exceptions to ordinary income treatment applies, the tax implications to the payor are "mirrored". Accordingly, an amount jointly elected under paragraph 56.4(3)(c) to be treated as proceeds for the disposition of shares will be added to the payor's adjusted cost base of the shares.

Parties to a transaction may attempt to avoid the application of section 56.4 by allocating no consideration to the restrictive covenants. However, under new paragraph 68(c), such part of an amount as can reasonably be regarded as being consideration for the restrictive covenant is deemed to be an amount received or receivable by the taxpayer in respect of the restrictive covenant, irrespective of the form or legal effect of the restrictive covenant. The part of the amount is deemed to be an amount paid or payable to the taxpayer by the person to whom the restrictive covenant was granted. There are, however, three important exceptions to the application of new paragraph 68(c).

One of these exceptions is contained in proposed subsection 56.4(8).[69] It will generally apply where a non-compete covenant is granted by the vendor to an arm's length purchaser (determined without reference to paragraph 251(5)(b)) of property, the restrictive covenant is an undertaking of the vendor not to provide property or services in competition with the

purchaser or a person related to the purchaser, and it is reasonable to conclude that the covenant is integral to a written agreement under which the vendor disposes of assets or shares to the purchaser for valuable consideration. Additionally, the restrictive covenant must reasonably be regarded as having been granted to maintain or preserve the fair market value of the vendor's property or shares disposed of to the purchaser and subsection 84(3), section 85, and subsection 97(2) must not apply to the transaction. Where shares of a target corporation are sold, no part of the amount of the consideration that can reasonably be considered to be consideration for the restrictive covenant can be received, directly or indirectly in any manner whatever, by an individual with whom the vendor does not deal at arm's length.

Where a restrictive covenant is granted, it will be important for the parties to carefully consider what amount, if any, should be allocated to it if the exceptions to the application of section 68 are not available.

Financing the Share Purchase

A. General Principles

Paragraph 20(1)(c) is the principal provision in the ITA that deals with interest deductibility. Generally, in the absence of such provision, interest would not be deductible in computing income. The basic conditions for interest deductibility under paragraph 20(1)(c) are as follows:

(a) the amount of interest must be paid or payable pursuant to a legal obligation to pay interest;

(b) the interest must be payable in respect of borrowed money used for the purpose of earning income from a business or property or be payable for property acquired for the purpose of gaining or producing income from a business or property; and

(c) the amount of interest must be reasonable.

In the context of an arm's length acquisition of shares, reasonable interest paid or payable by a purchaser of shares should be deductible in computing the purchaser's income pursuant to paragraph 20(1)(c).[70]

B. Consolidation

Interest expense on money borrowed to make the acquisition will be incurred by the purchaser. However, the income earned by the business acquired by the purchaser through the acquisition of the shares of the target corporation will be subject to tax in the target. Therefore, if the purchaser is a corporation, typically the target and purchaser will be merged post closing such that the interest expense can be claimed as a deduction in computing the income of the acquired business. Interpretation Bulletin No. IT-533 confirms that in a debt financed acquisition of shares followed by a merger of the purchaser and target, there is a

link between the current use of the borrowed money to acquire the shares and the assets formerly held by the target corporation that has been wound up or amalgamated.

Historically, the merger of the corporations would generally have increased the capital tax liability in Ontario.[71] Prior to the merger, the purchaser corporation's share investment in the target corporation would have offset the debt of the purchaser company for the purposes of computing the capital tax liability. After the merger, the merged corporation would still have been required to include the acquisition debt in calculating its capital, but would not have had an offsetting deduction for a share investment in the target corporation. This will soon cease to be an issue, given that Ontario capital tax will be eliminated on July 1, 2010.

Consequences of an Acquisition of Control

A. Meaning of Acquisition of Control

An acquisition of control[72] of a corporation by a person or group of persons gives rise to a number of consequences under the ITA.[73] There is no general definition in the ITA of when control is acquired; however, there are provisions that deem control not to have been acquired for the purposes of certain sections of the ITA.[74]

In general, a person or group of persons who acquires more than 50% of the voting stock acquires control of a corporation.[75]

One of the leading cases to consider the meaning of *de jure* control is *The Queen v. Duha Printers (Western) Limited.*[76] The Court had to determine who had control of two corporations during certain stages of an amalgamation. Iacobucci J. confirmed that "control" meant *de jure* control and, after canvassing the case law, Iacobucci J. held that the test as enunciated in *Buckerfield's* remained the appropriate one to apply when considering the interpretation of *de jure* control. In *Buckerfield's,* the Court focused upon the share register of the corporation to determine who had control of the corporation. However, Iacobucci J. wrote that the important principle from *Buckerfield's* is that the court must determine whether the majority shareholder enjoy "effective control" over the "affairs and fortunes" of the corporation. Iacobucci J. stated that:

> To determine whether such "effective control" exists, one must consider:
>
> (a) The corporation's governing statute;
>
> (b) The share register of the corporation; and
>
> (c) Any specific or unique limitation on either the majority shareholders' power to control the election of the board or the board's power to manage the business and affairs of the company, as manifested in either the constating document of the corporation or any unanimous shareholder agreement.

Iacobucci J. drew a distinction between a unanimous shareholder agreement and other legal documents and shareholder agreements that modify a shareholder's shares and voting rights. Documents that are not unanimous shareholder agreements are not to be considered for the purposes of *de jure* control. These documents could however be relevant in the determination of *de facto* control of a corporation.

Therefore, the general test for *de jure* control continues to focus on the shareholder's ability to ultimately control the corporation through voting rights, with particular attention being paid to the ability to elect directors of the corporation. However, the constating documents, including any unanimous shareholders agreement, can be used in order to determine whether a majority shareholder's voting rights have been altered or constrained, such that the majority shareholder no long has effective control of the corporation.

Both the cases before *Duha* and those which followed it have tended to focus on the issue of the shareholder's ability to control enough of the voting shares of the corporation to elect a majority of the board of directors and thereby ultimately control the future of the corporation.[77] In the case *R. v. W. Ralston & Co. (Canada) Inc.,*[78] the Court discussed a contextual approach, similar to the one discussed in *Duha*. In this case, the Court had to determine whether the corporations were "associated" for the purposes of subsection 39(5) of the ITA. In order to settle this question, the Court had to decide if a certain group controlled the company. The Court held that the test to ascertain *de jure* control has been extended beyond a mere examination of the share register to determine who has voting control. The consideration must take place within the context of the corporate structure. The Court went on to state that:

> … 'control' is not a question of who, in fact, directs the affairs of the company (e.g. management officials or the directors) but of who, under the company's constitution, has the right to control. It is, however, an extension of the rule in that it determines the question of control by reference to the right to control the ultimate destiny of the company rather than the right to direct the current destinies (i.e. the operation) of the company.

In *Parthenon Investments Ltd. v. R.,*[79] the Federal Court of Appeal held that the concept of control has a character of exclusivity, finality, and has necessarily latent within it a notion of ultimate control. In that case the Court had to determine whether a company was a Canadian-controlled private corporation. While the corporation in question, Pacific Canada, was owned by an American corporation, the American corporation was in turn owned by two Canadian resident corporations. The Court held that the *de jure* control, or ultimate control, rested with the Canadian resident corporations and therefore, the company, Pacific Canada, was a Canadian-controlled private corporation. As a legislative override to this decision, however, subsection 256(6.1) was enacted to address control in multi-tiered corporate structures. Subsection 256(6.1) provides that where a corporation would be controlled by a "parent" corporation if the parent corporation was not controlled by a person or group of persons, the corporation is deemed to be controlled by both the parent corporation and the person or persons who control the parent corporation. Therefore, in multi-tiered structures such as the one at issue in *Parthenon*, the subject corporation may be deemed to be controlled by multiple persons, any one of whom could affect the subject corporation's status as a Canadian-controlled private corporation.

An acquisition of a minority interest may give rise to an acquisition of control if the minority shareholder acts in concert with another group of shareholders. This may occur, for example, where a plan is implemented to give new shareholders access to a corporation's

losses without triggering the rules that restrict the use of losses after an acquisition of control. In *Income Tax Technical News No. 7*.[80] the CRA stated that:

> It remains our view that it is a question of fact whether persons who owned the majority of voting power in a corporation constitutes a group that has *de jure* control of the corporation. Two or more persons who become the owners of a majority of the voting shares of a corporation will generally be considered to have acquired control of the corporation where there is an agreement amongst them to vote their shares jointly, where there is evidence that they act in concert to control the corporation, or where there is evidence of their intention to act in concert to control the corporation. A group of persons would be regarded as acting in concert when the group acts with considerable interdependence in transactions involving a common purpose. A common link or interest between members of a group is required to ensure that an acquisition of control is a result of a jointly decided action, rather than a mere or fortuitous event.

More recently, in the case of *Silicon Graphics Ltd. v. R.*,[81] the Federal Court of Appeal considered what would be required for a group of persons to control a corporation:

> … I agree with the appellant's submission that simple ownership of a mathematical majority of shares by a random aggregation of shareholders in a widely held corporation with some common identifying feature (e.g. place of residence) but without a common connection does not constitute *de jure* control as that term has been defined in the case law. I also agree with the appellant's submission that in order for more than one person to be in a position to exercise control it is necessary that there be a sufficient common connection between the individual shareholders. The common connection might include, *inter alia*, a voting agreement, an agreement to act in concert, or business or family relationships.

Therefore, a determination of whether a group is acting in concert will turn on the specific facts, including the actions of the shareholders and their intentions.

B. <u>Time of Acquisition of Control</u>

Subsection 256(9) provides:

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

If an election is filed under subsection 256(9), the time at which control is legally acquired, determined under commercial law principles, will establish the time of the acquisition of control for the purposes of the ITA.

The 2006 Federal Court of Appeal decision in *La Survivance* v. *The Queen*[82] prompted a recent legislative amendment to subsection 256(9). Prior to the amendment, the subsection did not contain the words "other than for the purposes of determining if a corporation is, at any time, a small business corporation or a Canadian controlled private corporation". The absence of these words caused some uncertainty as to how the provision should be applied in situations where a vendor of shares was seeking to claim certain tax benefits (such as an allowable business investment loss that is available on the sale of the shares of a small business corporation, or alternatively, the lifetime capital gains exemption that is available on the sale of the shares of a CCPC). In particular, it was unclear whether the deeming provision in subsection 256(9), which deems control to be acquired by a purchaser at the beginning of the day of sale, had the effect of changing the status of the shares (as small business corporation shares or CCPC shares) to the vendor at the actual time of disposition, which would generally be later that same day. This was essentially the issue faced by the Court of Appeal in *La Survivance*.

In *La Survivance*, the Minister disallowed the deduction of an allowable business investment loss ("ABIL") and non-capital loss carryovers claimed by a public corporation arising from the disposition of shares of a controlled subsidiary. The taxpayer was a public insurance company that owned the majority of shares of another public insurance company, La Clairvoyance. The taxpayer sold its shares of La Clairvoyance to a private corporation, Société Nationale. The taxpayer claimed that as a result of the deeming rule in subsection 256(9), Société Nationale was deemed to have gained exclusive control of La Clairvoyance at the commencement of the day of sale such that the taxpayer had no control over La Clairvoyance at the time that it actually transferred the shares to Société Nationale. Since Société Nationale was a private corporation, the taxpayer claimed that at the actual time of transfer it had disposed of shares of a small business corporation and had realized an ABIL on the disposition.

The Tax Court of Canada dismissed the taxpayer's appeal, holding that while Société Nationale was deemed to have acquired control of La Clairvoyance at the commencement of the day, nothing in subsection 256(9), as it then read, precluded La Survivance from continuing to have legal control until the time it actually transferred the shares of La Clairvoyance to Société Nationale. Consequently, the Tax Court held that taxpayer had not disposed of shares of a small business corporation since La Clairvoyance was not under the exclusive control of Société Nationale at the time of the transfer. The Federal Court of Appeal reversed the decision of the Tax Court. It held that the legal fiction created by subsection 256(9) was equally applicable to the party <u>ceding</u> control of corporation as it was to the party <u>acquiring</u> control. Consequently, La Survivance ceded control of La Clairvoyance at the commencement of the day such that it had no control over La Clairvoyance at the actual time of transfer. Accordingly, the shares were small business corporation shares at the time of the sale and the taxpayer was entitled to claim an ABIL on the disposition.

As noted above, the Federal Court of Appeal's decision in La Survivance has effectively been overruled by a recent amendment to subsection 256(9), which now explicitly provides that the rule in subsection 256(9) does not apply for purposes of determining whether a corporation is a small business corporation or a CCPC. The amendment is effective in

respect of acquisitions of control that occur after 2005, other than an acquisition of control that occurs before January 28, 2009 where the taxpayer has elected for the amendment not to apply.[83]

C. Deemed Year-End

An acquisition of control will result in a corporation having a taxation year-end immediately before the time of the acquisition of control and a new taxation year will be deemed to have commenced at the time of the acquisition of control.[84] If the corporation's last taxation year ended within the seven day period that ended immediately before the acquisition of control, the corporation may elect to have the last taxation year extended to end immediately before the acquisition of control.[85] Ordinarily, a corporation requires the concurrence of the Minister to change a fiscal period. In the case of an acquisition of control, however, it is not necessary to obtain any approvals with respect to establishing the first taxation year-end following the acquisition of control.[86]

Some of the income tax consequences that may arise from the deemed taxation year-end on an acquisition of control are as follows:

- Requirement to file a tax return and pay taxes.
- Shorter carry-forward or carry-back periods for items such as non-capital losses, donations and investment tax credits.
- Pro-ration of capital cost allowance deductions.
- Income inclusion of unpaid amounts: subsection 78(1).
- Deduction denial for unpaid bonus: subsection 78(4).
- Income inclusion as a result of shareholder loans: subsection 15(2) and (2.6).
- Recognition of reserves on inventory profit and capital gains.
- Inventory write-down: subsection 10(1).
- Contributions to plans such as RPPs, EPSPs, DPSPs.
- Shorter time to acquire replacement properties: subsections 13(4), 14(6) and 44(1).

Where a purchaser acquires control of a target corporation and amalgamates with the target on the same day, there is the potential for the target to have two separate year-ends (and consequently, two short taxation years). The reason is that the ITA deems the target to realize a year-end immediately before the amalgamation but does not specify the time of day that an amalgamation occurs. Accordingly, there is some uncertainty, as a matter of law, as to whether the year-end resulting from the amalgamation occurs at a different time (and therefore is in addition to) the year-end resulting from the acquisition of control.[87] The CRA has resolved this uncertainty by taking the position that an amalgamation occurs at the earliest moment of the date shown on the certificate of amalgamation, unless the certificate states a

particular time.[88] Accordingly, provided the taxpayer does not make the 256(9) election discussed above, the CRA's view is that the time of the amalgamation should coincide with the time of the acquisition of control such that only one year-end will arise.

D. Other Consequences of an Acquisition of Control

Many of the significant tax consequences that arise from an acquisition of control are provided for in section 111. The consequences of an acquisition of control, other than those provided for in section 111 and subsection 249(4), discussed above, include the following:

- Limitation on unused surtax credits: subsection 181.1(7).
- Loss of capital dividend account on a non-resident controlled private corporation becoming a CCPC: subsection 89(1.1).
- Restrictions on the use of investment tax credits: subsections 127(9.1) and (9.2)
- Reduction in SR&ED expenses: subsection 37(6.1).
- Restriction on resource expenses: subsection 66.7(10).

E. Use of Losses

A corporation's non-capital losses can generally be carried back three taxation years and forward twenty taxation years pursuant to paragraph 111(1)(a).[89] Non-capital losses may be applied against capital gains and other sources of income of the corporation. The ITA contains an ordering rule in paragraph 111(3)(b) such that non-capital losses remaining from the oldest taxation year must be applied first (i.e. a first incurred, first used basis).

A corporation's net capital losses may be carried back three taxation years and forward indefinitely pursuant to paragraph 111(1)(b). These losses may be applied only against capital gains of the corporation. As with non-capital losses, net capital losses must be used in the order they were incurred.

There are rules that significantly limit a corporation's ability to use its non-capital and net-capital losses following an acquisition of control.

Paragraphs 111(4)(a) and (b) provide that capital losses incurred in taxation years ending before the acquisition of control cannot be carried forward and deducted against capital gains realized in years ending after the acquisition of control and that capital losses incurred in taxation years ending after the acquisition of control cannot be carried back and applied in a taxation year that occurred prior to the acquisition of control. In other words, pre-acquisition of control capital losses are lost and post-acquisition of control capital losses can only be applied against post-acquisition capital gains.

As is the case with capital losses, non-capital losses derived from property expire on an acquisition of control.

Pre-acquisition of control non-capital losses from a business may be carried forward to taxation years ending after the acquisition of control and deducted in computing taxable income if that same business is carried on by the corporation for profit or with a reasonable expectation of profit throughout a particular year and then only to the extent of the corporation's income from that business. In addition, if the "old" business was one in which properties were sold, leased, rented or developed or services were rendered in the course of carrying on that business, then the old non-capital losses from that business may be applied against the income of a "new" business where substantially all the income of it is derived from the sale, leasing, rental or development of similar properties or the rendering of similar services as the old business.

The post-acquisition non-capital losses from a business can be carried back and applied against income from a pre-acquisition business if the criteria mentioned in the preceding paragraph for the carrying forward of non-capital losses are satisfied.

F. Non-Depreciable Capital Property

If the adjusted cost base of a corporation's non-depreciable capital property exceeds its fair market value immediately before the acquisition of control, the excess is deducted from the adjusted cost base and treated as a capital loss in the year ending with the acquisition of control.[90] As a result, the accrued capital loss in such properties is crystallized and cannot be realized after the acquisition of control and deducted against capital gains realized in the post-acquisition period.

If the target corporation owns a capital property that has an accrued gain, the corporation may make a designation which deems such non-depreciable capital property to be disposed of for proceeds equal to the lesser of (i) the fair market value of the property, and (ii) the adjusted cost base of the property, or such greater amount as is designated in respect of the property.[91] Generally, such a designation would only be made to trigger a gain if it could be sheltered with net capital losses that would otherwise cease to be available for carryforward. The property that is the subject of the designation is deemed to be reacquired for an amount equal to the deemed proceeds. As a result, the adjusted cost base of such property can potentially be increased to its fair market value at the time of the acquisition of control.

G. Depreciable Property

If the target corporation owns depreciable property, any accrued losses will be converted into non-capital losses of a taxation year ending prior to the acquisition of control. In such circumstances, the corporation is required to deduct in computing its pre-acquisition of control income the excess of the undepreciated capital cost of the class over the aggregate of the fair market value of all of the property of the class and the amount of the capital cost allowance otherwise allowed or terminal loss otherwise deductible in computing the corporation's income in respect of that class in the taxation year ending on the acquisition of control.[92] The amount deducted is deemed to have been allowed as capital cost allowance. As a result, the limitations on the deduction of such amounts following the acquisition of control are applicable.

If the target corporation owns depreciable property of a prescribed class in respect of which there is no inherent loss, an election can be made under paragraph 111(4)(e) deeming property to have been disposed of for an amount not exceeding its fair market value. Generally, a corporation would make this election if it anticipated that the pre-acquisition of control non-capital losses would expire before they could be utilized. The effect of the election is to convert such losses into future capital cost allowance claims.

H. Eligible Capital Property

Where control of a corporation has been acquired, there must be claimed as a deduction in computing income in the taxation year ending on the acquisition of control the amount, if any, by which the corporation's cumulative eligible capital exceeds the aggregate of 75% of the fair market value of its eligible capital property and the amount otherwise deducted under paragraph 20(1)(b) in computing income for the taxation year deemed to end immediately before the acquisition of control.[93] The amount of any loss resulting therefrom will then be subject to the loss streaming rules applicable on an acquisition of control.

I. Doubtful Debts and Bad Debts

On an acquisition of control, no amount may be deducted as a doubtful debt in computing the corporation's income for the taxation year ending immediately prior to the acquisition of control. Rather, the maximum amount that would be deductible in that year as a doubtful debt is deemed to be a separate debt that became a bad debt and must be deducted under paragraph 20(1)(p).[94] Any loss arising as a consequence of such a deduction would be subject to the loss streaming rules applicable on an acquisition of control.

J. Foreign Currency Losses

As a result of recently enacted amendments to the ITA, capital gains and losses resulting from foreign currency fluctuations on a corporation's debt liabilities, which previously had not been subject to the change of control rules in the ITA, have now been brought into the regime. The new rules, which are found in subsections 111(8) and 111(12), extend the general treatment of accrued capital gains and losses on an acquisition of control of a corporation to also apply to a corporation's accrued capital gains and capital losses resulting from foreign currency fluctuations on debt liabilities denominated in a foreign currency.[95]

Non-Resident Issues

A. Non-Resident Vendor

If the vendor is a non-resident of Canada, special tax issues arise. Subject to the provisions of any applicable income tax convention, when a non-resident disposes of "taxable Canadian property", any capital gain arising therefrom will be subject to tax in Canada under the ITA.[96]

Recently announced proposed changes to the definition of "taxable Canadian property" significantly narrow the circumstances in which shares will be caught by the definition.[97] If enacted, the changes will be effective for determinations made after March 4, 2010.

Assuming the proposed amendments are enacted as proposed, "taxable Canadian property" will include:

(i) a share of the capital stock of a corporation that is not listed on a designated stock exchange if, at any time in the prior 60 month period, more than 50% of the fair market value of the share was derived, directly or indirectly, from real or immovable property situated in Canada, Canadian resource properties or timber resource properties (including options in respect of or interests in such properties); and

(ii) a share of the capital stock of a corporation that is listed on a designated stock exchange, if at any time in the prior 60 month period, the shareholder (together with any persons not dealing at arm's length with the shareholder) owned 25% or more of the issued shares of any class of the corporation, and more than 50% of the fair market value of the share was derived directly or indirectly from properties described in (i) above.[98]

Accordingly, a non-resident vendor should only be subject to Canadian federal income tax on a capital gain resulting from a disposition of shares where those shares derive, or have derived, at some point in the prior 60 months, their value principally from real or immovable property situated in Canada, Canadian resource property or timber resource property. This is significant since, prior to the proposed amendments, shares would often constitute "taxable Canadian property", even though the gains realized on their disposition would generally be exempt from Canadian federal income tax under many of Canada's tax treaties.[99] As a result of the changes to the definition, a non-resident vendor that does not qualify for treaty benefits will generally no longer be liable for Canadian federal income tax on a disposition of shares unless in the 60 month period ending at the time of the disposition more than 50% of their value has been derived from real property situated in Canada. In addition, all non-resident vendors should often be able to avoid the reporting/withholding tax obligations in section 116 (discussed below) in respect of share dispositions.

Although the proposed amendments to the definition of taxable Canadian property discussed above greatly reduce the number of situations in which non-resident vendors will require treaty relief, there will continue to be circumstances in which treaty relief will be sought. For instance, where a non-resident disposes of shares that constitute taxable Canadian property because the shares derived their value from real property at some point in the 60 month period prior to the disposition (but not at the actual time of the disposition), treaty relief may still be relevant since the relevant exemption in Canada's tax treaties generally only looks to whether the shares derive their value primarily from real property situated in Canada at the time of the disposition. Treaty relief may also be relevant where a taxpayer disposes of shares within 60 months of acquiring those shares on a transfer of taxable Canadian property to which section 85 or 85.1 applied. Pursuant to proposed amendments to sections 85 and 85.1, shares acquired on such a rollover will be deemed to be taxable Canadian property for a period of 60 months following their acquisition.[100] Although a

subsequent disposition of those shares within that 60 month period will be considered to be a disposition of taxable Canadian property, treaty relief may be available if the shares do not derive their value principally from real property at the time of such disposition.[101]

Fifth Protocol to the Canada - U.S. Tax Treaty

On December 15, 2008, the fifth protocol (the "Protocol") to the *Canada U.S. Tax Convention (1980)* (the "Treaty") came into force upon the exchange of instruments of ratification. The Protocol amended the Treaty in a number of ways that are potentially relevant on the disposition of shares of a Canadian corporation.

Historically, the CRA had denied treaty benefits to U.S. LLCs (other than those which elected to be taxed as corporations for U.S. tax purposes) on the grounds that they were not liable to tax in the U.S. and thus were not residents of the U.S. pursuant to paragraph 1 of Article IV of the Treaty.[102] In addition, since U.S. LLCs are characterized as corporations for Canadian tax purposes, the CRA had not been prepared to "look-through" a U.S. LLC and provide treaty benefits to members that were residents of the U.S. for purposes of the Treaty.[103] This problem is addressed in new paragraph 6 to Article IV of the Treaty. It generally provides that an amount of income, profit or gain will be considered to be "derived by" a person who is a resident of the U.S. where:

(a) the person is considered under the taxation law of the U.S. to have derived an amount through an entity (other than an entity that is resident in Canada); and

(b) by reason of the entity being treated as fiscally transparent under the laws of the U.S., the treatment of the amount under the taxation law of the U.S. is the same as its treatment would be if that amount had been derived directly by that person.

Another significant change introduced by the Protocol is the extension of Article XXIX-A to U.S. residents claiming the benefits of the Treaty provided by Canada. Under new Article XXIX-A, a resident of the U.S. claiming treaty benefits now has to be a "qualifying person" and meet certain tests establishing the person's nexus to the U.S. If the person fails to meet the tests and would otherwise be denied treaty benefits, the Canadian competent authority (the CRA) is required, upon that person's request, to determine on the basis of all factors (including history, structure, ownership and operations) whether the person's creation and existence did not have as a principal purpose the obtaining of benefits under the Treaty that would not otherwise be available, or it would not be appropriate, having regard to the purpose of Article XXIX-A, to deny the person benefits under the Treaty.

Section 116 Liability

Section 116 of the ITA contains measures intended to protect Canada's ability to collect taxes on a non-resident's disposition of "taxable Canadian property". Unless (i) the purchaser has no reason to believe, after making reasonable enquiries, that the vendor is not a non-resident of Canada, (ii) the purchaser concludes after reasonable inquiry that the non-resident person is resident in a country with which Canada has a tax treaty, the property

disposed of would be "treaty protected property" if the non-resident were resident in such country, and the purchaser provides the CRA with a required notice, or (iii) the purchaser is provided with a certificate (a "Section 116 Certificate") in respect of the disposition issued by the CRA, the purchaser will be liable to pay, as tax on behalf of the non-resident, an amount equal to 25% of the purchase price of non-listed shares of a corporation that constitute taxable Canadian property. Where application is made for a Section 116 Certificate and an exemption from Canadian tax on the gain is available under a treaty, the form of security generally acceptable to the Minister prior to issuing the certificate is a written statement claiming the applicable treaty exemption and an undertaking to pay Canadian taxes in the event it is ultimately determined that taxes are due.

Where a purchaser requires a non-resident vendor to provide a Section 116 Certificate and the vendor is not able to provide the certificate on closing, the purchaser will generally withhold 25% of the purchase price from the vendor. The payment must be remitted by the 30th day of the month following the month of acquisition.[104] As a practical matter, if it appears that the vendor has a reasonable likelihood of obtaining a certificate before the 30th day of the month following the month in which the disposition will occur, the purchaser and vendor may agree that the vendor can withhold on closing and the withheld amount will be held in escrow. The escrowed amount either will be released to the vendor or remitted to the Receiver General depending on whether a certificate is obtained by the 30th day of the month following the month of the disposition.[105]

Tax Return Requirement

In addition to having to comply with the section 116 procedure described above, a non-resident who disposes of taxable Canadian property is generally required to file a Canadian tax return reporting the disposition. However, pursuant to recent amendments to the ITA (which apply to dispositions beginning in 2009) a non-resident is not required to file a Canadian tax return if the disposition of the taxable Canadian property is an "excluded disposition."[106]

A disposition of property will be an excluded disposition of a taxpayer where:

(a) the taxpayer is a non-resident at that time;

(b) no tax is payable under Part I of the ITA by the taxpayer for the taxation year;

(c) the taxpayer is, at that time, not liable to pay any amount under the ITA in respect of any previous taxation year (other than an amount for which the Minister has accepted, and holds, adequate security under Section 116 or 220); and

(d) each taxable Canadian property disposed of by the taxpayer in the taxation year is:

(i) excluded property within the meaning assigned by subsection 116(6); or[107]

(ii) a property in respect of the disposition of which the Minister has issued a section 116 clearance certificate to the taxpayer.

Restrictive Covenants

Former Bill C-10, if reintroduced and enacted, will add new paragraph 212(1)(i) to the ITA. Paragraph 212(1)(i) will impose Part XIII tax on an amount paid by a resident of Canada to a non-resident in respect of a restrictive covenant to which paragraph 56(1)(m) or subsection 56.4(2) applies.[108]

Former Bill C-10 also includes amendments that will impose Part XIII tax on certain amounts paid between non-residents of Canada in respect of restrictive covenants. Pursuant to proposed paragraph 212(13)(g), where an amount is paid between non-residents in respect of a restrictive covenant to which paragraph 56(1)(m) or subsection 56.4(2) applies, and the amount affects, or is intended to affect, in any way whatever

(i) the acquisition of property or provision of services in Canada,

(ii) the acquisition of property or provision of services outside of Canada by a resident of Canada, or

(iii) the acquisition or provision outside Canada of taxable Canadian property,

the non-resident payer will be deemed to be a resident of Canada for purposes of Part XIII withholding tax.

B. Non-Resident Purchaser

Canadian Acquisition Vehicle

A non-resident may acquire shares of a Canadian corporation directly, but usually the acquisition will be made through a Canadian subsidiary that may be incorporated solely for the purpose of making the acquisition. The main advantages of using a Canadian acquisition company have been summarized as follows[109]:

(i) the ability to return paid-up capital to a shareholder without the distribution being treated as a distribution of income or contributed surplus for Canadian tax purposes;

(ii) the opportunity to step up the tax cost of eligible non-depreciable capital property upon the winding-up of a wholly-owned subsidiary; and

(iii) the possibility of maximizing the amount of interest expense on acquisition debt that can be matched against income from the acquired business.

Generally, the stated capital and tax paid-up capital of the target shares will be significantly lower than the purchase price. If the non-resident purchaser acquired those shares directly, the adjusted cost base of the shares to the non-resident would be equal to the purchase price but the paid-up capital of those shares would remain unchanged. If the non-resident wanted to subsequently return (i.e. repatriate) the original value of its investment (i.e. the purchase price) the excess of the amount repatriated over the paid-up capital would be considered a payment of a dividend and subject to withholding tax.[110]

If the non-resident acquires the target corporation shares through a Canadian holding company ("Canco"), the entire purchase price may be repatriated free of Canadian tax. The non-resident could incorporate Canco and subscribe for shares with a subscription amount equal to the purchase price of the target shares. Canco would then use the subscription proceeds to purchase the target shares. The adjusted cost base and paid-up capital of the Canco shares would be equal to the purchase price of the target corporation's shares. As the target earns profits, inter-corporate dividends could be paid tax free to Canco which could pay these amounts to the non-resident on capital reductions without attracting withholding tax.

There may be other tax benefits to using Canco to acquire the target shares. For example, Canco may be able to deduct more interest on debt issued to its non-resident parent. Under the thin capitalization rules, there are limits on the amount of interest that may be deducted on debt owing to persons who are "specified non-residents" in relation to the debtor corporation.[111] In general terms, if the amount of "outstanding debts to specified non-residents" exceeds two times the "equity" of a Canadian subsidiary, a pro-rated portion of the interest paid or payable in the year to such non-residents would not be deductible in computing the income of the subsidiary.[112] For every dollar of increased paid-up capital obtained through the use of Canco, two dollars of additional debt capacity is created on which interest may be deducted.

Another potential advantage of using Canco is the ability to maximize the benefit of the interest expense deduction on debt used to acquire the shares of the target. If the non-resident acquired the target shares directly through debt financing, the interest expense could not be directly matched against the target's income. If instead, Canco incurred the acquisition debt and subsequently merged with the target, the interest expense would be deductible against the operating income of the merged corporation.[113] Historically, one disadvantage of merging Canco with its high paid-up capital and the target with its low paid up capital was the potential for an increased liability for Ontario capital tax. As discussed above, Ontario capital tax will be eliminated on July 1, 2010.

Hybrid Canadian Acquisition Vehicle

Historically, additional tax advantages could be obtained by using a Canadian acquisition vehicle that was incorporated as an unlimited liability company under the laws of Alberta, British Columbia or Nova Scotia.[114] Such entities are corporations for Canadian tax purposes, but generally may elect to qualify as a partnership or a branch for U.S. tax purposes. This offered the ability to flow Canadian losses to a profitable United States

parent corporation, thereby maximize cross-border usage of losses of a Canadian corporation.

However, the Protocol introduced a new set of rules in the residency article of the Treaty designed to deny treaty benefits to certain hybrid entities commonly used in cross-border transactions between the two countries. Under new Article IV(7)(b), an amount of income, profit or gain will not be considered to be paid to or derived by a person who is a resident of a Contracting State (the "Residency State") where:

> (a) the person is considered under the taxation law of the "Source State" to have received the amount from an entity that is a resident of the Source State; and
>
> (b) by reason of the entity being treated as fiscally transparent under the laws of the Residency State, the treatment of the amount under the taxation law of the Residency State is not the same as its treatment would be if that entity were not treated as fiscally transparent under the laws of the Residency State.

One implication of this rule appears to be that dividends, interest and royalties paid by a Canadian resident unlimited liability company to its parent U.S. shareholder will not qualify for reduced withholding tax under the Treaty. As a result, an unlimited liability company in Canada that is treated as a disregarded entity for U.S. tax purposes may no longer be a viable acquisition structure without additional structuring.[115]

Surplus Stripping

Section 212.1 is an anti-avoidance rule designed to prevent the removal of the surplus of a Canadian corporation by a non-resident shareholder. In general, section 212.1 applies where the non-resident seeks to convert surplus, which would otherwise be subject to withholding tax on distribution to the non-resident, into proceeds from the disposition of shares of the corporation which may be exempt from Canadian tax under a treaty. This provision is analogous to section 84.1, which applies to resident individuals.

Where a non-resident person or designated partnership ("non-resident") disposes of shares of a corporation resident in Canada ("subject corporation") to another corporation resident in Canada ("purchaser corporation") with which the non-resident does not deal at arm's length, and immediately after the disposition the purchaser corporation controls the subject corporation or owns shares in the subject corporation representing more than 10% of the votes and value attached to all of the subject corporation's shares, subsection 212.1(1) provides that:

> (i) the amount by which the non-share consideration received by the non-resident from the purchaser corporation exceeds the paid-up capital of the disposed shares is a dividend deemed to be paid by the purchaser corporation and received by the non-resident; and

(ii) any increase in the paid-up capital of the shares of the purchaser corporation by virtue of the disposition will be reduced by the amount, if any, by which the paid-up capital of the shares of the subject corporation immediately before the disposition exceeds the fair market value of any non-share consideration.[116]

PART TWO: TAX ISSUES IN DOCUMENTATION[117]

General Comments

The tax lawyer's due diligence responsibilities involve reviewing the target corporation's tax position and advising on the provisions in the agreement of purchase and sale that allocate the tax risks between the parties.

It is necessary to include in the share purchase agreement clauses that address the tax position of the target, since even the most thorough review of financial information and tax returns of the target corporation will not provide certainty with respect to the target company's tax history and current position. Tax clauses will generally be found throughout the agreement including the definitions, the covenants, the representations and warranties, and the indemnifications. Generally, the tax clauses will identify which party is responsible for which taxes, during what period(s) the party has this responsibility, what happens if something goes wrong and for how long one party can look to the other for indemnification.

There will be some tension between the vendor and purchaser over the scope of the tax provisions in the agreement. In general, the purchaser will be responsible for taxes post-closing and the vendor will be responsible for pre-closing tax liabilities. The tension will result, in part, from the purchaser's desire to inflate the pre-closing tax liability and the vendor's opposing desire to reduce the pre-closing tax liability that will defer taxes until post-closing. For example, the vendor will want to claim the maximum amount of reserves in the target corporation's return for the taxation year ending immediately before the acquisition of control. Another source of tension may be the desire on the part of the purchaser to take a more aggressive tax filing position commencing with the final pre-closing return. The vendor will generally resist such aggressive positions since, if reassessed negatively, the vendor will be liable for the taxes and interest unless the parties agree that the purchaser will ultimately bear such costs. These tensions are best resolved in advance by well thought out tax clauses.

Tax clauses are generally for the benefit of the purchaser since its main concern is that the target corporation may have hidden tax liabilities, whereas the vendor is primarily concerned that it will receive the purchase price. In certain circumstances, however, tax clauses in favour of the vendor will be appropriate. For instance, as mentioned above, if a vendor has arranged for the payment of safe income dividends, the agreement should prevent the purchaser from taking steps after closing which have the effect of reducing that safe income. In some cases, the vendor will require the purchaser to pay, as an addition to the purchase price, refunds of taxes that are in respect of periods prior to closing.

Definitions

The definitions section of the agreement should define the term "tax" in a clear and broad manner to cover all types of taxes paid to various levels of government, including interest and penalties with respect to such taxes. The term "tax return" should also be broadly defined in the agreement to encompass all forms and elections. There may also be definitions for assessments, penalties, fines, tax legislation, taxing authority etc.

Covenants

The main covenant of the purchaser is to pay the purchase price. The purchase price is often subject to adjustment that may be in the form of an earn-out and may vary depending on certain financial information as of a particular date.

There will be a covenant requiring the vendor or the purchaser to prepare and file the returns for the taxation year ending as a result of the acquisition of control. Pursuant to section 236 of the ITA, the tax return must be signed by "the President, Secretary or Treasurer of the corporation or by any other officer or person thereunto duly authorized by the Board of Directors or other governing body of the corporation."[118] Assuming this is a mandatory as opposed to directory requirement, if the vendor is responsible for the filing, including the signing of the return, then the new board of directors of the target corporation elected by the purchaser must duly authorize the signatory.

The parties will usually agree that the pre-acquisition return is to be filed in a manner consistent with prior tax returns filed by the corporation. The vendor will covenant to pay within the prescribed time all taxes owing from the return and any assessments. The party that is not responsible for preparing the return will likely want the opportunity to review and comment on the return prior to its filing. The agreement should specify a procedure for resolving any disputes with respect to such returns.

There may also be covenants to file various tax designations or elections either in respect of any pre-closing reorganizations or in relation to the disposition of the shares. The former category would include elections under section 85 where assets were transferred to a subsidiary of the target pre-closing. Elections in the latter category would include any applicable section 56.4 election.

Representations and Warranties

The representations and warranties made by the vendor are statements that confirm specific facts. If a statement is false, then in the case of a representation the purchaser can sue for damages but may not rescind the agreement, whereas in the case of a false warranty the purchaser can claim damages and may be able to rescind the agreement if the warranty is a fundamental term.

The vendor will make representations that all tax returns have been filed in prescribed form and in prescribed manner, that they are correct in all material respects and that all taxes owing from such returns and assessments have been paid. There may be an undertaking given by the vendor to obtain confirmation or certificates from various government

authorities confirming the status of the tax accounts.[119] There may be other general representations regarding transfer pricing obligations, withholding taxes, compliance with GST and sales tax matters and that all relevant returns have been provided to the purchaser. The foregoing is usually contained in an omnibus tax clause.

There may be representations by the vendor concerning specific tax balances that are not contained in the tax returns, such as the paid-up capital of the shares and the adjusted cost base of certain assets. The vendor will also represent, if applicable, that it is not a non-resident of Canada in order to relieve the purchaser from any liability imposed by section 116 of the ITA.

If the target corporation acquired property from a non-arm's length party for less than fair market value consideration and the non-arm's length party owed income tax for the year of the transfer or a previous year, then pursuant to section 160 the target corporation will be jointly and severally liable to pay the tax owing to the extent that it paid less than fair market value for the property. A similar provision applies for GST under the *Excise Tax Act* (Canada). Accordingly, the purchaser may request a representation and warranty to specifically protect it against this liability, although the general tax clause may be broad enough to cover such a reassessment.

The purchaser will want the representations and warranties given by the vendor to survive closing otherwise the purchaser will not be able to claim damages except in the case of fraud. The vendor may negotiate to limit this survival period, although generally the representations and warranties will survive for so long as a taxing authority is able to assess taxes.

If the purchaser successfully sues the vendor for a breach of warranty or representation, then the payment by the vendor will reduce the purchaser's adjusted cost base of the shares of target corporation. If the payment is paid or becomes payable on or before the vendor's filing-due date for the taxation year in which the disposition occurs, the vendor will be required to deduct the payment in computing its proceeds of disposition. If the payment is paid or becomes payable after the filing-due date, the vendor is deemed to suffer a capital loss on the payment.[120]

Indemnities

An indemnity clause permits one party to claim damages for the breach of a term of the agreement. It creates a separate debt and unlike the case of a breach of a representation or warranty, the aggrieved party usually does not have to prove damages but only that a breach is covered by the indemnity.

The agreement will generally provide that indemnified amount includes any taxes that may be payable by the purchaser upon receiving the payment. As well the indemnity clause will generally provide that vendor will obtain the benefit, through a reduction in the indemnity amount paid, of any tax savings realized by the purchaser in connection with the event giving rise to the indemnity claim. There is also usually a limitation period for claiming the indemnity that coincides with the reassessment period. Finally, there may also be a floor and

ceiling to the amount covered by the indemnity and certain matters may be excluded from coverage.

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[1] The authors would like to thank Mitchell Thaw of Fasken Martineau DuMoulin LLP and Jason Vincze of GE Canada for their contributions to earlier versions of this paper.

[2] For a discussion of the tax aspects to consider when determining whether to structure a transaction as a sale of shares or a sale of assets, see Edwin Kroft, "Some Tax Aspects of Buying or Selling Assets or Shares," in *Income Tax and GST Planning for the Purchase, Sale and Canada-US Expansion of a Business*, 1996 Corporate Management Tax Conference (Toronto: Canadian Tax Foundation, 1997) 1:1 and the articles cited in footnote two of that article.

[3] These obligations arise under section 116. See Douglas S. Ewens, "When is a Disposition" in *Report of Proceedings of the Twenty-Sixth Tax Conference*, 1974 Conference Report (Toronto: Canadian Tax Foundation, 1975) 515 for a more detailed discussion of the importance of the timing of a disposition.

[4] RSC 1985, c.1 (5th Supp). Except as otherwise noted, all section references in this paper are to the ITA, as amended.

[5] Definition of "proceeds of disposition" in section 54.

[6] Paragraph (e) of the definition of "disposition" in subsection 248(1).

[7] See Ewens, *supra* at note 3 at 517.

[8] *Hewlett Packard (Canada) Ltd.* v. *R.*, 2004 DTC 6498 (F.C.A.). See also *La Survivance* v. *the Queen*, 2007 DTC 5096 (F.C.A.) where the Federal Court of Appeal affirmed that this principle applied to a sale of shares. In *La Survivance*, the governing private law was the Civil Code of Quebec.

[9] See Ewens, *supra* at note 3 at 536. See also *Estate of Nicholas Stefanyk* v. *Minister of National Revenue*, 67 DTC 570 (T.A.B.) and *Ross Cultura* v. *Minister of National Revenue*, 80 DTC 1623 (T.R.B.). With respect to stock exchange transactions, the Canada Revenue Agency ("CRA") has stated in Interpretation Bulletin IT-133 that for the usual transactions on a Stock Exchange there is a disposition and acquisition of shares traded on a Stock Exchange, by the vendor and purchaser, respectively, on the settlement date which is the time designated by the Stock Exchange, usually two or three days subsequent to the trade date, on or before which the vendor is required to deliver the share certificates and the purchaser is required to make payment therefor.

[10] *Turnery* v. *Zhilka*, [1959] SCR 578.

[11] This principle is illustrated in a number of cases. See, for example, *Dr. Arthur W. Nauss, Doris B. Nauss* v. *M.N.R.*, 78 DTC 1796 (T.R.B.). This is also consistent with the decision of *La Survivance, supra* at note 8, where the Federal Court of Appeal held that there was no disposition of shares until all of the steps laid out in a public offering had been realized, which included payment.

[12] See for example CRA document no. 1999-0006705 (November 23, 2000).

[13] The CRA has stated that the documents relating to a future purchase and sale of shares will result in the application of paragraph 251(5)(b) if the documents establish that the purchaser has either an absolute or contingent right, immediately or in the future, to acquire the shares. A conclusion as to whether such a right exists can only be made after a complete examination of all the provisions of a particular document, letter or agreement. See: CRA document no. 9812255 (September 17, 1998).

[14] A business investment loss will result on a sale if the shares are disposed of at a loss to an arm's length person and they are shares in the capital stock of a small business corporation at the time or within the 12 months preceding that time: paragraph 39(1)(c) and 248(1) "small business corporation."

[15] The election is provided in subsection 39(4). Subsection 39(5) provides that the election does not apply to a disposition of a Canadian security owned by "a trader or dealer in securities", a financial institution,

a non-resident or a corporation whose principal business is the lending of money or the purchasing of debt obligations. For "trader or dealer" cases, see *Kane v. Canada*, [1995] 1 CTC 1 (F.C.T.D.) and *Vancouver Art Metal Works Ltd. v. Canada*, [1993] 1 CTC 346 (F.C.A.).

[16] For the CRA's views on what constitutes a separate business see Interpretation Bulletin IT-206R. For a brief summary of the leading cases and factors used to identify whether an operation constitutes a separate business, see Norman Loveland and Jack Silverson, "The Purchase and Sale of Shares: Preserving Tax Basis," in *Income Tax and GST Planning for the Purchase, Sale and Canada-US Expansion of a Business*, 1996 Corporate Management Tax Conference (Toronto: Canadian Tax Foundation, 1997) at pp. 2:15 - 2:18.

[17] 2001 DTC 5269 (F.C.A.).

[18] Subsections 82(1), 112(1) and 186(1).

[19] For example, if a company with shares with a fair market value of $100 pays a dividend of $10, then the fair market value of the shares should be reduced to $90 and a purchaser should only be willing to pay $90 for the shares.

[20] The definition is contained in subsection 55(1).

[21] For a discussion of cases and views on safe income and subsection 55(2) see Osborne, D. "Practical Issues in Computing Safe Income" in *Report of Proceedings at the Fifty-Fourth Tax Conference*, 2002 Conference Report (Toronto: Canadian Tax Foundation, 2003) 41:1 and Ruby, S. "Some Judicial and Administrative Views of Safe Income" presented at 14th Annual Senior Practitioners' Institute**,** October 19, 2000.

[22] Canadian courts have affirmed certain components of the concept of "safe income on hand" in *Deuce Holdings Ltd.* v. *R.*, 97 DTC 921 (T.C.C.), *Gestion Jean-Paul Champage Inc* v. *Minister of National Revenue*, 97 DTC 155 (T.C.C.) and *Kruco, infra* at note 23. In particular, the courts have held that it is appropriate to reduce safe income by taxes, dividends and non-deductible debt.

[23] 2003 DTC 5506 (F.C.A.). Two other significant decisions are *VIH Logging* v. *The Queen*, 2005 DTC 5095 (F.C.A.) and *729658 Alberta Ltd.* v. *R.*, 2004 D.T.C. 2909 (T.C.C.). In *VIH Logging*, the Federal Court of Appeal confirmed the CRA's longstanding administrative position that "stub period" income (that is, income for the short taxation years existing at the beginning and end of the holding period of a share) should be included in computing a taxpayer's safe income. In *729658*, the Tax Court of Canada rejected the CRA's longstanding administrative position that, where an accrued gain is partly realized on a partial rollover made pursuant to subsection 85(1) of the ITA, safe income must necessarily flow through on a *pro-rated* basis to the same extent that the accrued gain flows through.

[24] See paragraph 55(5)(b).

[25] See Income Tax Technical News No. 37 (February 15, 2008).

[26] The Court in *The Queen v. Nassau Walnut Investments*, 97 DTC 5051 (F.C.A.), permitted a late designation under paragraph 55(5)(f).

[27] At one time, there was a concern that double tax could result if safe income was extracted through an increase in the stated capital of a share. If the amount of the capital increase was not covered by safe income, such that subsection 55(2) deemed the amount to be a capital gain and not a dividend, the adjusted cost base of the share would not be increased under paragraph 53(1)(b) since this paragraph only provides for the step-up in the adjusted cost base when there is a deemed dividend. Therefore, *prima facie* the same amount could be realized as a capital gain a second time when the share was sold. However, it is now accepted that subsection 248(28) may be relied upon to avoid the double tax problem. In an advance income tax ruling (CRA document no. 9727743) the CRA ruled that to the extent that subsection 55(2) applied to a particular deemed dividend arising on the increase in the stated capital of a share such that the deemed dividend was deemed not to be a dividend, neither paragraph 55(2)(b) or (c) would be applied to the deemed dividend. If a dividend is actually paid the potential problem is not present. If an actual dividend is paid and it is recharacterized as a capital gain or as proceeds of disposition under subsection 55(2) because of insufficient safe income, the value of the company will nevertheless have been reduced by the payment of the dividend. Therefore, a further gain will

not be realized on the disposition of the share. Further, if the dividends were re-contributed as capital to the target corporation, the adjusted cost base of the shares would be bumped under paragraph 53(1)(c) and a further gain would not be realized on the sale of the share.

[28] Subsection 84(1). Stated capital is the corporate law term. Subject to the adjustments provided for in the ITA, paid-up capital will be equal to stated capital. The increase in stated capital and, therefore, paid-up capital will not result in a deemed dividend if the increase results from one of the exceptions enumerated in paragraphs 84(1)(a) to (c.3).

[29] Former Bill C-10 was before Canada's 39th Parliament. The proposed amendments in former Bill C-10 require reintroduction, given that the 39th Parliament was dissolved prematurely on September 7, 2008.

[30] Generally, the amount of a stock dividend is equal to the increase in the paid-up capital of the corporation arising as a result of the stock dividend. See the definition of "amount" in subsection 248(1).

[31] See J. Colden and S. Bhatia "November Technical Amendments Affect Safe Income Strips" (2007) Vol.17 No.4 *Canadian Current Tax*.

[32] Other possibilities exist. See M. Atlas "Beware of Pitfalls in November 9, 2006 Technical Amendments when Crystallizing "Safe Income" *Tax Topics* no. 1820 (Toronto: CCH Canadian, January 25, 2007).

[33] As part of its election platform, the Conservative Party indicated on October 7, 2008 that, if re-elected, it would index the lifetime capital gains exemption to inflation. The Conservative Party was re-elected, forming a minority government.

[34] Subsection 212(2) provides that non-resident shareholders are subject to withholding tax on dividends that are taxable dividends or capital dividends.

If a corporation makes a capital dividend election in respect of a dividend that is greater than the balance of its capital dividend account immediately before that time, the dividend will be deemed to be a capital dividend only to the extent of the corporation's capital dividend account, but the entire amount of the dividend will still be excluded from the income of the shareholders (paragraphs 83(2)(a) and (b)). In such circumstances, however, a penalty tax will be payable by the corporation to the extent that the amount of the dividend exceeds its capital dividend account, unless a separate election is made by the corporation to treat the excess amount as a separate taxable dividend (Subsections 184(2) and (3)). Former Bill C-10, which as indicated in note 29 above requires reintroduction, will, if reintroduced and enacted, decrease the penalty tax for dividends paid by a corporation after its 1999 taxation year from 75% to 60%.

[35] Subsection 111(4).

[36] The deemed dividend should not be subject to tax since it will be included in computing the recipient's income but deducted in computing taxable income: 12(1)(j) and 112(1). The dividend will not be subject to Part IV tax since the companies should be connected with each other. However, in the case of connected corporations, Part IV tax may be payable by the recipient to the extent a refund of RDTOH is received by the payor as a result of the deemed dividend: 186(4) and 186(2). There will be no capital gain on the disposition of the shares since the proceeds of disposition would be reduced by the amount deemed to be a dividend pursuant to subsection 84(3): "proceeds of disposition" section 54. The dividend should not be recharacterized as a capital gain pursuant to subsection 55(2) provided that there is not as part of the series of transactions a disposition of property to an unrelated person or significant increase in any corporation by an unrelated person: 55(3)(a) – see discussion in the text. The deemed dividend that arises in respect of the preferred shares should not be subject to Part VI.1 tax since the dividend will be an "excluded dividend" due to either: (i) the substantial interest exception in subsection 191(2) i.e. the corporations are related, or (ii) the fair market value exception in subsection 191(4) i.e., the redemption amount specified in the preferred share conditions does not exceed the fair market value of the consideration received in issuing the shares.

[37] See John Tiley, "Series of Transactions" in *Report of the Proceedings of the Fortieth Tax Conference*, 1988 Conference Report (Toronto: Canadian Tax Foundation, 1989), 8:1 and Loveland and Silverman, *supra*, footnote 16, at 2:8.

[38] There are a number of Canadian cases that have considered what constitutes a series of transactions at common law, most notably *Canada Trustco*, *infra* at note 41, *OSFC*, *infra* at note 40 and *The Queen* v. *Canadian Utilities Limited et. al.* 2004 DTC 6475 (F.C.A.).

[39] In *OSFC*, *infra* at note 40, the Federal Court of Appeal confirmed that a "series of transactions" at common law requires that each transaction in the series be pre-ordained to produce a final result, and that pre-ordination in this context means that when the first transaction of the series is implemented, all essential features of the subsequent transaction or transactions are determined by persons who have the firm intention and ability to implement them. This approach was endorsed by the Supreme Court of Canada in *Canada Trustco*. It follows that where the spin-off occurs prior to identifying a potential buyer and the commencement of any sale negotiations, the essential features of the sale have not yet be determined and thus it is unlikely that the sale would be considered to form part of the same series of transactions as the spin-off under the common law test.

[40] 2001 DTC 5471 (F.C.A.).

[41] 2005 DTC 5523 (S.C.C.).

[42] 2006 TCC 460 aff'd by 2007 DTC 5437 (F.C.A.).

[43] 2009 D.T.C. 5918 (F.C.A.) aff'g 2007 DTC 1230 (T.C.C.). Leave to Appeal to the Supreme Court of Canada granted January 28, 2010.

[44] For a discussion of the "bump" rules, see Singh, M. "An Introduction to the 'Bump' Rules" in *Report of the Proceedings of the Fifty-Fifth Tax Conference*, 2003 Conference Report (Toronto: Canadian Tax Foundation, 2004), 14:1.

[45] The definition of "ineligible property" found in paragraph 88(1)(c) must be carefully reviewed to determine whether there are any transactions that would deny the bump-up in cost base. See Woods, J. and Wortsman, J., "The Bump Denial Rule in 88(1)(c)(vi)" in Report of the Proceedings of the Fiftieth Tax Conference, 1998 Conference Report, (Toronto: Canadian Tax Foundation, 1999), 14:1.

[46] The ITA also contains rules that generally decrease the amount of the bump by the amount of dividends paid on the shares of the target (or shares substituted or exchanged therefor) received by the parent corporation or by a corporation with which the parent was not dealing at arm's length: subparagraph 88(1)(d)(i.1) and subsection 88(1.7).

[47] In *Continental Bank v. The Queen*, 94 DTC 1858 (T.C.C.), affirmed, for purposes of the capital gains issue, at 96 DTC 6355 (F.C.A.) and 98 DTC 6501 (S.C.C.), depreciable leasing assets were transferred to a partnership on a rollover basis under subsection 97(2) and, shortly thereafter, the partnership interest was sold to a third party purchaser. Had the assets been sold directly to the purchaser, it appears that recaptured capital cost allowance of approximately $84 million would have been realized. In addition to assessing on the basis that the partnership was a sham and that in substance the entire series of transactions was a sale of assets, as a protective measure, the Minister assessed on the basis that the profit realized on the sale of the partnership interest was income from an adventure in the nature of trade. The Tax Court acknowledged that normally a purchase followed by an immediate resale would infer that the intention of the acquisition was to earn a profit on income account. However, once it had reviewed a number of factors which assisted in determining whether the immediate resale of the partnership interest was on income or capital account, the Tax Court concluded:

> I do not think that the traditional tests applicable in a land trading case are necessarily applicable here. Quite simply <u>this is not a case of trading in partnership interests as a speculator or trader might deal in lands or securities</u>. The shares of CBL were, in CB's hands, obviously capital assets. Accepting, as I do, the validity of the transfer [of depreciable leasing assets of CBL] to the partnership, the partnership interest was a capital asset in CBL's hands and it preserved that quality on its transfer on the winding up of CBL. The Crown's position would be that during a period of three days … during which title to the partnership interest was held by CB, it lost that quality and became trading stock. That conclusion is not, in my view, sustainable. <u>I do not think that this aspect of the corporate transaction had the indicia of a speculative trading venture</u>.

> … If the assets are not inventory in the subsidiary's or the transferor's hands they do not become inventory in the parent's or transferee's hands simply because of the rapid resale. (*emphasis added*)

The decision of the Tax Court in *Continental Bank*, regarding the capital nature of the transaction, was affirmed by both the Federal Court of Appeal and the Supreme Court of Canada.

[48] A share issued after December 15, 1987 that is a short-term preferred share at a particular time will be a taxable preferred share at that time.

[49] Former Bill C-10, which, as indicated in note 29 above requires reintroduction, will, if reintroduced and enacted, amend subparagraph 191.1(1)(a)(i) to reduce the tax rate in respect of dividends on short-term preferred shares from 66 2/3% to 50%, applicable to dividends paid by a corporations in 2003 or later.

[50] In *The Queen v. Citibank Canada*, 2002 DTC 6876 (F.C.A.), the court addressed the interpretation of the definition of "term preferred share" which may be helpful in interpreting the definitions of "taxable preferred share" and "short term preferred share." The court stated: "Thus, the definition of "term preferred share" was clearly designed to combat a particular activity prevalent among specific actors in a specific setting, that is, financing transactions between a small group of specified financial institutions as defined in subsection 248(1) and corporations which were, for a variety of reasons, unable to utilize interest deduction provisions. Accordingly, in my view, it is clear that the definition of "term preferred share" arises from a narrow and particular context and applies to a specific and sophisticated segment of taxpayers. Therefore, the Tax Court Judge was correct, in my opinion, to conclude that the legal or commercial understandings of the disputed words are the appropriate contexts in which to interpret them."

[51] The exception in subsection 191(4) may apply such that no Part VI.1 tax will be payable. For further discussion of the preferred share rules, see Downie, D. and Martin, T. "The Preferred Share Rules: An Introduction" in *Report of the Proceedings of the Fifty-Fifth Tax Conference*, 2003 Conference Report (Toronto: Canadian Tax Foundation, 2004), 15:1.

[52] As discussed below under the heading Consequences of an Acquisition of Control – Deemed Year End, an acquisition of control will result in a corporation having a taxation year-end immediately before the time of the acquisition of control.

[53] See discussion above under the heading Basic Principles – Time of Disposition.

[54] The issue was raised with the CRA at the 2007 Canadian Tax Foundation annual conference, where the CRA confirmed that subsection 249(3.1) may be triggered. See also T. Duholke "Deemed Year-End Trap" (2007) vol. 15, no. 2 *Canadian Tax Highlights*, 9.

[55] Subparagraph 40(1)(a)(ii).

[56] See *Groulx v. MNR*, 67 DTC 5284 (S.C.C.); *Vanwest Logging Co. Ltd. v. MNR*, 71 DTC 5120 (Ex. Ct.); *Rodmon Construction Inc. v. The Queen*, 75 DTC 5038 (F.C.T.D.); and *Club de Courses Saguenay Ltée & La Piste Pré Vert Inc. v. MNR*, 79 DTC 579 (T.R.B.).

[57] The "normal" earnout will provide for a minimum price plus further payments calculated according to a formula that is based on future earnings. A "reverse earnout" sets a maximum price which is subject to reduction should future earnings not attain certain levels.

[58] Interpretation Bulletin IT-426R.

[59] *Ibid*, paragraph 2.

[60] Interpretation Bulletin IT-170R (see discussion above under the heading Basic Principles – Time of Disposition).

[61] See the February 27, 2004 draft legislation.

[62] Interpretation Bulletin IT-432R2.

[63] Subsection 248(1). See also Interpretation Bulletin IT-337R4 [Consolidated].

[64] Paragraph 60(j.1).

[65] *Manrell v. R.*, 2003 DTC 5225 (F.C.A.) and *Fortino v. R.*, 2000 DTC 6060 (F.C.A.).

[66] Proposed subsection 56.4(2) is found in former Bill C-10 which, as indicated in note 29 above, requires reintroduction.

[67] For a detailed discussion of the exceptions, see C. Taylor and C. Gifford, "Restrictive Covenants, a Backgrounder", 2007 Prairie Provinces Tax Conference (*Toronto: Canadian Tax Foundation, 2007*).

[68] The exception in paragraph 56.4(3)(c) is subject to an anti-avoidance rule in new subsection 56.4(10). Paragraph 56.4(3)(c) will not apply if the amount would have otherwise been included in employment, business or property income but for subsections 56.4(2) to (15).

[69] The other two exceptions are found in 56.4(6) and 56.4(7).

[70] Compound interest is deductible only on a paid basis under paragraph 20(1)(d). Paragraph 20(1)(d) is necessary due to the finding in *Stock Exchange Building Corporation Limited v. MNR*, 55 DTC 1014 (S.C.C.), that compound interest was not deductible under paragraph 20(1)(c) on the basis that the simple interest (on which compound interest accrued) was not borrowed money.

[71] Certain transactions, not discussed herein, can be undertaken to avoid the increased capital tax liability.

[72] This portion of the paper generally addresses control in its legal or *de jure* sense. The expression "controlled, directly or indirectly in any manner whatever" is referred to as control in fact and it has a special meaning for the purpose of the ITA: subsection 256(5.1) and see *Transport M.L. Couture Inc. v. R.*, 2004 DTC 6141 (F.C.A.) and *Mimetix Pharmaceutical Inc. v. R.*, 2001 DTC 1026 (T.C.C.) affirmed 2003 DTC 5194 (F.C.A.).

[73] For a discussion of the concept of control, see David Williamson and Michael Manly, "Acquisition of Control: An Update," in *Income Tax and GST Planning for the Purchase, Sale, and Canada-US Expansion of a Business*, 1996 Corporate Management Tax Conference (Toronto: Canadian Tax Foundation, 1997) at 5:1.

[74] Subsection 256(7). These rules must be read carefully in a merger situation to determine whether an acquisition of control is deemed not to occur.

[75] *Buckerfield's Ltd. v. MNR*, 64 DTC 5301 (Ex. Ct.); *MNR v. Consolidated Holdings Company Limited*, 72 DTC 6007 (S.C.C.); *The Queen v. Imperial General Properties Limited* [1985], 2 SCR 288; *Oakfield Developments (Toronto) Ltd. v. MNR*, 71 DTC 5175 (S.C.C.); *The Queen v. Duha Printers (Western) Limited*, 98 DTC 6334 (S.C.C.); and *The Queen v. W. Ralston & Co. (Canada) Inc.*, 96 DTC 6488 (F.C.T.D.).

[76] *Ibid*.

[77] See *Campbell v. The Queen*, 99 DTC 1073 (T.C.C.); *Monquart Hardwoods Ltd. v. Queen*, 99 DTC 818 (T.C.C.); *Multiview Inc. v. The Queen*, 97 DTC 1489 (T.C.C.); *HSC Research Development Corp. v. The Queen* 95 DTC 225 (T.C.C.).

[78] *Supra* at note 75.

[79] 97 DTC 5343 (F.C.A.).

[80] Income Tax Technical News No. 7, (dated February 21, 1996) at page 9-10.

[81] 2002 DTC 7112 (F.C.A.).

[82] 2007 D.T.C. 5096 (F.C.A.).

[83] The election must be made on or before the taxpayer's filing-due date for the taxpayer's 2009 taxation year. A taxpayer will be deemed to have made the election if it can reasonably be considered that the position taken in respect of the acquisition of control in the taxpayer's return of income (or notice of objection or notice of appeal) filed (or served) before January 28, 2009 relies upon the interpretation that subsection 256(9) applies for purposes of determining a corporation's status as a small business corporation or CCPC at the time of transfer.

[84] Paragraphs 249(4)(a) and (b).

[85] Paragraph 249(4)(c). The election is not available if there was another acquisition of control of the corporation within that 7 day period.

[86] Paragraph 249(4)(d) and subsection 249.1(7).

[87] Assuming that the certificate of amalgamation does not itself specify a time for the amalgamation.

[88] See Question 39 of the Revenue Canada Round Table (1990 Canadian Tax Foundation Conference) and CRA Technical Interpretation #2002-0156725 (October 11, 2002).

[89] For non-capital losses arising in taxation years that end on or before March 22, 2004, the carryforward period is limited to seven years. Losses for taxation years ending in the period March 23, 2004 to December 31, 2005 may only be carried forward 10 years.

[90] Paragraphs 111(4)(c) and (d).

[91] Paragraph 111(4)(e).

[92] Subsection 111(5.1).

[93] Subsection 111(5.2).

[94] Subsection 111(5.3).

[95] New subsections 40(10) and 40(11) contain related rules for computing gains and losses on foreign currency debts where the relevant corporation had previously realized a capital gain or loss on the foreign currency debt because of subsection 111(12).

[96] Subsection 2(3). This would equally apply to the shares of an unlimited liability company established under the laws of Alberta, British Columbia or Nova Scotia since the CRA recognizes it as a corporation for the purposes of the ITA, notwithstanding the fact that it may be a disregarded entity in the United States.

[97] On March 29, 2010 the Department of Finance introduced the *Jobs and Economic Growth Act* in the House of Commons. The proposed legislation contains the proposed amendments to the definition of "taxable Canadian property" that were originally announced in the 2010 Federal Budget.

[98] Paragraphs (d) and (e) of the proposed amended definition of "taxable Canadian property".

[99] For example, Article XIII of the *Canada U.S. Tax Convention (1980)* provides that gains derived from the alienation of shares of a Canadian resident corporation by a resident of the U.S. may be taxed in Canada if the "value" of the shares is "derived principally from real property situated in Canada." If the shares do not derive their value principally from real property situated in Canada, then the gain will be taxable only in the U.S. The technical explanation to the Treaty states that the term "principally" means more than 50% and in Interpretation Bulletin IT-173R2 the CRA recognizes this interpretation at paragraph 2.

[100] Proposed amendments to section 87 provide a similar result for shares acquired on an amalgamation.

[101] Another situation where the treaty exemption remains relevant is where shares disposed of constitute taxable Canadian property because more than 50% of their value is attributable to real property in which the corporation carries on business. Certain of Canada's tax treaties specifically exclude from the definition of real (or immovable) property, for the purposes of determining whether shares derive their value from real (or immovable) property, the real (or immovable) property (other than rental property) in which a business is carried on; see for example, Article 13 of the *Canada-Germany Tax Agreement*. Accordingly, it is possible for shares to be considered to derive more than 50% of their value for purposes of the definition of taxable Canadian property but not for purposes of determining whether a treaty exemption is available.

[102] CRA's position was found to be wrong in law in cases where all of the membership interests in the LLC are held by persons subject to comprehensive taxation under the laws of the US. In *TD Securities*

(USA) LLC v. The Queen, 2010 TCC 186. Boyle J held that TD LLC was a resident of the US under Article IV(1) of the Canada-US Treaty since TD LLC was liable to tax in the US "by virtue of all of its income being fully and comprehensively taxed under the US Code albeit at the member level" and the income of TD LLC was subject to tax in the US by reason of the place of incorporation of its member, which he found to be a ground similar to those enumerated in Article IV(1) (i.e., domicile, residence, citizenship, place of management and place of incorporation). In *obiter*, Boyle J stated that his analysis would not apply to the Canada-US Treaty as amended and revised by the 5th Protocol.

[103] The concerns regarding the ability of partners of certain U.S. partnerships to gain access to Treaty benefits where the partnership is recognized by state law as a separate entity were addressed in CRA document no. 2000-0056715.

[104] Subsection 116(5).

[105] In recent years, it has become common practice for the CRA to issue "comfort letters" prior to the date that the purchaser is otherwise required to remit payment under subsection 116(5). Such letters typically state that the CRA is still reviewing the application and that in the meantime no payment is required and no interest or penalties will be charged if it is determined that payment is ultimately required.

[106] See new subsection 150(5), clauses 150(1)(a)(i)(C)-(D) and subparagraph 150(1.1)(b)(iii).

[107] Pursuant to the recent amendments to subsection 116(6), "excluded property" includes, in addition to other types of property, a "treaty exempt property". A property will be a "treaty exempt property" where (i) it is a property that is a "treaty-protected property" to the non-resident and (ii) where the purchaser and non-resident are related, the purchaser provides the required notice, as discussed above, within 30 days of the acquisition.

[108] Where an amount that is receivable in respect of a restrictive covenant is included in income under proposed subsection 56.4(2), the draft amendments also contemplate bad debt write-offs for amounts that are not received (proposed paragraph 60(f)) and re-inclusion in income of any such write-offs that are subsequently collected (proposed paragraph 56(1)(m)).

[109] David W. 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-US Expansion of a Business*, 1996 Corporate Management Tax Conference (Toronto: Canadian Tax Foundation, 1997) 19:1.

[110] The dividend would be subject to a statutory withholding tax at a rate of 25%, but in the case of a Canadian corporation owned by a parent corporation that is a resident of the U.S. the withholding will be reduced to a rate of 5% under the Treaty.

[111] Subsections 18(4) to (8).

[112] One of the measures announced in the Federal Budget, released February 28th, 2000, was a proposal to amend the thin capitalization rules for taxation years that begin after 2000 to bring within the ambit of the rules third party debt guaranteed by a specified non-resident. In a press release, issued on May 9, 2000, the Finance Minister announced the deferral of this budget measure.

[113] See Financing the Share Purchase, *supra*.

[114] An AULC has a number of administrative advantages over an NSULC given the more modern statutory framework: (i) conversion to an AULC may be undertaken by way of a continuance without the need for an amalgamation; (ii) amalgamations involving AULCs do not generally require court approval; and (iii) returns of capital from an AULC do not generally require court approval. Such advantages can be particularly attractive where timing is tight or when transaction sequencing is essential in the context of a reorganization or otherwise. The AULC is not without its disadvantages, however. Unlike Nova Scotia, at least one-quarter of an AULC's directors must be Canadian residents. The most significant disadvantage of an AULC is that its shareholders are jointly and severally liable with the AULC for any liability, act or default of the AULC. By contrast, the unlimited liability of a shareholder of a NSULC is only applicable for the debts of the NSULC where it becomes bankrupt or following the winding-up of the NSULC.

[115] CRA has issued a number of rulings on structures intended to avoid the application of Article IV(7)(b). See for example, CRA Rulings E 2009-0343641R3, E 2009-0348581R3, E 2009-0348041R3 and TI E 2009-0346291E5.

[116] A reduction in paid-up capital under subsection 212.1(1) may be offset by a subsequent addition under subsection 212.1(2) to the extent that the original reduction has the effect of increasing the amount of any dividends deemed to have been paid by the purchaser corporation under subsections 84(3), (4) or (4.1) on a subsequent redemption, acquisition, cancellation or reduction of capital of its shares.

[117] Some useful articles on this topic that include precedents are: Graham Turner, "Tax Issues in Acquisition Agreements," in *Income Tax and GST Planning for the Purchase, Sale and Canada-US Expansion of a Business*, 1996 Corporate Management Tax Conference (Toronto: Canadian Tax Foundation, 1997) 8:1, E.G. Kroft, "Tax Clauses in Acquisition Agreements," in *Selected Income Tax and Goods and Services Tax Aspects of the Purchase and Sale of a Business*, 1990 Corporate Management Tax Conference, (Toronto: Canadian Tax Foundation, 1991) 9:1, and Louise Houle, "Acquisition Agreements: Specific Tax Clauses," (1991) vol. 39, no. 5 in *Canadian Tax Journal* at 1245.

[118] There is some jurisprudence which suggests that an unsigned return may be valid; *The Queen v. Hart Electronics Ltd.*, [1959] CTC 507 (Man. C.A.), but this seems to be an exceptional case, and *Elmer T. Carlson and Gordon E. Carlson v. The Queen*, 73 DTC 5192 (F.C.T.D.). It appears that an unsigned return may still be valid if the taxpayer's intention was to be bound and there is no prejudice to the taxing authorities.

[119] This will be more common in an asset sale where most provincial legislation provides a procedure for issuing a certificate that all sales taxes have been remitted. In a share sale, notices of assessment and the like will usually suffice.

[120] Proposed section 42.