

The Pursuit of Purity

Some Roadblocks on the Way

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INTRODUCTION

This paper is meant as a coda to a paper I wrote for the Ontario Bar Association in 2009,¹ on the asset tests that must be met before shares will be “qualified small business corporation shares” (“QSBCSs”), gains on which can be sheltered by the \$750,000 capital gain exemption. The present paper discusses the problems often encountered when attempting to ‘purify’ a corporation before it is sold to an arm’s length party.

PURIFICATION TECHNIQUES

My OBA paper discusses some of the techniques available to purify a corporation so that it will meet the asset tests, which techniques include the following:

1. Using cash to pay down accounts payable, bank debt or shareholder loans.
2. Selling passive assets and using the proceeds to pay down debt or invest in active assets (eg equipment that will be used in the business).
3. Transferring passive property and related debt to a wholly-owned subsidiary.
4. Effecting a single-wing butterfly.
5. Paying a dividend of redundant assets on a portion of its Common Shares to a holdco.

The latter two techniques involve the payment of dividends that can trigger tax liabilities when they are paid as part of a series of transactions in which an arm’s length

¹ “The Capital Gains Exemption and the Pursuit of Purity”. A copy of the latter paper, which I updated in September, 2010, accompanies this paper.

party acquires an interest in the corporate issuer. The culprit is the dreaded subsection 55(2) of the *Income Tax Act*.²

A SINGLE-WING BUTTERFLY

Before discussing subsection 55(2), it might be useful to describe the single-wing butterfly.

Assume for a moment that Mr. X owns all of the issued shares of Opco. Opco holds passive investments with a fair market value of \$700,000 that Mr. X wishes to transfer to a sister corporation (“Investco”) on a tax-deferred basis. To make matters simpler, assume that the passive investments do not have accrued and unrealized gains. In that case, a single-wing butterfly might consist of the following steps.

1. If necessary, Opco will file articles of amendment to create an unlimited number of shares that are designated as Class A Special Shares that are non-voting, redeemable and retractable for \$100 per share and entitled to non-cumulative dividends at an annual rate that does not exceed, say, 4% of the redemption amount of the shares.
2. Mr. X will incorporate Investco under the laws of Ontario. Investco will not issue shares immediately upon incorporation.
3. Opco will declare a dividend on its Common Shares satisfied by 7,000 Class A Special Shares in the capital of Opco. Opco will add only \$100 to the stated capital of the Class A Special Shares so that the amount of the dividend for the purposes of the Act will be \$100. Opco will issue a T5 to Mr. X for this amount.

² R.S.C. 1985, c. 1 (5th Supp) (the “Act”). All statutory references are to the Act unless otherwise noted.

4. Mr. X will sell, and Investco will purchase, his 7,000 Class A Special Shares in the capital of Opco for a purchase price equal to their fair market value (\$700,000). Investco will satisfy the purchase price payable for the shares by issuing to Mr. X 1,000 Common Shares. Investco and Mr. X will file an election jointly under section 85 of the Act at an agreed amount equal to \$100 so that Mr. X will not realize a gain in respect of the sale of the Class A Special Shares to Investco.
5. Opco will redeem the 7,000 Class A Special Shares in its capital held by Investco. Opco will issue to Investco a demand, non-interest bearing promissory note with a principal amount equal to \$700,000 in satisfaction of the proceeds of redemption. Under the Act, Opco will be deemed to pay a dividend to Investco in an amount equal to \$700,000 minus \$100 or \$699,900. Investco, in computing its taxable income for the purposes of the Act, should be entitled to deduct the amount of the deemed dividend. If Opco will have refundable dividend tax on hand, then Investco might be required to pay Part IV tax in an amount equal to any refund to which Opco is entitled upon the redemption of the Class A Special Shares in its capital.
6. Opco will satisfy the principal amount of the note issued in the previous step by transferring the Excess Assets to Investco.

SUBSECTION 55(2)

The single-wing butterfly works only because a corporation that receives a dividend from another taxable Canadian corporation is generally entitled to deduct the amount of the dividend in computing taxable income. Subsection 55(2) is an anti-avoidance rule that is intended to prevent the deduction of dividends to avoid corporate-level tax.

An example will help to illustrate the evil for which 55(2) is supposed to be the remedy. Suppose Opco owns an asset that Buyco, an unrelated corporation, wants to purchase. Instead of Opco selling the asset to Buyco directly and realizing a gain (which would trigger corporate level tax), Opco transfers the asset to Subco on a rollover basis and takes back Common Shares in the capital of Subco as consideration. Subco then declares a dividend in an amount equal to the fair market value of the asset, which dividend is satisfied by a note. Opco, in the absence of the application of subsection 55(2), would be entitled to deduct the amount of the dividend in computing its taxable income. That is, Opco would not pay tax on the dividend. Opco can now sell the note and its shares in the capital of Subco to Buyco without triggering a gain. Buyco and Subco would amalgamate on a rollover basis. As a result, Opco would have sold the target asset to Buyco without paying corporate-level tax.

Subsection 55(2), however, would likely apply to the transactions described above to re-characterize the Subco dividend as a capital gain. Subsection 55(2) provides as follows:

Where a corporation resident in Canada has received a taxable dividend in respect of which it is entitled to a deduction under subsection 112(1) or (2) or 138(6) as part of a transaction or event or a series of transactions or events, one of the purposes of which (or, in the case of a dividend under subsection 84(3), one of the results of which) was to effect a significant reduction in the portion of the capital gain that, but for the dividend, would have been realized on a disposition at fair market value of any share of capital stock immediately before the dividend and that could reasonably be considered to be attributable to anything other than income earned or realized by any corporation after 1971 and before the safe-income determination time for the transaction, event or series, [consequence] notwithstanding any other section of this Act, the amount of the dividend (other than the portion of it, if any, subject to tax under Part IV that is not refunded as a consequence of the payment of a dividend to a corporation where the payment is part of the series)

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

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

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

The subsection is not exactly light reading, as one judge pointed out:

It surpasses my imagination that anyone considers language such as this to be capable of an intelligent understanding, or that such language is thought to be capable of application to the events of real life, such as the sale of a business.³

For our purposes, the key phrase in 55(2) is “that could reasonably be considered to be attributable to anything other than income earned or realized by any corporation after 1971”.

“INCOME EARNED OR REALIZED BY ANY CORPORATION AFTER 1971”

Subsection 55(2) provides that, to the extent a gain is reduced by paying a dividend of safe income (“income earned or realized ... after 1971”), its anti-avoidance rule does not apply because corporate level tax has been paid on those earnings (on the gain that is attributable to those earnings). Suppose that the gain on a share is \$100 and that \$80 of that gain is attributable to safe income and \$20 to something else. If, before a sale of that share, the issuer pays a dividend of \$20 on it, then 55(2) ought not to apply because the reduction of the gain by \$20 is from safe income. A dividend of \$90, on the other hand, would be problematic because it would reduce the gain on the shares by something other than safe income.

Safe income—“income earned or realized by any corporation after 1971”—is related to retained earnings because safe income is the earnings of the corporation on

³ *J.F. Newton Ltd. v. Riddell*, 45 D.T.C. 5276, [1991] 2 C.T.C. 91, 50 B.L.R. 136, 1990 CanLII 933 (BC S.C.)

which tax has been paid by the corporation. Safe income is *not* the same as retained earnings, however. Safe income begins with earnings on which tax has been and then must be adjusted to take into account numerous CRA technical interpretations and several court cases that pronounce upon what items should be included in safe income. An experienced accountant must calculate it.⁴

SAFE INCOME STRIPS

It is common to “strip” safe income before a sale of shares. Consider Holdco, which owns all of the shares of Opco. Opco has safe income of \$150 and excess cash of \$100. Buyco wishes to acquire all of the shares of Opco, but Buyco does not want Opco’s cash. Moreover, Holdco’s shareholders would prefer not to pay tax on any gain realized on the sale of the Opco shares with the cash still in it. What to do? Opco can solve the problem by paying a dividend of \$100 of cash to Holdco immediately before the sale. The fair market value of the Opco shares, and the gain, is reduced accordingly. 55(2) does not apply, and so Holdco does not pay any tax on the dividend, because the CRA accepts that the dividend in this case is paid from safe income.

⁴ Safe income calculations often encounter technical issues which makes the amount of safe income uncertain. This is why dividends are often paid in series. 55(2) applies to the entire amount of a dividend to the extent it exceeds safe income. As a result, even if a dividend exceeds safe income by only a few dollars, the entire amount of the dividend could be re-characterized as a capital gain under 55(2). Accordingly, if an accountant is uncertain about the amount of safe income, he or she will give instructions to pay safe income dividends in series. For example, if safe income is thought to be \$100,000, then the accountant might ask that dividends of \$50,000, \$20,000, \$10,000, \$10,000, \$5,000 and \$5,000 be paid, one after the other at five minute intervals on a particular day. That way, if the safe income is really only \$97,000, only the last \$5,000 of dividends will be tainted rather than the entire \$100,000.

PURIFICATIONS AND STRIPS

What happens where Mr. X, the sole shareholder of Opco, wishes to sell all of its shares to Buyco, Opco holds excess cash and methods 1–3 3 above for purifying a corporation will not help? In that case, Mr. X must remove the excess cash either through a dividend or by paying himself additional salary. If he pays himself a taxable dividend or salary, he must pay tax. Clients never like that option. What are the alternatives?

Let us assume that Opco has a fair market value of \$500,000 (before any safe income is removed), excess cash of \$100,000, no significant debt and safe income of \$150,000. The tax cost of Mr. X's Opco shares is nominal. The shares of Opco do not meet the 90% QSBCS test (the excess cash is 20% of the gross fair market value of the assets of Opco). The solution to this problem appears simple, however. Mr. X can roll the shares of Opco to Holdco, and then cause Opco to pay a dividend of \$100,000 to Holdco. 55(2) will not apply because the dividend paid is less than the safe income of Holdco's shares. Opco has now been "purified".

The difficulty, however, is that an *individual* must sell shares to claim the \$750,000 exemption. Mr. X must sell the Holdco shares to claim the exemption, but Holdco's shares will not qualify for the exemption because it now holds the excess cash that caused Opco shares to fall offside the QSBCS test.

What about the following solution? Opco would amend its articles to create two classes of common shares where dividends can be paid on one class to the exclusion of the other. Mr. X would exchange 10% of his Common Shares for Class I Common Shares (common shares of a separate class). Mr. X would transfer the Class I Common Shares to Holdco under section 85 on a rollover basis. Opco would then pay a \$100,000 dividend to Holdco. Opco would be "pure", and gains on Mr. X's shares should qualify for the \$750,000 exemption. The ability of Mr. X to claim the full exemption on his

shares has been impaired somewhat—he cannot claim the exemption on the 10% of the issued shares of Opco held by Holdco—but he should be able to receive \$360,000 of the gain tax free.

The foregoing does not seem to present a problem under the *Business Corporation Act*⁵ or the Act except under subsection 55(2). The latter subsection does create problems, however. The CRA takes the position that shares share proportionately in the safe income of a corporation. As a result, the CRA would take the position that Opco's Class I Common Shares held by Holdco have attributable to them only 10% of the total safe income of Opco. That is, the safe income of Holdco's Class I Common Shares would only be \$15,000, and so the \$100,000 dividend would be caught by subsection 55(2). The entire amount of the dividend would be re-characterized as a capital gain that Holdco realized on a deemed disposition of the Class I Common Shares.

What if Mr. X tries the same pre-sale reorganization but he exchanges 67% of the existing Common Shares for Class I Common Shares, which he then rolls over to Holdco? The safe income of the Holdco shares in Opco would be \$100,000,⁶ which means that Opco can pay the purification dividend in that amount and remove all of the excess cash. Mr. X can claim the \$750,000 exemption on his Common Shares in the capital of Opco, and subsection 55(2) will not apply to the dividend paid to Holdco to re-characterize it as a capital gain.

The difficulty, of course, is that the amount of the exemption that Mr. X can claim has been reduced significantly. The Opco shares are worth \$400,000 after the excess cash, with a fair market value of \$100,000, is removed, but Mr. X owns only 33% of that value, which means that he can receive only 33% of the proceeds (\$120,000) sheltered

⁵ R.S.O. 1990, c. B.16.

⁶ 67% of \$150,000.

by the exemption. Mr. X and Holdco will be required to pay tax on the remaining proceeds (\$280,000).

In a situation like this, the taxpayer almost always must compromise. Some tax will need to be paid. The accountant will need to do some number-crunching to figure out what combination of tax-free dividends and taxable payments will minimize the overall tax burden.

CORPORATE BENEFICIARIES

The foregoing problem often cannot be solved when it is time to sell a business. Instead, the problem must be anticipated by good planning. What is to be done? One good solution is to have a trust hold the Common Shares of Opco and designate a corporation as a beneficiary of the trust. The advantages of this method can be illustrated by yet another example.

Assume that Father owns 100% of the shares of Opco. He wants to effect a freeze for the benefit of a family trust of which his children will be the beneficiaries. He could transfer his shares to Holdco for freeze shares, and the trust could then subscribe for Common Shares. But what happens if Opco or Holdco begin to accumulate redundant assets so that the Holdco shares risk ceasing to qualify as QSBCSs? The redundant assets must be removed from Holdco *and* Opco because paying a dividend from Opco to Holdco might leave Opco “pure”, but leave Holdco impure. Father and his advisers must still confront all of the issues described above with purifying a corporation while maximizing the availability of the capital gain exemption.

Father could try the following instead. He could exchange his existing Common Shares in the capital of Opco for freeze shares. A family trust could subscribe for the Common Shares, but the trust’s beneficiaries could include Holdco in addition to Father’s kids. Holdco would be wholly-owned by the kids (that is, the freeze is a real freeze and

not a “gel”). In general, the other beneficiaries of the trust can still claim the capital gain exemption in respect of a disposition of the Common Shares in the capital of Opco, and keeping the redundant assets of Opco to a minimum while deferring tax at the individual shareholder level can be as simple as paying a dividend from Opco on its Common Shares to the trust that it allocates to Holdco as a beneficiary of the trust. If the structure is set up properly, then the dividends will pass from Opco through the trust to Holdco tax free. This kind of structure will also greatly simplify safe income strips. The tax professional who must provide advice on a sale share where this kind of structure was put in place well in advance will be a happy tax professional.

Of course, making a corporation a beneficiary of a trust has its own set of issues, and some of the most important are not tax related. For a discussion of some of the most important tax issues associated with making a corporation a beneficiary of a trust, see <http://goo.gl/gLDy>.

CONCLUSION

The asset tests of the capital gain exemption and the anti-avoidance rule in subsection 55(2) create tensions in planning for a share sale that often require difficult choices to be made between maximizing the exemption and avoiding the receipt of taxable dividends or salary to “purify” a corporation. If the proper planning is not done in advance, then it may not be possible to avoid paying tax to maximize the exemption. Careful advance planning—perhaps involving a corporation that is a beneficiary of a trust that holds the Common Shares in the capital of Opco—will minimize (but not eliminate) the likelihood of such an eventuality.