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ARTICLES

THE UNITED STATES AND CANADA: A COMPARISON OF CORPORATE NONRECOGNITION PROVISIONS

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Christine Manolakas***

I. INTRODUCTION

Under both the Canadian and United States tax systems, income realized from the disposition of property is recognized for tax purposes.1 Nevertheless, both tax systems allow for nonrecognition of gain in transactions where the investment of the taxpayer in the transferred assets remains unliquidated. Not surprisingly, the corporate tax provisions of both countries contain many such nonrecognition provisions. With the emergence of the North American Free Trade (NAFTA) zone,2 it is increasingly important for U.S. legal counsel to have knowledge of Canadian corporate nonrecognition provisions. These provisions may impact on every stage of corporate development from organization to reorganization to dissolution. U.S. counsel must be sufficiently informed to act as co-counsel on cross-border projects, to work with Canadian clients living in the United States, and to confirm information provided to U.S. clients by Canadian counsel. This Article provides a detailed discussion of the Canadian corporate nonrecognition provisions and provides important parallels between these and U.S. corporate nonrecognition provisions. The discussion is crafted to alert U.S. counsel as to how Canadian corporate tax provisions will affect a corporate transaction and

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* Footnote references to applicable Canadian law are cited using Canadian legal format. The authors wish to thank Christine M. Adams for all of her efforts extended on behalf of this Article.

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to highlight critical tax issues in order to allow counsel to intelligently advise and plan for transactions involving Canadian corporations. This article will be of interest to anyone with clients who hold or intend to hold shares in a Canadian corporation.

II. FUNDAMENTAL PRINCIPLES IN CORPORATE TAX: SOME SIGNIFICANT DIFFERENCES

Although many similarities exist between the Canadian and U.S. corporate tax systems, some fundamental differences in the underlying principles remain. Some of the more significant differences are discussed below.

A. Corporate Double Taxation v. Integration

The United States corporate income tax is a classic or double tax system. The Internal Revenue Code (I.R.C.) establishes a corporation as a taxpaying entity separate and distinct from its shareholders. A corporation must pay an income tax on its profits even if the corporation distributes those profits to its shareholders as dividends. Profits received by shareholders as dividends are included in the gross income of the shareholder and taxed as ordinary income. If a shareholder sells stock in a corporation, the shareholder can recover the basis in the stock without tax and any gain recognized to a noncorporate shareholder on the disposition may be taxed at a lower capital gains rate. These two fac-

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3 See I.R.C. § 11(a). See also I.R.C. §§ 1361-1378 (defining S corporations and discussing their tax treatment).

4 Generally, corporate taxpayers are taxed at marginal rates of 15% on the first $50,000 of taxable income and 25% on the next $25,000 increment of taxable income. Taxable income above $75,000 is taxed at 34% with a marginal rate of 35% applying to taxable income above $10,000,000. See I.R.C. § 11(b). If a corporation has taxable income in excess of $100,000, the tax liability of the corporation is increased by the lesser of 5% of the excess or $11,750. If a corporation has taxable income in excess of $15,000,000, the tax liability of the corporation is further increased by the lesser of 3% of the excess or $100,000. See I.R.C. § 11(b). Qualified personal service corporations are taxed at a flat 35% rate. See I.R.C. § 11(b)(2) (defining qualified personal service corporation).

5 See I.R.C. § 61(a)(7). See also I.R.C. § 301. Noncorporate taxpayers are taxed at marginal rates ranging from 15% to 39.6%. See I.R.C. § 1.

6 See I.R.C. § 1001(a).

7 Generally, net capital gains generated on the disposition of capital assets held longer than eighteen months are taxed at a maximum tax rate of 20% with a rate of 10% applying to the net capital gains of individuals in the 15% tax bracket. The net capital gains resulting from capital assets held over one year are taxed at a minimum rate of 28%. A special lower rate of 18% and 8% for individuals in the 15% tax
tors, the double tax on corporate profits and the preferred rate for capital gains, have caused much of the complexity in the corporate tax arena. Congress must continually legislate to prevent taxpayers from structuring transactions solely to eliminate a tax at either the corporate or shareholder level or to bail out earnings of the corporation in the guise of a disposition of corporate stock.\textsuperscript{8}

In contrast, Canada purports to have an integrated tax system. In theory, the same overall tax should result whether income is earned by an individual directly or by a corporation and then distributed to the individual as dividends. The dividend received credit is the mechanism used to achieve this outcome. Specifically, dividend income in an individual shareholder’s hands is grossed up to its theoretical pretax amount at the corporate level and personal tax liability is calculated on the grossed up dividend. A dividend tax credit equal to the amount of the corporate level tax may be claimed by the shareholder.\textsuperscript{9} The credit is intended to reflect the corporate tax that has already been paid by a Canadian controlled private corporation (CCPC).\textsuperscript{10}

\textsuperscript{8} Because of the dividend received deduction, corporate shareholders may prefer dividend treatment. Generally, the dividend received deduction is 70\% of the amount of the distribution. However, the deduction increases to 80\% if the corporate shareholder owns 20\% or more of the distributing corporation. The deduction is 100\% if the shareholder corporation and the distributing corporations are members of an affiliated group. See I.R.C. § 243. See infra note 29 and accompanying text (expressing the reasoning behind the dividend received deduction).

\textsuperscript{9} Consider the following example. A corporation earns $100 of taxable income. After paying tax of $20 (the approximate federal and provincial combined small business tax rate), $80 will be available for distribution to the shareholders. The $80 amount will be grossed up by $20 to $100. Personal tax liability is then calculated. If we assume the combined federal and provincial personal tax rate is 50\%, $50 in tax is due. A combined tax credit of $20 may be claimed against this $50, resulting in $30 in personal tax liability. Total tax paid between the corporation and the shareholders on the $100 is thus $50. If this individual had earned the $100 directly, approximately $50 in tax would also be payable depending on the province in which the individual resides. See generally STRIKEMAN INCOME TAX ACT ANN. XVI-XVII (Richard W. Pound et al. eds., 26th ed. 1997) (providing Provincial Tax rates).

\textsuperscript{10} See I.T.A. subsection 125(7) (defining a CCPC, generally, as a corporation which
Full integration for active business income under the Canadian corporate tax system is premised on several important assumptions. First, it is assumed that the federal corporate tax rate is 20%. This is rarely the case. Only CCPCs are subject to a corporate tax rate that approximates 20% and only with respect to the first $200,000 of active business income earned in Canada. Income above that level is taxed at the maximum corporate rate of approximately 45%. Second, full integration assumes a combined federal/provincial tax rate of 50% for individuals. This is also rarely the case. Provincial tax rates vary between 45% and 69%. Finally, full integration assumes no federal or provincial surtaxes of which there are many. Canada, therefore, has at best a partially inte-

is resident in Canada for Canadian tax purposes and is not controlled directly or indirectly by one or more public or nonresident corporations or nonresident persons).

See also Canadian Department of Finance, June 20, 1996 Notice of Ways and Means Motion (discussing a proposal to exclude from the definition of CCPC any corporation that is not actually controlled by nonresidents but avoids that status only because the shares are widely held or the shares are listed on a foreign stock exchange).

There are three federal corporate tax rates in Canada. The maximum corporate tax rate, including surtaxes, is 29.12%. Manufacturing corporations are subject to a preferred rate of 22.12% and CCPCs are subject to a 13.12% rate on the first $200,000 of active business income. This federal tax liability is almost doubled by provincial income taxes which add between 8.9% to 16.5%. Thus, the combined maximum rates of corporate tax ranges between 38% and 46.1%. Corporations eligible for the manufacturing tax credit or small business deduction at the federal level may also be subject to reduced provincial tax rate. The current combined federal and provincial small business tax rate in Canada ranges between 15.6% in the Yukon Territories to 22.6% in Alberta. See generally I.T.A. sections 125(1), 125.1.

Individuals are taxed at the federal level based on a three-band system. Income below $27,590 is taxed at 17%, income between $27,590 and $59,180 is taxed at 26% and income over $59,180 is taxed at 29%. Provincial tax is added to this amount and is calculated as a percentage of federal tax payable. Individual provincial tax rates range between 45% and 69%, the average being about 55%. Where income is taxed at the maximum corporate rate and paid out to a shareholder in the highest tax bracket, combined corporate and personal tax liability will exceed 60%. In Alberta for example, the combined personal and corporate tax at the maximum rates will equal 61.99%. In general, the maximum individual marginal tax rates exceed the maximum corporate tax rate. Thus, little incentive exists to distribute funds that will be taxed at maximum personal rates. See I.T.A. subsection 117(2) (providing the rules relating to the computation of federal tax liability); STRIKEMAN INCOME TAX ACT ANN., supra note 9, at XVI-XVII (providing Provincial tax rates).

For example, a surtax of 3% of federal tax is added after tax credits and if basic federal tax exceeds $12,500 an additional surtax of 5% of the basic federal tax in excess of $12,500 is applicable. See I.T.A. subsection 180.1. Many of the provinces also impose provincial surtaxes. In Alberta, for example, there is a surtax of 8% of
grated system with respect to active business income earned in Canada and corporate double taxation occurs on many corporate distributions. Consequently, considerable attention is focused on reducing or avoiding the element of double taxation, particularly by private corporations.

Two additional aspects of integration are significant. The first relates to the tax treatment of intercorporate dividends earned by corporations. The second relates to the treatment of capital gains earned by private corporations and of passive, or investment, income and taxable capital gains earned by CCPCs. In Canada, taxable dividends paid to a corporate shareholder flow free of tax; that is, a corporate shareholder does not generally pay an income tax on taxable dividends received from taxable Canadian corporations. Rather, recognition of dividend income for tax purposes is generally deferred until the dividend is actually distributed to an individual shareholder.

Investment income such as interest, rents, and royalties and three quarters of a capital gain realized is included in corporate income and taxed as ordinary income at the maximum corporate rate of approximately 45%. This income is subject to two other integration mechanisms. First, the tax-free portion of the capital gain realized by a private corporation is included in an account called the capital dividend account. Tax-free

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15 "A 'private corporation' is a corporation that is resident in Canada for Canadian tax purposes and is not a public corporation or controlled by one or more public corporations." I.T.A. subsection 89(1). "Public corporations" are defined as a Canadian resident corporation that has its shares listed on a prescribed stock exchange in Canada or which has elected or is designated by the Minister of Finance to be a public corporation. See id.

16 I.T.A. section 82(1)(a)(ii) requires that the dividend be included in income. I.T.A. subsection 112(1) then permits a deduction for certain taxable dividends received in calculating income for the year. In order to prevent individual shareholders from incorporating for the purpose of recovering dividend income tax free, a special Part IV tax is imposed equal to 33 1/3% of the taxable dividends received from corporations in which there is essentially a share holding of less than 10%. See I.T.A. subsections 186(1), S. 70(1), 186(4). This tax is refunded to the corporation at a rate of $1 for every $3 in taxable dividends paid to shareholders. If the recipient shareholder who triggers a Part IV refund for one corporation is also a corporation it will become responsible for payment of the Part IV tax if the payer corporation receives a Part IV refund as a result of the taxable dividend paid. See I.T.A. subsection 186(1)(b).

17 See supra note 11 (providing the marginal rates applicable to corporate income tax).

18 See I.T.A. section 89(1) (defining "capital dividend account").
dividends can be paid to shareholders from this account by the private corporation if an election is filed.\(^9\) Second, taxable capital gains and investment income, although initially taxed at the top corporate rate of approximately 45%, plus an additional tax of 6 2/3% of the investment income,\(^{20}\) entitle CCPCs to a potential tax refund equal to 33 1/3% of the corporate tax paid. This refund is made to the corporation through the refundable dividend tax on hand account at a rate of $1 for every $3 of taxable dividends paid.\(^{21}\) The total corporate tax payable on taxable capital gains and investment income earned by a CCPC is thus approximately 20%. When the after tax amount is distributed as a dividend to individual shareholders in the top tax bracket, personal tax of between 32% and 36% will be payable depending on the rate of provincial tax. The combined personal and corporate tax payable for this type of income is thus between 50% and 56%, approximately equal to the maximum personal tax rate.\(^{22}\) This result will not occur if the corporation is not a CCPC. For example, public corporations do not have a capital dividend account. Public corporations and private corporations which do not meet the definition of a CCPC will also not have a refundable dividend tax on hand account. Consequently, the total tax payable on dividends paid to top bracketed shareholders distributed from corporations which are not CCPCs will be between 62% and 65% of the corporate profit.

The integration system is also intended to remove any preference for capital gains over dividends at the individual shareholder level. If a

\(^9\) See I.T.A. subsection 83(2).
\(^{20}\) See I.T.A. section 123.3. The additional tax was added in 1995 and is intended to eliminate any advantage of deferral by earning investment income through a corporation where the maximum individual tax rate exceeds the maximum corporate tax rate. The maximum corporate tax rate is assumed to equal 45%. In Ontario, however, the provincial tax rate is 56%. This results in a combined federal provincial rate of tax, without considering surtaxes, in excess of 50%. See generally STRIKEMAN INCOME TAX ACT ANN., supra note 9, at XVI-XVII (providing Provincial tax rates).
\(^{21}\) See I.T.A. section 129(1). In integration theory, the refund rate is 1/3. Thus, a dividend refund of $26.67 will be refunded on $100 of corporate income, once $80 in dividends is paid ($26.67 x 3). See I.T.A. subclause 129(3)(a)(i)(A). The $80 is what remains after 20% corporate tax, reflecting the expected refund. The up-front corporate tax is $40 (presumed federal and provincial rate) plus $6.67, under I.T.A. section 123.3, to $46.67. That leaves the corporation with $53.33 which added to the $26.67 dividend refund, gives the corporation $80 to pay out as a dividend. Once the corporation receives the dividend refund of $26.67, its total tax is reduced to $20.
\(^{22}\) In Ontario, for example, the combined rate of tax on investment income earned by a CCPC and paid out as taxable dividends to an individual shareholder in the maximum tax bracket will equal 53%. See generally STRIKEMAN INCOME TAX ACT ANN., supra note 9, at XVI-XVII (providing Provincial tax rates).
corporation qualifies as a CCPC\textsuperscript{23} the elimination of any preference is largely achieved. As a CCPC is taxed at a corporate rate of approximately 20% and dividend income received by an individual shareholder in the top tax bracket is taxed at 32% to 36%, the combined corporate and personal tax rate will approximate the maximum personal marginal rate of 50% to 56%. Compare the personal tax rate on dividend income to capital gains which are subject to an effective tax rate for top income taxpayers of approximately 34% to 38%.\textsuperscript{24} This result occurs because only three quarters of the capital gain is included in the taxpayer's income and taxed as ordinary income at the taxpayer's marginal rate.

Notwithstanding that the tax rate for taxable dividends and capital gains are approximately equal, some capital gains may be eligible for the $500,000 capital gains exemption for qualifying small business corporations.\textsuperscript{25} This results in the tax-free receipt of the first $500,000 of gain on shares held by individuals. Since some capital gains are given this special preference under the I.T.A., considerable incentive exists for individual shareholders who qualify for the exemption on the disposition of their shares in a small business corporation to receive income in this form. Thus, tax preference for capital gains may influence whether a Canadian taxpayer will agree to a corporate redemption which triggers deemed dividends or a third-party sale which gives rise to a capital gain and a corresponding exemption from tax liability. It is also the reason for many of the dividend stripping anti-avoidance provisions\textsuperscript{26} sprinkled throughout the I.T.A.

In contrast to individuals, corporate shareholders generally prefer dividend income to capital gains. Dividend income flows tax free between corporations\textsuperscript{27} while capital gains are taxable upon realization to the corporate shareholder. As a result, tax avoidance provisions were also enacted to prevent the conversion of capital gains into tax-free intercorpo-
rate dividends. Prior to these tax avoidance rules, instead of selling a corporate asset which would result in an immediate capital gain, the corporation would exchange the asset for redeemable shares in the purchaser using a corporate nonrecognition provision. Without the anti-avoidance provisions, the shares could be redeemed by the corporate vendor for proceeds equal to the fair market value of the exchange asset. The redemption would result in the receipt of a tax-free intercorporate dividend rather than taxable capital gain arising from the disposition of the asset.

B. Corporate Distributions

In both the United States and Canada, corporate profit can be distributed to the shareholders as dividends. For corporate law purposes, dividends are declared by the directors and may be paid in money or other property. However, for tax purposes the concept of a dividend is much broader. In the United States, it includes actual and constructive dividends. Constructive dividends result when, to avoid the double tax, corporations attempt to distribute corporate earnings to shareholders in a form that is deductible at the corporate level. Such distributions are merely recharacterized by the Internal Revenue Service as dividends, and taxed accordingly. Distributions which result in constructive dividend treatment include excessive compensation and rents, questionable business expenses, and interest payments on shareholder debt that in reality represents equity. Other examples of constructive dividends include purchases of shareholder property above fair market value, bargain rents or purchases of corporate property, interest-free loans from the corporation, and loans to shareholders without shareholder intent to repay. In Canada, such distributions are treated as shareholder benefits and are taxed as ordinary income. The penalty resulting from this characterization is that no dividend tax credit is available to the individual shareholder to reflect the corporate tax that has already been paid on the income. It follows that integration in the form of the dividend gross-up and tax credit will not apply and double taxation will result. As in Canada, a corporate shareholder may deduct all, or a portion of, a dividend and, therefore, may prefer dividend characterization.

Generally, Revenue Canada takes the position that any distribution by a corporation of its income or capital gains made pro rata to its share-

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28 See, e.g., I.T.A. subsection 85(1).
29 See I.T.A. subsection 15(1).
30 See supra note 11 (describing the integrated corporate tax system).
31 See I.T.A. subsection 112(1); I.R.C. § 243.
holders may properly be described as a dividend. The following is a discussion of certain provisions in the Canadian corporate tax system applicable to dividends and other corporate distributions.

1. Paid-Up Capital and Deemed Dividends

The I.T.A. contains special rules to deem certain payments that might otherwise not be considered dividends to be treated as dividends for tax purposes. These rules apply to amounts paid to shareholders by a corporation on a winding-up, discontinuance, or reorganization of its business, a redemption, an acquisition, or a cancellation of its shares or on a reduction of its capital. Central to the tax result in each of these transactions is the paid-up capital (PUC) of the shares. A corporation’s PUC represents the amount that a corporation can return to its shareholders as a tax-free return of capital.

The starting point in calculating PUC is found in corporate law. While PUC is not a term specifically used in the Canadian corporate statutes, the amount generally is shown as capital on the financial statements of the corporation. This amount is the aggregate of the consideration, as set by the directors, for which the shares were issued. The business corporation statutes refer to this amount as “stated capital.”

The amount of a deemed dividend is generally the difference between the amount received by the shareholder from the corporation and the PUC of the share or shares held by the shareholder.

Where an amount is deemed to be a dividend, it is treated for all purposes of the I.T.A. as an ordinary dividend. As such, the distribution is subject to the gross-up and credit mechanisms if received by an individual shareholder or, if received by a corporate shareholder, is

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34 See I.T.A. subsection 89(1) (defining PUC). Calculation of the PUC amount differs depending upon whether the time period involved occurs prior to May 7, 1974, between May 6, 1974, and April 1, 1977, or after April 1, 1977. The computation for the earlier time periods is not presented.
35 For tax purposes, there may be further adjustments to PUC as defined in I.T.A. subsection 89(1). This subsection defines the PUC of a share, of a class of shares, and of a corporation. The PUC per share is the PUC of that particular class of shares divided by the number of shares in that class. The PUC per class of shares is the PUC of the class computed without reference to the I.T.A. Therefore, PUC is amount received for issuance of the shares. The PUC of the corporation is the sum of the PUC of each class of shares of the corporation. The PUC may trigger deemed dividends, and where it differs from the share’s cost basis may result in capital gains or capital losses on a corporate transaction such as a redemption or a winding-up.
deductible by it in computing taxable income. The deemed dividend provisions are contained in I.T.A. section 84. This section applies in four circumstances.

First, I.T.A. subsection 84(1) deems a dividend where a corporation increases the PUC of its shares without receiving corresponding consideration from its shareholders either in cash or other property or by converting a debt owed to the shareholder to shares. When I.T.A. subsection 84(1) applies, the corporation is deemed to have paid a dividend in the amount by which the increase in PUC exceeds the amount by which the value of the corporation’s assets less its liabilities has been increased, or the amount by which the value of its liabilities less its assets has been reduced, and the amount by which the PUC of other classes of shares has been reduced. Any amount treated as a deemed dividend is added to the adjusted cost base of the shares.

Second, I.T.A. subsection 84(2) applies where funds or other property of a corporation are distributed or otherwise appropriated to its shareholders on the winding-up, discontinuance, or reorganization of its business. The corporation is deemed to have paid a dividend equal to the amount of funds or property distributed, minus the amount by which the PUC of the class of shares on which the distribution is made is reduced on the distribution or appropriation.

Third, I.T.A. subsection 84(3) applies where a corporation has “redeemed, acquired or canceled in any manner whatever” shares of any class, and I.T.A. subsection 84(2) is not applicable to the transaction. Where such a transaction occurs, the corporation is again deemed to have paid a dividend in the amount paid on the redemption in excess of the PUC of the shares immediately prior to the transaction.

36 Specifically, I.T.A. subsection 84(1) applies where a corporation has increased its PUC otherwise than by:
1. payment of a stock dividend;
2. a transaction by which the value of the corporation’s assets less its liabilities has been increased an amount not less than the increase in PUC;
3. a transaction by which the value of its liabilities less its assets has been decreased by an amount not less than the increase in PUC;
4. a transaction by which the PUC of shares of the corporation of other classes is reduced by an amount not less than the increase in question.

See I.T.A. section 53(1)(b).

37 Where the distribution or appropriation includes property other than cash, the amount of the dividend is the value of the property distributed or appropriated. The shares of the corporation on which the distribution is made are also deemed to have been disposed of and I.T.A. paragraph 54(j) excludes any amount treated as a deemed dividend under I.T.A. subsection 84(2) from the definition of “proceeds of disposition” of the shares. I.T.A. paragraph 54(j).

39 If the shares are also disposed of, however, subsection (j) excludes the amount
I.T.A. subsection 84(6) provides an exception to I.T.A. subsections 84(2) and (3) on any purchase by a corporation of any of its shares in the open market on a winding-up or a redemption if the corporation acquired the shares in the same manner in which shares would normally be purchased by any member of the public. In such a case, the vendor will receive capital gains and not dividend treatment.

Finally, I.T.A. subsection 84(4) provides that a dividend may be deemed to have been paid on a reduction of capital in the amount by which the amount paid to the shareholders exceeds the actual reduction in PUC.\(^{40}\)

In addition to a deemed dividend, a capital gain or loss may occur on a winding-up or redemption since the share is also deemed to have been disposed of for tax purposes.\(^{41}\) This will necessitate determining the shares adjusted cost base\(^{42}\) (ACB). Unlike the share's PUC that will not change even if the share changes hands, the share's ACB is determined by reference to the acquisition price paid by the current holder. It is this amount that is used to calculate the capital gain. In many cases, the PUC and ACB of a share will be the same. For example, if each share in class A was originally issued for $1, the PUC and ACB of each share will equal $1. If a Class A share is later sold for $5, the PUC would remain at $1 but the ACB would increase to $5 in the hands of the new owner. There is a significant difference in the tax results to the shareholder when a share with a low PUC but high ACB is redeemed as compared to when the PUC and ACB are the same. For example, if the share with a PUC and ACB of $1 is redeemed for $5, a $4 deemed dividend will result. Proceeds for the share will also initially equal $5 for capital gains purposes; however, the amount of the $4 deemed dividend may be deducted from the proceeds in calculating any gain or loss to the shareholder. As a result, the proceeds will be reduced by $4 to $1. Since this is also the ACB of the share, no capital gain will result. On the other

\(^{40}\) To the extent that the amount distributed on a reduction of capital is not deemed to be a dividend, there will be a reduction in the ACB of the shares pursuant to ITA subparagraph 53(2)(a)(ii). In other words, if the PUC is reduced by the exact amount distributed, the ACB of the shares will also be reduced by that amount. If the reduction in PUC is less than the amount distributed, there will be a deemed dividend but no reduction in the ACB of the shares. If a public corporation reduces PUC, the rule is different. To the extent that an amount is paid when PUC is reduced the shareholders are deemed to have received a dividend. However, there is no reduction in the ACB of their shares.

\(^{41}\) See I.T.A. subsection 84(9).

\(^{42}\) See I.T.A. section 54 (definition of adjusted base).
hand, if the share with a PUC of $1 and an ACB of $5 is redeemed for $5, a deemed dividend of $4 will also result. However, there will also be a capital loss of $4 since the proceeds of $5 will be reduced by the amount of the $4 deemed dividend to $1 and the ACB of the share is $5. Contrast this treatment to the result if this share had been sold to a third party for $5. The tax result would simply be a $4 capital gain. This result occurs because the PUC of the share is irrelevant to the tax result in a third-party sale. The proceeds for the share were $5 and its ACB was $1. Thus, the only immediate tax result will be the $4 capital gain.

The following illustrates these transactions:

<table>
<thead>
<tr>
<th>Purchaser</th>
<th>Deemed Dividend</th>
<th>Capital Gain</th>
<th>Capital Loss</th>
</tr>
</thead>
<tbody>
<tr>
<td>PUC $1 ACB $1</td>
<td>Corporate Redemption $5</td>
<td>$4</td>
<td>0</td>
</tr>
<tr>
<td>PUC $1 ACB $1</td>
<td>Third Party $5</td>
<td></td>
<td>$4</td>
</tr>
<tr>
<td>PUC $1 ACB $5</td>
<td>Corporate Redemption $5</td>
<td>$4</td>
<td>($4)</td>
</tr>
<tr>
<td>PUC $1 ACB $5</td>
<td>Third Party $5</td>
<td>0</td>
<td></td>
</tr>
</tbody>
</table>

2. I.T.A. section 15 and Shareholder Benefits and Loans

Where a corporation confers a benefit upon a shareholder or on a person in contemplation of becoming a shareholder, the amount of that benefit must be included in the shareholder's income without the benefit of integration. Certain persons who receive loans from, or incur indebtedness to, a corporation may also be required to include this amount in income unless either the loan was made for certain specified purposes and bona fide arrangements were made for repayment within a reasonable time, or the loan was repaid within one year from the end of the taxation year in which it was made. Again, such loans are not treated as divi-

I.T.A. subsection 84(6) provides an exception to deemed dividend treatment where a corporation purchases its shares in the open market on a redemption and acquires the shares in the same manner in which shares would normally be purchased by any member of the public.
3. I.T.A. subsection 56(2) and the Diversion of Income

Additionally, in Canada, tax liability may arise on a corporate distribution by virtue of I.T.A. subsection 56(2). I.T.A. subsection 56(2) applies where a payment or transfer of property is made pursuant to the direction of, or with the concurrence of, a taxpayer to another person for the benefit of the taxpayer or as a benefit the taxpayer desired to have conferred on the other person. The provision is intended to prevent a taxpayer from avoiding tax on income by directing an amount to a third party. Recently, there has been a considerable focus on the potential application of I.T.A. subsection 56(2) to income splitting through the use of discretionary dividends. Revenue Canada has taken the position that the payment of such dividends represents a transfer of property with the direction or concurrence of the other shareholders, generally, in their capacity as directors.

Although this view was recently rejected by the Supreme Court of Canada, a comment made by Justice Dickson suggesting that dividend sprinkling was justified when, in the particular circumstances of the case since, the recipient shareholder made a real contribution to the business, left the door open for further challenges where no substantial financial contribution was made. Unfortunately, Revenue Canada’s renewed position that I.T.A. subsection 56(2) will continue to apply to discretionary dividends unless the dividends represent reasonable compensation for services performed by the shareholder, or a reasonable return on investment appears to have gained some support in the courts. In 1996, the Federal Court of Appeal in Neuman applied I.T.A. subsection 56(2) to tax income of the husband when his spouse, who did not make a valuable contribution to the corporation, declared discretionary dividends to herself in her role as corporate director. The Neuman decision is on appeal to the Supreme Court of Canada. Until the case is heard, there is considerable concern that I.T.A. subsection 56(2) will be used to include discretionary dividend income in the taxable income of a related shareholder.

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44 See I.T.A. subsection 15(2) (explaining that a loan from corporation to shareholder, or person contemplating becoming a shareholder, is included in computing gross income of that person).


47 Id. at 6471-73.
who is the higher income earner.

C. Estate and Gift Tax Provisions

The estate and gift tax provisions of the United States and Canada differ dramatically. Although not a realization event for income tax purposes, gratuitous intervivos and testamentary transfers subject the transferor to an excise tax in the United States. The Canadian federal government and all of the ten provinces abolished both the estate and gift tax more than a decade ago. These taxes were replaced with deemed disposition provisions in the I.T.A. Taxpayers who dispose of an asset by way of gift, or to a related party at an amount that is less than or more than the fair market value of the asset, are deemed to have disposed of the asset at its fair market value for income tax purposes. Individual taxpayers are also deemed to have disposed of all of their assets at fair market value for income tax purposes immediately prior to death. An exception to both deemed disposition provisions is made when assets are transferred to a spouse or spousal trust, and with respect to certain qualified farm property transferred to children of the taxpayer. In those cases, it is considered a nonrecognition event and a rollover occurs for Canadian tax purposes. Considerable planning, particularly for private corporations, evolves around the deemed disposition of shares on death and the minimization of tax liability. The integrity of the deemed disposition provisions both intervivos and at death is preserved by complex anti-avoidance provisions sprinkled throughout the corporate reorganization provisions. The apparent harshness of the deemed disposition rules is partially alleviated by a $500,000 lifetime capital gains exemption that is available to each individual taxpayer with respect to shares of a qualified small business corporation and for certain qualified farm property.

III. JUDICIAL DOCTRINES AND PRINCIPLES

A. United States

In order for a transfer of property, stock, or securities to receive tax-deferred treatment, the specific requirements of the corporate nonrecognition provisions must be met. The U.S. tax system also contains various statutory anti-avoidance provisions. In addition, a transaction

48 See I.R.C. §§ 2001(a), 2501(a)(1).
49 See I.T.A. subsection 69(1)(b)(ii).
50 See I.T.A. subsection 70(5).
51 See I.T.A. subsections 70(6), (9).
52 See, e.g., I.T.A. subsection 85(1)(e.2) (creating an indirect gift rule).
53 See I.T.A. subsection 110.6(1).
54 See, e.g., I.R.C. § 269; I.R.C. § 306 (providing for ordinary income treatment on
must meet certain judicially created requirements. Courts often apply common law principles of tax law to recharacterize for tax purposes transactions between a corporation and its shareholder. These judicial doctrines are generally imprecise and often overlapping, but a transaction cannot be evaluated without their careful consideration. In the United States, fundamental principles of income taxation include the following judicial doctrines.

1. Sham Transaction

A transaction is a sham if it takes place solely to produce favorable tax consequences. The characterization of a transaction as a sham implies fraudulent behavior. Therefore, the courts generally reserve this doctrine for the more extreme cases. The Fourth Circuit defined a sham transaction as follows.

To treat a transaction as a sham, the court must find that the taxpayer was motivated by no business purpose other than obtaining tax benefits in entering the transaction, and that the transaction has no economic substance because no reasonable possibility of a profit exists.\footnote{Rice's Toyota World, Inc. v. Comm'r, 752 F.2d 89, 91 (4th Cir. 1985) (citations omitted).}

2. Substance Over Form

The substance over form doctrine provides that tax consequences should turn on the substance of a transaction rather than on its form. However, the form the transaction takes often has substantive and legal consequences. Generally, a taxpayer is bound by the form chosen, although the government may attack the form on the ground that it does not reflect the substance of the transaction.\footnote{See Higgins v. Smith, 308 US 473 (1940) (disregarding a loss sale to a wholly-owned corporation as a sham).} Recently, the Tax Court has been reluctant to restructure transactions if the taxpayer has shaped an otherwise legitimate transaction to comply with statutory requirements.\footnote{See Esmark, Inc. v. Comm'r, 90 T.C. 171 (1988), aff'd 886 F.2d 1318 (7th Cir. 1989) (respecting prearranged stock purchase and trade-in).}
The incidence of taxation depends on the substance of the transaction. The tax consequences which arise from gains from the sale of property are not finally to be determined solely by the means employed to transfer legal title. Rather, the transaction must be viewed as a whole, and each step, from the commencement of negotiations to the consummation of the sale, is relevant.58

3. Step Transaction

The step transaction doctrine assures that an integrated transaction is not broken into independent steps. Courts apply three different tests in determining whether the step transaction doctrine applies: end result test, interdependence test, and binding commitment test.

The step-transaction doctrine is a particular manifestation of the more general tax law principle that purely formal distinctions cannot obscure the substance of the transaction. Under the “end result test,” “purportedly separate transactions will be amalgamated with a single transaction when it appears that they were really component parts of a single transaction intended from the outset to be taken for the purpose of reaching the ultimate result.”

A second test is the “interdependence” test, which focuses on whether “the steps are so interdependent that the legal relations created by one transaction would have been fruitless without a completion of the series.”

Finally, the “binding commitment” test most restricts the application of the step-transaction doctrine. The “binding commitment” test forbids use of the step-transaction doctrine unless “if one transaction is to be characterized as a ‘first step’ there [is] a binding commitment to take the later steps.”59

4. Business Purpose

Similar to the sham and substance over form doctrines, the business purpose doctrine requires that a transaction must serve a business purpose other than mere tax avoidance.60 A classic example illustrating the lack

59 McDonald’s Restaurants v. Comm’r, 688 F.2d 520, 524-25 (7th Cir. 1982) (citations omitted).
60 See Helvering v. Gregory, 69 F.2d 809,811 (2d Cir. 1934), aff’d, 293 U.S. 465 (1935).
of such a business purpose was described in the following terms:

[S]imply an operation having no business or corporate purpose—a mere device which put on the form of a corporate reorganization as a disguise for concealing its real character, and the sole object and accomplishment of which was the consummation of a preconceived plan, not to reorganize a business or any part of a business, but to transfer a parcel of corporate shares to the petitioner. No doubt, a new and valid corporation was created. But that corporation was nothing more than a contrivance to the end last described.61

5. Continuity of Interest

The continuity of interest doctrine requires that the transferors of property to a corporation receive a sufficient proprietary interest in the acquiring corporation to justify treating the exchange as a tax-deferred transaction.62 With the exception of the A reorganization,63 the continuity of interest doctrine is often a condition of nonrecognition within a specific provision.64

While no precise formula has been expressed for determining whether there has been retention of the requisite interest, it seems clear that the requirement of continuity of interest consistent with the statutory intent is not fulfilled in the absence of a showing: (1) that the transferor corporation or its shareholders retained a substantial proprietary stake in the enterprise represented by a material interest in the affairs of the transferee corporation, and (2) that such retained interest represents a substantial part of the value of the property transferred.65

6. Continuity of Business Enterprise

Continuity of business enterprise is necessary to meet the definition of a corporate reorganization.66 The doctrine requires that the acquiring corporation either continue the historic business of the acquired corporation or use a significant portion of the historic business assets of the

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63 See I.R.C. § 368(a)(1)(A). In tax practice, the seven categories of corporate reorganizations are referred to by their alphabetic designations in I.R.C. § 368(a)(1).
64 See, e.g., I.R.C. §§ 351, 368(a)(1)(B), (C), 368(a)(2)(E) (conditioning nonrecognition on the satisfaction of the applicable continuity requirement).
65 Southwest Natural Gas Co. v. Comm'r, 189 F.2d 332, 334 (5th Cir. 1951).
66 See Treas. Reg. § 1.368-1(b) (1980).
acquired corporation in a business. ⁶⁷

To qualify as a "reorganization" under the applicable statutes, the new corporation does not have to engage in an identical or similar type of business. All that is required is that there must be continuity of the business activity. ⁶⁸

7. Assignment of Income

Under an income tax system that imposes a tax on taxable income at progressive rates, attributing income to the proper taxpayer becomes particularly important. The assignment of income doctrine assures that income from services is taxed to the earner of the income ⁶⁹ and income from property is taxed to the owner of the property. ⁷⁰

There is no doubt that the statute could tax salaries to those who earned them and provide that the tax could not be escaped by anticipatory arrangements and contracts however skillfully devised to prevent the salary when paid from vesting even for a second in the man who earned it. That seems to us the import of the statute before us and we think that no distinction can be taken according to the motives leading to the arrangement by which the fruits are attributed to a different tree from that on which they grew. ⁷¹

B. Canada

In Canada, tax avoidance transactions are combated in two significant ways, through statutory interpretation and legislation. ⁷²

1. Statutory Interpretation

Historically, Canadian taxpayers have asserted that they are entitled to rely upon a strict and literal interpretation of the I.T.A. in planning their affairs. ⁷³ However, in recent years, developments in the

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⁷¹ Lucas, 281 U.S. at 114.
⁷² This portion of the Article is based on MAURICE CULLITY et al., TAXATION AND ESTATE PLANNING 1-22 to 1-75 (4th ed. 1996).
⁷³ This traditional approach to statutory interpretation of tax legislation has generally been traced back to Lord Cairns' statement in Partington v. The Attorney General: I am not at all sure that, in a case of this kind-a fiscal case-form is not amply suffi-
law of statutory interpretation in the tax context have significantly eroded this principle. As in the United States, a substantial body of case law provides support for revenue authorities who assert that a taxing statute cannot be circumvented by shams, artificial transactions, schemes which do not accord with the object and spirit of the legislation, or transactions which have no business purpose and are motivated solely by a desire to reduce or avoid taxation. Canadian case law often parallels U.S. common law principles, particularly in the area of sham transactions. There remain, nevertheless, some significant differences in the approaches adopted by each country.

a. Substance Over Form

There are two categories of what is loosely referred to as the substance over form doctrine, legal substance over form and economic substance over form. Legal substance over form is generally accepted

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in Canadian income tax jurisprudence, and looks to commercial factors to determine the true legal substance (i.e., the respective legal rights and obligations of the parties) of a transaction. By way of contrast, the economic substance over form doctrine considers economic and commercial factors and recharacterizes an otherwise legally complete and effective transaction in light of such considerations. This latter approach, although firmly established in the United States, is not generally accepted in Canada. Notwithstanding, Revenue Canada takes a broad view of the application of the legal substance over form doctrine and is prepared to challenge a wide variety of transactions.

b. Legally Ineffective Transactions

Transactions are sometimes successfully attacked based on the effectiveness or completeness of the taxpayer’s attempt to create a particular relationship under the rules of private law. In numerous situations in which the taxpayer has purported to create trusts, make gifts, incorporate companies, establish pension plans, or bring into existence economic consequences of the transactions as a justification for ignoring the fact that the legal relationships were actually created under the relevant principles of private law. The transactions are recharacterized as creating different legal relationships than those actually created and the tax consequences which would otherwise have attached to the transactions are held to be inapplicable.

See Gregory v. Helvering, 293 U.S. 465 (1935). The U.S. Supreme Court looked to the economic substance of a reorganization undertaken to effect a tax-free distribution of shares and determined that the transaction was, in substance, a dividend payment. Id. at 469-70.

See The Queen v. Gesser Estate [1992] D.T.C. 6273 (holding that where a pseudo transfer concealed a taxable stock option benefit tax would be assessed); The Queen v. Placer Dome Inc. [1992] D.T.C. 6402 (stating that the trial court should inquire into the overall focus of the taxable activity and all of its underlying transactions).


some other combination of legal rights and duties\textsuperscript{84} to attract favorable tax consequences, the attempt has been unsuccessful because of a failure to comply with private law formalities or other requirements.\textsuperscript{85} The presence or absence of an intention to avoid tax has no direct relevance to the effectiveness of a transaction within the rules of private law. However, if a transaction is legally ineffective,\textsuperscript{86} it will generally not be considered to have occurred for tax purposes.\textsuperscript{87}

c. Sham Transaction

In \textit{Snook v. London & West Riding Investments Ltd.}, Justice Diplock stated the following, which has received the approval of Canadian courts in a number of cases.

I apprehend that, if it has any meaning in law, it means acts done or documents executed by the parties to the "sham" which are intended by them to give to third parties or to the court the appearance of creating between the parties legal rights and obligations different from the actual legal rights and obligations (if any) which the parties intend to create. But one thing, I think, is clear in legal principle, morality and the authorities . . . that for acts or documents to be a "sham," with whatever legal consequences follow from this, all the parties thereto must have a common intention that the acts or documents are not to create the legal rights and obligations which they give the appearance of


\textsuperscript{86} See ELB Productions Ltd. v. M.N.R. [1991] D.T.C. 1466 (T.C.C.); a legally ineffective transaction is a transaction which is permitted by the private law, but has not been validly effected. For example, Transports Desgagnes Inc. v. M.N.R., 91 D.T.C. 270 (T.C.C.); Langer Family Trust v. M.N.R., [1992] D.T.C. 1055.

\textsuperscript{87} Stubart Investments Limited v. The Queen [1984] 1 C.T.C. 294 (S.C.C.). In Stubart, the Supreme Court of Canada found that the transfer and sale of a business was legally ineffective notwithstanding minor deficiencies in the legal implementation. Ingram v. M.N.R. [1991] D.T.C. 939 (T.C.C.) (holding that, despite the fact that the purported agency agreement was void pursuant to provincial law, the terms of the agency agreement were completed and the taxpayer was not liable for tax on proceeds received as agent for, and remitted to, the partnership).
creating.\textsuperscript{83}

In many cases in which transactions have been determined to be "shams," the parties were careful to comply with the formalities required by private law including full documentation was completed. In each such case, the court's conclusion was based either on the ground that the taxpayer did not intend to be bound by the terms of the documents or that the taxpayer intended to ignore the arrangements they described. The fact that a transaction was motivated by an intention to avoid tax liability and had no business purpose had no direct bearing on the question of its possible characterization as a sham.\textsuperscript{89}

d. Step Transaction Doctrine

In "step transactions," a taxpayer seeks to achieve certain tax results by entering into a number of transactions which have economic effects largely identical to those which could have been achieved in a more direct manner, but producing results less favorable to the taxpayer.

In view of the decision of the Supreme Court of Canada in \textit{Stubart}, and the enactment of the General Anti-Avoidance Rule (GAAR),\textsuperscript{90} the principles applied in Canadian courts have now diverged so far from the traditional step transaction doctrine that U.S. jurisprudence in this area is unlikely to be of any assistance in gaining the response of Canadian courts.

e. Business Purpose Test

Despite repeated attempts by Revenue Canada to have the business purpose test accepted judicially as an independent principle of Canadian taxation law, such attempts were finally repudiated by the Supreme Court of Canada in the \textit{Stubart} decision.\textsuperscript{91} This aspect of \textit{Stubart} is thought to


\textsuperscript{89} See R.A. Jodrey Estate v. Minister of Finance (N.S.) [1980] C.T.C. 437 at 456-66 (4-3 decision) (Dickson, J., dissenting) (stating that tax statutes should be strickly construed to the tax payor's advantage).

\textsuperscript{90} See I.T.A. section 245; see also discussion \textit{infra} Part III.B.2. (explaining the impact of GAAR on the recharacterization of various transactions).

\textsuperscript{91} See supra note 74 (detailing the \textit{Stubart} decision and the rejection of the business purpose test for Canadian tax purposes). For two opposing views on whether the business purpose test was clearly and unequivocally rejected, see S.W. Bowman, \textit{Interpretation of Tax Legislation: The Evolution of Purposive Analysis}, 43 CAN. TAX. J. 1167, 1176-77 (1995); H.J. Kellough, Q.C., \textit{Tax Avoidance: 1945-1995} 43 CAN. TAX.
be one of the main factors that contributed to the decision of the Ministry of Finance to seek legislative intervention in the form of GAAR. The guidelines stated by Justice Estey in *Stubart* do not deny all relevance to the absence of such a business purpose, but the situations in which the absence of such a purpose will be directly relevant appear to have been severely restricted. The absence of a business purpose may still have some relevance, for example, where the provisions of the I.T.A. necessarily relate to an identified business function.\(^2\)

2. The General Anti-Avoidance Rule (GAAR)

With three important qualifications,\(^3\) the GAAR, contained in I.T.A. subsection 245, is expressed in broad generalities. I.T.A. subsection 245(2) provides:

Where a transaction is an avoidance transaction, the tax consequences to a person shall be determined as is reasonable in the circumstances in order to deny a tax benefit that, but for this section, would result, directly or indirectly, from that transaction or from a series of transactions that includes that transaction.

GAAR empowers Revenue Canada to recharacterize payments or amounts, disallow deductions, re-allocate deductions, income, or losses

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\(^2\) This guideline appears to apply only in cases where the statutory provision indicates a clear intention to deny tax benefits with respect to a transaction adopted solely for the purpose of avoiding tax. If the existence of a business purpose can be proved, this would presumably be sufficient to prevent the principle from applying. If there was no business purpose, it would not necessarily follow that the sole purpose of the transaction was to avoid tax but, in a case involving business entities or business income, the taxpayer might well have difficulty in establishing that the particular transaction was entered into for some other purpose. This guideline has generally been interpreted as an acknowledgment by the Court that provisions of the I.T.A. may promote certain social and economic objectives of Parliament and does not solely contain business related provisions.

\(^3\) The qualifications are: (1) transactions that may reasonably be considered to have been undertaken or arranged primarily for bona fide purposes other than a purpose of obtaining a tax benefit are excepted from the definition of avoidance transactions; (2) GAAR does not apply where it may reasonably be considered that the transaction would not result directly or indirectly in "a misuse of the provisions of [the] Act or an abuse" with due regard to the other provisions of the I.T.A. read as a whole; and (3) in order to deny the tax benefit, the Minister of Finance's power to dictate the tax consequences of a transaction is limited to determinations that are "reasonable in the circumstances." See I.T.A. section 245.
and, generally, to ignore the tax consequences of an avoidance transaction. An avoidance transaction is a transaction, or part of a series of transactions, that would otherwise result, directly or indirectly, in a reduction, avoidance, or deferral of taxes or other amounts payable under the Act or an increase in any refund otherwise payable. To date, only one reported decision deals with the application of GAAR. Consequently, its scope remains both uncertain and untested in Canadian law. What is certain is that any tax opinion regarding transactions motivated by other than strictly commercial reasons must be prefaced with a caveat as to the potential application of GAAR.

IV. CORPORATE NONRECOGNITION PROVISIONS

A. Transfers of Property to a Corporation

I.R.C. section 351 and I.T.A. section 85 provide for nonrecognition on the transfer of property to a corporation in exchange for its stock. Absent these sections, an exchange of property for stock would constitute dispositions of property at fair market value. Tax deferment reflects a policy decision by both countries that a transfer of property to a corporation for stock represents a continuation of investment in a modified form, rather than a liquidation of the investment in the assets transferred. I.R.C. section 351 is a mandatory nonrecognition provision applicable to the transfer of property to a new or existing corporation, if the transferors have control of the corporation immediately after the transfer. By way of comparison, I.T.A. section 85 is elective and does not contain a "control" requirement. As continuity of interest is not a factor, I.T.A.

94 McNichol v. R. (1997) 2 C.T.C. 2088 (T.C.C.) was decided by the Tax Court of Canada in January 1997. It is the lowest level court at which tax matters can be heard.

95 I.R.C. § 351(a); I.T.A. subsection 85(1).

96 See I.T.A. sections 54(c), 69.

97 See Treas. Reg. § 1.1002-1(c) (1960) (viewing the transaction as a continuation of the original investment).

98 For tax purposes, a voluntary contribution to capital by a shareholder is treated similar to an I.R.C. § 351 exchange. Compare I.R.C. § 118 (1997) (providing that contributions to the capital of a corporation are not included in the gross income) with I.R.C. § 351 (1997) (extending non-recognition of gain or loss when property is transferred to a controlled corporation); see also Treas. Reg. § 1.118-1 (1960) (providing for an increase in the contributing shareholder's basis in the corporate stock).

99 Although "control" is relevant for a number of purposes in determining the operation of I.T.A. section 85, it is particularly relevant in determining whether a loss may be claimed by the transferor on a transfer to a controlled corporation. See I.T.A. subsection 85(4) (denying taxpayer any capital loss on transfer to controlled corpora-
section 85 applies to a wider range of circumstances.

Briefly, I.R.C. section 351 provides that no gain or loss will be recognized if property is transferred to a corporation by one or more persons solely in exchange for stock in the transferee corporation, if the transferors are in control of the transferee corporation immediately after the exchange.\textsuperscript{100} Control is defined as the ownership of stock possessing at least 80% of the total combined voting power of all classes of voting stock and at least 80% of the total number of shares of each class of nonvoting stock.\textsuperscript{101} If the transferor receives not only stock but also money or other property (boot), realized gain, if any, but not loss, will be recognized to the transferor on the exchange.\textsuperscript{102} The transferors will receive nonrecognition treatment even though the transferee corporation assumes liabilities or takes property subject to liabilities; however, an individual transferor will recognize gain if the aggregate amount of debt relief exceeds the basis of the property transferred.\textsuperscript{103} The basis of the stock received by the transferor is the same as the basis of the transferred assets prior to the exchange, increased by any gain recognized on the transfer and decreased by the value of any boot and debt relief received.\textsuperscript{104} Boot received is given a fair market value basis.\textsuperscript{105} At the corporate level, the transferee corporation does not recognize gain or loss on the receipt of money or other property in exchange for its stock.\textsuperscript{106} With regards to the property received in the exchange, the transferee corporation receives a basis equal to the transferor’s basis in the assets, increased by any gain recognized to the transferor on the transfer.\textsuperscript{107} Thus, the unrecognized gain or loss on the exchange is preserved in both the basis of the stock received by the transferor and the basis of the property received by the transferee corporation.

I.T.A. section 85\textsuperscript{108} is comparable to I.R.C. section 351. Generally, \footnotesize{\begin{itemize}
\item See I.R.C. § 351(a).
\item See I.R.C. § 358(c).
\item See I.R.C. § 351(b).
\item See I.R.C. § 357(a), (c). If the principal purpose of the transferor with respect to the assumption or acquisition is to avoid income tax or is not a bona fide business purpose, the liabilities are treated as boot received by the transferor on the exchange.
\item See I.R.C. § 357(b).
\item See I.R.C. § 358(a)(1), (d)(1).
\item See I.R.C. § 358(a)(2).
\item See I.R.C. § 1032(a).
\item See I.R.C. § 362(a).
\item See generally A. Dunn & K. Neilson, Exchanges of Property for Shares: Section \end{itemize}}
a taxpayer who transfers eligible property to a taxable Canadian corporation in exchange for consideration that includes shares of the transferee corporation may elect an amount not less than the tax cost of the asset and not greater than its fair market value of the asset transferred as the proceeds received on the disposition of the asset.\textsuperscript{109} The election permits a rollover of the cost basis of the transferred asset to the shares received by the transferor as well as to the asset received by the transferee corporation. I.T.A. section 85 will not operate unless the transferor receives consideration from the corporation which includes shares of the transferee corporation. The section also permits the receipt of other types of consideration, however, the receipt of nonshare consideration may result in gain recognition if such consideration exceeds the tax cost of the transferred asset. A taxpayer who transfers property to a controlled corporation is not entitled to recognize loss on the disposition. The taxpayer is, nevertheless, allowed to "bump up" the cost basis of the shares received from the corporation by the amount of the disallowed loss.\textsuperscript{110} I.T.A. section 85 is more versatile than I.R.C. section 351; there is no requirement of control immediately after the exchange and, within limits, the transferor can elect the amount of income or gain which will be recognized on the transfer.

The I.T.A. section 85 rollover is available to any taxpayer,\textsuperscript{111} whether resident or nonresident, who disposes of eligible property to a taxable Canadian corporation. This requires the transferee corporation to be resident and incorporated in Canada.\textsuperscript{112} "Eligible property"\textsuperscript{113} in-

\textsuperscript{85} (pts. 1&2) 43 CAN. TAX. J. 203, 496 (1995) (discussing recent statutory changes and jurisprudence regarding section 85); Information Circular 76-19R3, Transfer of Property to a Corporation under Section 85, June 17, 1996.

\textsuperscript{109} See I.T.A. subsection 85(1).

\textsuperscript{110} See I.T.A. subsection 85(4); I.T.A. subsections 14(12), 40(3.4), 40(3.6) (proposed December 8, 1997), Notice of Ways and Means Motion. These proposed subsections will replace I.T.A. subsection 85(4).

\textsuperscript{111} The term "taxpayer" includes any person whether or not liable to pay tax. "Person" is broadly defined to include an individual, a trust, and a corporation. See I.T.A. subsection 248(1). Comparable treatment is available for transfers of property by a partnership to a corporation. See I.T.A. subsections 85(2)-(3) (providing for the transfer of property to a corporation from a partnership and the winding-up of a partnership).

\textsuperscript{112} See I.T.A. subsection 89(1) (defining a Canadian corporation). Thus, the rollover provisions in I.T.A. section 85 will not extend to transfers to a nonresident corporation, even if it carries on business in Canada.

\textsuperscript{113} I.T.A. subsection 85(1.1) defines "eligible property" as capital property (other than real property, or an interest in or an option in respect of real property, owned by a non-resident), eligible capital property, inventory (other than real property, an interest in real property or an option in respect of real property), Canadian resource properties,
includes capital property but does not include the following:

1. real property which is inventory (for example, land owned by a dealer in real estate), or any interests in or options in respect of real property which form part of the inventory of the taxpayer; and

2. real property including interests and options in respect of real property owned by a non-resident, unless the property is used during the year by the taxpayer in a business carried on in Canada.

I.T.A. section 85 requires the taxpayer transferring the assets and the corporation receiving the assets to jointly elect tax deferment treatment. The election allows the transferor and the transferee corporation to specify an amount, within the parameters of I.T.A. section 85, which will be deemed to be the proceeds received on the disposition of the property and the cost basis to the taxpayer and the corporation of the assets received in the exchange. For example, a taxpayer transferring land with a basis of $50 and a value of $100 can elect jointly with the transferee corporation $50 as the deemed proceeds on disposition and, thereby, defer all gain recognition. The taxpayer's basis in the shares received from the corporation and the transferee corporation's basis in the asset received from the taxpayer is $50. If the taxpayer and the corporation jointly elected $75 as the deemed proceeds on disposition, a $25 capital gain would be recognized by the taxpayer and the resulting basis of the shares to the transferor and the land to the transferee corporation would be $75.

Generally, upper and lower limits exist on the amount that may be agreed upon by the transferor and the transferee corporation as the deemed proceeds on disposition. First, the amount elected with respect to an asset cannot exceed its fair market value. Second, the elected amount cannot be less than the value of any nonshare consideration received from the corporation. Where the elected amount is less than the value of the nonshare consideration received, the value of the boot is deemed to be the elected amount. This places a lower limit on the

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114 See I.T.A. subsection 85(1.1)(f).
115 See I.T.A. subsections 85(1.1)(a), (h).
116 I.T.A. subsection 85(6).
117 I.T.A. subsection 85(1)(a).
118 If the elected amount exceeds the fair market value of the property received, the fair market value is deemed to be the elected amount.
election. The purpose of this lower limit is to prevent a taxpayer from actually realizing and extracting the economic value of a gain without recognizing the gain for tax purposes. Thus, the election can range from between the fair market value of the property transferred to the corporation and the value of the boot received from the transferee corporation where that value exceeds the asset’s cost basis. If the consideration received from the corporation exceeds this range, further tax consequences will follow either in the form of a shareholder benefit under I.T.A. section 15 or a deemed dividend under I.T.A. section 84.

In the above example, assume the taxpayer received shares and $50 cash boot from the transferee corporation in exchange for the land. If the taxpayer and the corporation elect $50 as the amount of proceeds on disposition, the taxpayer will not recognize gain and the corporation will have a $50 basis in the land; however, the taxpayer will have a zero basis and PUC in the shares. If the cash boot received is $25, again no gain is recognized to the taxpayer and the corporation has a $50 basis in the land, but the taxpayer will have a $25 basis and PUC in the shares. Finally, if the cash boot were $75, the amount of proceeds on disposition can not be less than $75. The taxpayer will have $25 gain and a zero basis and PUC in the shares, and the corporation will have a $75 basis in the land. Thus, in an I.T.A. section 85 transaction, gain will always be recognized to the extent the amount of the boot received by the transferor exceeds the basis of the asset transferred to the transferee corporation. By way of contrast, pursuant to I.R.C. section 351(b), boot received will trigger recognition of gain only to the extent of gain realized. As a result, the value of both the stock and boot received by the transferor becomes relevant.

The amount of consideration received by the transferor from the transferee corporation in an I.T.A. section 85 exchange is fundamental to an effective rollover. If the transferor is not the sole shareholder and related persons hold shares, the shares received by the taxpayer on the rollover must be structured to ensure avoidance of a constructive gift. I.T.A. paragraph 85(1)(e.2) operates as a penalty provision if a benefit is conferred on a person related to the taxpayer as a result of a I.T.A. section 85 rollover. If this paragraph applies, the elected amount is deemed to be increased by the value of the benefit. The provision requires a calculation of the difference between the fair market value of the transferred property at the time of the disposition and the greater of the fair market value of all consideration received by the transferor and the elected amount. If any portion of this difference can reasonably be regarded as a benefit which the transferor is conferring on a related person, the elected amount is deemed to be increased by the benefit portion. However, this increase is not reflected for purposes of calculating
the cost basis of the shares received by the transferor on the transfer.\textsuperscript{119}

Preference shares redeemable for a fixed amount will eliminate any "gifting." Thus, preference shares redeemable for the fair market value of the transferred asset are considered to be an acceptable solution to this problem. The taxpayer must also consider any nonshare consideration to be received. It is the total consideration received from the transferee corporation that must equal the fair market value of the transferred assets. The value of the preference shares must, therefore, equal the value of the assets transferred less any nonshare consideration received. Excess consideration may result in a benefit conferred on the taxpayer\textsuperscript{120} and insufficient consideration may trigger the gift provisions.\textsuperscript{121} Since improper valuation of the assets transferred can give rise to immediate tax liability, price adjustment clauses are often included when the joint election is filed\textsuperscript{122} to ensure an inaccurate valuation can be corrected without adverse tax consequences. Finally, when using I.T.A. section 85, the PUC of the shares issued on the transfer cannot exceed the elected amount less any nonshare consideration received.\textsuperscript{123}

Similarly, under the U.S. tax system, when a relationship exists between parties to a transaction, the terms of the agreement are closely scrutinized; however, under I.R.C. section 351, the method of recharacterizing the transaction has not been formalized. Nevertheless, if the stock and boot received by the transferor is disproportionate to the value of the property transferred to the transferee corporation, the entire transaction will be effectively taxed in accordance with its true nature. For example, the transfer may be recharacterized as in part a gift, compensation for services, or satisfaction of an obligation.\textsuperscript{124}

B. Corporate Divisions

Tax-deferred corporate divisions are available under both the U.S. and Canadian tax systems. I.R.C. section 355 allows a tax-free division of a corporate enterprise into two separate corporations owned by the shareholders of the original corporation. A corporate division pursuant to I.R.C. section 355 need not be part of a corporate reorganization.\textsuperscript{125} If

\textsuperscript{119} See I.T.A. subsection 85(1)(c.2).
\textsuperscript{120} See I.T.A. subsection 15(1).
\textsuperscript{121} See I.T.A. subsection 85(1)(c.2).
\textsuperscript{122} See Interpretation Bulletin IT-169, Price Adjustment Clauses, Aug. 6, 1974.
\textsuperscript{123} See I.T.A. subsection 85(2.1) (providing the computation of PUC); I.T.A. section 84.1 (providing for the non-arm's length sale of shares).
\textsuperscript{125} I.R.C. § 355(a)(2)(C).
a parent corporation distributes stock of an existing subsidiary, the transaction is governed exclusively by I.R.C. section 355. If the parent transfers part of its assets to a newly-formed subsidiary and then distributes the subsidiary stock, the transaction in its entirety will constitute a divisive reorganization as defined in I.R.C. section 368(a)(1)(D). Canada does not have a code provision that specifically addresses corporate divisions; however, I.T.A. section 85 can provide nonrecognition to a Canadian corporation which is being divided among its current shareholders in a "butterfly reorganization."

A transaction qualifying for nonrecognition under I.R.C. section 355 may take the form of a spin-off, a split-off or a split-up. A spin-off consists of a distribution by the parent corporation to its shareholders of stock in a controlled subsidiary. A spin-off is analogous to a dividend since the shareholders of the distributing corporation do not surrender stock in exchange for the distributed stock. A split-off is similar to a spin-off, except that the shareholders of the distributing corporation surrender part of their stock in the distributing corporation for stock in the controlled corporation. A split-off is analogous to a redemption. In a split-up, the distributing corporation distributes stock of two or more controlled corporations to its shareholders in complete liquidation. If the stringent requirements of I.R.C. section 355 are met, each form qualifies as a tax-free division. If the transaction fails I.R.C. section 355, the distributions will be treated as a dividend, redemption, or liquidation, respectively.

I.R.C. section 355 is a very complex anti-avoidance provision. It was enacted to prevent corporations from bailing out corporate earnings at capital gain rates.\textsuperscript{126} Currently, I.R.C. section 355 also serves as a backstop to the repeal of the General Utilities Doctrine,\textsuperscript{127} assuring a tax at the corporate level on the distribution of appreciated assets as part of a plan of reorganization.\textsuperscript{128} As a result, a corporate division must satisfy

\textsuperscript{126} See Gregory, 293 U. S. at 815 (describing such a transaction); see supra note 7 (describing the maximum tax rate imposed on net capital gains).

\textsuperscript{127} The General Utilities Doctrine provided that a distributing corporation did not recognize gain or loss on the distribution of property to its shareholders with respect to its stock on a liquidating or nonliquidating distribution. The doctrine resulted from the broad application of the Supreme Court decision, General Utilities & Operating Company v. Helvering, 296 U.S. 200 (1935), and was codified in I.R.C. § 311 (nonliquidating distributions), and I.R.C. § 336 (liquidating distributions). I.R.C. § 311 and § 336 were amended by the Tax Reform Act of 1986, and now generally provide for recognition of gain at the corporate level on the distribution of appreciated assets in liquidating and nonliquidating distributions.

\textsuperscript{128} I.R.C. § 355(c). If the stock distribution is preceded by a D reorganization, the
the many statutory requirements of I.R.C. section 355 and its accompanying judicial doctrines in order to receive tax deferment.

Briefly, I.R.C. section 355 permits a corporation with one or more businesses actively conducted for five years or more to make a tax-free distribution of the stock of a controlled subsidiary, provided that the transaction is being carried out for a legitimate business purpose, is not being used principally as a device to bail out earnings and profits, and the requisite continuity of interest is maintained. If the requirements of I.R.C. section 355 are met, the shareholders of the distributing corporation will not recognize gain or loss on the distribution of stock or securities of a controlled corporation. In the case of a distribution of securities, if the principal amount of the securities of the controlled corporation received by the distributee shareholder exceeds the principal amount of the distributing corporation's securities surrendered, the value of the excess is treated as boot. The distribution of this and other forms of boot does not necessarily disqualify a transaction under I.R.C. section 355, but causes the distributee shareholder to recognize any realized gain, usually as ordinary income, to the extent of boot received. The aggregate basis of the property received by the distributee shareholder in a I.R.C. section 355 transaction is the aggregate basis of the shareholder's stock, increased by gain recognized and decreased by money and the value of boot received in the exchange. This aggregate

treatment of the distributing corporation is governed by I.R.C. § 361(c). I.R.C. § 355(c) was added to prevent the use of I.R.C. § 355 to avoid recognition of corporate gain on the sale of a business.

I.R.C. § 355(a)(1)(C), (b).

I.R.C. § 355(a)(1)(D) (providing that the distributing corporation must distribute all the stock of the controlled corporation or, at least, an amount of stock sufficient to constitute control within the meaning of I.R.C. § 368(c), which requires ownership of 80% of the total combined voting power and 80% of the total number of shares of all other classes of stock).

I.R.C. § 355(a)(1)(A) (discussing subsidiary which is a corporation).


I.R.C. § 355 does not apply to a transaction used principally as a device for the distribution of earnings and profits of the distributing or the controlled corporation, or both, at capital gains rates. See I.R.C. § 355(a)(1)(B); Treas. Reg. § 1.355-2(b) (1989).


I.R.C. § 355(a)(1). Debt-like preferred stock received in a distribution with respect to stock other than such debt-like preferred stock is not treated as stock or securities. I.R.C. § 355 (a)(3)(D).


basis is then allocated among the stock or securities received and retained in proportion to their relative fair market value. The boot receives a fair market value basis.

If one or more corporations are formed as a preparatory step to a qualifying corporate division, the transaction as a whole is a divisive D reorganization. I.R.C. section 368(a)(1)(D) defines a divisive D reorganization as a transfer by a corporation of all or part of its assets to another corporation if immediately after the transfer the transferor corporation, or one or more of its shareholders, or any combination thereof, is in control of the transferee corporation, but only if the stock or securities of the transferee corporation are distributed in a transaction which qualifies under I.R.C. section 355. The transferor corporation does not recognize gain or loss on the transfer of its assets to the controlled corporation, and takes an exchange basis in the stock and securities received. The newly formed controlled corporation does not recognize gain on the issuance of its stock and takes the assets with a transferred basis.

A divisive corporate reorganization is also possible for Canadian tax purposes provided there is significant continuity of interest in the property of the distributing corporation. As previously mentioned, such divisive reorganizations in Canada are commonly referred to as butterfly transactions. The essence of a butterfly transaction is that property of a corporation is transferred to one or more corporate shareholders in proportion to their share interest in that corporation in a tax-deferred exchange for shares under I.T.A. section 85. Subsequently, shares of the transferee corporations owned by the transferor corporation are redeemed and the shares of the transferor corporation owned by a subsidiary of the transferees are redeemed, thereby triggering deemed intercorporate dividends pursuant to I.T.A. subsection 84(3). These dividends are deductible pursuant to I.T.A. subsection 112(1) provided the tax avoidance provisions

138 See I.R.C. § 358(a)(1), (b).
139 See I.R.C. § 358(a)(2).
140 See I.R.C. § 368(a)(1)(D) (requiring a nondivisive D reorganization meet the requirements of I.R.C. § 354(b)). In the case of a D reorganization meeting the requirements of I.R.C. § 355, the shareholders will be treated as having control of the corporation to which the assets are transferred if the shareholders of the distributing corporation own more than 50% of the stock of the controlled corporation, measured by vote and value. See I.R.C. § 368(a)(2)(H)(ii).
141 See I.R.C. § 361(a).
142 See I.R.C. § 358(a).
143 See I.R.C. § 1032(a).
144 See I.R.C. § 362(b).
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in I.T.A. subsection 55(3) are not offended. As a result, a transaction which would otherwise give rise to a capital gain is instead executed using a combination of a nonrecognition provisions and the integration mechanism which permits the tax-free flow of intercorporate dividends.

The policy reason for permitting a distribution of property free of capital gains tax in certain circumstances is that there is no true economic disposition of the property. The shareholders still retain their proportionate beneficial interest in the assets of the corporation, but in a different form. As in the United States, the characterization of a distribution to a corporate shareholder as a dividend is preferred to a capital gain because of the intercorporate dividend deduction.

Consider the following example which illustrates a classic butterfly transaction:

Mr. Break and Mr. King each own 50% of Breaking Up, Inc. They wish to go their separate ways.

BEFORE

Mr. Break
50%

Breaking Up, Inc.

Mr. King
50%

The separation is accomplished in a series of five steps:
1. Mr. Break and Mr. King would each transfer their shares in Breaking Up, Inc. to a holding company (Hold Co.) using I.T.C. section 85.
2. A wholly owned subsidiary would be incorporated for each of the Hold Co.s, resulting in Break Co. and King Co.
3. Fifty percent of the assets of Breaking Up, Inc. would be transferred to each Break Co. and King Co. in exchange for shares.
4. The shares of Break Co. and King Co. held by Breaking Up, Inc. would be redeemed by each corporation for cash.
5. Breaking Up, Inc. will use the cash to redeem its shares held by each of the Hold Co.'s.

Mr. King → Hold Co. (s.85) → Breaking Up, Inc. → King Co. → Hold Co. (s.88(1) Winding Up) → King Co.

During:
- Mr. Break holds 50% of Hold Co. and Breaking Up, Inc.
- Mr. King holds 50% of Hold Co. and Breaking Up, Inc.

AFTER:
- Mr. Break and Mr. King's shares are transferred to their respective companies.
- Remaining assets are transferred from Breaking Up, Inc. to Break Co. and King Co.
The "double-wing butterfly" is the term commonly used to describe this type of divisive reorganization. The transactions will occur on a rollover basis so long as the provisions of I.T.A. subsection 55(2) are not offended. I.T.A. subsection 55(2) is an anti-avoidance provision directed at arrangements designed to convert a capital gain on a corporate disposition into a tax-free intercorporate dividend.\textsuperscript{145}

I.T.A. subsection 55(2) will not apply if a dividend is received as part of a series of transactions or events and does not result in a disposition of property to, or a significant increase in, the interest in any corporation of, any person who deals at arm's length\textsuperscript{146} with the dividend recipient,\textsuperscript{147} namely, in a spin-off transaction. A second exception is provided if a dividend is received in the course of a reorganization in which property of a corporation is transferred to certain of its corporate shareholders with each transferee corporation receiving its pro rata share of each type of property so transferred, based on the fair market value of its shares of the transferor corporation, namely, in a split-up or butterfly transaction described above. This exception is again limited to those situations in which there is a degree of continuity of interest in the underlying assets of the corporation. Thus, a tax deferred corporate distribution is available only "where no one has acquired a direct or indirect equity interest in the distributing corporation in contemplation of the distribution and there is a continuity of interest, after the distribution, in the distributed assets by the shareholders of the transferee corporation and in the remaining assets of the distributing corporation by the remaining shareholders of the distributing corporation."\textsuperscript{148} Thus, I.T.A. paragraph 55(3)(b) will only accommodate the tax-deferred division of one corporation into two or more corporations if the shares of the new corporation continue to be owned by the shareholders of the original corporation, and the tax-deferred division of a corporation's assets is among its corporate

\textsuperscript{145} \textit{Compare} I.R.C. §§ 246, 246(A), 301(e), 1059 (anti-avoidance provisions in the United States tax code which work to limit the dividend received deduction allowed by I.R.C. § 243).

\textsuperscript{146} I.T.A. section 251 sets forth the rules for establishing whether parties are dealing at arm's length. I.T.A. subsection 55(5)(c) further provides that for the purposes of I.T.A. section 55, brothers and sisters are deemed to be dealing with each other at arm's length and not related to each other. I.T.A. subsection 55(4) also adds an anti-avoidance provision. Where the principal purpose of one or more transactions or events is to cause two or more persons to not deal with each other at arm's length, making I.T.A. subsection 55(2) inapplicable, for the purposes of I.T.A. section 55, those persons shall be deemed to deal with each other at arm's length. \textit{See} I.T.A. subsection 55(4).

\textsuperscript{147} \textit{See} I.T.A. subsections 55(2)(b), (c).

\textsuperscript{148} \textit{See} Canadian Department of Finance Technical Notes, Nov. 1994.
shareholders. In any other situation, the distribution will result in proceeds of disposition to the transferor.

C. Stock-for-Stock Exchanges

Under both the U.S. and Canadian tax systems, stock-for-stock exchanges are given nonrecognition treatment. I.R.C. § 368(a)(1)(B) defines a B reorganization as the acquisition of stock of one corporation in exchange solely for the voting stock of the acquiring corporation, or its parent, provided the acquiring corporation has control of the acquired corporation immediately after the transaction, whether or not the acquiring corporation had control immediately before the acquisition. The term "solely" has been strictly interpreted to preclude the use of any amount of consideration in a B reorganization other than voting stock of the acquiring corporation or its parent. The receipt of other consideration in lieu of fractional shares in the acquiring corporation, however, is permitted. Control of the target corporation need not be acquired in one transaction. A creeping acquisition of control, as well as, an increase in ownership by a corporation that is already in control of the target corporation can qualify. Minority shareholders unwilling to accept acquiring corporation stock cannot receive cash or other property directly from the acquiring corporation without violating the solely for voting stock requirement. Nevertheless, it is possible for the target corporation to redeem the stock of the dissenting shareholders with its own funds or the shareholders of the acquiring corporation to purchase the stock of dissenters. If a transaction qualifies as a B reorganization, the I.R.C. generally provides for nonrecognition of gain or loss to the target corporation shareholders and the acquiring corporation shareholders on the exchange of stock. The target corporation shareholders' basis in the target corporation stock becomes the shareholders' basis in the acquiring corporation stock received and the acquiring corporation's basis in the target stock re-

150 See I.R.C. § 368(a)(1)(B) (describing the requirements of a B reorganization).
156 I.R.C. § 354(a).
157 I.R.C. § 361.
Under the Canadian tax system, I.T.A. section 85.1 allows shareholders who exchange the shares of a taxable Canadian corporation, the target corporation, for the shares of a Canadian corporation, the acquiring corporation, to receive tax-deferred treatment. In the absence of this rollover provision, the target corporation shareholder would be considered to have disposed of the shares of the target corporation for proceeds equal to the fair market value of the shares received from the acquiring corporation. The exchange must be solely for shares of a single class of the acquiring corporation's treasury stock. No nonshare consideration may be received on the transaction. In order to qualify for nonrecognition, the parties to the exchange must be dealing at arm's length before and after the exchange. The shareholders of the target and the acquiring corporation are considered not to have dealt at arm's length after the exchange if the shareholders of the target, or the target's shareholders together with persons with whom the shareholders did not deal at arm's length, control the acquiring corporation, or own more than 50% of the fair market value of all outstanding shares of the stock of the acquiring corporation. The rollover is not mandatory and the shareholder may recognize any amount of gain or loss realized on the transaction. If gain or loss is not recognized, the basis of the shareholder's old shares is rolled over into the basis of the new shares, thus, preserving any

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158 See I.R.C. § 362(b).
159 I.T.A. section 85.1 is inapplicable if the parties to the exchange have filed an election under I.T.A. subsections 85(1) or 85(2). See I.T.A. subsection 85.1(2)(c). The stock on both sides of the exchange must be capital stock or non-inventory stock. See I.T.A. subsection 81.1(1).
160 A taxable Canadian corporation is a corporation: (1) resident in Canada, (2) incorporated in Canada, and (3) not exempt from tax. See I.T.A. subsection 89(1).
161 But see I.T.A. subsection 85.1(1)(a) (limiting tax-deferrability).
162 See P. Cobb, Share for Share Exchanges: Section 85.1, 43 CAN. TAX. J. 2230 (1995) (discussing the requirements for and results of using section 85.1 to effect a rollover); see also Interpretation Bulletin IT-450R, Share for Share Exchange, Apr. 8, 1993.
163 See I.T.A. subsection 85.1(2)(d).
164 See I.T.A. subsections 85.1(2)(a), (b). Subsection 85.1(2)(b) precludes the application of I.T.A. subsection 85.1(1) to a share transaction where immediately after the transaction the shareholder and/or related parties either control the acquiring corporation or own shares of the acquiring corporation that have a fair market value of more than 50% of the fair market value of all the outstanding shares of the acquiror. This type of transaction is sometimes referred to as a "reverse takeout" because the shareholder(s) of the target corporation end up with control of what had been the acquiring corporation.
165 See I.T.A. subsection 85.1(2)(d).
unrecognized gain or loss on the exchange.\textsuperscript{166} The basis in the target shares to the acquiring corporation is the lesser of the fair market value of the shares or their PUC\textsuperscript{167} immediately before the exchange.\textsuperscript{168} As a result, the acquiring corporation will inherit the PUC of the target corporation shares as its cost basis in the target shares. In consequence, the new cost basis to the acquiring corporation will generally be less than the fair market value of the exchanged shares.

To prevent an artificial tax-free return of capital to the target shareholders, the increase in the PUC of the shares issued by the acquiring corporation to the target shareholders is also limited to the amount of PUC attributable to the target shares received.\textsuperscript{169} To the extent that the stated capital assigned to the shares issued by the acquiring corporation in exchange for the target's shares exceeds the PUC of the target's shares, a difference between the PUC and stated capital of the corporation will exist. Consequently, future reorganizations of capital, minority interest squeeze outs, or redemption of shares may be restricted since it is only the PUC amount which may be returned to the shareholders as a tax-free return of capital.

As can be seen, many significant differences exist between a B reorganization and an I.T.A. section 85.1 share-for-share exchange. Both provisions require that the consideration for the target corporation's stock be solely stock of the acquiring corporation, however, I.T.A. section 85.1 does not require voting stock but does require a single class of acquiring corporation stock. Control immediately after the exchange is an important part of the rationale for nonrecognition in a B reorganization while the I.T.A. section 85.1 share-for-share exchange requires that the target shareholders be at arm's length with the acquiring corporation both before and after the exchange. Finally, a I.T.A. section 85.1 share-for-share exchange is not mandatory and the shareholders may recognize any amount of gain or loss on the exchange.

A share-for-share exchange can also be achieved in Canada by filing an election under I.T.A. section 85.\textsuperscript{170} In that case, the I.T.A. section 85 rollover provisions will require that the elected amount be between the cost basis of the shares and their fair market value. The cost of the new shares received on the exchange will equal the cost basis of the old shares to both the shareholder and the corporation if no nonshare consid-

\begin{itemize}
\item \textsuperscript{166} See I.T.A. subsection 85.1(1)(a).
\item \textsuperscript{167} See supra note 40 and accompanying text (discussing the computation of paid-up-capital).
\item \textsuperscript{168} See I.T.A. subsection 85.1(1)(b).
\item \textsuperscript{169} See I.T.A. subsection 85.1(2.1).
\item \textsuperscript{170} See discussion supra Part III.B. (discussing I.T.A. section 85).
\end{itemize}
eration is received. In a share-for-share exchange, I.T.A. section 85 may be preferable to I.T.A. section 85.1. I.T.A. section 85 permits nonshare consideration to be received in the transfer and avoids a potential reduction in the cost basis of the target shares by the acquiring corporation where the PUC of the target shares is less than their adjusted cost basis. If I.T.A. section 85.1 is used to acquire the target shares, it will be the PUC of the target shares and not the share's higher adjusted cost basis which will become the new cost basis of the shares in the hands of the acquiring corporation. Thus, using I.T.A. section 85 rather than I.T.A. section 85.1 can yield significantly different tax results.

For example, assume the target corporation's shares have an ACB of $5 and a PUC of $1. If the acquiring corporation uses I.T.A. section 85.1 to acquire the shares of the target corporation, it will acquire the shares at a PUC and ACB of $1 notwithstanding the fact that the shareholders of the target corporation had an ACB of $5. In contrast, if a I.T.A. section 85 rollover is used and an election is made to transfer the shares at their tax cost of $5, the shares of the target corporation now held by the acquiring corporation will have an ACB of $5, a considerably improved position from that attained with I.T.A. section 85.1. This will not always be the case. For example, compare this to a situation where the shares of target corporation have a PUC of $5 and an ACB of $1. In that case, I.T.A. section 85.1 would produce a better overall result for the acquiring corporation; the newly acquired shares of the target corporation would have both an ACB and PUC of $5. If a I.T.A. section 85 rollover were instead used, the target corporation shares would have an ACB of $1 and PUC of $1 in the hands of the acquiring corporation. It would appear to be a matter of tax indifference to both the shareholders of the target corporation and Revenue Canada as to which provision, I.T.A. section 85 or 85.1, is chosen by the acquiring corporation to acquire the target corporation shares. Provided the statutory requirements of each section are otherwise met, some scope for effective tax planning in this type of acquisition is permitted.

I.T.A. subsection 85.1(3) also provides for a tax-deferred rollover when a shareholder disposes of shares of one foreign affiliate to any other corporation which is a foreign affiliate of the taxpayer immediately following the disposition. This rollover is available provided the shares are capital property of the shareholder and the vendor receives consideration that includes shares of the acquiring foreign affiliate. Where

171 See I.T.A. subsection 95(1) (defining a foreign affiliate, for purposes of I.T.A. subsection 85.1(3), as a nonresident corporation in which the taxpayer's equity percentage is not less than 1% and the total of the equity percentages in the corporation of the taxpayer and of each person related to the taxpayer are not less than 10%).
nonshare consideration is received there is no rollover if the value of the nonshare consideration exceeds the adjusted cost basis of the transferred shares.

**D. Mergers or Amalgamations**

Both the U.S. and the Canadian tax systems contain provisions allowing the combination of two or more corporations without recognition of gain or loss. I.R.C. section 368(a)(1)(A) defines an A reorganization as a statutory merger or consolidation. Typically, under a state merger statute, the assets and liabilities of the target corporation are transferred to the acquiring corporation and the target corporation dissolves by operation of law. The shareholders of the target corporation receive stock or debt instruments of the acquiring corporation, cash or other property, or a any combination of these types of consideration. A consolidation involves a similar transfer of assets and liabilities of two or more corporations to a newly created corporate entity and the shareholders of the transferor corporations become shareholders of the new corporation by operation of law. A merger and a consolidation are both classified as A reorganizations.

I.T.A. section 87 allows for the tax-free fusion of two or more corporations into an amalgamated corporate entity. The shareholders and the creditors of the transferor corporations become the shareholders and creditors of the amalgamated corporation. To qualify as an amalgamation under this provision, no new corporate entity can result from the exchange. Therefore, in comparison to an A reorganization, only a transaction similar to a consolidation, and not a merger, is possible.

An A reorganization is defined simply as a statutory merger or consolidation. As the I.R.C. provides no further requirements. In order to preserve the Congressional intent for nonrecognition, the doctrines of continuity of interest and business enterprise are very important considerations in characterizing a transaction. The continuity of interest doctrine requires the shareholders of the target corporation to receive sufficient proprietary interest in the acquiring corporation to justify treating the

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172 See Treas. Reg. § 1.368-2(b)(1) (1986) (requiring an A reorganization to be a merger or consolidation effected pursuant to federal, state, or territorial corporate laws or the District of Columbia's corporate laws).

173 Corporations may amalgamate only with other corporations governed by the same corporate statutes. See, e.g., Canada Business Corporations Act, R.S.C. ch 44 § 182 (1997) (Can.).

174 If a new corporate entity results, the transaction constitutes a I.T.A. section 85 transfer by each transferor corporation.

175 See Treas. Reg. § 1.368-1(b) (1986).
transaction as a tax-free reorganization rather than a taxable sale.\textsuperscript{176} For advance ruling purposes, the shareholders of the target corporation must receive stock in the acquiring corporation which is equal in value to at least 50% of the value of all formerly outstanding stock of the target. Sales, redemptions and other dispositions of stock occurring prior or subsequent to the exchange that are part of the plan of reorganization will be considered in determining whether the 50% continuing interest is met.\textsuperscript{177} The transaction must also satisfy the continuity of business enterprise doctrine. This means the acquiring corporation must either continue the target corporation’s historic business or use a significant portion of the target corporation’s historic business assets.\textsuperscript{178}

If the transaction qualifies as an A reorganization, the shareholders of the target corporation, the target corporation and the acquiring corporation each receive nonrecognition treatment. The target shareholders recognize gain only to the extent of boot received,\textsuperscript{179} and the acquiring corporation does not recognize gain or loss on the exchange of its stock and securities.\textsuperscript{180} Generally, the transferor corporation does not recognize gain or loss on an exchange of property solely for stock and securities of the acquiring corporation.\textsuperscript{181} The transferor corporation can also receive boot without gain or loss recognition if the boot is distributed to the shareholders pursuant to the reorganization.\textsuperscript{182} In addition, the distribution by the target corporation to its shareholders of stock and obligations of the target corporation as a tax-free reorganization rather than a taxable sale.\textsuperscript{176} For advance ruling purposes, the shareholders of the target corporation must receive stock in the acquiring corporation which is equal in value to at least 50% of the value of all formerly outstanding stock of the target. Sales, redemptions and other dispositions of stock occurring prior or subsequent to the exchange that are part of the plan of reorganization will be considered in determining whether the 50% continuing interest is met.\textsuperscript{177} The transaction must also satisfy the continuity of business enterprise doctrine. This means the acquiring corporation must either continue the target corporation’s historic business or use a significant portion of the target corporation’s historic business assets.\textsuperscript{178}

If the transaction qualifies as an A reorganization, the shareholders of the target corporation, the target corporation and the acquiring corporation each receive nonrecognition treatment. The target shareholders recognize gain only to the extent of boot received,\textsuperscript{179} and the acquiring corporation does not recognize gain or loss on the exchange of its stock and securities.\textsuperscript{180} Generally, the transferor corporation does not recognize gain or loss on an exchange of property solely for stock and securities of the acquiring corporation.\textsuperscript{181} The transferor corporation can also receive boot without gain or loss recognition if the boot is distributed to the shareholders pursuant to the reorganization.\textsuperscript{182} In addition, the distribution by the target corporation to its shareholders of stock and obligations of the target

\textsuperscript{176} See Southwest Natural Gas Co. v. Comm’r, 189 F.2d 332 (5th Cir. 1951). Recently, the issue of who constitutes a historic shareholder of the target corporation has generated much controversy. See Kass v. Commissioner, 60 T.C. 218 (1973) (holding that continuity of interest must be measured by considering all pre-tender of shareholders); contra J.E. Seagram Corporation v. Commissioner, 104 T.C. 75 (1995).

\textsuperscript{177} Rev. Proc. 77-37, 1977-2 C.B. 568, 569. Courts have found continuity of interest where shareholders of the acquired corporation received less than 50% in value of the acquired corporation’s stock. See John A. Nelson Co. v. Helvering, 296 U.S. 273 (1935) (38% continuity sufficient).

\textsuperscript{178} See Treas. Reg. § 1.368-1(d)(2) (1986) (examples 4 and 5 note that disposal or liquidation of a company’s assets immediately before or after the merger prevent the finding of continuity of business enterprise).

\textsuperscript{179} See I.R.C. §§ 354, 356. Debt-like preferred stock received in exchange for stock other than such debt-like preferred stock is not treated as stock or securities. I.R.C. § 354(a)(2), 356(c). If the principal amount of the securities received exceeds the principal amount of the securities surrendered, the fair market value of the excess is treated as boot. See I.R.C. §§ 354(a)(2), 356(d).

\textsuperscript{180} See I.R.C. § 1032(a).

\textsuperscript{181} See I.R.C. § 361(a).

\textsuperscript{182} See I.R.C. § 361(b)(1)(A). The assumption by the acquiring corporation of the liabilities of the target is not treated as boot. See I.R.C. § 357(a).
or the acquiring corporation does not trigger gain or loss. The distribution of other property does, however, result in gain recognition. The target shareholders receive an exchange basis in the stock and securities received and a fair market value basis in any boot, and the acquiring corporation receives a transferred basis in the assets received. The tax attributes of the target corporation are carried over to the acquiring corporation.

For Canadian income tax purposes, an amalgamation is a merger of two or more taxable Canadian corporations which results in the amalgamating corporations continuing as one amalgamated corporation. No new corporate entity is created. Instead, all of the property and liabilities of the amalgamating corporations become the property of the amalgamated corporation and all of the shareholders of the amalgamating corporations receive stock in the amalgamated corporation. The most common patterns are vertical and horizontal amalgamations. In a vertical amalgamation, a parent corporation merges with one or more subsidiary corporations to form the amalgamated corporation. Thus, a vertical amalgamation is similar in effect to the winding-up of a subsidiary into its parent corporation. A horizontal amalgamation is the merger of two or more corporations to form the amalgamated corporation. The corporate entity resulting from either form of amalgamation carries forward the tax attributes of the merged corporations. The shareholders of the target corporations receive an exchange basis in the shares in the amalgamated corporation.

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183 See I.R.C. § 361(c).
184 See I.R.C. § 358.
185 I.R.C. § 362(b).
186 See I.R.C. § 381 (providing for carryover of various tax attributes, including loss carryovers). Complex loss limitation rules apply, however, if the loss corporation undergoes a significant change of ownership. See I.R.C. § 382 (detailing the limitations on net operating loss carryovers).
188 For a discussion of the Canadian corporate law cases dealing with the effect of an amalgamation, see The Queen v. Black & Decker Mfg. Co. [1975] 1 S.C.R. 411 (Can.) (holding that when two pre-existing corporations amalgamated together no new corporation was created). See also Commercial Corp. Fin. Serv. Inc. [1995] 3 Alta LR (3d.) 177 (QB).
189 See I.T.A. subsection 87(1).
190 See I.T.A. subsection 87(1.2) (deeming the new corporation to be a continuation of the old corporation with regards to listed provisions). See, e.g., I.T.A. subsection 87(2)(l) (allowing the new corporation to utilize unused research expenditures of old corporation); I.T.A. subsection 87(2) (providing rules applicable to the amalgamation of two or more corporations).
corporation\textsuperscript{191} and the amalgamated corporation receives a transferred basis in the assets received from the target corporations.\textsuperscript{192}

In addition, I.T.A. section 87 deems certain corporate transactions to be amalgamations for tax purposes.\textsuperscript{193} A deemed amalgamation occurs, for example, where a corporation and one or more of its wholly-owned subsidiaries,\textsuperscript{194} or two or more corporations each of which is a wholly-owned subsidiary of the same corporate parent, are merged and no shares are issued by the amalgamated corporation.

The following illustrates these types of amalgamations:

\begin{figure}[h]
\centering
\includegraphics[width=\textwidth]{amalgamation_diagram.png}
\caption{Diagram illustrating types of amalgamations.}
\end{figure}

\begin{itemize}
\item \textbf{Paragraph 87(1.1)(a)}
\item \textbf{Paragraph 87(1.1)(b)}
\end{itemize}

\begin{footnotes}
\item See I.T.A. subsection 87(4)(b).
\item See I.T.A. subsection 87(2)(e).
\item I.T.A. subsections 87(1.1) (a), (b).
\item See I.T.A. subsection 87(1.1). See also I.T.A. subsection 87(1.4) (defining subsidiary wholly-owned corporation).
\end{footnotes}
No new shares are issued and the shareholders hold shares in Parent Co. both before and after the amalgamation.

Similar to a reorganization, the Canadian merger provisions also allow for triangular amalgamations. If two or more taxable Canadian corporations merge to form an amalgamated corporation that immediately after the merger is controlled by a taxable Canadian corporation, the shares issued by the parent corporation are deemed to be issued by the new corporation.

The following illustrates this type of amalgamation:

BEFORE

Parent Co.

Amalgamates

Sub. Co.

AFTER

Parent Co.

Public Co.

Amal. Co.

Paragraph 87(9)

These rollovers are automatic, not elective.

I.T.A. subsection 87(2) provides detailed rules for the rollover of particular types of property that may be acquired by the amalgamated corporation. For example, under I.T.A. paragraph 87(2)(e) if capital property is acquired by the amalgamated corporation by virtue of the amalgamation, the cost of that property to the amalgamated corporation is simply the adjusted cost basis of that property to the predecessor corporation. An additional provision provides for a flow-through of the property and tax accounts to the new corporation. A number of special provisions also affect the tax accounts of the predecessor corporations. For example, on the amalgamation of a parent company and one or more of its subsidiaries, I.T.A. subsection 87(2.11) deems the amalgamated corporation to be the same corporation as, and a continuation of, the parent corporation to permit a corporation formed through a vertical amalgamation to apply its post-amalgamation losses against the pre-amalgamation income of its predecessor parent corporation.

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195 See I.R.C. § 368(a)(2)(C), (D), (E).
196 See I.T.A. subsection 87(9).
197 See I.T.A. subsection 111.
198 Proposed I.T.A. subsection 87(2.11) was intended to put vertical amalgamations
Proposed amendments to I.T.A. section 87 would equate the overall tax treatment of an amalgamated corporation more closely with the tax result on the winding-up of a subsidiary corporation into its parent. Specifically, the proposed provision would permit an increase in the cost of the shares of the amalgamating subsidiaries owned by the parent over the tax cost of the underlying assets. This increase will parallel the "bump" currently available on the winding-up of a wholly-owned subsidiary into its parent and incorporates the same conditions that apply on a winding-up.

E. Recapitalization

A recapitalization has been defined by the United States Supreme Court as a "reshuffling of a capital structure within the framework of an existing corporation." The readjustment of the financial structure of a single corporation is a tax-free transaction in both the United States and Canada. In the United States, I.R.C. section 368(a)(1)(E) includes a recapitalization as a form of reorganization called an E reorganization. Although the continuity of interest and the continuity of business enterprise doctrines are not relevant, as only a single corporation is involved, for U.S. tax purposes, a recapitalization must serve a corporate business purpose in order to qualify for nonrecognition. Recapitalizations fall within four categories depending on the type of consideration exchanged.

on the same footing as I.T.A. subsection 88(1) wind-ups with the ability to carry back post merger losses to offset taxable income of the parent premerger. If a subsidiary has been wound up into its parent, any losses that occur after the wind-up can generally be carried back to reduce the taxable income of the parent for tax years that end before the wind-up. The reverse is not true. The losses of a wholly-owned subsidiary can not be applied to the taxable income of its parent for taxation years prior to the amalgamation. See Revenue Canada Technical Release No. 3, Jan. 30, 1995.

See discussion supra Part II.B.1. (discussing the mechanics of I.T.A. treatment of the winding-up of wholly-owned subsidiaries).

See Canadian Department of Finance, June 20, 1996, Notice of Ways and Means Motion.


See Rev. Proc. 81-60, 1981-2 C.B. 680 (providing guidelines and listing information which must be included in ruling requests); Rev. Rul. 82-34, 1982-1 C.B. 59 (holding that business-continuity is not required).

See §§ 1272-75, 163(e) (explaining the rules and conditions under which the exchange of bonds may trigger original issue discount).
1. Exchanges of Stock for New Stock

An exchange of stock-for-stock qualifies as an E reorganization.\(^{205}\) In an equity for equity exchange, the distributing corporations is entitled to nonrecognition on the issuance of stock to the shareholders\(^{206}\) and the shareholders of the corporation will not recognize gain on the exchange of stock unless boot is also received.\(^{207}\) The shareholder’s basis in the stock received is the same as the basis of the stock exchanged.\(^{208}\) A recapitalization may constitute a deemed taxable stock dividend if the reorganization is pursuant to a plan to periodically increase a shareholder’s proportionate interest in the assets or earnings of the corporation.\(^{209}\) Additionally, if a corporation distributes preferred stock for its outstanding common stock, the new stock may be characterized as Section 306 stock.\(^{210}\)

2. Exchanges of Stock for New Bonds

An exchange of stock for bonds or other securities raises a potential bailout problem. The United States Supreme Court has held that the pro rata exchange of common stock for common stock and bonds payable on demand constitute the distribution of a dividend.\(^{211}\) Even if characterized as an E reorganization, if the principal amount of the securities received exceed the principal amount of the securities surrendered or if securities were received and none were surrendered, the value of the excess will constitute boot.\(^{212}\)

\(^{205}\) Cf. I.R.C. § 1036(a) (explaining that when an exchange of common stock-for-common stock or preferred stock-for-preferred stock solely involves shareholders of the same corporation such exchange is tax-free).

\(^{206}\) See I.R.C. § 1032(a).

\(^{207}\) See I.R.C. §§ 354(a), 356.

\(^{208}\) See I.R.C. § 358 (providing the tax payer does not receive any money or property in the exchange and receives none).

\(^{209}\) See I.R.C. § 305(c); see Treas. Reg. § 1.305-7(c) (1995) (explaining when a reorganization will result in a distribution of stock, it is taxable to the shareholder).

\(^{210}\) I.R.C. § 306(c)(1)(B). Generally, the subsequent disposition of § 306 stock will generate ordinary income. I.R.C. § 306(a).


\(^{212}\) See I.R.C. § 354(a). The shareholder will receive an exchange basis increased by gain recognized and decreased by boot received. The boot will receive a fair market value basis. See I.R.C. § 358(a).
3. Exchanges of Bonds for New Stock

If a corporation discharges outstanding bonds with stock, the bondholder will recognize gain only to the extent stock received is attributable to accrued interest on the bonds.\textsuperscript{213} Generally, the corporation will not recognize gain or loss on the distribution of the stock.\textsuperscript{214} If the value of the stock is less than the principal amount of the indebtedness, however, the corporation may experience cancellation of indebtedness income.\textsuperscript{215} An insolvent or bankrupt corporation may exclude any discharge of indebtedness income by reducing its tax attributes.\textsuperscript{216}

4. Exchanges of Bonds for New Bonds

Generally, the bondholder in a bond-for-bond exchange will not recognize gain or loss unless the bonds received are attributable to accrued interest,\textsuperscript{217} the principal amount of the bonds received exceed the principal amount of the bonds surrendered, or bonds are received and none are surrendered.\textsuperscript{218} In addition, the original issue discount rules may apply, a corporation may experience cancellation of indebtedness income,\textsuperscript{219} and the debt modification may be treated as a realization event.\textsuperscript{220}

For Canadian tax purposes, a reorganization involving the disposition of existing shares (old shares) in exchange for other shares (new shares) of the corporation gives rise to a capital gain. I.T.A. sections 86 and 51 are provisions which allow the taxpayer to defer the realization of the capital gain on the old shares exchanged for the new shares, or, in the case of the more flexible I.T.A. section 51, the old shares or debt instruments exchanged for the new shares. Unlike the U.S. recapitalization provisions, the requirements of these sections are quite detailed and must be followed carefully in order to qualify for nonrecognition.

\textsuperscript{213} See I.R.C. § 354(a)(1), (2)(B).
\textsuperscript{214} See I.R.C. § 1032(a).
\textsuperscript{215} See I.R.C. § 108(e)(8) (stating that if a debtor corporation transfers stock to a creditor in satisfaction of indebtedness, debt is satisfied by the fair market value of the stock).
\textsuperscript{216} I.R.C. § 108(a), (b).
\textsuperscript{217} See I.R.C. § 354(a)(2)(B).
\textsuperscript{218} See I.R.C. § 354(a)(2)(A).
\textsuperscript{219} I.R.C. § 108(e)(10).
a. I.T.A. Section 86

I.T.A. section 86 is often used in an exchange of one class of shares for another class of shares for any number of commercial reasons. For example, preference shares issued to investors with special dividend rights may be exchanged for common shares with winding-up rights if dividends cannot be paid. Another common use of I.T.A. section 86 is to freeze of a taxpayer's interest in an operating company for estate planning purposes. In that case, the taxpayer may exchange common shares for preferred shares which do not participate in the future growth of the corporation.

Provided the old shares are capital property of the taxpayer, on the disposition of the old shares for the new shares, any increase in value of the old shares is not taxed to the shareholder provided that: (1) all of the shares of that particular class owned by the taxpayer are exchanged; (2) the taxpayer receives consideration that includes shares of the same corporation; and (3) the transaction occurs in the course of a reorganization of capital of the corporation. If these requirements are met, I.T.A. section 86 applies automatically, provided I.T.A. section 85 does not apply to the transaction. No gain is recognized by the shareholder unless the shareholder also receives boot in excess of the adjusted cost basis of the old shares. It is not necessary that the corporation undergoing the reorganization or the shareholder be a resident of Canada, or that the corporation be incorporated in Canada to obtain this rollover treatment.

A number of additional matters should be noted. First, if a deemed dividend is to be avoided, it is important to ensure that the PUC of the new shares issued on the reorganization equals the PUC of the old shares exchanged minus the fair market value of any nonshare consideration received on the exchange. In short, if the corporation's PUC is increased as a result of the reorganization or it is not decreased to reflect the value of any nonshare consideration received by the shareholder, I.T.A. subsec-

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21 See generally D. Ewens, Reorganizations of Capital: Section 86, 43 CAN. TAX. J., 783 (1995) (discussing the requirements that must be met in order for shareholders to obtain a tax-deferred rollover for their shares where a corporation undergoes a reorganization of its share capital).

22 I.T.A. subsections 84(9), 86(3).

23 The results of the share exchange are as follows:
   1. The cost of the boot received is its fair market value (I.T.A. paragraph 86(1)(a));
   2. The ACB of the new shares to the taxpayer is the ACB of the old shares minus the value any boot (I.T.A. paragraph 86(1)(b)); and
   3. The proceeds on disposition of the old shares is the ACB of the new shares plus the value of the boot received (I.T.A. paragraph 86(1)(c)).
tion 84(1) will apply to deem a dividend.

Second, the gift tax rules of I.T.A. subsection 86(2) must also be considered. This provision will operate to deny a tax-deferred rollover to a shareholder if, immediately after the reorganization, the total fair market value of the consideration received is less than the fair market value of the old shares immediately before the reorganization, and it is reasonable to regard any portion of the difference as a benefit that the shareholder desired to confer on a related person. Where the gift rule applies the result will be an immediate capital gain or a decrease in the cost basis of the newly issued shares.224

b. I.T.A. Section 51

I.T.A. section 51225 is another method of reorganizing the capital structure of a corporation, and applies to transaction where I.T.A. subsection 85(1) and I.T.A. section 86 have no application. This section allows the taxpayer to convert debt into shares or shares into shares of a different class, provided that the taxpayer receives no consideration other than the new shares on the exchange. I.T.A. section 51 has the advantage of permitting a taxpayer in a recapitalization to exchange only part, rather than all, of the taxpayer’s shares. By virtue of I.T.A. paragraph 51(1)(a), the conversion will not be deemed a disposition of property. Under I.T.A. paragraph 51(1)(b), the adjusted cost basis of the new shares is the adjusted cost basis of the old shares.

The gift rule in I.T.A. subsection 51(2) is similar to that in both I.T.A. subsection 86(2) and I.T.A. paragraph 85(1)(e.2) and imposes adverse tax consequences when the fair market value of the old shares exchanged is greater than the fair market value of the new shares issued

224 The gift rule operates as follows:

If the fair market value of the old shares before the exchange is greater than the cost of any boot received plus the value of the new shares received, and it is reasonable to regard any portion of this excess as a benefit the taxpayer desired to have conferred on a related person, I.T.A. subsection 86(2)(b) applies. If I.T.A. section 86(2) applies, I.T.A. section 86(1) does not. Instead, the results are as follows:

1. The proceeds on disposition of the old shares are deemed to equal the lesser of: the value of the old shares, or the cost of the boot received plus the amount of the benefit;
2. The capital loss on the disposition of the old shares is deemed to be $0; and
3. The cost of the new shares is deemed to be equal to the ACB minus the cost of boot plus the amount of the benefit.

and it is reasonable to assume that the taxpayer has conferred a benefit on a related person. Again, since no new assets are being acquired by the corporation, the PUC of the new shares cannot exceed the PUC of the old shares or deemed dividends will arise.226

F. Corporate Dissolutions

In both the United States and Canada, the dissolution of a corporation results in recognition of gain or loss at the shareholder and corporate levels. In the United States, with the repeal of the General Utilities Doctrine,227 the distributing corporation is treated as if it sold its assets to the shareholders at fair market value228 However, the provision contains complex rules limiting the ability of a liquidating corporation to recognize losses on the distribution.229 The shareholders of the distributing corporation are considered to have exchanged their stock for an amount equal to the fair market value of the property received from the corporation.230 Similarly, assets distributed by a Canadian corporation to its shareholders on winding-up are deemed to have been disposed of by the corporation at fair market value.231 A shareholder is entitled to receive in cash or property an amount equal to its PUC without any tax consequences.232 However, if a shareholder receives cash or property in excess of PUC, the excess will be treated as a deemed dividend.233 In addition, the shareholder will be deemed to have disposed of its shares. Proceeds of disposition, however, are reduced by the amount of any deemed dividend received in the transaction. The result, where the PUC and cost basis of the share are the same, is no capital gain or loss realized on the winding-up.234 Comparing the two provisions, it is important to note that, in

226 See I.T.A. subsection 84(1).
227 See supra note 127 (discussing the General Utilities Doctrine).
228 See I.R.C. § 336(a).
229 See I.R.C. § 336(d).
230 See I.R.C. § 331. The shareholder to whom property is distributed in a complete liquidation takes the property with a basis equal to its fair market value. See I.R.C. § 334(a).
231 See I.T.A. subsections 69(5), 88(2). Generally, full loss recognition is allowed. See I.T.A. paragraph 69(5)(a)(ii). See I.T.A. subsections 85(4)(b)(iv), 85(5.1) (describing the tax consequences transfers of assets from the taxpayer to the corporation). Although no rollover is available on a winding-up, I.T.A. subsection 88(2) does provide some tax relief in the form of special rules to facilitate the distribution of the capital dividend account and the pre-1972 capital surplus on hand. See infra notes 265-67 (defining and discussing pre-1972 capital surplus on hand (CSOH)) (describing the transfer of assets from the taxpayer to the corporation).
232 See I.T.A. subsections 84(2), 89(1).
233 See I.T.A. subsection 84(2).
234 An exception to this general rule may occur if the winding-up includes pre-1972
Canada, corporate distributions of dividends are preferable to capital gains as Canada has an integrated corporate tax system. In the United States, unless the shareholder is a corporate shareholder, capital gains treatment is generally preferred over dividend treatment.

Both Canada and the United States provide exceptions to recognition upon the liquidation of a subsidiary corporation by a parent corporation. In the United States, if the requirements of I.R.C. section 332(b) are met, the distribution of property by a subsidiary to a parent in complete liquidation constitutes a nonrecognition event for the parent and the subsidiary. In order to qualify for nonrecognition, I.R.C. section 332(b) requires that the parent corporation own a specific amount of the subsidiary stock and that the liquidating distributions occur within a specified time period. The first requirement is met if the parent corporation owns stock that possesses at least 80% of the total voting power of the outstanding stock of the subsidiary corporation and has a value equal to at least 80% of the stock of the subsidiary corporation without regard to certain nonvoting stock that is limited and preferred as to dividends. The 80% stock-ownership test must be met on the date of adoption of the plan of liquidation and must continue until the final liquidating distribution.

If the requirements of I.R.C. section 332(b) are satisfied, the parent corporation recognizes no gain or loss on receipt of property distributed in complete liquidation of the subsidiary corporation. The property distributed to the parent corporation has a substituted basis to the parent equal to the subsidiary’s basis. In the case of property distributed to a shareholder other than the parent corporation, the minority shareholder receives taxable exchange treatment and a fair market value basis in the assets received on the liquidation.

CSOH as defined in I.T.A. paragraph 88(2)(a)(iii). This provision will be of relevance in the case of corporations incorporated prior to 1992.

See I.R.C. § 337.

I.R.C. §§ 332(b)(1), 1504(a)(2). If the purchase constitutes a qualified stock purchase, the purchasing corporation may make a I.R.C. § 338 election. Without liquidating, the subsidiary is treated as a new corporation having sold and repurchased all of its assets at fair market value. See I.R.C. §338(a)(1).

See I.R.C. § 332(b)(1).

See I.R.C. § 332(b)(2), (3).

See I.R.C. § 332(a).

See I.R.C. § 334(b).

See I.R.C. § 331 (discussing distribution to shareholder in complete liquidation
which I.R.C. section 332 applies, the subsidiary corporation recognizes no gain or loss on distributions to the parent corporation.\textsuperscript{243} As to distributions to minority shareholders, the subsidiary corporation will recognize gain on the distribution of appreciated assets but generally no loss will be recognized.\textsuperscript{244} The tax attributes of the liquidated subsidiary will generally carry over to the parent corporation.\textsuperscript{245}

1. I.T.A. Subsection 88(1): Winding-Up of a Subsidiary Corporation

I.T.A. subsection 88(1)\textsuperscript{246} provides that a taxable Canadian corporation\textsuperscript{247} which is at least 90% owned by another taxable Canadian corporation can be wound up into its parent on a tax-free basis. Immediately before winding-up, the parent corporation must own not less than 90% of the shares of each class of shares of the subsidiary corporation and the remaining shares must have been owned by shareholders with whom the parent corporation was dealing at arm’s length.\textsuperscript{248} Generally, the assets and liabilities of a subsidiary are rolled over into its parent without triggering immediate gain or loss recognition. If the requirements of I.T.A. subsection 88(1) are met, the rollover is not elective, but mandatory. In the case of nondepreciable capital property, the proceeds of disposition to the subsidiary corporation on the distribution of its property to the parent corporation are deemed to be the cost amount of the property.\textsuperscript{249} The cost amount of depreciable property is the undepreciated capital cost. The accounts receivable of the subsidiary are transferred to the parent corporation at face amount.\textsuperscript{250} The subsidiary’s inventory is deemed to be distributed to its parent corporation at the lower of its cost or fair market value.\textsuperscript{251} Generally, the parent corporation is deemed to

\textsuperscript{243} See I.R.C. § 337(a).

\textsuperscript{244} See I.R.C. § 336(d)(3).

\textsuperscript{245} See I.R.C. § 381.

\textsuperscript{246} See S. Roberts & M. Briggs, Winding-Up (pts. 1&2), 44 CAN. TAX. J. 533, 943 (1996) (specifying the conditions that must be met to use section 88 for the winding up of a subsidiary on a tax-deferred basis).

\textsuperscript{247} See I.T.A. subsection 89(1).

\textsuperscript{248} See I.T.A. section 251 (stating that related persons are deemed not to deal with each other at arm’s length).

\textsuperscript{249} I.T.A. subsection 88(1)(a)(iii); see also I.T.A. subsection 248(1) (defining the phrase “cost amount”); see also I.T.A. paragraph 88(1)(a)(i) (providing that the proceeds of disposition to the subsidiary in the case of Canadian resource property are deemed to be nil).

\textsuperscript{250} See I.T.A. subsection 88(1)(e.2).

\textsuperscript{251} See I.T.A. subsection 88(1)(a).
acquire the assets of the subsidiary at a cost basis equal to the deemed proceeds on disposition by the subsidiary corporation. The parent corporation thus steps into the shoes of the subsidiary corporation by taking over the assets at their tax values.

Although the parent corporation cannot recognize loss on the winding-up, it may recognize capital gain. The parent corporation is deemed to have disposed of the stock in the subsidiary for proceeds equal to the greater of the PUC of the shares or the tax value of the subsidiary’s net assets after deducting liabilities, whichever is less; or the adjusted cost basis of the stock immediately before the winding-up. If a loss occurs, the parent corporation is permitted to increase the cost of capital properties acquired on the winding-up that were previously owned by the subsidiary. This is referred to as the I.T.A. section 88 “bump.” The increase is limited to the amount by which the adjusted cost basis of the parent’s previous shares in the subsidiary exceeds the total cost amount of the properties which were acquired from the subsidiary on winding-up. The bump for each capital property is also limited to the amount by which the fair market value of the capital property at the time the parent last acquired control of the subsidiary exceeds the cost amount to the subsidiary of the capital property. Depreciable capital property and other ineligible property do not qualify for the bump. The rollover is not available with respect to assets transferred to minority shareholders which are deemed to have been sold at fair market value. Thus, gain and loss will be recognized at both the subsidiary and shareholder level.

While offering nonrecognition on a winding-up, I.T.A. subsection 88(1) has a number of obvious limitations. First, the rollover provisions do not apply if the parent company owns less than 90% of the shares of the capital stock of the subsidiary. Second, both the parent and subsidiary corporations must be taxable Canadian corporations or rollover relief will be denied. Finally, there is no rollover in the case of the winding-up of a corporation whose shares are owned by individuals and the corporate assets are distributed to those individual shareholders. In such an event, there is a deemed disposition of the corporate assets distributed at fair market value. In addition, the individual shareholders will be deemed to have disposed of their shares. The corporate winding-up will thus be

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252 See I.T.A. subsection 88(1)(c).
253 See I.T.A. subsection 88(1)(b).
254 I.T.A. subsection 88(1)(d).
255 See I.T.A. subsections 69(5)(a), 88(2)(b).
256 See I.T.A. subsection 89(1)(f) (providing a definition of a Taxable Canadian corporation).
257 See I.T.A. subsection 69(5) (providing for fair market value upon winding-up).
a taxable event both to the corporation and to its shareholders and result in the realization of any accrued gain or loss to the corporation on the property distributed, and in deemed dividends and a capital gain or loss to the individual shareholders.

2. Subsection 88(2): Winding-Up of Canadian Corporations

I.T.A. subsection. 88(2) may apply to the winding-up of a corporation where the shareholders are individuals or where the requirements of I.T.A. subsection 88(1) have not been met. Revenue Canada has indicated that the phrase "on the winding-up," for purposes of I.T.A. subsection 88(2), means the period during which the winding-up takes place; that is, the period that begins on the implementation of the winding-up procedure and ends on the actual dissolution of the corporation. Revenue Canada has further indicated that, for purposes of I.T.A. subsections 88(2) and 84(2), the corporation is considered to have been wound up if it has followed the appropriate winding-up and dissolution procedures, or has been otherwise dissolved under the provisions of its incorporating statute. Both federal and provincial corporate statutes require that the debts and obligations of the corporations must be paid, or creditor assent obtained, and that the corporation have distributed all assets before a dissolution will be authorized.

Corporate assets which are distributed by the corporation to its shareholders on a winding-up are deemed to have been disposed of at their fair market value by the corporation. Capital gains, recapture of capital cost allowance, or income in the case of inventory may be realized. If a capital loss is generated it is deductible. The shareholders' cost basis of any property received is its fair market value. The shareholders are entitled to receive in cash or property an amount equal to the PUC of the shares without any tax consequences. However, if they receive cash or property in excess of the PUC of their shares, a deemed

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258 See I.T.A. subsections 69(5), 84(2) (discussing rules for the winding up of a corporation); see also Interpretation Bulletin IT 149R4, Winding-up Dividend, June 28, 1991 (providing detailed analysis of dividends received in a winding-up).


260 See id. ¶ 3.

261 See id. ¶ 4.

262 See I.T.A. subsection 69(5); Interpretation Bulletin IT-488R2, June 24, 1994.

263 See I.T.A. subsection 40(2)(e) does not apply to levy the loss by virtue of I.T.A. subsection 69(5)(a)(ii). Also, I.T.A. subsections 85(4) and (5.1) do not apply on a winding-up to prevent the immediate realization of a capital or terminal loss on the transfer of property to a controlled corporation.
dividend will arise under I.T.A. subsection 84(2).

Although no rollover is available on a winding-up, I.T.A. subsection 88(2) does provide some tax relief in the form of special rules to facilitate the distribution of the capital dividend account (CDA) and the pre-1972 capital surplus on hand (CSOH) where the statutory requirements are met.\(^{264}\) For the purposes of computing the CDA and pre-1972 CSOH account, I.T.A. paragraph 88(2)(a) includes any unrealized capital gains in existence before the final distribution in the computation of the CDA and pre-1972 CSOH accounts. This is accomplished by deeming the taxation year of the corporation to have ended before the final distribution of corporate property. Also, each property distributed on the final distribution is deemed to have been disposed of at its fair market value immediately before the end of the taxation year that was deemed to have ended before the final distribution. As a result, the deemed dividends received on a winding-up will include both CDA and pre-1972 CSOH\(^{265}\) amounts. Each shareholder is deemed to have received a separate dividend from the CDA or pre-72 CSOH accounts or a taxable dividend in proportion to the number of shares held. If a shareholder is a nonresident, withholding tax may be payable.\(^{266}\) Treaty relief should be available with respect to these dividends. If the shares are taxable Canadian property the nonresident will also be required to comply with the provisions of I.T.A. section 116. That provision requires that the nonresident shareholder provide information respecting the transaction to the Minister of Finance and pay tax equal to 33 1/3% of the estimated taxable capital gain or provide security for the tax.

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\(^{264}\) Pre-1972 CSOH is defined and computed in I.T.A. subsections 88(2.1) and 88(2.2) Pre-1972 CSOH is the total of a corporation’s 1971 capital surplus computed under specific rules, plus the portion of the capital gains realized on the disposition of capital property owned on December 31, 1971, attributable to the period before this date, minus capital losses incurred on property owned on December 31, 1971, attributable to the period before this date.

\(^{265}\) The requirement that the I.T.A. subsection 84(2) deemed dividend provision include the CDA and pre-1972 CSOH accounts is set out in I.T.A. subsection 88(2)(b). If the I.T.A. subsection 83(2) election is made, a separate dividend from the CDA in an amount not exceeding the CDA is considered to have been paid. If the deemed winding-up dividend under I.T.A. subsection 84(2) exceeds the separate CDA dividend, an amount from pre-1972 CSOH is deemed not to be a dividend, and any excess over the CDA dividend and pre-1972 CSOH deduction is a taxable dividend.

\(^{266}\) For the purposes of the Canadian nonresident withholding tax, only the portion of the winding-up dividend paid to a nonresident shareholder, and paid out of pre-1972 CSOH (or certain capital gains dividends) will not be subject to withholding tax. The balance of the dividend paid to nonresident shareholders, including amounts elected to be paid as a capital dividend, will be subject to Canadian nonresident withholding tax.
Similar treatment results if a foreign corporation liquidates at a time when it operates a business in Canada or has Canadian assets. The sale or distribution of such assets is a taxable event for Canadian purposes, whether the liquidation is to a foreign parent or to other shareholders. Where a Canadian individual shareholder receives proceeds on the liquidation of a foreign corporation, it is also a taxable event for Canadian purposes. The fair market value of the property received is treated as proceeds of disposition of the shares.

V. CONCLUSION

Legal practice in the NAFTA market requires practitioners to become more involved in planning and advising around the tax consequences of transactions concerning Canadian corporations. It is thus becoming more important for U.S. counsel to have a basic understanding of Canadian corporate tax provisions. Fortunately, this task is not as daunting as first blush might suggest. There are a considerable number of parallels between the Canadian and U.S. tax systems. This is not surprising. It is an old Canadian adage that when the United States coughs, Canada gets the flu. The obvious parallels between the two tax systems are often not coincidental; the Canadian provisions are just a reflection of United States tax law.