Public Company Non-Butterfly Spinouts

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Abstract

This paper reviews the various methods by which a public corporation can effect a pro rata distribution of property to its shareholders, other than on a divisive reorganization known as a "butterfly." The reasons why a butterfly transaction might not be possible or appropriate are discussed. The alternative forms of spinout transaction are then reviewed in detail, and various related issues that may arise on the spinout (for example, treatment of employee stock options) are discussed. The advantages and disadvantages of the different alternatives (including butterfly transactions) are reviewed.

Keywords Dividends; public companies; spinoffs; butterfly transactions; paid up capital; share exchanges.

Introduction

For any number of reasons, a corporation may decide that some of its assets should be distributed to its shareholders in one form or another. Different segments of its business may become incompatible with the corporation's core business activities, occupying too much management attention or having different financing needs. Separating such business segments allows management to focus on its core operations. In addition, such separation of assets may enhance the ability of the various business segments to obtain financing. Capital markets may not fully value all of the corporation's business activities, putting a premium on "pure plays" that can be valued (using earnings multiples or other criteria relevant to the particular business) in a simple way that is easily comparable with others in that industry. If the valuation that the market puts on the existing entity with the combined businesses is less than the total of its businesses valued separately, putting different businesses into separate entities can "unlock" value for shareholders. Where different businesses attract different kinds of investors (for example, growth versus yield), separating the businesses into distinct entities can also maximize shareholder value. Moreover, there may be business opportunities open to an entity competing in only one industry that would not be available to a conglomerate with a greater number of competitors, customers, and suppliers to consider. For all these reasons, the sum of the parts is sometimes greater than the whole.

A public corporation wishing to distribute some of its assets pro rata to its shareholders (herein, "a spinout") has a variety of options to choose from, each with different consequences under the Income Tax Act.[1] While transactions utilizing the paragraph 88(1)(d) bump to effect a general distribution of property to shareholders of the distributing corporation are effectively precluded by the rules in subparagraph 88(1)(c)(vi),[2] often a traditional "butterfly" divisive reorganization will be possible. However, in many cases, a butterfly transaction may not be possible or may be suboptimal compared to other possible transactions. This paper discusses

- some of the reasons why a butterfly transaction may not always be the most suitable alternative for effecting a spinout;
- the tax issues arising from a spinout effected as a dividend in kind;
- the tax issues arising from a spinout based on utilizing the paid-up capital of the distributing corporation, including the various forms such a transaction might take and the differences between them; and
- certain related tax issues that arise in the course of effecting any spinout.

Public Company Butterfly Transactions

Overview

In many cases, a public corporation seeking to distribute property to its shareholders (other than in the form of a regular cash dividend) will employ a traditional divisive reorganization colloquially known as a "butterfly transaction." Butterfly transactions have been discussed in considerable detail in numerous other papers[3] and so will not be the subject of detailed discussion here. However, it is useful to briefly summarize the basic structure and consequences of a butterfly in order to establish its limitations and provide a basis of comparison against the various forms of non-butterfly spinouts discussed in detail in this paper.

A butterfly transaction is governed by the rules in section 55 and, in particular, the constraints set out in paragraph 55(3)(b) and subsection 55(3.1). While several variations exist, the standard butterfly of a public corporation[4] ("Pubco") effected for the purpose of spinning out assets pro rata to its shareholders consists of the following basic steps:

1) Pubco's shareholders transfer an identical percentage of their Pubco common shares to a newly created taxable Canadian corporation ("Newco"), which will be the new public company holding the assets to be distributed, in exchange for common shares of Newco. The percentage (by value) of Pubco common shares so transferred would correspond to the percentage of Pubco's assets that are to be distributed to the Pubco shareholders (for example, if Newco were to receive, say, 30 percent of Pubco's net assets, Pubco shareholders would each transfer 30 percent of their Pubco shares to Newco). This share-for-share exchange generally occurs on a tax-free basis under subsection 85.1(1) and/or subsection 85(1).[5]
2) Pubco transfers to Newco the assets that are intended to be held by the new publicly held corporation in return for the assumption of liabilities associated with such assets and the issuance of Newco preferred shares with a fair market value and redemption amount equal to the net fair market value of the transferred assets. The parties elect under subsection 85(1) for this transfer to occur on a tax-deferred basis.
3) Pubco purchases for cancellation the Pubco shares acquired by Newco in step 1, issuing in payment a promissory note equal to their fair market value. The excess of the purchase price over the paid-up capital of the purchased shares is deemed to be a dividend,[6] the amount of which is subtracted from Newco's proceeds of disposition,[7] thereby eliminating any capital gain on those shares.
4) Newco redeems the Newco preferred shares issued in step 2, issuing in payment a promissory note equal to their fair market value. As with the repurchase of Pubco shares in step 3, the resulting intercorporate deemed dividend eliminates any capital gain otherwise resulting from the share redemption.
5) Pubco and Newco set off the promissory notes that each owes to the other.

The result is that Pubco shareholders hold shares of two corporations, Pubco and Newco, with Newco holding whatever assets are desired to be distributed by Pubco. The Pubco shareholders hold their Newco shares in the same pro rata proportions as they hold their Pubco shares. In addition, this bifurcation of their investment in Pubco into shares of two separate entities occurs on a tax-deferred basis to the shareholders and, provided that the requirements of paragraph 55(3)(b) are satisfied, to Pubco and Newco. The ability to undertake a spinout on a fully tax-deferred basis (in particular at the corporate level) is the advantage of undertaking a butterfly transaction as opposed to one of the other forms of spinout described herein.

The basic requirements of a spinout butterfly imposed by paragraph 55(3)(b) and subsection 55(3.1) are as follows (expressed in very general terms):

- Each Pubco shareholder must receive shares of Newco in the same pro rata proportion as the holder's shareholding in Pubco (ignoring certain debt-like classes of shares).
- Subject to the potential relaxation of this rule for qualifying butterflies (discussed below), Newco must receive the same proportion of each "type" of property owned by Pubco prior to the butterfly; that is, it is not possible to transfer, say, 30 percent of Pubco's cash/near-cash property and 70 percent of Pubco's business property to Newco.
- There are restrictions on acquisitions and dispositions of property by Pubco and Newco prior to and following the butterfly.
- There are restrictions on dispositions of Pubco and Newco shares by significant shareholders, acquisitions of control of Pubco and Newco, and acquisitions of Pubco or Newco shares before a butterfly transaction by significant shareholders.

Legislative Amendments Facilitating Public Company Butterflies

The rules in the Act governing butterfly transactions are complex and (perhaps more than any other area of the Act) are supplemented by a substantial body of administrative practice that has developed within the Canada Customs and Revenue Agency (CCRA) over the years. Compliance with the relevant law and administrative policy is often not a simple exercise, particularly in the case of a public company that has little or no control over the actions (or even knowledge of the identity) of its shareholders.

In 1999, the Department of Finance announced a proposal to make spinout butterflies easier to accomplish for public corporations.[8] This proposal largely eliminated the requirement that Newco receive the same pro rata portion of each type of Pubco's property.[9] Such relief is limited to distributing corporations that are "specified corporations," being essentially public corporations and their wholly owned subsidiaries, and applies only in the case of spinout transactions (that is, those in which Pubco's shareholders end up with the same pro rata holdings in both Pubco and Newco).

The relief afforded by waiving compliance with the "types of property" requirement otherwise applicable to butterfly transactions is considerable. In many cases, it is not easy to cause a distributing corporation to transfer the same proportion of each type of its property, particularly given the administrative requirement to determine its types of property on a consolidated basis, factoring in the assets and liabilities of subsidiaries and other corporations over which the distributing corporation exercises significant influence. The very limited tolerance allowed by the CCRA for complying with the "types of property" requirement leaves little room for error[10] and often requires Herculean efforts on the part of public corporations seeking to ensure that all assets and liabilities of all relevant corporations have been appropriately classified, valued, and accounted for in the transfer. The 1999 amendments (which are the subject of several other articles)[11] eliminate many of these problems, although they do not afford relief from a number of the issues referred to below.

Some minor additional amendments to facilitate butterflies were proposed in late 2002, as part of a large package of technical amendments.[12] Only one of these changes was specifically directed at public company butterflies, although a number of the other provisions will facilitate butterfly transactions by public corporations.[13] Proposed subsection 55(6) will apply to public company spinoff butterflies and is designed to facilitate the use of a preliminary section 86 reorganization of Pubco's share capital to create a special class of reorganization shares.[14] The concern addressed by this proposal is that where listed shares of Pubco are exchanged for new listed common shares of Pubco and a new class of Pubco reorganization shares (the latter being transferred to Newco for Newco common shares and then repurchased by Pubco on the cross-redemption), the transitory Pubco reorganization shares will not be listed on a prescribed stock exchange. As a result, non-resident shareholders of Pubco will have a portion of their investment momentarily changed into unlisted shares, a result that has negative implications for non-residents.[15] Proposed subsection 55(6) will deem the Pubco reorganization shares to be listed on a prescribed stock exchange for purposes of section 116 and the "taxable Canadian property" definition if both the existing Pubco shares they are received in exchange for and the Newco common shares they are exchanged for are listed on a prescribed stock exchange.[16]

Reasons Why a Butterfly Might Not Be Undertaken

Even though it is now easier for public companies to effect spinouts as butterfly transactions, there are still any number of reasons why using a butterfly transaction may be impractical or (even if feasible) may not be the preferred course of action. Many of these reasons arise from the butterfly rules themselves, which (even for public company spinouts) remain complex and sometimes difficult to comply with. The consequences of a non-complying butterfly can be serious, especially for public corporations, given their size and the number of shareholders potentially affected. In addition, it usually takes a great deal of effort for a public company to do the things necessary to comply with the requirements of a butterfly and honour the representations that must be made in any advance income tax ruling obtained.

Various areas of the butterfly rules may make it impractical to effect a spinout by way of a butterfly transaction in particular circumstances:

- *Prohibited pre-butterfly transactions.* Subject to limited exceptions, paragraph 55(3.1)(a) prohibits property from becoming property of the distributing corporation, corporations it controls, or predecessors of either "in contemplation of and before" the butterfly. While this restriction has not proven to be one that has precluded public company butterfly transactions, there may be cases where the distributing corporation may not be able to live with these constraints, particularly given that no de minimis exception exists. For example, if the distributing corporation needs to raise equity before the spinout, the CCRA may well be very concerned about the potential application of paragraph 55(3.1)(a). At the very least, paragraph 55(3.1)(a) requires monitoring of all significant pre-butterfly transactions.

- *Prohibitions on acquisitions of control*. Subparagraph 55(3.1)(b)(ii) precludes control of the distributing corporation or any transferee corporation from being acquired as part of the same series of transactions or events as the butterfly transaction (referred to herein as "the relevant series of transactions"). Consequently, if the spinout is intended to facilitate an acquisition of control of the distributing corporation or the transferee corporation as part of the relevant series of transactions, the spinout cannot occur by way of a butterfly transaction.[17]
- *Shareholder restrictions*. Subparagraph 55(3.1)(b)(i) imposes restrictions on the sale of shares[18] of the distributing corporation or transferee corporations by "specified shareholders"[19] as part of the relevant series of transactions, which restriction can give rise to various difficulties in public company butterflies.[20] Thus, for example, if the purpose of the spinout is to allow shareholders (including specified shareholders) to dispose of the spun-out operations while retaining an interest in the distributing corporation, a butterfly transaction will not be viable. Even where no such purpose exists, where a distributing corporation has specified shareholders, some restrictions on their ability to dispose of the shares of the distributing corporation or a transferee corporation (or certain other property)[21] may be required. Implementing such restrictions is far from simple. Since in many cases shares are held in "street" name, simply identifying "specified shareholders" can be problematic, especially since the "specified shareholder" definition attributes ownership of shares to persons not actually owning them in various circumstances. The overly broad definition of "specified shareholder," coupled with a rule that deems corporate "specified shareholders" to be themselves defined as "transferee corporations" for purposes of paragraph 55(3.1)(b),[22] may expand the requisite scope of inquiry beyond entities within the distributing corporation's knowledge. Identification of specified shareholders is only the first hurdle to be overcome. Specified shareholders may simply not be willing to agree to abide by these restrictions, especially if there are legal consequences to them for breaching the agreement. In particular, specified shareholders will generally not be willing to take the risk of identifying when the relevant series of transactions finishes. Even if a specified shareholder is itself willing to abide by sale restrictions, there may be circumstances where it is impractical for the shareholder to provide the requisite covenants.[23] Finally, since public companies generally cannot control who owns their shares, they cannot prevent persons (for example, arbitrageurs) from acquiring sufficient shares to become specified shareholders or control their actions.[24]

- *Prohibited post-butterfly transactions*. Where Pubco and Newco are not related immediately following the butterfly, paragraphs 55(3.1)(c) and (d) restrict the ability of persons not related to Newco or Pubco to acquire most property received by Newco or retained by Pubco on the butterfly (respectively) as part of the relevant series of transactions. Again, the scope of property caught by these rules is expanded to include derivative property, not just property acquired or retained on the butterfly.[25] Relying on the 10 percent de minimis exception (which requires valuations) or the "ordinary course of business" exception (this being an undefined term) may not be practical and may create significant uncertainty.
- *Constraints of public company spinoff rules*. While the 1999 amendments dropping the "types of property" requirement for qualifying public company butterflies offer welcome relief, taking advantage of them limits the ability of the transferee corporation (and to a lesser extent the distributing corporation) to effect butterflies in the three-year period following the butterfly.[26]
- *"Series of transactions."* As noted above, many of the butterfly restrictions are based on whether particular transactions occur as part of the relevant series of transactions. There continues to be considerable uncertainty over the scope of the term "series of transactions" (as that term is expanded by subsection 248(10)), in terms of the linkage required between two events so as to make both part of the same series of transactions. The CCRA has generally taken an expansive view of this phrase, and the jurisprudence to date has by no means made its interpretation any easier. In particular, many practitioners are troubled by the Tax Court's holding in *Mathew et al. v. The Queen*[27] to the effect that later transactions were part of the same series of transactions as earlier transactions because the actors in the later transactions were aware of the earlier transactions and took them into account in completing the later transactions.

Summary

In summary, the restrictions imposed by the rules governing butterfly transactions will preclude using a butterfly to effect a spinout in some circumstances. For example, if there are one or more specified shareholders of a public corporation and they intend to dispose of their shares of the spun-off corporation,[28] subparagraph 55(3.1)(b)(i) will make it impractical to effect a butterfly transaction. The fundamental butterfly requirement that the spun-out property continue to be held in corporate form[29] may also make a butterfly inappropriate in some cases: the recent proliferation of income funds and similar trust-based entities in Canadian public markets shows that in many cases businesses are best held other than by a taxable Canadian corporation. Furthermore, it may be desirable to give Pubco shareholders a choice of receiving different forms of property, rather than receiving shares of the same corporation pro rata.[30]

Public corporations seeking to effect a spinout by way of a butterfly transaction therefore remain subject to very significant limitations and uncertainties in the butterfly rules themselves, notwithstanding the removal of the "types of property" requirement for qualifying public company butterflies.[31] Even where a butterfly transaction is feasible, in some cases its advantages (tax deferral to Pubco and its shareholders) may not outweigh its disadvantages (for example, restrictions on future transactions, uncertainty, or risk caused by the scope of the relevant series of transactions), compared to other available forms of spinout transactions. It should also be noted that a butterfly transaction (which involves a mandatory transfer of Pubco shares by all Pubco shareholders) typically requires a plan of arrangement under the relevant corporate statute in order to be implemented. The tradeoffs between alternatives are discussed below under the heading "Comparison of Spinout Alternatives."

Dividends in Kind

A distribution by a public corporation ("Pubco") by way of a dividend in kind involves Pubco's declaring a dividend on shares of a class of its capital stock and satisfying the dividend by distributing property (for example, shares of a subsidiary—"Subco") to the holders of such class of shares. Apart from the nature of the property distributed on the dividend, an in-kind dividend is generally no different than any other dividend declared by the corporation.[32]

Corporate Authority

The corporate law procedures applicable to a cash dividend also apply to a dividend in kind.[33] For example, the dividend would be declared by the board of directors of Pubco (that is, shareholder approval would not be required), the dividend would be payable to shareholders of record on a particular date (the record date), and the distribution would be made on the date (the payment date) determined by the board of directors. As with the payment of a cash dividend, a corporate solvency test would have to be satisfied.[34]

Tax Consequences to Shareholders

A shareholder receiving a dividend in kind is considered to receive a taxable dividend equal to the fair market value of the distributed property received. While there is no provision of the Act expressly setting out how to determine the amount of a dividend in kind, the definition of "amount" in subsection 248(1) provides that "amount" means "money, rights or things expressed in terms of the amount of money or the value in terms of money of the right or thing." The amount of a dividend in kind should thus be the fair market value of the distributed property.[35] Property received as a dividend in kind is deemed to have been acquired by the recipient at a cost equal to its fair market value, determined at the time the shareholder receives the property.[36]

Shareholders Resident in Canada

A dividend in kind received by Pubco shareholders is treated the same as a cash dividend, and hence the amount of the dividend will be included in computing a Canadian-resident shareholder's income.[37] Where the shareholder is an individual, the amount of the dividend is subject to the gross-up and dividend tax credit rules.[38]

Where the holder is a corporation resident in Canada, the amount of the dividend is deductible in computing taxable income, subject to the denial of the dividend deduction rules in subsections 112(2.1) to (2.4)[39] and the dividend recharacterization rule in subsection 55(2). A dividend in kind used to effect a spinout transaction would typically be a dividend on the common shares of the distributing corporation. Consequently, one would not generally expect any of the dividend-deduction denial rules in subsections 112(2.1) to (2.4) to apply, although the circumstances of the shareholders need to be considered.[40] In particular, none of the corporate actions required to effect a dividend in kind would cause the application of the dividend deductibility denial rules.[41] Similarly, such actions would not cause the common shares of the corporation to be taxable preferred shares[42] or taxable RFI shares,[43] and consequently taxes under part IV.1 (applicable to dividend recipients) or part VI.1 (applicable to the dividend payer) of the Act should not apply to a dividend in kind.

Where the dividend recipient is a private corporation[44] or subject corporation,[45] a dividend in kind that is deductible under subsection 112(1) will be subject to part IV tax unless Pubco is connected with the dividend recipient. In the unusual event that the dividend is not deductible to a shareholder that is a Canadian-controlled private corporation,[46] the amount of the dividend will be included in its "aggregate investment income"[47] for purposes of the refundable tax on such corporations in section 123.3.

Where a dividend in kind is used to effect a spinout transaction, the amount of the dividend is normally larger than any ordinary course dividend paid by Pubco. If subsection 55(2) were to apply to a dividend received by a Canadian-resident corporation, all or part of the dividend could be deemed not to be a dividend and to be either a capital gain or proceeds of disposition of the Pubco shares.[48] In very general terms, subsection 55(2) could apply to a dividend in kind paid by Pubco to a corporate dividend recipient if one of the purposes of the dividend (or of the series of transactions that includes the payment of the dividend) is to reduce the capital gain that would have been realized in respect of any share if such share had been disposed of for fair market value proceeds of disposition immediately before the dividend.

The typical result of a dividend in kind would be to reduce the fair market value of Pubco's shares. Consequently, if a Canadian-resident corporation held Pubco shares with an accrued gain, the result of the dividend in kind would be to reduce the capital gain that would otherwise have been realized by that shareholder on a sale of those shares. However, it does not follow that the purpose of the deemed dividend would be to cause such a reduction.

The leading case on the application of subsection 55(2) to a significant dividend paid by a public corporation is *The Queen v. Placer Dome Inc.*[49] In that case, for purposes of determining whether the purpose test was satisfied, the Federal Court of Appeal examined the purpose of both of the dividend payer and the dividend recipient. It concluded that the dividend payer's purpose for paying the dividend was to allow it to make an issuer bid for the significant block of the shares of its capital stock held by the taxpayer (so that such block was not acquired by a third party). The court also found that since the taxpayer (that is, the dividend recipient) did not participate in the creation and submission of the dividend payer's plan that included the dividend, one of its purposes in receiving the dividend could not have been to reduce the capital gain realized on the shares of the dividend payer.

Applying the analysis from *Placer Dome* to a dividend in kind by Pubco, one would not expect that Pubco's purpose in distributing the relevant property would be to allow its Canadian-resident corporate shareholders to reduce capital gains realized by them on a subsequent disposition of their Pubco common shares. As noted above (under the heading "Introduction"), Pubco's purpose in effecting the spinoff would generally be to maximize shareholder value, not to allow a small number of its shareholders to obtain favourable income tax treatment.

From the perspective of the Pubco shareholders, few (if any) holders would have input into whether the dividend is paid, and thus Pubco's shareholders would not satisfy the purpose test set out in subsection 55(2) since they have no purpose in respect of the dividend. Possibly, if a corporate shareholder had sufficient voting power to direct or at least influence the actions of Pubco and had input into the decision to declare the dividend, that shareholder could conceivably have a purpose in respect of the dividend in kind by Pubco. However, even in this case, if the shareholder had no intention of disposing of its Pubco common shares as a result of receiving the dividend in kind, the purpose test would not be satisfied.

Non-Resident Shareholders

Non-resident withholding tax is exigible in respect of a dividend in kind that is paid to non-residents of Canada who do not hold their Pubco shares as part of a business carried on in Canada, at a rate of 25 percent of the amount of the dividend (unless reduced under the provisions of an applicable tax treaty).[50]

The method for funding such withholding tax needs to be considered since the withholding tax liability must be paid in cash.[51] One possibility would be for Pubco to declare a cash dividend payable at the same time as the dividend in kind and then use such cash to satisfy the withholding tax in respect of both the cash dividend and the dividend in kind. However, where the value of the distributed property is significant, the payment of a large cash dividend may well be impractical. In particular, the cash dividend would have to be paid to all shareholders (not just non-resident holders) and thus would be an expensive way of funding such tax liability.[52]

Where the distributed property is readily saleable, a second alternative is for the corporation to withhold and sell a portion of the distributed property on behalf of non-resident shareholders and use the cash proceeds to pay the withholding tax.[53] The CCRA's position is that it is necessary to value the distributed property on the day of the distribution and to calculate and remit the required withholding tax on the basis of such value. Consequently, if the property distributed to a particular holder (for example, Subco shares) generated actual sale proceeds that were less than the CCRA-determined value, the proportion of that property that would need to be sold in order to satisfy that person's part XIII withholding tax liability would exceed the part XIII tax rate applicable to that holder (for example, 25 percent for a person resident in a country with which Canada does not have a tax treaty).

As a practical matter, the withholding tax obligations of Pubco would be less onerous than those that might be imposed on a broad reading of the Act. We understand that Canadian corporations typically withhold and remit non-resident withholding tax only on dividends paid to non-residents who are *registered* shareholders. Where non-resident persons may be the beneficial holders of shares that are held by intermediaries (such as brokers), such intermediaries generally withhold and remit the applicable withholding tax.

Tax Consequences to Pubco

Where a corporation distributes property to a shareholder as a dividend in kind, the corporation is deemed to have disposed of the property for proceeds equal to the fair market value of the property received by the shareholder, determined at the time that the property is so received.[54] Consequently, any accrued gain or loss in respect of the distributed property will be realized by the corporation, subject to the denial of loss recognition on property distributed to an "affiliated" person under the usual stop-loss rules.[55]

Pubco is liable to withhold and remit any part XIII withholding tax on the dividend in kind (described above)[56] and is itself liable to pay any amount of such tax that it fails to withhold and remit, along with interest and penalties.[57] There is no time limit for the CCRA to reassess in respect of a failure to withhold under part XIII.[58] The normal reporting obligations applicable to dividends under the Act apply to a corporation paying a dividend in kind, in respect of both resident and non-resident recipients.[59]

Example of a Public Dividend in Kind: Magna International Inc.–MEC

In March 2000, Magna International Inc. ("Magna") distributed to holders of its class A subordinate voting shares and its class B shares the following shares: (1) subordinate voting shares ("the MEC subordinate voting shares") of Magna Entertainment Corp. ("MEC"), a wholly owned US subsidiary; and (2) shares ("the MEC Canada exchangeable shares") of MEC Holdings (Canada) Inc. ("MEC

Canada"), a Canadian subsidiary of MEC, that mirrored the economics of and were exchangeable for the MEC subordinate voting shares.[60] The interesting feature of this transaction is that holders of Magna class A subordinate voting shares and Magna class B shares effectively had the choice to receive either MEC subordinate voting shares or MEC Canada exchangeable shares. The choice mechanism was achieved by declaring a dividend on the Magna shares to be satisfied by the distribution of MEC subordinate voting shares, but giving Magna shareholders the right to elect to receive MEC Canada exchangeable shares in satisfaction of their entitlement to receive MEC subordinate voting shares.

Providing shareholders with the choice of which share to receive in satisfaction of the dividend in kind gave tax-exempt and other holders the opportunity to receive property that was not "foreign property," since the MEC Canada exchangeable shares were listed on a prescribed stock exchange in Canada and MEC Canada had a substantial Canadian presence.[61] In addition, any dividends paid on the MEC Canada exchangeable shares would benefit from the favourable treatment under the Act afforded to dividends paid by Canadian corporations.

Paid-Up Capital Transactions

Overview

An important method for a public company to effect a spinout transaction is the utilization (in one form or another) of the paid-up capital of its shares to distribute property to its shareholders. Once viewed as an insignificant attribute for public companies,[62] paid-up capital should now be recognized as an important tax attribute that gives public corporations significant flexibility for effecting distributions to their shareholders.

In general terms, there are two basic kinds of transactions for accessing a public corporation's paid-up capital to make a distribution. The first of these is a reduction of capital under which property is distributed on the existing Pubco shares. For purposes of the Act, reductions of capital by a public corporation can be divided into two categories: (1) those to which subsection 84(2) does not apply and (2) those to which subsection 84(2) applies, which (as discussed below) are those that occur on the winding up, discontinuance, or reorganization of the business of the corporation. The second kind of transaction that utilizes a public corporation's paid-up capital is a share exchange, whereby existing Pubco shares are exchanged by Pubco shareholders for the distributed property and the issuance of new Pubco shares.

Paid-Up Capital

Calculation of Paid-Up Capital

Paid-up capital and how it is determined have been discussed at length elsewhere[63] and so will not be discussed in detail here. However, given the importance of this concept to the transactions discussed in this portion of the paper, a brief summary is appropriate. The term "paid-up capital" is defined somewhat obliquely in subsection 89(1) and is generally acknowledged to take as its starting point the corporate law governing the particular corporation. While the relevant corporate law concept depends on the particular corporate statute, "stated capital" is the term most commonly used in Canadian corporate statutes to denote the account reflecting amounts paid to the corporation in exchange for shares that it issues. Thus, corporate law stated capital is the starting point for determining paid-up capital.[64]

The basic principle in most Canadian corporate statutes is that when a corporation issues shares, it adds to its stated capital account maintained for the relevant class or series of shares the full amount received by the corporation in exchange for issuing the shares.[65] The corporation may add a lesser amount to its stated capital under certain limited circumstances,[66] and transactions such as (inter alia) amalgamations and share repurchases can also affect a corporation's stated capital. Distinct from stated capital are surplus accounts such as retained earnings and contributed surplus (which are essentially accounting concepts that are acknowledged by the corporate law).

Using stated capital as its starting point, the Act provides for paid-up capital adjustments in various circumstances,[67] with the result that paid-up capital may well be different from stated capital in any particular instance. However, where the corporate law provides for a reduction in the stated capital of a share, such reduction will generally produce a corresponding reduction in paid-up capital (unless there is insufficient paid-up capital to fully match a dollar-for-dollar reduction of stated capital).

Effect of Transactions on Paid-Up Capital

An examination of the effect of corporate reorganizations and other transactions on the paid-up capital of shares of a corporation is well beyond the scope of this paper. However, transactions should be reviewed (1) to ensure that they do not result in an unnecessary loss of paid-up capital and (2) to determine whether they present opportunities for increasing paid-up capital.

One example of the first type of transaction is the use of a reduction of stated capital by a corporation to eliminate a retained earnings deficit. The benefits associated with achieving this accounting result may justify the result, but it should be noted that such transaction will result in a loss of paid-up capital (since a reduction in corporate stated capital will also result in a reduction of paid-up capital, to the extent that paid-up capital exists). If such stated capital were subsequently reinstated by way of a shareholders' resolution to increase stated capital,[68] a deemed dividend would arise under subsection 84(1) to the extent of the increase in paid-up capital.[69]

An example of the second type of transaction is a share-for-share exchange to which section 85.1 could apply. Where that provision applies, the addition to the paid-up capital of the shares of the acquiring corporation is effectively limited to the lesser of the fair market value of the acquired shares (this generally being the maximum permissible stated capital increase) and the paid-up capital of the acquired shares (the limit in subsection 85(2.1)). Many acquisition transactions have been structured in such a manner that section 85.1 did not apply to the share exchange.[70] Holders were then allowed to file elections under subsection 85(1) of the Act to obtain rollover treatment. Such a structure maximizes not only the acquiring corporation's cost of the acquired shares but also the paid-up capital of such shares. It is interesting to note that a similar mechanism was used in the butterfly transaction undertaken by Canadian Pacific Limited in the fall of 2001.[71]

Reductions of Capital Not Described Within Subsection 84(2)

One manner of effecting a spinout of property to holders of a particular class of a corporation's shares by utilizing the paid-up capital of those shares is a distribution of property occurring on a reduction in the corporate law stated capital of that class of shares. As noted above, reductions of capital by public corporations can be subdivided into those that are described within subsection 84(2) and those that are not, the difference being that subsection 84(4.1) (as it is presently drafted) will apply to the latter.

Scope of Subsection 84(4.1)

Central to any consideration of a public company spinout by way of a reduction of capital is subsection 84(4.1), which (where applicable) deems the amount paid by a public corporation on a reduction of its paid-up capital to be a dividend. Subsection 84(4.1) applies where a public corporation has reduced the paid-up capital of any class of its shares, other than by (1) a redemption, acquisition, or cancellation of any shares of that class, (2) a transaction described in subsection 84(2), or (3) a transaction described in section 86.

This provision was introduced in 1978 "[t]o prevent the possibility of an unintended tax deferral on distributions by public corporations."[72] The government's concern arose from the announcement in the March 1977 budget of the pending elimination of certain corporate surplus accounts created in the 1971 reform of Canada's tax system (under which capital gains first became taxable). While corporations with such surpluses were free to take advantage of them by making distributions before the end of 1978, the Department of Finance was concerned about schemes intended to extend their ability to effectively make tax-free distributions out of those surpluses indefinitely. The legislative response was explained by one contemporary practitioner as follows:

> [I]n the months following the March 1977 budget the ever-fertile minds of advisers began to concoct elaborate plans whereby public companies could make full use of their 1971 surpluses (primarily only 1971 capital surplus)

even though the company could not afford to pay such amounts in cash to shareholders before the end of 1978. Without going into all of the intricacies, one of the common approaches suggested would be simply to use the 1971 capital surplus accounts to increase the paid-up capital of the corporation's existing shares. Such an increase in capitalization would be a deemed dividend to the shareholder. This deemed dividend could be "covered" by an appropriate election with respect to an equivalent amount of 1971 surpluses, resulting in no net income inclusion to the individual shareholders (and no net adjustment to the cost basis of their shares, since the "grind" in respect of the 1971 surplus distribution would offset the "bump" on capitalization). The corporation could then, after 1978, gradually reduce the paid-up capital of its shares by returning various amounts to shareholders as a return of capital, thus achieving the equivalent of paying out 1971 surpluses after 1978. This possible procedure was obviously objectionable to the government, and the introduction of section 84(4.1) in the 10 April 1978 budget was the result.[73]

Whatever the policy rationale underlying subsection 84(4.1), its broad wording was a deterrent to undertaking a reduction of capital transaction except in circumstances where subsection 84(2) applied, since any amount paid on the capital reduction would be deemed to be a dividend. That changed in 1998 as a result of a comfort letter from the Department of Finance (dated July 2, 1998) proposing a significant revision to subsection 84(4.1) that would have amounted to a near-repeal, stating as it did that

> [t]he amendment would provide that subsection 84(4.1) apply only in respect of a reduction in the paid-up capital of a class of shares to the extent that a previous increase in the paid-up capital of that class resulted in a dividend in respect of which the taxpayer elected to treat the dividend as having been paid out of the taxpayer's 1971 CSOH [capital surplus on hand].

No reference was made to any other preconditions to be satisfied in order for subsection 84(4.1) not to apply; and indeed, given the original purpose of this provision that caused its enactment (that is, to prevent inappropriate capitalization and distribution of 1971 surplus accounts), it was reasonable to assume that there was no other compelling tax policy reason to treat public company paid-up capital returns as dividends.

After the release of that comfort letter, it appeared that public corporations could return capital without regard to subsection 84(2) except in very limited circumstances, since the deemed dividend rule in subsection 84(4.1) would not generally apply.[74] However, further comfort letters subsequently released by the Department of Finance indicate that restrictions on the application of subsection 84(4.1) will be much narrower than suggested by the 1998 comfort letter.

A second comfort letter (dated May 12, 1999) made reference to an additional concern and was the first sign that Finance viewed subsection 84(4.1) as being directed at something more than the capitalization of 1971 surplus accounts.

After discussing whether or not the exception for transactions described in subsection 84(2) would or would not properly apply to the taxpayer's intended distribution of surplus capital as a capital reduction, the letter notes the Department of Finance's stated intention to amend subsection 84(4.1) "so that it applies only in respect of certain reductions of the paid-up capital of a class of shares of a corporation." This being the case, the Department of Finance stated that on the basis of its understanding of the facts, it did "not regard the [proposed] distribution as a substitution for an ordinary-course dividend and therefore [the Department is] prepared to recommend that such a reduction be excluded from the application of subsection 84(4.1)." Hence, on its face this second comfort letter limits the application of subsection 84(4.1) to capital reductions by a public corporation that are in lieu of an ordinary-course dividend. The reference to ordinary-course dividends may have indicated, however, that the Department of Finance intended there to be an exception for transactions that were analogous to those described in subsection 84(2) (that is, extraordinary events) but that did not technically come within that provision, although this is not clear from the wording of the letter.

The third comfort letter (dated March 21, 2001) was also concerned with whether subsection 84(2) would apply to the taxpayer's intended distribution of surplus capital realized on a disposition of some subsidiaries. It is understood that owing to the length of time that elapsed between the cash-generating sales and the subsequent distribution to shareholders, the CCRA had doubts as to whether the distribution was occurring "on" the reorganization of the taxpayer's business, as required by subsection 84(2). Once again the Department of Finance indicated that notwithstanding whether or not subsection 84(2) applied, a recommendation would be made to amend subsection 84(4.1) to limit its scope to certain reductions of paid-up capital, and expressed the view that it "[did] not regard that subsection 84(4.1) of the Act should apply to deem a dividend in the case of the historic paid-up capital portion of the special distribution."

On the basis of discussions with officials at the Department of Finance, it is understood that the extent of the changes to subsection 84(4.1) has been largely resolved in terms of tax policy, although what that tax policy is remains confidential. It is clear that any revised version of subsection 84(4.1) will apply to more than simply paid-up capital attributable to 1971 CSOH. Whether or not there will be a blanket exception for any distribution by a public corporation that is not a substitute for ordinary-course dividends is uncertain. Finance is understood to be concerned with the circumstances in which distributions effected as a reduction of capital replace what would otherwise occur as an ordinary-course dividend. While part II.1 already deals to some extent with payments in place of an ordinary-course dividend, it requires a payment of proceeds of disposition of property in order to apply,[75] and in any event the language of this rarely used provision is thought to leave much to be desired. Moreover, at a policy level, the basic decision for Finance is whether what constitutes an ordinary-course dividend is based on the timing and amount of the dividend or instead is also based on the source of the funds or property used to pay it—that is, should a distribution that is not in lieu of an ordinary-course dividend have to be from something other than ordinary-course profits? Put another way, the question might be phrased as, how extraordinary must the circumstances surrounding a distribution be in order to be outside the scope of subsection 84(4.1)? Discussions with Finance suggest that a draft version of revised subsection 84(4.1) will be released within the next 6 to 12 months.

Tax Consequences

Given the discussion above, at present it would not be prudent to effect a spinout by way of a reduction of capital other than in circumstances where the distribution satisfies the requirements of subsection 84(2) (discussed below). Since the application of subsection 84(4.1) will generally produce unacceptable tax consequences to many shareholders (in particular, individuals and non-residents), it is generally not feasible for a public corporation to effect a non-subsection 84(2) reduction of capital at this time, and consequently, this paper does not contain a detailed discussion of reductions of capital to which subsection 84(2) does not apply.

Pending amendments to subsection 84(4.1) may change this in the future, in which case the tax consequences of a reduction of capital that occurs outside subsection 84(2) and to which subsection 84(4.1) does not apply will generally be the same as those occurring on a transaction described in subsection 84(2).[76] An exception to this similarity of treatment would be subsections 84(4.2) and (4.3), which (by their terms) do not apply to transactions described in subsection 84(2). While ordinarily a public company spinout involves a distribution of property on common shares of the public corporation and therefore should not result in the application of these provisions, they could be relevant in unusual circumstances.[77] As with subsection 84(4.1), the application of subsection 84(4.2) or (4.3) results in the amount received by the shareholder on the reduction in paid-up capital being recharacterized as a dividend.

Subsection 84(4.2) applies where paid-up capital is reduced on a "term preferred share" owned by a "specified financial institution"[78] (or a partnership or trust of which a specified financial institution or person related thereto was a member or beneficiary),[79] otherwise than on a redemption, acquisition, or cancellation of the share or a transaction described in either of subsection 84(2) or (4.1). An exception exists where the share was not acquired in the ordinary course of the business carried on by the shareholder.[80] This provision can be seen as an extension of the dividend-denial rule in subsection 112(2.1), applicable to term preferred shares acquired by specified financial institutions in the ordinary course of business, in that amounts deemed by subsection 84(4.2) to be a dividend would generally then be denied the benefit of the intercorporate dividend deduction under subsection 112(2.1). Similarly, subsection 84(4.3) applies to a reduction in the paid-up capital of a share owned by a corporation[81] that would (if it were a taxable Canadian corporation) be subject to the deduction-denial rules in either subsection 112(2.2) or (2.4) on a dividend on that share. As with subsection 84(4.2), this provision does not apply on a redemption, acquisition, or cancellation of the share or on a transaction described in either subsection 84(2) or (4.1).[82]

Reductions of Capital Described Within Subsection 84(2)

As noted, the paid-up capital of a public corporation's shares can be utilized to distribute property to the corporation's shareholders by taking the required steps under the relevant corporate law to reduce the stated capital of those shares. A reduction in stated capital does not involve shareholders disposing of their shares of the corporation, but rather their receiving property as a non-dividend distribution on their shares. Subsection 84(4.1) will not apply where the reduction of capital occurs on a transaction described in subsection 84(2), and the discussion that follows proceeds on this basis.

Corporate Authority

Canadian corporate law generally allows a corporation to reduce the stated capital of a class[83] of shares of its capital stock for any purpose, including the distribution to holders of a particular class of the corporation's shares of an amount not exceeding the stated capital of the relevant class of shares.[84] A special resolution[85] of shareholders is generally necessary to effect a reduction of capital, specifying the particular stated capital accounts to be reduced.[86] A corporate solvency test must also be satisfied, prohibiting the corporation from making a reduction of capital that would either leave the corporation unable to meet its liabilities as they come due or render the realizable value of its assets less than its aggregate liabilities.[87]

Where the amount of money or property to be distributed to holders of a particular class of shares is less than the existing stated capital of that class, the corporation may consider increasing the stated capital of that class. Canadian corporate law generally permits a corporation to add to its stated capital an amount from its retained earnings or other surplus accounts (for example, contributed surplus).[88] This occurred in the recent spinout of MI Developments Inc. ("MID") by Magna, where the pre-existing stated capital of the Magna class B shares was less than the value of the MID class B shares to be distributed to Magna class B shareholders. Accordingly, the special resolution voted on by Magna shareholders included a separate step to increase the stated capital of the Magna class B shares by transferring the required amount from Magna's retained earnings.[89]

Where the distribution to be made on the reduction of capital consists of property other than money, some uncertainty may exist as to the fair market value of the property to be distributed (and hence the "amount" by which stated capital is reduced), valuation being an inexact science. One can envision concern arising if the resolution authorizing the reduction of stated capital is phrased as a particular dollar amount and the fair market value of the distributed property is subsequently determined to be higher or lower than this dollar amount.[90] One way of dealing with this on an in-kind distribution would be to express the amount of the distribution as the fair market value of the distributed property (without specifying a number or particular valuation methodology), such that whatever the value of that property, a distribution of that amount (no more and no less) is duly authorized as a capital reduction by the special resolution. To the extent that a numerical estimate of that amount is required (for example, to quantify the amount by which the relevant stated capital accounts are reduced), such estimate could be made, but it would remain subordinate to the legal authority of the special resolution defining the amount of the stated capital reduction as the fair market value of the distributed property, no matter what that fair market value is determined to be. The Magna-MID special resolution is an example of expressing the amount of the stated capital reduction as a principle (that is, fair market value of the distributed property) rather than a number.[91]

Transactions Described in Subsection 84(2)

On a reduction of the stated capital of a particular class or series of shares, there will be a corresponding reduction in the paid-up capital of that class or series, except to the extent that (1) stated capital exceeds paid-up capital and (2) paid-up capital would otherwise be reduced to an amount less than zero. However, where the reduction occurs on a transaction described in subsection 84(2), the deemed dividend rule in subsection 84(4.1) does not apply.

Subsection 84(2) refers to a distribution of property to shareholders of a corporation "on the winding-up, discontinuance or reorganization of its business." There is not an abundance of jurisprudence on the meaning of this phrase, but such as there is suggests that its scope is reasonably broad. For example, in *RMM Canadian Enterprises Inc. et al. v. The Queen*, the Tax Court expressed the view that

> the words "distributed or otherwise appropriated *in any manner whatever* on the winding-up, discontinuance or reorganization of its business" are words of the widest import, and cover a large variety of ways in which corporate funds can end up in a shareholder's hands.[92]

The "winding-up" or "discontinuance" of a business is a reasonably simple concept, implying a degree of finality about the business (as distinct from the corporation itself). For example, in *Merritt v. Minister of National Revenue*, a sale of all of the assets of a corporation was held to constitute a discontinuance of its business:

> I entertain no difficulty over the construction to be given the words "winding-up, discontinuance or reorganization," as used in s. 19(1) of the Act. In

> construing those words we must look at the substance and form of what was done here. In the case *In re South African Supply and Cold Storage Company*, (1904) 2 Ch. D. 268, Buckley J. had to consider whether or not there had been a winding-up "for the purpose of reconstruction or amalgamation," and he said "that neither the word reconstruction nor the word amalgamation has any definite legal meaning. Each is a commercial and not a legal term, and, even as a commercial term has no exact definite meaning." I think that would be equally true of the words of s. 19(1) which I have just mentioned. There was no "winding-up" of the Security Company by a liquidator, but there was in fact, I think, a winding-up of the business of that company and I think the word "winding-up" may be given that meaning here, although I need not definitely so decide because, in any event, there was a "discontinuance" of the business of the Security Company, and whether that was brought about by a sale to or amalgamation with the Premier Company is, in my opinion, immaterial. I therefore think there is no room for any dispute of substance but that the Security Company discontinued its business in a real and commercial sense, and that for a consideration it disposed of all its property and assets, however far that may carry one in deciding the issues in this case. There is, therefore, no necessity for attempting any precise definition, of the words "winding-up, discontinuance or reorganization." What was done with the business of the Security Company fell somewhere within the meaning and spirit of those words.[93]

This reasoning was adopted verbatim by the Supreme Court of Canada in *Smythe et al. v. MNR*,[94] where a sale of all of the assets of a corporation in exchange for preference shares of the purchaser corporation was similarly held to come within the scope of these terms.

Defining the "reorganization" of a business is more difficult, since it is not clear how much about the business needs to be changed in order to constitute a "reorganization." The leading authority is probably *Kennedy v. MNR*,[95] in which Cattanach J considered the circumstances of a car dealership that had sold to its sole shareholder the real property on which it carried on business, continuing to carry on business there as his tenant. In concluding that the shift from landowner to tenant did not constitute a "reorganization" of the corporation's business, the court stated as follows:

> If an undertaking of some definite kind is being carried on but it is concluded that this undertaking should not be wound up but should be continued in an altered form in such manner that substantially the same persons will continue to carry on the undertaking, that is what I understand to be a reorganization. It is that the same business is carried on by the same persons but in a different form. . . .
>
> In section 81(1) the word "reorganization" is used in association with the words "winding-up" and "discontinuance." Both of those words contain an element of finality. The company is ended. It is therefore logical to assume that the word "reorganization" presupposes the conclusion of the conduct of the business in one form and its continuance in a different form.

> In the *Shorter Oxford Dictionary*, 3d Ed. at page 1704, the word "reorganization" is defined as "a fresh organization" and the verb "reorganize" is defined as "to organize anew."
>
> In the circumstances of the present case there has been no "fresh" organization. The same Company continued the same business in the same manner and in the same form. The only difference was that by reason of the sale of its premises the Company operated the same business from the same premises which were rented by it rather than being owned by it.
>
> This was merely the sale by the Company of a capital asset which did not result in the end of the business of the Company. It might have bought other premises from which to carry on its business but it chose to continue its business from the rented premises it had owned formerly. Obviously this would not affect the conduct of its business *per se* but only the manner in which the Company held the premises from which it conducted its business.
>
> In my view this is not a "reorganization" of the business in a commercial sense nor in the sense of the word as contemplated in section 81(1).[96]

It is therefore clear from *Kennedy* that the "reorganization" of a business is something quite different from its winding up or cessation.

Another older case is *Cangro Resources Ltd. v. MNR*,[97] in which the taxpayer was a significant shareholder of a US corporation ("Marine") that made a distribution "in partial liquidation" to its shareholders, who were given the opportunity to subscribe for shares of a new corporation ("Bankers"). The tax treatment of the funds distributed by Marine to its shareholders depended in part on whether these transactions involved a "winding-up, discontinuance or reorganization" of Marine's business. Unfortunately, it is difficult to draw much guidance from this case as to the meaning of "reorganization" of a business, since it is not clear whether the board's reasoning is on all fours with the facts. According to the agreed statement of facts, the relevant transactions "resulted in the business formerly conducted by Marine Capital being thereafter conducted through the two Companies, Marine Capital and Bankers Financial."[98] However, the board concluded that no such reorganization of Marine's business had occurred, on the apparent basis that Bankers carried on no business previously carried on by Marine.[99]

Somewhat further along the spectrum of change to the business than *Kennedy* is *Geransky v. The Queen*,[100] in which the taxpayer was a shareholder of a holding corporation ("GH") that held all of the shares of an operating corporation ("GBC") engaged in the business of concrete construction. Some years earlier, GBC had ceased to acquire concrete from arm's-length suppliers and begun to manufacture concrete itself, constructing its own cement manufacturing plant for this purpose. Approximately one-third of the concrete thereby produced was sold to outsiders and the balance used in GBC's own concrete construction business.

GBC later decided that concrete manufacture was uneconomic, and it determined to sell its concrete manufacturing assets to an arm's-length supplier ("Lafarge"), which would thereafter supply GBC with concrete under a long-term contract. Thus, GBC outsourced its major business input. To effect this transaction in a way that allowed GH's shareholders to use their $500,000 capital gains exemption, GBC distributed the concrete manufacturing assets to GH as a dividend in kind, GH's shareholders transferred a corresponding portion of their GH shares to a new corporation that was in turn sold to Lafarge, and the GH shares held by the new corporation (now owned by Lafarge) were redeemed in exchange for the cement manufacturing assets.

The Tax Court concluded that subsection 84(2) did not apply to the taxpayer's receipt of sale proceeds for the shares of the new corporation to Lafarge for a variety of reasons (in particular, that these proceeds were not the funds of GH or GBC). Among those reasons were that no reorganization of any company's business had occurred, and that even if a reorganization of GBC's business had occurred, the taxpayer was not a shareholder of that corporation but rather of GH:

> Subsection 84(2) is a reasonably broad section that permits the type of conclusion that we find in *Smythe*, *RMM* and *Merritt*. Nonetheless, I do not think that one can contort it beyond all recognition.
>
> (a) There was no discontinuance, wind-up or reorganization of any company's business. Both GH and GBC continue to this day to do what they have always done.
>
> (b) The appellant is a shareholder of GH, not of GBC. GH's "business" (if that is an appropriate term considering that it is a passive holding company) is the holding of the shares of GBC. Even if one regards the taxable event as the "reorganization" of GBC's business because it disposed of some assets that can hardly bear on the appellant who is not a shareholder of GBC.
>
> (c) I asked counsel for the respondent what corporation we were talking about in subsection 84(2) and he said both GH and GBC. Leaving aside the fact that the appellant was not a shareholder of GBC I do not see where any funds or property of either company ended up in the appellant's hands. . . . He sold his shares of 606103 to Lafarge and was paid by Lafarge out of its own funds. Lafarge was no accommodation company of the type used in *Smythe* or *RMM* where the payment was made essentially by using the funds of the very company whose surplus was being stripped.[101]

Thus, not only did the outsourcing of the operating company's major business input and consequent sale of manufacturing assets not constitute a "reorganization" of its business; even if it had, the court seems to view the "reorganization" as having occurred one level down from the corporation to which subsection 84(2) was sought to be applied.

With respect to the court, it is suggested that the complete cessation of a significant portion of a business (especially a portion that made sales to arm's-length parties) and the resulting sale of assets could very reasonably be considered to constitute a "reorganization" of the business, which (to paraphrase *Kennedy*) involves changing the form in which the business is carried on. While the primary output of the business (concrete construction services) did not change, the manner in which the corporation generated that output did, and a secondary output of the business (surplus manufactured concrete sold to third parties) was discontinued altogether. Indeed, if this does not constitute a "reorganization" of the business, it is not clear what does, and this aspect of the court's reasoning does not appear to be consistent with the broader, "commercial concept" interpretation of these elements of subsection 84(2) laid down in *Merritt*, *Smythe*, and *Kennedy*.

Since *Kennedy* makes it clear that the business continues on a reorganization, it is not necessary for the business to cease in order that there be a reorganization. Instead, the business continues to be carried on, albeit in a different form or on a different scale, and possibly with different assets, employees, capital, or customers. Similarly, it would not seem necessary that the goods or services produced by the business be different: that would likely amount to the cessation of the old business and the commencement of a new one. Rather, it seems reasonable to suppose that the activities of the business or the business inputs (materials, capital, labour) change in some material way on a reorganization, or perhaps the manner of management and supervision. The better view is that changes of the type undertaken by GBC in *Geransky* should be considered to constitute a "reorganization" of its business, and this conclusion is consistent with both the tax policy underlying subsection 84(2) and the *Merritt*, *Smythe*, *Kennedy* line of cases that calls for this term to be interpreted in a commercial context.

Also troubling is the court's conclusion in *Geransky* that even had a reorganization occurred at the GBC level, this did not constitute a reorganization at the GH level necessary to come within subsection 84(2). With respect, this again seems inconsistent with the broader, commercial view of the relevant terms adopted by the courts in *Merritt* and *Smythe*. The nature of a holding company's business is to hold the shares of other corporations, and it seems overly formalistic to require that the holding company dispose of some of those shares on the distribution in order for a "winding-up, discontinuance or reorganization" of its business to occur. Where a holding corporation's subsidiary reorganizes its business, the holding company's own business has also been reorganized in the commercial sense of that term mandated by *Merritt* and *Smythe*.

One would expect the CCRA to resist a formalistic interpretation of subsection 84(2), given that provision's general role as a charging section (rather than a relieving provision, being the role that it plays in the context of subsection 84(4.1)). Indeed, after some misgivings, the CCRA had become comfortable with the broader view of subsection 84(2), issuing reduction-of-capital rulings involving distributions by holding companies,[102] which it continues to do. Now, however, it is understood that the CCRA (Rulings) is concerned about the impact of *Geransky* on these rulings. As a result, taxpayers submitting subsection 84(4.1)/84(2) ruling requests in holding company spinouts are now being asked to provide additional comfort to Rulings by representing that the proposed capital reduction would fall within the scope of the Finance comfort letters on subsection 84(4.1) dealing with paid-up capital attributable to 1971 capital surplus on hand and ordinary-course dividends—that is, that even if subsection 84(2) did not apply, the proposed capital return would not fall within subsection 84(4.1) were it to be amended as proposed in the Finance comfort letters.[103] We believe that the "no reorganization" issue in *Geransky* was ultimately irrelevant to the determination of the case, since even if a "reorganization" had occurred, subsection 84(2) would not have applied because the funds received by the shareholders were not the funds of GH or GBC. However, since the CCRA has withdrawn its appeal in *Geransky*, there will be no chance for the Federal Court of Appeal to consider this case,[104] and some further legislative response from Finance (which is understood to support the broader view on this issue) may be necessary. In the meantime, public corporations undertaking spinout transactions in reliance on subsection 84(2) are advised to seek an advance income tax ruling on this issue, particularly where the distributing corporation is a holding company.[105]

It is understood that in some cases, problems have arisen where a significant period of time has elapsed between the winding up, discontinuance, or reorganization of the business and the distribution. The latter is required to occur "on" the former, and apparently the CCRA has applied a rule of thumb that no more than 12 months should elapse between the winding up, discontinuance, or reorganization of the business and the distribution to shareholders. As can be inferred from the Department of Finance comfort letters described above, Finance seems to take a more sanguine view of the temporal connection between the two events, but taxpayers should nonetheless be cognizant of the issue and govern themselves accordingly.

Tax Consequences to Shareholders

Where subsection 84(2) applies to a reduction of capital by a public corporation, no deemed dividend will arise provided that the amount of funds or value of property distributed to holders of the relevant class or series of the corporation's shares does not exceed the amount of the reduction in the paid-up capital of that class of shares. Consequently, a deemed dividend could arise where both the stated capital of a class of shares and the value of the property distributed on the reduction of stated capital exceed the paid-up capital of the class:

Example

Stated capital of class	\$100
Paid-up capital of class	\$30
Amount of distribution on class	\$40

Since a \$40 reduction in stated capital accompanied by the distribution of property worth \$40 to the holders of shares of the class reduces paid-up capital by only \$30 (since paid-up capital cannot be reduced below nil), subsection 84(2) will deem a dividend of \$10 to arise.

A deemed dividend could also arise if (for some reason) the value of property distributed on the stated capital reduction exceeded the amount of the stated capital reduction (and corresponding paid-up capital reduction). An example of such a case would be the situation where the authorizing resolution provided for the distribution of a specified dollar amount (payable in kind) based on the estimated fair market value of the distributed property, and it was subsequently determined that the property had been undervalued.[106] However, where the paid-up capital of the class is reduced by the fair market value of the property distributed, no deemed dividend will arise.[107]

A shareholder holding Pubco shares as capital property is required to reduce the adjusted cost base of his or her shares by the amount received on the reduction of paid-up capital.[108] To the extent that this reduction would cause a holder's adjusted cost base of his or her Pubco shares to become a negative amount (for example, the value of the property received on the distribution exceeds the holder's adjusted cost base), a capital gain will result.[109] Unless such deficiency of adjusted cost base occurs to create a deemed disposition, the reduction in stated capital will not constitute a disposition of the Pubco shares.[110] Consequently, accrued losses on the Pubco shares will not be realized in any circumstances. Table 1 illustrates the tax consequences to shareholders of a reduction of capital occurring on a transaction described in subsection 84(2) in various circumstances.

An interesting issue arising on a reduction of capital relates to the timing of the distribution and its potential effect on the basis reduction of the Pubco shares. As is the case with a dividend, a reduction of capital has a record date (the date on which one must be a shareholder in order to be entitled to the distribution) and a distribution date (the date on which the distribution is actually made). If the record date for the distribution were to precede the date of the distribution, anomalous results might arise in respect of the reduction in the adjusted cost base of the Pubco shares. For example, a shareholder who held Pubco shares on the record date but disposed of them before the distribution date[111] would be entitled to receive the property to be distributed on the distribution date by virtue of being a shareholder of record on the record date. However, technically it would not appear that the reduction in the holder's adjusted cost base of the Pubco shares caused by the actual distribution of the distributed property on the distribution date would apply to the selling shareholder since the basis reduction would not appear to apply retroactively. In this respect, a reduction of stated capital (which produces a basis grind) creates timing issues that do not exist for a dividend. This anomaly can be avoided by making the record date of the reduction of capital the same as the distribution date.

An amount received by a shareholder on a reduction of paid-up capital or on the winding up, discontinuance, or reorganization of the corporation's business is explicitly precluded from being a subsection 15(1) shareholder benefit.[112] CCRA rulings obtained on reduction of capital transactions often include rulings to the effect that other benefit provisions such as subsections 56(2), 56(4.1), and 246(1) are inapplicable.[113]

There is no provision in the Act establishing the cost of property received by a shareholder on an in-kind reduction of capital. This is perhaps somewhat

Table 1 Subsection 84(2) Reduction of Capital

	No gain, no dividend	Dividend, no gain	Gain, no dividend	Gain, dividend	Accrued loss
FMV of Pubco share	$10	$10	$10	$10	$10
ACB of Pubco share	$8	$8	$3	$3	$12
PUC of Pubco share	$5	$3	$7	$6	$5
FMV of distributed property	$3	$5	$5	$7	$3
Subsection 84(2) deemed dividend	nil	$2	nil	$1	nil
ACB reduction	$3	$3	$5	$6	$3
Capital gain	nil	nil	$2	$3	nil
Revised ACB of Pubco share	$5	$5	nil	nil	$9
Revised PUC of Pubco share	$2	nil	$2	nil	$2

surprising, given that a statutory provision to this effect exists for dividends in kind, as discussed above.[114] Given the basis reduction (or possible capital gain) on the Pubco shares that the shareholder endures, there can be little doubt from a policy perspective that the correct answer is that the shareholder receives the distributed property at a cost equal to its fair market value.[115] Fortunately, the point would seem moot from a practical perspective, since the CCRA has ruled in a number of instances that property received by shareholders on an in-kind reduction of capital is indeed received at a cost equal to its fair market value.[116] The absence of any specific statutory authority on this issue favours obtaining an income tax ruling to confirm that shareholders will acquire distributed property at a cost equal to its fair market value.

Tax Consequences to Pubco

The primary tax consequence for Pubco on a reduction of capital is that property distributed to shareholders will be deemed to have been disposed of for proceeds of disposition equal to its fair market value.[117] As a result, the corporation will realize any capital gain or loss accrued on the distributed property. To the extent that property is distributed to a shareholder that is affiliated with the corporation, the loss may be denied recognition.[118]

Pubco will also be concerned with ensuring that no dividend arises on the reduction of stated capital. Were a dividend to arise, this could have negative tax consequences for Pubco under part XIII (for example, withholding obligation on dividends deemed to have been paid to non-residents). Different options for dealing with the withholding required on a dividend taxable under part XIII are discussed above with reference to dividends in kind.

Share Exchange Spinouts

The other principal method of utilizing Pubco's paid-up capital to effect a spinout of property is for Pubco's shareholders to exchange their existing Pubco shares with Pubco for a combination of new Pubco shares and the property to be distributed (herein, "a share exchange spinout"). By virtue of the fact that a share exchange spinout involves an exchange of shares (as opposed to a distribution on the existing shares), an additional consideration arises: the need for a rollover or partial rollover for exchanging shareholders on the share exchange. The tax considerations relevant to the structuring of a share exchange spinout are discussed below.

Corporate Authority

Canadian corporate law does not generally require shareholder approval in order for a corporation to acquire its own shares.[119] However, in a share exchange spinout, each holder of the class in respect of which the spinout is to occur (that is, Pubco common shares) exchanges such shares for newly issued shares of the distributing corporation and the distributed property. Consequently, this effectively requires the spinout transaction to be implemented pursuant to a plan of arrangement,[120] which will cause the share exchange to be effected. A plan of arrangement generally requires shareholder approval as well as court approval. Corporate solvency tests must also be satisfied by a CBCA corporation proposing a plan of arrangement.[121]

Tax Consequences to Shareholders

The primary issue from the perspective of shareholders is to ensure that the exchange of the existing Pubco common shares for new Pubco common shares and distributed property qualifies for a rollover. Section 86 will generally apply on a share exchange spinout for shareholders who hold their shares as capital property, subject to the potential for filing subsection 85(1) elections discussed below. In most cases, the application of section 86 will produce a rollover for shareholders to whom it applies, although, as noted below, it is possible for a shareholder to realize a capital gain even if section 86 applies to a share exchange spinout.

While the preconditions to the application of section 86 have been discussed in detail elsewhere,[122] it is nonetheless appropriate to describe them briefly here. Subsection 86(1) applies to a transaction under which, in the course of a reorganization of a corporation's capital, a taxpayer disposes of capital property that is all of the taxpayer's shares of a particular class of the capital stock of the corporation and receives from that corporation in exchange property that includes other shares of that corporation. There is no requirement that the taxpayer be a Canadian resident. The provision requires that the taxpayer's shares must be disposed of, and all of the taxpayer's shares of the relevant class of the corporation's shares must be disposed of. These requirements should not prove problematic on a share exchange spinout.[123]

The term "reorganization of capital" is not defined in the Act. The accepted practice is that virtually any transaction involving an amendment to a corporation's articles will generally suffice to constitute a reorganization of its capital.[124]

On a typical share exchange spinout, the articles of Pubco are amended to create a new class of Pubco shares, so that this requirement should generally be satisfied. It would not appear necessary for the new common shares to have different terms and conditions than the old common shares in order for a reorganization of capital to have occurred such that section 86 will apply.[125]

Subsection 84(4.1) would not apply on a share exchange spinout since that provision does not apply to an "acquisition" or "cancellation" of a share by the issuer or a transaction described in section 86.[126] On a section 86 share exchange, the paid-up capital of the new Pubco common shares will be limited to the excess (if any) of the paid-up capital of the old Pubco common shares over the fair market value of the distributed property (that is, all consideration received by the Pubco shareholder other than new Pubco shares).[127] Because new Pubco shares are issued, there will be an increase in the stated capital (and hence the paid-up capital) of those shares.[128] Subsection 84(1) deems a dividend to have been paid on a class of shares where the paid-up capital of that class has been increased unless (inter alia) the paid-up capital of some other class of the corporation's shares has been reduced by at least an equal amount. By limiting the increase in the paid-up capital of the new Pubco shares to an amount that cannot exceed the paid-up capital of the old Pubco shares[129] (no matter what the increase in the stated capital of the new Pubco shares), subsection 86(2.1) prevents a subsection 84(1) deemed dividend from arising.

This paid-up capital limitation is also relevant to subsection 84(3),[130] which deems a dividend to have been paid to the extent that the "amount paid" by Pubco on the exchange exceeds the paid-up capital of the old Pubco shares. For this purpose, the new Pubco common shares are valued at an amount equal to their paid-up capital.[131] Since that paid-up capital cannot exceed the excess (if any) of the paid-up capital of the old shares over the value of the distributed property,[132] this means that a deemed dividend will arise under subsection 84(3) only if the fair market value of the distributed property exceeds the paid-up capital of the old Pubco shares.

Where applicable, subsection 86(1) deems the following:

- the distributed property is received at a cost to the Pubco shareholder equal to its fair market value;[133]
- the new Pubco shares are acquired by the Pubco shareholder at a cost equal to the excess (if any) of the adjusted cost base of the old Pubco shares over the fair market value of the distributed property;[134] and
- the old Pubco shares are disposed of for proceeds of disposition equal to the Pubco shareholder's aggregate cost of the distributed property and the new Pubco shares[135] (subject to the proceeds being reduced by any amount deemed to be received as a dividend).[136]

Accordingly, the shareholder will not realize a capital gain unless the fair market value of the distributed property (net of any deemed dividend arising under subsection 84(3)) exceeds the holder's adjusted cost base of the old Pubco shares, since section 86 allows non-share consideration to be applied first against the existing tax cost of the old Pubco shares. A capital loss cannot arise on a subsection 86(1) exchange, except where the shareholder's proceeds have been reduced by the amount of a deemed dividend (that is, where the value of the distributed property exceeds the paid-up capital of the old Pubco shares). Recognition of any capital loss is subject to the application of a number of stop-loss rules.[137]

In summary, no gain or dividend will arise if the value of the distributed property does not exceed either the adjusted cost base or the paid-up capital of the holder's old Pubco common shares.[138] Table 2 illustrates the tax consequences to shareholders of a share exchange spinout for a shareholder to whom section 86 applies in various circumstances.

Tax Consequences to Pubco

As with a reduction of capital, the primary tax issue for Pubco on a share exchange spinout is the deemed disposition of the distributed property for proceeds of disposition equal to its fair market value.[139] Hence, any accrued gains or losses on the distributed property will be realized, subject to the potential denial of losses on property distributed to an "affiliated" shareholder.[140] Pubco will also wish to ensure that no deemed dividend arises, with the accompanying consequences under part XIII (that is, withholding obligation on dividends deemed to have been paid to non-residents). Different options for dealing with the withholding required on a dividend taxable under part XIII are discussed above with reference to dividends in kind. Where the old Pubco shares are "acquired" or "cancelled" (as is usually the case), an information return will be required.[141] While not ordinarily applicable on the facts, since a share exchange spinout involves an issuer paying proceeds of disposition to shareholders for their old Pubco shares, the purpose tests in subsections 183.1(2) and (6) should be reviewed to confirm that Pubco will not be subject to tax under part II.1.[142]

Subsection 85(1) Elections

While we are not aware of any share exchange spinouts in which a subsection 85(1) option has been offered, in concept an alternative to reliance on subsection 86(1) in order to obtain a rollover for Pubco shareholders (or perhaps the only option for doing so if for some reason section 86 does not apply to the transaction generally or to any particular shareholder) is for Pubco and the shareholder to file an election under subsection 85(1).[143] There are at least some reasons why a public corporation effecting a share exchange spinout might consider offering the option of subsection 85(1) elections to its shareholders:

- subsection 85(1) allows (and in fact requires) the realization of any accrued loss on the old Pubco shares (subject to the usual stop-loss rules),

Table 2 Section 86 Share Exchange Spinout

	No gain, no dividend	Dividend, loss	Gain, no dividend	Gain, dividend	Accrued loss
FMV of Pubco share	$10	$10	$10	$10	$10
ACB of Pubco share	$8	$8	$3	$3	$12
PUC of Pubco share	$5	$3	$7	$6	$5
FMV of distributed property	$3	$5	$5	$7	$3
Subsection 84(3) deemed dividend	nil	$2	nil	$1	nil
Proceeds of disposition	$8	$6	$5	$6	$12
Capital gain (loss)	nil	($2)[a]	$2	$3	nil
ACB of new Pubco share	$5	$3	nil	nil	$9
PUC of new Pubco share	$2	nil	$2	nil	$2

[a] Recognition of capital loss may be restricted under various stop-loss rules.

since generally the permissible elected amount cannot be less than the lesser of the cost amount and fair market value of the disposed-of property;[144]

- unlike section 86, subsection 85(1) does not require the old Pubco shares to be held as capital property; and
- the subsection 85(1) election allows the shareholder to choose proceeds of disposition within a permitted range, allowing some or all of any accrued gain on the old Pubco shares to be realized if desired.

However, there can be potential differences in the paid-up capital aspects of share exchange spinouts governed by section 86 and those governed by section 85, which can in turn result in differences in the deemed dividends arising on the share exchange. Consequently, the use of subsection 85(1) elections must be approached with care.

Unlike subsection 86(2.1) (which prevents any net increase in the corporation's paid-up capital no matter what amount is added to the stated capital of the new Pubco common shares), subsection 85(2.1) limits the paid-up capital increase in the new Pubco common shares to the difference between the elected amount under subsection 85(1) and the fair market value of the distributed property. Therefore, where the elected amount exceeds the paid-up capital of the old Pubco common shares, the paid-up capital increase in the new Pubco common shares could be greater on a subsection 85(1) election, depending on the stated capital increase arising under the relevant corporate law. This creates the potential for a deemed dividend to arise.

The stated capital (and hence the paid-up capital) of the new Pubco common shares will be increased on their issuance.[145] Subsection 84(1) deems a dividend to have been paid on a class of shares where the paid-up capital of that class has been increased unless (inter alia) a corresponding decrease has occurred in the paid-up capital of some other class of the corporation's shares. The relevant corporate law generally requires Pubco to eliminate the stated capital (and hence paid-up capital) of the old Pubco common shares;[146] therefore, on a share exchange spinout, a deemed dividend under subsection 84(1) will arise on the new Pubco common shares to the extent that the increase in their paid-up capital exceeds the paid-up capital of the old Pubco common shares. This could occur if the maximum permissible paid-up capital increase in the new Pubco common shares under subsection 85(2.1) (that is, the excess of the elected amount over the value of the distributed property) and the amount added to the stated capital of the new Pubco shares both exceed the paid-up capital of the old Pubco common shares.

Subsection 84(3) could also apply to deem a dividend to arise on the cancellation of the old Pubco common shares where the amount paid by the issuer thereon exceeds the paid-up capital of the cancelled shares.[147] For this purpose, the new Pubco common shares are valued at an amount equal to their paid-up capital.[148] Consequently, if the combination of the fair market value of the distributed property and the paid-up capital of the new Pubco common shares exceeds the paid-up capital of the old Pubco common shares (which can occur in the absence of subsection 86(2.1) suppressing the paid-up capital of the new Pubco common shares), a subsection 84(3) deemed dividend can result.[149]

These untoward results can be avoided by limiting the stated capital addition on the issuance of the new Pubco common shares to the excess of the paid-up capital of the old Pubco shares over the fair market value of the distributed property (the same limit provided for in subsection 86(2.1)). Whether this can be done depends upon the governing corporate law, the general rule under which (as discussed above) typically requires a corporation to add to its stated capital the "full amount" of any consideration it receives in exchange for shares that it issues.[150] Where an old Pubco share is acquired by Pubco in exchange for a new Pubco share and some distributed property, presumably one would view this as Pubco having issued the new Pubco share in exchange for a fraction of the old Pubco share equal to the fair market value of the new Pubco share over the aggregate fair market value of the new Pubco share and the distributed property.[151] As a result, unless an applicable exception can be found to limit the increase in stated capital to something less than the fair market value of the fraction of the old Pubco share delivered in exchange for the new Pubco share, the stated capital of the new Pubco share will generally be an amount equal to the fair market value of that fraction of the old Pubco share.[152]

One potential exception allowing a lesser amount to be added to stated capital would be the exception for shares issued in exchange for shares of a body corporate with which the issuer does not deal at arm's length within the meaning of the Act.[153] When asked some years ago whether a corporation acquiring its own shares would deal with itself not at arm's length so as to be able to rely on the relevant provision of the CBCA to limit the stated capital of the newly issued shares, the CCRA declined to answer.[154] Related persons are deemed to deal not at arm's length under paragraph 251(1)(a), but a person is generally not related to himself unless specifically so deemed by the Act.[155] One might think that, given the "common mind" element of the de facto dealing test,[156] it would be reasonable to assume that one does not deal at arm's length with oneself. This, however, seems at odds with the fact that in at least one place, the Act deems persons not to deal at arm's length with themselves.[157] In fact, in at least one case, the CCRA seems to take the position that the existence of such provisions indicates that in their absence, persons would not be considered to deal with themselves not at arm's length.[158] At least one set of authors has expressed the view, however, that this type of share exchange should not give rise to an increase in corporate capital.[159]

Another potential avenue for suppressing the stated capital of the new Pubco shares is the use of a plan of arrangement (which, as noted above, is generally necessary for a share exchange spinout in any event). The OBCA and the CBCA do not expressly provide for the ability to limit the amount added to the stated capital of newly issued shares on a plan of arrangement, except in the case of a plan of arrangement effecting an amalgamation.[160] However, the breadth and flexibility of the arrangement provisions in these statutes and the extensive powers of the court to approve the terms of an arrangement allow transactions effected under a plan of arrangement to vary from the specific provisions of the corporate law otherwise applicable,[161] and this has occurred on numerous occasions. For example, the OBCA provides that on a plan of arrangement, the procedure provided for in section 182 of the OBCA dealing with plans of arrangement takes precedence over the procedure provided for in other sections of that statute,[162] and the courts have interpreted this precedence to include substantive matters of corporate law rather than merely procedural steps.[163] Subject, then, to any peculiarities of the relevant corporate law, it would appear possible to offer Pubco shareholders the opportunity of filing subsection 85(1) elections on a share exchange spinout without risking inappropriate deemed dividend results by using a plan of arrangement and taking the necessary steps to limit the stated capital of the new Pubco shares.[164]

Related Issues

Tax-Exempt Shareholders

Spinout transactions can have tax consequences for shareholders exempt from tax under part I of the Act. Such shareholders will generally be concerned with the "qualified investment" and "foreign property" status of their shares of Pubco and any property they receive on the spinout.

Registered retirement savings plans, registered retirement income funds, deferred profit-sharing plans, and registered education savings plans are all subject to negative tax consequences if they acquire property that is not a "qualified investment."[165] A "qualified investment" is defined to include a share of a corporation listed on a prescribed stock exchange.[166] Where the distributed property to be received by Pubco shareholders on a spinout includes a property such as a share that derives its "qualified investment" status from being listed on a prescribed stock exchange, such tax-exempt shareholders will want to be sure that the share is "listed" at the moment of distribution. This can generally be arranged with the relevant stock exchange upon request; the stock exchange issues a letter advising that the shares to be distributed will be listed after the close of trading on the day preceding the distribution date (or, in the event of a distribution occurring after the close of trading on a particular day, prior to the time of distribution on that date). Formal trading in the newly listed shares will generally commence at the opening of trading on the following day.

Various tax-exempt taxpayers are also concerned with the tax on excess holdings of "foreign property"[167] in part XI of the Act. Such taxpayers include registered pension plans, registered retirement savings plans, registered retirement income funds, and deferred profit-sharing plans. Since tax-exempt shareholders are more likely to dispose of (and are less likely to purchase) property that is "foreign property" (thereby negatively affecting its trading value), Pubco and its taxable shareholders will also be interested in ensuring, if possible, that Pubco shares and distributed property are not "foreign property." Essentially, for each month at the end of which the cost amount of the entity's "foreign property" exceeds 30 percent of the cost amount of all of its property, the entity is required to pay a tax of 1 percent of the excess.[168]

Because the tax is based on the "cost amount" of property, an entity liable to tax under part XI will be concerned with the effect of the spinout on the cost amount of its Pubco shares and the cost amount of any property received on the spinout. These cost amounts may vary considerably among different methods of achieving a spinout. The appendix to this paper illustrates the differences in cost amount that arise on a simple fact pattern.

Valuation Issues

As discussed above, determining the fair market value of the distributed property (for example, Subco shares) will be relevant for establishing the distributing corporation's proceeds of disposition, as well as the cost of the distributed property to the shareholders and the amount of the dividend (if any) received by the shareholders. The standard practice for valuing the shares of a corporation distributed on a spinout transaction is to use the trading price of those shares for a number of days after public trading of such shares commences.[169] It is prudent to obtain formal valuation advice to confirm that this is an appropriate valuation methodology on the facts and to determine an appropriate number of trading days.

The use of the Subco share trading price as the basis for determining fair market value is supported by the case law. Canadian tax courts have generally held that the stock exchange trading price, while not necessarily determinative of fair market value, is the best evidence of the fair market value of shares of a public company unless proven otherwise.[170] Tax courts have required clear evidence that trading price does not reflect fair market value before adopting another method of valuation, such as evidence of

- a "transient boom" in market prices or a "sudden panic on the market";[171]
- market prices being "spasmodic and ephemeral";[172] or
- the shares in question being distributed subject to a bona fide arm's-length sale agreement with a purchase price different than exchange-traded value.[173]

There are numerous cases in which the exchange-traded price of shares was found to be determinative of fair market value despite circumstances that might have indicated that exchange-traded prices did not reflect fair market value. Evidence that market prices have been manipulated,[174] that purchasers do not have all relevant information about the shares,[175] that the intrinsic value of shares differs from the exchange-traded price,[176] that the shares are thinly traded,[177] or that the share price is highly volatile[178] have all been insufficient to displace the use of stock exchange trading prices as the best evidence of fair market value.

Employee Stock Options

Since the distribution of assets by Pubco would generally result in a reduction in the trading price of the Pubco common shares, holders of employee stock options to acquire Pubco common shares (herein "Pubco options") will be prejudiced unless adjustments are made to the terms of those options. In concept, a number of alternatives are available for adjusting Pubco options. For example, where the distributed property includes securities of another entity (for example, Subco common shares), a Pubco option could be exchanged for a new option to acquire a Pubco share and an option to acquire a Subco common share. Alternatively, holders of Pubco options who are employees of Subco could have their Pubco options exchanged for options to acquire Subco common shares. Finally, the exercise price of Pubco options could be reduced to reflect the reduction in the fair market value of the common shares of Pubco resulting from the distribution of the shares of Subco. Since (as discussed below) the provisions governing the repricing of existing options largely incorporate the rules relevant on an exchange of options, the discussion herein is limited to the repricing of existing options.[179]

Paragraph 110(1)(d): Current Law

When repricing an employee stock option, it is crucial to ensure that the holder of the Pubco option continues to be eligible for the deduction in computing taxable income provided in paragraph 110(1)(d) in respect of the exercise of the option. Pursuant to that provision, a taxpayer is entitled to deduct in computing his or her taxable income one-half of the amount of the benefit deemed to have been received by the taxpayer under subsection 7(1) on the exercise of an employee stock option, provided that certain conditions are satisfied. In particular, if the option was not acquired by the taxpayer under an exchange of stock options governed by subsection 7(1.4),[180] the exercise price of the option must not be less than the fair market value (at the time of the option grant) of the share to be issued on the exercise of the option, less any amount paid by the taxpayer to acquire the option. In addition, the option holder must have been dealing at arm's length with the corporation granting the option (and, if applicable, certain other persons) immediately after the grant of the option.

If the Pubco options are repriced to reduce the exercise price (as opposed to being exchanged for new options with a reduced exercise price under subsection 7(1.4)), there is likely no disposition of the option so that no option exchange occurs to which subsection 7(1.4) could apply. In *Amirault v. MNR*,[181] the court found that a change to the exercise price of an employee stock option was not sufficient to result in a disposition of the stock option.[182] If the Pubco option is not disposed of, the requirement in subparagraph 110(1)(d)(ii) will not be satisfied since the amended option exercise price will be less than the fair market value of a Pubco common share on the date the option was granted, and the option holder will no longer be entitled to a deduction under paragraph 110(1)(d) on the exercise of the option.[183]

Proposed Amendments to the Act

The December 2002 technical bill[184] proposes to add subsections 110(1.7) and (1.8) to alleviate the aforementioned problem with reducing the exercise price of an employee stock option. Proposed subsection 110(1.7) provides that where certain conditions are satisfied, the repricing of an option will be deemed to be a disposition of the option in consideration for a new option. Consequently, the requirement in subsection 7(1.4) that the taxpayer's existing options be disposed of in consideration for new options can be satisfied without an actual exchange occurring, as long as the conditions set out in proposed subsection 110(1.8) are satisfied. Proposed subsection 110(1.8) essentially requires that the taxpayer would have been entitled to a paragraph 110(1)(d) deduction if the options held by the taxpayer had been exchanged for new options pursuant to subsection 7(1.4). In summary, assuming that subsections 110(1.7) and (1.8) are enacted as proposed, and provided that the requirements of subsection 7(1.4) would have been satisfied had an actual exchange of options occurred (for example, the in-the-money amount immediately after the repricing does not exceed the in-the-money amount immediately before the repricing), Pubco options that are repriced to take the spinout into account should continue to be eligible for the paragraph 110(1)(d) deduction without having to be exchanged for new options.

Amount of Exercise Price Reduction

Where an employee stock option is exchanged for a new option under subsection 7(1.4) or deemed to be so exchanged by subsection 110(1.7), in order to qualify for the paragraph 110(1)(d) deduction, the amount by which the exercise price is reduced cannot result in an increase in the in-the-money amount of such option.[185] Of the four variables used in determining the pre- and post-repricing in-the-money amount, three are beyond the parties' control (the value of the Pubco share before and after the option repricing and the pre-adjustment option exercise price); therefore, the revised option exercise price must be set at a level that maintains (or at least does not increase) the option holder's in-the-money amount. Applying this limitation to a distribution of Subco shares by Pubco, the maximum permissible reduction in the exercise price of a Pubco option would be equal to the decrease in the fair market value of a Pubco common share, regardless of the fair market value of the Subco common share distributed.

For example, assume that Pubco distributes a Subco common share worth \$30 to each holder of a Pubco common share but the fair market value of the Pubco common share decreases by only \$20. In these circumstances, the exercise price of a Pubco option could be reduced by no more than \$20 without disqualifying that option from the paragraph 110(1)(d) deduction on a subsequent exercise of that option. Table 3 illustrates the limitations on the repricing of employee stock options (or pricing of exchanged stock options) in a variety of circumstances, comparing the decrease in the Pubco share price from the distribution with the fair market value of the spunout Subco share.[186]

In the case of public company spinouts, there is typically a significant period of time between the date the proposed transaction is announced and the date it is implemented. In this regard, it is important to note that the time the Pubco shares are valued for purposes of determining the maximum permissible in-the-money amount usually occurs well after the date of the spinout announcement. As a result, changes in the value of Pubco shares occurring between the time the spinout is announced and the time the options are actually repriced will affect the relevant in-the-money amount. One would expect Pubco management to propose a spinout only where it thinks the spinout will be accretive to shareholder value (that is, where management expects that the combined post-distribution value of the Pubco shares and the Subco shares will exceed the pre-announcement value of the Pubco shares). To the extent that the Pubco share price increases following the date of the spinout announcement, the option holder's in-the-money amount increases, making the existing Pubco option more valuable. Such increases in value occurring up to the option repricing time increase the in-the-money amount at the relevant valuation time, so that the in-the-money amount of the repriced option can be that much larger. Hence, holders of employee stock options will participate in changes in value to the extent that, in response to the spinout announcement, the Pubco share price fluctuates prior to the time of option repricing (which, as discussed below, should be the distribution record time).

However, to the extent that the aggregate post-distribution value of a Pubco share and a Subco share exceeds the value of a Pubco share immediately before the distribution, holders of Pubco options who do not exercise them prior to the distribution will not participate in that increase in value (or, in the event of the converse, suffer any part of the decrease in value). Such persons must therefore exercise their Pubco options prior to the distribution to benefit from any accretion in value occurring on the actual distribution itself. This is also illustrated in table 3,

Table 3 Employee Stock Option Repricing

	Subco FMV > Pubco decrease	Subco FMV < Pubco decrease	Subco FMV = Pubco decrease
FMV of Pubco share at option issuance	$60	$60	$60
Option strike price	$60	$60	$60
FMV of Pubco share before record time	$85	$85	$85
In-the-money amount	$25	$25	$25
FMV of Pubco share after record time	$65	$65	$65
Decrease in Pubco share price	$20	$20	$20
FMV of Subco share after record time	$30	$15	$20
Revised option strike price required to maintain in-the-money amount	$40	$40	$40
Original option strike price less FMV of Subco share	$30	$45	$40

the first column of which shows that while an option holder who does not exercise his or her options before the distribution has such options repriced to maintain a $25 in-the-money amount, a holder who exercises options before the distribution pays $60 and acquires a Pubco share that together with the Subco share received on the distribution has a combined post-distribution value of $95 (that is, $35 of net value).

Timing of Price Reduction

The timing of the option repricing is critical in satisfying the requirement in subsection 7(1.4) that the in-the-money amount of a Pubco option after the repricing not exceed the pre-repricing in-the-money amount. To achieve this, the timing of the option repricing must coincide with the timing of the decrease in the fair market value of the Pubco common shares. The fair market value of the Pubco common shares should decrease to reflect the distribution at the time that ownership of Pubco common shares ceases to entitle the holder to receive the distributed property. Typically, this should occur immediately after the record time for the distribution (since after such time the share will no longer represent the right to receive the distribution). Thus, the repricing of the Pubco options should occur immediately after the close of trading on the record date. For example, assume the following:

- the original exercise price of a Pubco option was $60;
- holders of Pubco common shares at the close of trading on the record date ("the record time") are entitled to the distribution and the distribution occurs immediately after that time;
- the fair market value of a Pubco common share immediately before the record time is $85; and
- the fair market value of a Pubco common share immediately after the record time is $65.

The repricing of the Pubco option should be effective at the record time. In those circumstances, the in-the-money amount of the Pubco option immediately before the repricing is $25 (that is, $85 – $60). In order to satisfy the requirements in subsection 7(1.4), the exercise price of the Pubco option should be reduced at the record time so that immediately after the repricing, the in-the-money amount of the Pubco option is still $25 (that is, $65 – $40).

Because of the three-day settlement rule on many stock exchanges (such as the Toronto Stock Exchange), it should be noted that the time at which the Pubco share trading price decreases will likely be different than the time at which the options should be repriced. This difference is simply a reflection of the fact that sales of Pubco shares occurring, say, one day before the record date will not settle on or before the record date and therefore will not entitle the purchaser to receive the distribution. Accordingly, Pubco shares will typically begin trading *ex*-distribution at a reduced price a few days before the record date. This timing is a function of exchange settlement constraints, however, not of the value of the share, as is demonstrated by the situation of the option holders themselves. Since holders of employee stock options generally do not undergo any delay in receiving shares deliverable to them on the exercise of options (that is, an option holder could typically exercise options right up to the close of trading on the record date and receive Pubco common shares as a holder of record at the record time), it would not be appropriate to reduce the option exercise price before the record time.[187] Figure 1 provides a timeline for a typical spinout transaction illustrating the relevant dates.

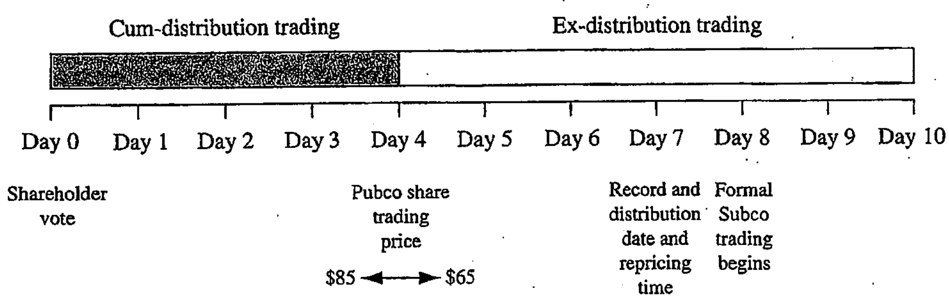
Convertible Securities Other Than Employee Stock Options

Where a distributing corporation has issued securities that are convertible into its common shares (for example, warrants or convertible debentures), the impact of the proposed distribution on such convertible securities must be considered. For the most part, the income tax analysis will depend upon the application of the anti-dilution provisions in the relevant convertible instrument.

Where an in-kind distribution is to be made on the common shares of a corporation, the anti-dilution provisions of convertible securities generally apply to decrease the conversion price in respect of the convertible security to take into account the reduction in the fair market value of the corporation's common shares. In such a case, the reduction in conversion price should not result in a disposition of the convertible security.[188] In addition, the availability of the section 51 rollover for the conversion of a convertible debt obligation of a corporation into shares of its capital stock should continue to apply on a subsequent conversion. Following the distribution, the common shares of Pubco would generally continue to be prescribed shares for purposes of the withholding tax exemption contained in subparagraph 212(1)(b)(vii).[189]

If the anti-dilution provisions of a convertible debt security provided that on the conversion, the holder would be entitled to receive both common shares of the

Figure 1 Spinout Timeline



Note: Assumes three-day trading settlement.

issuer (Pubco) and the distributed property (which would be an unusual result), the tax consequences would become more complicated. For example, it would not appear that the rollover under section 51 would be available on a subsequent conversion of the convertible debt since the holder of the convertible debt would receive consideration other than shares of the capital stock of the issuing corporation on the conversion. Furthermore, the distributed property (for example, the Subco shares) would not be prescribed shares within the meaning of regulation 6208. Consequently, interest payable on the convertible debt may no longer be eligible for the exemption from non-resident withholding tax contained in subparagraph 212(1)(b)(vii).[190]

Pre-Distribution Planning

Since all of the non-butterfly spinout alternatives result in the distributing corporation disposing of the distributed property (for example, Subco shares) for fair market value proceeds of disposition, the distributing corporation may realize a capital gain on the disposition. In such cases, consideration should be given to whether it is possible to shelter such gain using available attributes of Pubco or a controlled subsidiary of Pubco.

Safe Income Strip

If there is an accrued gain on the Subco common shares prior to their distribution and Subco has "safe income on hand" for purposes of subsection 55(2), Pubco should undertake a "safe income strip" prior to the distribution to increase its adjusted cost base of the Subco shares. The resulting increase in adjusted cost base will reduce any gain otherwise realized by Pubco on the distribution of the Subco shares to Pubco shareholders. Subsection 55(2) does not apply to dividends paid by a corporation out of its "safe income on hand." The "safe income on hand" attributable to any particular share of a corporation can be roughly defined as that share's pro rata portion of the corporation's post-1971 undistributed after-tax retained earnings generated during the relevant shareholder's holding period that are still available to contribute to the holder's accrued gain on the share. In principle, this amount represents earnings that have already been taxed at the corporate level and can therefore be distributed as an intercorporate deemed dividend without inappropriate deferral of tax.[191]

Loss Consolidation

If Pubco itself has capital losses at least equal to any capital gain realized on the disposition of the Subco shares, no planning is generally required. If a subsidiary of Pubco ("Lossco") has available losses, it should be possible to access such losses by amalgamating Lossco and Pubco prior to the distribution of the Subco shares. Alternatively, consideration could be given to undertaking an in-house loss consolidation transaction, described below.

Assume that the fair market value and Pubco's adjusted cost base of the Subco shares are $40 million and $35 million, respectively. Lossco, a wholly owned subsidiary of Pubco, has $20 million of capital losses available. In a typical loss consolidation transaction, Pubco would transfer the Subco shares to Lossco in return for preferred shares of Lossco with a redemption amount and fair market value of $40 million. An election would be filed under subsection 85(1) so that the transfer occurs on a tax-deferred basis to Pubco. Lossco would sell the shares of Subco to Pubco for a note of $40 million. Lossco would redeem its preferred shares for $40 million using a note that would be set off against the equivalent note owing from Pubco to Subco. Pubco would then distribute the shares of Subco on the spinout.

As a result of such transactions, Pubco would not realize a capital gain on the disposition of the Subco shares since it would have a cost of $40 million in the Subco shares (that is, their fair market value). Lossco would realize a capital gain on the disposition of the shares of Subco, but such capital gain would be sheltered using Lossco's available capital losses. Pubco would be deemed to have received a dividend on the redemption of the Lossco preferred shares. While the dividend would be deductible in computing Pubco's taxable income,[192] it would be subject to recharacterization as proceeds of disposition under subsection 55(2) unless the exemption therefrom in paragraph 55(3)(a) applied.

While a discussion of paragraph 55(3)(a) is beyond the scope of this paper, that exemption would not apply if subsequent sales of the shares of Pubco (the dividend recipient) by the Pubco shareholders occurred as part of the same series of transactions as the loss consolidation transaction.[193] In this regard, the loss consolidation transaction and the spinout transaction would occur as part of the same series of transactions or events. Since the spinout transaction allows a Pubco shareholder to separately trade the Subco shares and the Pubco common shares (representing the non-Subco assets), there would appear to be a significant risk[194] that a sale of Pubco shares occurring shortly after the spinout transactions would form part of the same series of transactions or events as the loss consolidation transaction.

Given the "series of transactions" risk associated with the transactions described above, the loss consolidation transaction should be structured so that Pubco transfers the Subco shares to Lossco for additional common shares of Lossco and an election is filed under subsection 85(1) for the transfer to occur on a tax-deferred basis. Lossco then sells the Subco shares to Pubco for cash equal to their fair market value, and thereafter Lossco distributes the cash to Pubco as a reduction of capital on its common shares to the extent of the subsection 85(1) elected amount and as a dividend for the remainder. The position would be taken that subsection 55(2) does not apply to the dividend since the purpose of the dividend is not to reduce a capital gain on the sale of any shares that would have arisen but for the dividend.[195] The gain on the Subco shares has been fully realized (sheltered by Lossco's losses) and has not been reduced by any dividend. While the accrued gain on the Lossco common shares created on the subsection 85(1) transfer of property is reduced by the dividend, Pubco has no intention of disposing of those shares, and accordingly, the purpose of the dividend is not to reduce the gain on those shares.

Interest Deductibility

Interest deductibility should not be an issue for the distributing corporation unless it funds the distributed property with borrowed money. In such a case, the borrowed money associated with the distributed property should be considered to have been used to make the distribution; thus, the continued deductibility of the interest on the borrowed money would depend upon whether the distribution constituted an eligible use of the borrowed money. To a large extent, the analysis would depend upon the form of the distribution.[196]

Where the distribution occurs as a dividend in kind, interest on the borrowed money would continue to be deductible provided that the amount of the borrowed money did not exceed the accumulated profits of the distributing corporation immediately before the distribution. At the 2002 Canadian Tax Foundation annual conference ("the 2002 conference"), the CCRA expressed the view that for this purpose, "accumulated profits" means retained earnings computed on an unconsolidated basis, with investments accounted for at cost and profits from non-arm's-length dispositions subtracted.[197]

For distributions occurring as a reduction of capital or a share exchange spinout,[198] interest on the borrowed money should continue to be deductible provided that the amount of the borrowed money does not exceed the capital of the corporation. The CCRA announced at the 2002 conference that for this purpose a corporation's "capital" generally includes its contributed capital (that is, funds provided by shareholders) and accumulated profits.[199] For this purpose, the CCRA normally considers stated capital under corporate law to be the best measurement of "contributed capital," although in some circumstances other measurements may be more appropriate. Presumably contributed surplus should be included in "contributed capital."

For shareholders of the distributing corporation who have borrowed for the purpose of acquiring their shares of the distributing corporation, a dividend in kind should not affect the continued deductibility of interest on the borrowed funds. The situation is less clear on a spinout effected as a reduction of capital or a share exchange spinout. However, in most cases, the distributed property will consist of securities of another entity with at least some income-earning potential (for example, Subco shares), such that the effect of the transaction will be that the borrowing shareholder will have two income-earning properties (for example, Pubco shares and Subco shares) rather than one. In such circumstances, interest on the share acquisition loan should continue to be deductible as long as the shareholder continues to hold both of those income-earning properties.

Comparison of Spinout Alternatives

The decision as to the appropriate method for a public corporation to undertake a spinout transaction will depend upon commercial and corporate factors as well as Canadian income tax considerations[200] relating to butterfly transactions or non-butterfly spinout alternatives. While the optimal form of spinout in any particular situation will depend on the facts of each case, some general comments can be made comparing the various spinout alternatives.

Butterfly Versus Other Alternatives

From an income tax perspective, the first step is to determine whether a butterfly transaction is a viable alternative since this would permit the spinout to occur on a fully tax-deferred basis to Pubco and its shareholders. Various reasons why a butterfly transaction may not be a viable alternative have been noted above. Even if feasible, however, in some circumstances a butterfly transaction may not be the preferred course of action either because of restrictions imposed by the butterfly rules or for other reasons. Determining whether to proceed with a butterfly transaction or another form of spinout will involve weighing the benefits associated with a fully tax-deferred butterfly transaction against the tax and commercial disadvantages associated with a butterfly, such as the delay involved in obtaining an advance income tax ruling; the necessity for a plan of arrangement; restrictions on future transactions by the distributing corporation, the transferee corporation, and possibly significant shareholders of the distributing corporation; and the assumption of the "series of transactions" risk associated with butterfly transactions.

One very relevant factor will be whether a non-butterfly spinout can be effected on a tax-deferred basis for most shareholders of the distributing corporation. A non-butterfly spinout can be tax-deferred for a Pubco shareholder in general only if the fair market value of the property received by the holder (that is, Subco shares) does not exceed the lesser of the paid-up capital and the adjusted cost base of the holder's Pubco shares. If Pubco does not have sufficient paid-up capital to allow the Subco shares to be distributed without a deemed dividend arising, or if a significant number of Pubco shareholders (or perhaps one or more significant shareholders) hold their Pubco shares at an adjusted cost base that is materially less than the fair market value of the Subco shares to be received by those holders, a butterfly transaction (if viable) may be the preferred course of action.

As noted above, the primary advantage of a butterfly transaction is that the distribution occurs on a tax-deferred basis to Pubco. However, this advantage is of no value if there is no accrued gain on the property to be distributed, or may be of limited value if such a gain exists but there is sufficient shelter available to offset it. Where there is a relatively small gain on the distributed property that cannot be sheltered, the ability to undertake a tax-deferred spinout may be of some advantage to Pubco, although it may not be sufficient to overcome the other disadvantages of a butterfly noted above—in particular, restrictions on future transactions. For example, since actions of various parties under a butterfly transaction may have very significant unfavourable income tax consequences to the other participants in the butterfly transaction,[201] it may be necessary for specified shareholders of Pubco to enter into contractual limitations on their ability to undertake future transactions.[202]

The likely actions of shareholders following the distribution must also be considered. In many spinout transactions, the business being distributed is of a different nature than the corporation's core business (indeed, this may be the reason for the spinout). Some Pubco shareholders may not be interested in holding Subco shares and are likely to dispose of them shortly after acquiring them on the distribution. In such circumstances, shareholders may prefer a non-butterfly distribution even if a butterfly is viable. In most cases, a butterfly transaction leaves Pubco shareholders with a lower cost in their Subco shares than does a non-butterfly alternative. Under a butterfly transaction, a Pubco shareholder's adjusted cost base of its Pubco shares is bifurcated between the Pubco shares and the Subco shares, so that a shareholder with an accrued gain will realize some portion of that gain on a post-distribution sale of Subco shares. Conversely, on a non-butterfly spinout, the Subco shares are received at a tax cost equal to their fair market value, such that no gain will be realized if the shares are sold immediately following the distribution. This is illustrated in the appendix, comparing the results of various forms of spinout on a simple fact situation. Moreover, as noted above, many tax-exempt shareholders will be interested in the post-distribution cost of their Pubco shares and Subco shares, and the "foreign property" status of each for purposes of minimizing the amount of their post-distribution foreign property under part XI. It is therefore relevant to consider the likely actions of Pubco shareholders following the distribution, and which security Pubco shareholders are likely to want to have their tax cost in.

It should also be noted that the paid-up capital of the Subco shares distributed on a spinout will generally be different as between butterfly and non-butterfly transactions. On a butterfly spinout, the paid-up capital of the shares of the spun-out corporation (that is, Subco) is generally limited under subsection 85.1(2.1) to the paid-up capital of the Pubco shares that the corporation acquires from Pubco shareholders. Accordingly, leaving aside the potential for subsection 85(1) elections on the transfer of Pubco shares by Pubco shareholders to Subco, on a butterfly Pubco's existing paid-up capital is essentially divided between Pubco and Subco. On a non-butterfly spinout, Subco's paid-up capital is a function of Subco's historical capital structure, including whatever transactions take place between Pubco and Subco in preparation for the spinout, and generally bears no relation to Pubco's paid-up capital. This is also illustrated in the appendix. As noted above, paid-up capital is a useful attribute for Subco that should be maximized and preserved wherever possible.

Comparison of Non-Butterfly Alternatives

While the differences among non-butterfly spinout alternatives are generally not as significant as those between butterfly and non-butterfly spinouts, it is nonetheless useful to consider briefly the differences between dividends in kind, reductions of capital, and share exchange spinouts.

Income Tax Considerations

Since each of the non-butterfly spinout transactions results in a taxable disposition to Pubco, the most significant area of comparison is the income tax consequences to the shareholders of Pubco. However, different forms of non-butterfly spinout may have distinct tax consequences to Pubco. For example, as noted above, if the distributed property has been acquired by Pubco using borrowed money, the form of distribution may affect the analysis of whether interest on the borrowed money continues to be deductible to Pubco after the spinout. Moreover, the part XIII withholding obligations on Pubco arising from a dividend in kind may not be present on a reduction of capital or share exchange spinout, depending on the paid-up capital of the Pubco shares relative to the fair market value of the distributed property.

From the perspective of a Pubco shareholder, the most salient difference between non-butterfly spinout methods is that the full value of property received as a dividend in kind is a taxable dividend, whereas under a reduction of capital or a share exchange spinout a Pubco shareholder generally receives a taxable dividend only to the extent (if any) that the value of the distributed property exceeds the paid-up capital of the holder's Pubco common shares.[203] A reduction of capital or a share exchange spinout generally results in a reduced post-distribution tax cost of the holder's Pubco common shares, which does not occur under a dividend in kind. The fact that a dividend in kind results in a higher cost amount of Pubco shares, compared to a reduction of capital or share exchange spinout, will be relevant to Pubco shareholders subject to tax under part XI, as well as those likely to dispose of their Pubco shares in a non-rollover transaction shortly after the spinout.

For most taxpayers (in particular, non-residents and Canadian-resident individuals), a dividend-in-kind transaction will be rather inefficient. The degree of inefficiency will depend on both how the particular taxpayer is taxed on dividend income and (more important) how much of the value of the distributed property could otherwise have been received as a non-dividend basis reduction—that is, how much paid-up capital and adjusted cost base in the holder's Pubco shares is going unused on a dividend in kind. Since a non-dividend basis reduction effectively represents an increased gain or decreased loss on a subsequent sale of Pubco shares, the post-distribution holding period of a particular holder's Pubco shares also affects the degree to which a dividend in kind is tax-inefficient (along with how the holder is taxed on that gain and whether that loss could otherwise have been used). For non-residents, relevant factors will also include the extent to which the spinout is a taxable transaction in their home jurisdiction and whether a foreign tax credit for Canadian part XIII tax on dividends is available and usable (that is, Canadian dividend withholding tax may not matter if fully creditable against home-country tax arising from the spinout).

There are relatively few tax differences between a reduction of capital and a share exchange spinout, apart from the relevance of obtaining an advance income tax ruling (discussed below). As illustrated in the appendix, the tax results of these transactions are essentially the same in the typical situation where the fair market value of the distributed property does not exceed either the paid-up capital or the adjusted cost base of the shareholder's Pubco shares. Where the fair market value of the distributed property exceeds the paid-up capital of the Pubco shares but is less than the holder's adjusted cost base, a reduction of capital produces no gain or loss and simply grinds the adjusted cost base of the Pubco shares by the non-dividend portion of the value of the distributed property (see table 1 above). However, the same situation on a share exchange spinout governed by section 86 results in the tax cost of the new Pubco shares being reduced by the entire value of the distributed property and (subject to any applicable stop-loss rules) produces a capital loss equal to the amount of the deemed dividend.[204] A share exchange spinout may offer the opportunity of making subsection 85(1) elections as discussed above, with the consequent possibility of allowing Pubco shareholders to realize accrued losses (subject to applicable stop-loss rules) or a variable amount of accrued gains. As noted above,[205] there can be differences in the treatment of stock options between reductions of capital and share exchange spinouts.

Need for Advance Income Tax Ruling

Absent unusual circumstances, no advance income tax ruling should be required in respect of a dividend-in-kind transaction.[206] Because of the statutory provision in subsection 52(2) to the effect that the distributed property is received at a cost equal to its fair market value, there is no need for a ruling on this point in respect of a dividend in kind.

If the spinout is undertaken by way of a reduction of capital such that it is necessary to come within subsection 84(2), it will often be prudent to obtain an advance income tax ruling because of the uncertainty as to whether a "reorganization" of the business of the distributing corporation has occurred.[207] As discussed above, the advisability of an advance income tax ruling is particularly acute in the case of a holding corporation effecting a subsection 84(2) reduction of capital. Given the absence of statutory authority and the importance of the issue, it is also prudent to include a ruling to the effect that shareholders acquire the property distributed on a reduction of capital at a cost equal to its fair market value, although, as noted, the CCRA does not seem to question this result.

It should generally be possible to effect a share exchange spinout without obtaining an advance income tax ruling. In this regard, the creation of a new class of Pubco common shares and the exchange of the existing class of common shares for shares of that new class and Subco shares should clearly qualify as a reorganization of capital for purposes of section 86, without the need for additional comfort from the CCRA. Furthermore, if all of the old Pubco common shares are clearly cancelled, the requirement that all of the shares of a class held by a holder be disposed of should also be clearly satisfied. While an advance income tax ruling would provide comfort that the CCRA would not seek to apply the general anti-avoidance rule in subsection 245(2) on the basis that the required disposition of all the shares of the class had not occurred in substance where the new common shares were virtually identical to the old common shares, such comfort is not strictly necessary since a number of advance tax rulings have been issued in respect of similar transactions.

Non-Tax Considerations

As discussed above, a dividend in kind is the simplest type of transaction to implement since it does not involve any form of shareholder approval. A reduction of capital requires approval by a special resolution of all of the holders of voting shares of the distributing corporation, as well as approval by a special resolution of the holders of each class or series of shares of the distributing corporation (whether or not those shares ordinarily have voting rights);[208] thus, a reduction of capital could be somewhat complicated to implement if the distributing corporation had any issued and outstanding preferred shares. A plan of arrangement would be required to implement a share exchange spinout, requiring court approval as well as shareholder approval (although it may not be necessary to obtain the approval of the preferred shareholders of Pubco). Thus, in cases where the corporation has a number of different classes of shares, a plan of arrangement may actually be simpler to implement than a capital reduction.

While a dividend in kind may seem advantageous from a timing perspective since no shareholders' meeting is required, this advantage may be somewhat illusory in many cases. In order for Subco shares to be distributed to the public, it would be necessary for a prospectus to be prepared.[209] In addition, where Pubco has US shareholders, such shares would have to be registered under the Securities Exchange Act of 1934[210] for public trading in the United States. The time required to comply with the prospectus disclosure requirements and complete the regulatory review process may reduce or eliminate any timing advantage associated with a dividend in kind.[211] Because the Canadian and US securities law disclosure and regulatory review requirements for a dividend in kind, a reduction of capital transaction, and a share exchange spinout are very similar and the time required for compliance is typically at least as long as the time required to hold a shareholders' meeting, practically there is little or no timing advantage to effecting a spinout as a dividend in kind.

The absence of any requirement for shareholder approval for a dividend-in-kind spinout was used to create an interesting twist on the corporate structure of the spinout by Brookfield Properties Corporation ("Brookfield") of all of the common shares of its wholly owned subsidiary Brookfield Homes Corporation ("Homes").[212] The purpose of this spinout was to separate Brookfield's US home-building operations in California and northern Virginia from its commercial property business. In doing so, Brookfield sought to make itself a "pure play" commercial property company that would be easier for the market to value and compare with other commercial property companies, and unlock for shareholders the value of the home-building business, which Brookfield management felt was not properly reflected in Brookfield's share price.

Under the governing corporate law, Brookfield management did not require shareholder approval to distribute the Homes shares as a dividend in kind. However, this corporate law advantage was tempered by the fact that for most Brookfield shareholders, a dividend in kind would be inefficient from a Canadian tax perspective compared to a reduction of capital. Brookfield therefore combined the dividend in kind and reduction of capital spinout alternatives into a hybrid transaction, announcing that the Homes shares would be distributed to Brookfield shareholders as a dividend in kind unless they voted to approve a special resolution authorizing such distribution to occur as a reduction of capital. Hence, Brookfield shareholders were destined to receive the Homes shares in all circumstances; the only decision left for them was whether to receive them as a dividend in kind or a reduction of capital. It will be interesting to see whether this form of "take it or take it" (as opposed to "take it or leave it") transaction becomes more prevalent in Canada.

Finally, while the form of the spinout transaction would not generally affect the rights of holders of convertible or other securities of Pubco, it is conceivable that the terms and conditions of such securities could be such that it would be easier to implement one form of spinout transaction rather than another.

Conclusion

Public corporations seeking to distribute property to their shareholders have a variety of options open to them, each of which has its own advantages and disadvantages. While a butterfly transaction may seem to be the most obvious alternative, in many cases such a transaction will be either impossible or suboptimal. In such circumstances, any or all of a dividend in kind, a reduction of capital, and a share exchange spinout may be suitable methods for distributing the desired property to the corporation's shareholders.

Appendix Comparison of Different Forms of Public Company Spinout

	Section 55	Repeal of subsection 84(4.1)	Subsection 84(2)	Section 86	Subsection 85(1)	Dividend in kind
FMV of Pubco share	$10	$10	$10	$10	$10	$10
ACB of Pubco share	$8	$8	$8	$8	$8	$8
PUC of Pubco share	$5	$5	$5	$5	$5	$5
FMV of Subco share spun out	$3	$3	$3	$3	$3	$3
Pubco share						
Dividend	nil	nil 84(4)	nil 84(2)	nil 84(3)	nil[a] 84(1), (3), (5)	$3 82(1)
Basis reduction	na	$3 53(2)(a)(ii)	$3 53(2)(a)(ii)	na	na	na
Proceeds of disposition	$8, $2.4 86(1)(c), 85.1(1)(a)(i)	na	na	$8 86(1)(c)	$8[a, b] 85(1)	na
Capital gain/loss	nil	nil	nil	nil	nil[a, b]	nil
Tax cost	$5.6 86(1)(b)	$5 53(2)(a)(ii)	$5 53(2)(a)(ii)	$5 86(1)(b)	$5[b] 85(1)(h)	$8
PUC	$3.5[c] 86(2.1)	$2 PUC definition	$2 PUC definition	$2 86(2.1)	$2[a] PUC definition	$5

(The appendix is concluded on the next page.)

Appendix Concluded

	Section 55	Repeal of subsection 84(4.1)	Subsection 84(2)	Section 86	Subsection 85(1)	Dividend in kind
Subco share						
Tax cost	\$2.4 86(1)(b), 85.1(1)(a)(ii)	\$3 admin. policy	\$3 admin. policy	\$3 86(1)(a)	\$3 85(1)(f)	\$3 52(2)
PUC	\$1.5[c] 86(2.1), 85.1(2.1)	na[d]	na[d]	na[d]	na[d]	na[d]

[a] Assumes that there is a corporate law mechanism to limit the stated capital of the new Pubco share to \$2, such that the non-share consideration (\$3) and the PUC of the new Pubco share (\$2) combined do not exceed the \$5 PUC of the old Pubco share. Otherwise, the PUC of that new share will be limited to \$5 under subsection 85(2.1), which limits the PUC increase to the excess of the elected amount (\$8) over the non-share consideration (\$3). Since subsection 84(5) will value the new Pubco share at its PUC for deemed dividend purposes, Pubco will be deemed to have paid a dividend of \$3 (\$8 of value distributed less \$5 of existing PUC) under subsection 84(3), subject to subsection 55(2). The amount of any such dividend would then be subtracted from the proceeds of disposition to yield a capital loss of \$3 (subject to any applicable stop-loss rules). Note that with these numbers no dividend arises under subsection 84(1), but with different numbers one could, unless the stated capital of the new Pubco share could be appropriately limited (for example, if the PUC of the old Pubco share was \$4 instead of \$5, a \$1 dividend would arise under subsection 84(1) on the new Pubco share, the amount of which would be added to the tax cost of that share under paragraph 53(1)(b)).

[b] Assumes an election at \$8; it is possible to elect at any amount between \$8 and \$10 inclusive under subsection 85(1).

[c] PUC can be allocated freely between the two classes of Pubco shares received on the preliminary subsection 86(1) capital reorganization, subject to the overall limit in subsection 86(2.1) of the PUC of the old class of Pubco shares. However, a PUC allocation pro rata to FMV is most common.

[d] PUC of Subco share is determined on the basis of preliminary transactions by which Subco acquires property and issues shares.

Notes

1 RSC 1985, c. 1 (5th Supp.), as amended (herein referred to as "the Act"). Unless otherwise stated, statutory references in this paper are to the Act. This paper is limited in scope to distributions to shareholders pro rata, thereby excluding discussion of other possible forms of corporate distributions such as (for example) issuer bids, or transactions that effectively split up a corporation's assets between different groups of shareholders (for a recent example of a split-up transaction, see the Notice of Annual and Special Meeting of Shareholders of Dundee Realty Corporation, Notice of Application and Management Information Circular, dated May 23, 2003).

2 See Firoz Ahmed, "Corporate Distributions Other Than Butterfly Transactions," in *Report of Proceedings of the Fiftieth Tax Conference*, 1998 Conference Report (Toronto: Canadian Tax Foundation, 1999), 15:1-38, at 15:12-15.

3 For examples of relatively recent papers on the topic of butterfly transactions, see Brian R. Carr, "Divisive Reorganizations or 'Butterfly Transactions,'" paper presented at the 2003 Tax Law for Lawyers National Tax Law CLE Conference, Niagara-on-the-Lake, May 25-30, 2003; and Manu Kakkar, "Reorganizing a Family Holding Company: Windups and Butterflies," Personal Tax Planning feature (2003) vol. 51, no. 1 *Canadian Tax Journal* 569-616.

4 Defined in subsection 89(1) to include a corporation that is resident in Canada and that lists a class of its shares on a prescribed stock exchange in Canada.

5 In some cases, a preliminary reorganization of Pubco's share capital occurs whereby all Pubco shareholders exchange all of their Pubco common shares for (1) new Pubco common shares and (2) a special class of Pubco shares with a value equal to the net assets to be received by Newco. This transaction occurs on a tax-deferred basis under subsection 86(1). The Pubco shareholders then transfer all of their Pubco special shares to Newco in exchange for Newco common shares, again on a tax-deferred basis under subsection 85.1(1) or subsection 85(1).

6 Subsection 84(3). Subject to the rules in subsections 112(2.1) to (2.4), Newco can deduct this intercorporate deemed dividend in computing its taxable income under subsection 112(1).

7 Section 54, definition of "proceeds of disposition," paragraph (j).

8 Canada, Department of Finance, *Legislative Proposals and Explanatory Notes Relating to Income Tax* (Ottawa: Department of Finance, November 1999), and accompanying Department of Finance press release, "Draft Technical Income Tax Amendments Released," *Release* no. 99-102, November 30, 1999.

9 The relieving provision is enacted in subsection 55(3.02).

10 See, for example, Kakkar, supra note 3, at 591-92 for a discussion of this issue.

11 See, for example, Firoz Ahmed, "March 16 Notice of Ways and Means Motion" (2001) vol. 11, no. 8 *Canadian Current Tax* 77-80, at 79; Firoz Ahmed, "Proposed Public Company Butterfly Rules" (2000) vol. 10, no. 6 *Canadian Current Tax* 48-51; and Jerald M. Wortsman, "The Public Company Spinoff Rule," in *Report of Proceedings of the Fifty-Second Tax Conference*, 2000 Conference Report (Toronto: Canadian Tax Foundation, 2001), 24:1-50.

12 Canada, Department of Finance, *Legislative Proposals and Explanatory Notes Relating to Income Tax* (Ottawa: Department of Finance, December 2002), and accompanying Department of Finance press release, "Federal Government Releases Draft Technical Income Tax Amendments," *Release* no. 2002-107, December 20, 2002.

13 For a discussion of the December 2002 proposed amendments as they affect butterfly transactions, see Firoz Ahmed, "Technical Bill Provides Relief for Divisive Reorganizations" (2003) vol. 13, no. 8 *Canadian Current Tax* 69-73.

14 See supra note 5.

15 Unlisted shares do not benefit from the 25 percent ownership threshold in paragraph (f) of the "taxable Canadian property" definition in subsection 248(1); therefore, such shares will be taxable Canadian property to a non-resident holder irrespective of the holder's percentage ownership (see paragraph (d) of the "taxable Canadian property" definition in subsection 248(1)). This will in turn cause the Newco common shares received in exchange for those reorganization shares under subsection 85.1(1) or 85(1) to be deemed to be "taxable Canadian property" notwithstanding any stock exchange listing of the Newco common shares: see the postamble of paragraph 85.1(1)(a) and paragraph 85(1)(i). Moreover, the withholding regime in section 116 will apply to the non-resident's disposition of unlisted Pubco shares to Newco.

16 In addition, the existing Pubco shares they are received in exchange for cannot be "taxable Canadian property." The Joint Committee on Taxation of the Canadian Bar Association and the Canadian Institute of Chartered Accountants made the additional point to the Department of Finance that deemed-listed status ought also to apply for purposes of the "qualified investment" definition in subsections 146(1), 146.1(1), and 146.3(1), and section 204 (although in most cases such shares would so qualify under regulation 4900(1)(b)): see letter from the Joint Committee on Taxation of the Canadian Bar Association and the Canadian Institute of Chartered Accountants to Len Farber, Director General, Legislation, Tax Policy Branch, Department of Finance, May 6, 2003, E.4 (letter available at http://www.ctf.ca/pdf/jcpdf/03may6techbillcover.pdf).

17 A recent example of such a situation is the plan by Assante Corporation to spin off its US operations to its shareholders as a reduction of capital and then have its shareholders tender their Assante shares to CI Fund Management Inc. for cash and CI shares: see Assante Corporation press release dated August 22, 2003 (available at http://www.assante.com/canada/aboutassante/news_03.cfm; click on "Assante Corporation Accepts CI Fund's Offer for Canadian Operations," August 22, 2003).

18 Or property 10 percent or more of the fair market value of which is derived from such shares, at any time in the course of the series of transactions.

19 Defined in subsection 248(1), as modified for (inter alia) this purpose by subsection 55(3.3).

20 Note also that subparagraph 55(3.1)(b)(iii) prohibits most share acquisitions in contemplation of the butterfly by (inter alia) anyone not dealing at "arm's length" with the transferee corporation.

21 See supra note 18.

22 Paragraph 55(3.2)(h). This deeming rule may also prove problematic for purposes of ensuring compliance with subparagraphs 55(3.1)(b)(ii) and (iii).

23 For example, assume that a subsidiary of a Canadian bank ("Banksub") owns 10 percent of the shares of the distributing corporation and that it is willing to commit that it would not dispose of its shares of the distributing corporation or the transferee corporation for a substantial period of time after the spinout. Not only would Banksub be a specified shareholder of the distributing corporation, but every corporation related to it would be deemed to be a specified shareholder no matter how small its shareholding of the distributing corporation. While it might be practical for Banksub to covenant not to sell its shares for a specified period, it would likely not be practical to preclude the securities dealer subsidiary of the same bank from buying or selling shares of the distributing corporation or selling shares of the transferee corporation for any period of time.

24 In such cases, it would still be arguable that purchases and sales of shares of the distributing corporation or the transferee corporation would not occur as part of the relevant "series of transactions"; but, as noted below, there is considerable uncertainty as to the interpretation of those words.

25 In this case, (1) property to which the fair market value of Newco-acquired property or Pubco-retained property is "wholly or partly attributable" at any time during the series of

transactions, and (2) property more than 10 percent of the fair market value of which is attributable to most Newco-acquired property or Pubco-retained property or property described in (1) at any time during the post-butterfly portion of the series of transactions.

26 See the definition of "specified corporation" in subsection 55(1), which prevents the distributing corporation from effecting any non-spinout butterfly within the three years following the spinout, and the transferee corporation from undertaking any butterfly within that period.

27 2002 DTC 1637, at 1683 (TCC).

28 That is, the transferee corporation that has acquired the distributed assets.

29 The butterfly requires the use of a taxable Canadian corporation in order to make the subsection 85(1) election to transfer the distributed property and in order to receive the intercorporate deemed dividend created on the cross-redemption of shares free of part I tax under subsection 112(1).

30 See, for example, the spinout of Magna Entertainment Corporation by Magna International Inc., discussed below with reference to dividends in kind.

31 For an excellent summary of the issues facing public corporations considering butterfly transactions, see Julie A. Colden, "Public Company Spin-Off Butterfly Checklist" (2002) vol. 12, no. 6 *Canadian Current Tax* 65-74.

32 In various instances, this paper uses a notional distribution by a public corporation ("Pubco") of shares of a wholly owned subsidiary ("Subco") to illustrate an example of a spinout transaction.

33 For example, see section 43 of the Canada Business Corporations Act, RSC 1985, c. C-44, as amended (herein referred to as "the CBCA"), and section 38(1) of the Ontario Business Corporations Act, RSO 1990, c. B.16, as amended (herein referred to as "the OBCA"), which provide that a corporation may pay a dividend in money or property.

34 Section 42 of the CBCA and section 38(3) of the OBCA.

35 This is also the position taken by the CCRA in *Interpretation Bulletin* IT-67R3, "Taxable Dividends from Corporations Resident in Canada," May 15, 1992, paragraph 6. On the other hand, it might be arguable that if the directors' resolution specifies a dollar amount (or at least a means for determining a dollar amount—for example, in the case of a distribution of Subco shares, the weighted average trading price of a Subco share over a specified period of time), such specified amount should be the amount of the dividend in kind, regardless of the value of the distributed property. In this regard, it is common practice in respect of stock dividends to declare a dividend of a nominal amount and then to satisfy such dividend by issuing a share of the capital stock of the dividend payer that has a fair market value greater than the nominal amount. The amount added to the stated capital of the shares of the dividend payer is also the nominal amount. In such circumstances, the amount of the dividend is the nominal addition to the stated capital so that the amount of the dividend paid by the dividend payer and received by the holders of the shares of the capital stock of the dividend payer is nominal (see paragraph (c) of the definition of "amount" in subsection 248(1)).

36 Subsection 52(2).

37 Paragraph 82(1)(a).

38 Paragraph 82(1)(b) and section 121.

39 In very general terms, subsections 112(2.1), (2.2), and (2.4) apply to certain dividends received on preferred shares or shares subject to a guarantee agreement. Subsection 112(2.3) applies to deny dividend deductibility in respect of dividends received as part of a "dividend rental arrangement."

40 For example, if Pubco were controlled by a corporation that is a "specified financial institution" within the meaning of the definition in subsection 248(1), the Pubco common shares would be term preferred shares (see paragraph (a) of the definition of "term preferred share"

in subsection 248(1)). Consequently, subsection 112(2.1) could apply to deny the specified financial institution a deduction of the dividend in kind if the Pubco common shares were acquired in the ordinary course of the business carried on by the specified financial institution.

41 While Pubco would not be involved in any such arrangements, where a significant dividend is to be paid on the shares of Pubco, there may be an incentive for financial intermediaries to provide a market for persons who wish to continue to own Pubco shares but do not wish to receive a dividend—for example, non-residents. For example, if a financial intermediary agreed to purchase Pubco shares prior to the record date of the dividend in kind for the market price (the "original purchase price") and then sell them back to the holder for a per share price equal to the original purchase price less the amount of the dividend less a "fee amount," one must consider whether rules denying the dividend deduction such as subsection 112(2.3) might apply.

42 As defined in subsection 248(1).

43 As defined in subsection 248(1).

44 See the definition of "private corporation" in subsection 89(1).

45 As defined in subsection 186(3).

46 As defined in subsection 125(7).

47 See paragraph (b) of the definition of this term in subsection 129(4).

48 A full exemption is available from the application of subsection 55(2) if the amount of the dividend received by a corporate holder does not exceed the holder's "safe income on hand" in respect of the holder's shares of the capital stock of the dividend payer. A partial exemption is available to the extent of the holder's safe income on hand if the holder makes an effective designation under paragraph 55(5)(f) to treat an amount of the dividend in kind equal to such safe income on hand as a separate dividend. In addition, a full or partial exemption from the application of subsection 55(2) is provided to the extent that the dividend paid to a corporate holder is subject to tax under part IV of the Act, provided that the tax is not refunded as part of the same series of transactions. A discussion of these exemptions is beyond the scope of this paper. Rather, the focus of the discussion herein is whether it can be established that the purpose test set out in subsection 55(2) is not satisfied.

49 96 DTC 6562 (FCA).

50 Subsection 212(2). Where the non-resident holds the shares as part of a business carried on in Canada, see regulation 805 for the circumstances in which the part XIII withholding may be forgone.

51 See, for example, *TaxPartner* (Toronto: Carswell) (CD-ROM database), document no. B-4234, May 10, 1983.

52 Where Magna International Inc. ("Magna") distributed the shares of MEC Corporation ("MEC") as a dividend in kind (described below), the distribution occurred contemporaneously with Magna's regular quarterly dividend. The cash from the regularly quarterly dividend was used to partially fund the part XIII tax liability in respect of the dividend in kind.

53 This method was used on the Magna-MEC distribution and was to be used in respect of the proposed dividend-in-kind distribution by Brookfield Properties Corporation of the shares of a subsidiary, described below.

54 Subsection 52(2).

55 See, for example, subsections 40(3.3) and (3.4) in respect of the disposition of non-depreciable capital property.

56 Subsection 215(1).

57 See subsections 215(6) and 227(8) and (8.3).

58 Subsections 227(10) and (10.1).

59 See regulations 201(1)(a) and 202(1)(g).

60 See Magna Entertainment Corp., "Non-Offering Prospectus," February 14, 2000 (available at http://www.sedar.com). The description of the MEC transaction contained herein is based on information contained in such prospectus.

61 See paragraphs (f) and (d.1) of the definition of "foreign property" in subsection 206(1), and subsection 206(1.1). Foreign property is discussed below under the heading "Related Issues—Tax-Exempt Shareholders."

62 Possibly this was due to the existence of subsection 84(4.1), discussed below, and the pre-1994 regime, under which there were significantly fewer restrictions on effecting in-kind distributions by way of a butterfly transaction.

63 See, for example, Howard J. Kellough and Peter E. McQuillan, *Taxation of Private Corporations and Their Shareholders*, 3d ed. (Toronto: Canadian Tax Foundation, 1999), 3:35-45; and Ronald K. Durand and Ian M. Freedman, "Dealing with Paid-Up Capital," in *Current Issues in Corporate Finance*, 1997 Corporate Management Tax Conference (Toronto: Canadian Tax Foundation, 1997), 17:1-42.

64 In this regard, see CCRA, *Interpretation Bulletin* IT-463R2, "Paid-Up Capital," September 8, 1995, paragraph 2.

65 See, for example, section 26(2) of the CBCA and section 24(2) of the OBCA.

66 Section 26(3) of the CBCA and section 24(3) of the OBCA. Basically, these circumstances are limited to (1) transactions between a corporation and a non-arm's-length shareholder, (2) transactions in which the issuer receives shares of a non-arm's-length body corporate as consideration, and (3) certain amalgamations. Section 26(3)(a)(iii) of the CBCA (which does not have an OBCA counterpart) contains a further exception applicable to shares issued in exchange for a transfer of property from an *arm's-length* person, where that person, the issuer, and all other shareholders of the relevant class or series consent to the exchange.

67 These are discussed in Durand and Freedman, supra note 63, at 17:4.

68 This might be possible under the relevant corporate law if, for example, the corporation subsequently generated retained earnings.

69 In this regard, subparagraph 84(1)(c.3)(iii) would not appear to prevent a subsection 84(1) deemed dividend, since the reduction in the stated capital of the shares of the public corporation would have been used to reduce a retained earnings deficit and not to create contributed surplus.

70 For example, by providing non-share consideration as partial consideration for all of the acquired shares.

71 See Canadian Pacific Limited Arrangement Circular dated August 3, 2001. In that transaction, shares of the distributing corporation were transferred to each transferee corporation in exchange for two classes of shares of the transferee corporation so that section 85.1 technically did not apply to the share exchange. The public shareholders of Canadian Pacific Limited were required to file an election with each transferee corporation under subsection 85(1) in order for the transfer to occur on a rollover basis. The result of such transaction was to increase the paid-up capital of the shares of each transferee corporation compared to what it would have been had section 85.1 applied to the share exchanges.

72 Canada, Department of Finance, 1978 Budget, Supplementary Information, April 10, 1978, 56.

73 Robert D. Brown, "Last Gun-Fight at the Surplus-Stripping Corral," in *Report of Proceedings of the Thirtieth Tax Conference*, 1978 Conference Report (Toronto: Canadian Tax Foundation, 1980), 590-626, at 594. See also P.M. Farwell, "Public Corporations: Capitalizing Surplus in 1978," in *Corporate Management Tax Conference 1978* (Toronto: Canadian Tax Foundation, 1978), 90-107.

74 As discussed below, subsection 84(4), (4.2), or (4.3) could apply to deem all or part of the capital return to be a dividend.

75 A review of the Department of Finance technical notes accompanying this part of the Act (in particular those from 1988) illustrates that it is directed at schemes involving a disposition of the shareholder's existing share or a high value/low paid-up capital share received as a dividend on that share.

76 Except that the relevant deemed dividend provision will be subsection 84(4) rather than subsection 84(2).

77 See, for example, supra note 40, with reference to dividends in kind.

78 Defined in subsection 248(1). Note that because of paragraphs (f) and (g) of the definition (dealing with corporations controlled by or related to a specified financial institution), the potential scope of this provision is broader than the name might indicate.

79 Note in this regard the interpretational rule in subsection 248(13), dealing with interests in trusts and partnerships.

80 For a discussion of the CCRA's views on the term "ordinary course of business," see CCRA document no. 9608455, March 28, 1996. See also Guy Fortin and Mélanie Beaulieu, "The Meaning of the Expressions 'In the Ordinary Course of Business' and 'Directly or Indirectly,'" in *Report of Proceedings of the Fifty-Fourth Tax Conference*, 2002 Conference Report (Toronto: Canadian Tax Foundation, 2003), 36:1-60.

81 Or a partnership or trust of which such corporation is a member or beneficiary (again the interpretational rule in subsection 248(13) applies).

82 Interestingly, subsections 84(4.2) and (4.3) both deem a dividend to have been received by the shareholder but (unlike subsection 84(4.1)) do not deem the issuer to have paid a dividend. The distinction would be relevant for shareholders such as non-residents otherwise taxable under part XIII on dividends, since unless a dividend has been (or been deemed to be) paid or credited, no withholding tax arises under subsection 212(2). The CCRA acknowledges this in CCRA document number 9213555, July 20, 1992. The same would also appear to be true for other provisions of the Act premised on the payment (rather than receipt) of a dividend, such as part VI.1 tax in subsection 191.1(1).

83 Or any series of a particular class: subsection 248(6).

84 See section 38(1) of the CBCA and section 34(1)(b) of the OBCA.

85 A special resolution requires a positive vote by at least two-thirds of the votes cast: see the definition of "special resolution" in section 2(1) of the CBCA and section 1(1) of the OBCA. Subject to special class voting rights, only holders of classes of shares that have voting rights would vote on a special resolution. Where a particular class or series of the corporation's shares would be affected differently by the capital reduction than would any other class or series of the corporation's shares, section 34(2) of the OBCA requires that the differently affected class or series be given a separate vote, whether or not such class or series otherwise has the right to vote.

86 See section 38(2) of the CBCA and section 34(3) of the OBCA.

87 See section 38(3) of the CBCA and section 34(4) of the OBCA. Where a capital reduction is made contrary to the relevant corporate law provisions, a creditor of the corporation is entitled to apply for a court order requiring shareholders to repay money or property distributed on the capital reduction: section 38(4) of the CBCA and section 34(5) of the OBCA.

88 See, for example, section 26(6) of the CBCA and section 24(5) of the OBCA. Other than in the case of capitalizing contributed surplus in circumstances described in paragraphs 84(1)(c.1) to (c.3), capitalizing surpluses will give rise to a deemed dividend under subsection 84(1).

89 See Magna International Inc., "Notice of Special Meeting of Magna Shareholders," July 8, 2003 (available at www.sedar.com), and Magna International Inc., "Management Information Circular/Proxy Statement," July 8, 2003 (available at www.sedar.com).

90 For example, if the dollar amount ascribed to the distributed property in the resolution is too high, could shareholders of record demand payment of the difference from the corporation? If the dollar amount ascribed to the distributed property in the resolution is too low, what is the legal character of the excess value distributed? Could creditors of the corporation demand repayment from shareholders of record on the basis of an ultra vires distribution?

91 Note also the need to ensure that the requisite corporate authority for the distribution encompasses any cash distributed in lieu of fractional interests in the distributed property.

92 97 DTC 302, at 308 (TCC).

93 (1941), 2 DTC 513, at 515-16 (Ex. Ct.); aff'd. on this point, (1942), 2 DTC 561, at 562 (SCC).

94 69 DTC 5361, at 5364 (SCC).

95 72 DTC 6357 (FCTD); aff'd. on this point, 73 DTC 5359, at 5361 (FCA).

96 Ibid., at 6362-63 (FCTD). In the butterfly context, the CCRA has adopted the principle established in *Kennedy* that "a reorganization involves the continuation of a business in an altered form by substantially the same persons who previously carried it on": see Michael A. Hiltz, "The Butterfly Reorganization: Revenue Canada's Approach," in *Report of Proceedings of the Forty-First Tax Conference*, 1989 Conference Report (Toronto: Canadian Tax Foundation, 1990), 20:32-48, at 20:44.

97 67 DTC 582 (TAB).

98 Ibid., at 583.

99 Ibid., at 584-85: "It is clear from the facts that, when the Bankers Financial Corporation was organized, its object and purpose was to transact a certain type of business which Marine Capital Corporation had been restrained, under the rules of the Small Business Administration, from carrying on. Thus the latter continued to carry on the business it was empowered to transact and, in doing so, forfeited nothing, while the new company entered into the particular business for which it had been specially created. It cannot be said that this constituted any reorganization on the part of Marine Capital Corporation."

100 2001 DTC 243 (TCC).

101 Ibid., at paragraphs 20-21.

102 See, for example, CCRA document no. 9701523, May 30, 1997.

103 See, for example, CCRA document no. 2003-0015903, October 1, 2003, and CCRA document no. 2002-0168603, February 19, 2003.

104 See question 2 of the October 2002 Revenue Canada Round Table at the Association de planification fiscale et financière conference, released as CCRA document no. 2002-0156695, October 11, 2002.

105 See also *Felray Inc. v. The Queen*, 97 DTC 5349; [1998] 2 CTC 4 (FCTD).

106 One way of dealing with this has already been discussed above under the heading "Corporate Authority," by expressing the amount of the reduction as a concept rather than a number.

107 Because a transaction described in subsection 84(2) is expressly excluded from the application of subsection 84(4), the latter provision will not be relevant.

108 Subparagraph 53(2)(a)(ii). Interestingly, in the basis reduction there is no explicit carveout for amounts deemed by subsection 84(2) to be a dividend, in contrast to deemed dividends arising under subsection 84(4) or (4.1). Presumably this is because an amount received in excess of the reduction of paid-up capital (so as to constitute a subsection 84(2) deemed dividend) would not be considered to be received "on" the paid-up capital reduction; that is,

an amount received in excess of paid-up capital cannot be received on a reduction of paid-up capital. In any case, the CCRA has previously ruled that the adjusted cost base reduction in subparagraph 53(2)(a)(ii) excludes the amount of any subsection 84(2) deemed dividend: see CCRA document no. 2002-0168603, February 19, 2003.

109 Subsection 40(3). The amount of any such deemed capital gain would then be added back to the holder's adjusted cost base under paragraph 53(1)(a), resetting the adjusted cost base to nil. Such capital gain is deemed to arise from a disposition of the Pubco share itself, so that even if a non-resident shareholder held the share as taxable Canadian property, any Pubco share listed on a prescribed stock exchange would be "excluded property" under paragraph 116(6)(b) for purposes of section 116.

110 The CCRA has so ruled in a number of subsection 84(2) capital reductions: see, for example, CCRA document no. 2003-0015903, October 1, 2003; CCRA document no. 2002-0168603, February 19, 2003; CCRA document no. 2002-0118973, May 29, 2002; CCRA document no. 2000-0031583, January 24, 2001; and CCRA document no. 2000-0062913, May 10, 2001.

111 In this regard, shares traded on a stock exchange would not be considered to have been disposed of until the settlement date established by the relevant exchange: see CCRA, *Interpretation Bulletin* IT-133, "Stock Exchange Transactions—Date of Disposition of Shares," November 30, 1973, and CCRA document no. 2002-0118887, May 9, 2002: "a share traded on a stock exchange will usually be considered to have been disposed of or acquired for income tax purposes on the 'settlement date,' the date on or before which the vendor is required to deliver the share certificates and the purchaser is required to make payment thereof [sic]." The settlement for trades on the Toronto Stock Exchange is three trading days.

112 Paragraph 15(1)(a). Moreover, any amount deemed to be a dividend under section 84 is similarly carved out by the postamble of subsection 15(1).

113 See, for example, CCRA document no. 2003-0015903, October 1, 2003; CCRA document no. 2002-0118973, May 29, 2002; CCRA document no. 2000-0029733, November 22, 2000; CCRA document no. 2000-0014443, October 25, 2000; and CCRA document no. 991426A, February 24, 2000.

114 Subsection 52(2) provides that property received on a dividend in kind is acquired at a cost equal to its fair market value.

115 There has been some discussion as to whether this should be so because the holders of the relevant shares are giving up something of value when the stated capital of their shares is reduced: see Ahmed, supra note 2, at 15:26; and David W. Ross, "Reducing Paid-Up Capital," The Taxation of Corporate Reorganizations feature (1985) vol. 33, no. 3 *Canadian Tax Journal* 591-603, at 602-3, citing *Wigan Coal and Iron Co., Ltd. v. IRC*, [1945] 1 All ER 392 (KB).

116 See, for example, CCRA document no. 2003-0015903, October 1, 2003; CCRA document no. 2002-0168603, February 19, 2003; CCRA document no. 2002-0118973, May 29, 2002; and CCRA document no. 9701523, May 30, 1997.

117 Subsection 69(4).

118 Subsections 40(3.3) and (3.4).

119 See section 34 of the CBCA and section 30 of the OBCA.

120 See section 192 of the CBCA and section 182 of the OBCA.

121 See section 192(3) of the CBCA. There is no express solvency requirement under the OBCA arrangement provisions.

122 See, for example, Daniel MacIntosh, "Share Exchanges," paper presented at the 2003 Tax Law for Lawyers National Tax Law CLE Conference, supra note 3; Ahmed, supra note 2, at 15:31-34; and Douglas S. Ewens, "Reorganizations of Capital: Section 86," The Taxation of Corporate Reorganizations feature (1995) vol. 43, no. 3 *Canadian Tax Journal* 783-92.

123 Notwithstanding the degree of similarity between the terms of the old shares and the terms of the new shares, a "disposition" can be ensured by cancelling the old shares: see subparagraph (b)(i) of the definition of "disposition" in subsection 248(1). See also Ahmed, supra note 2, at 15:31-32. Note that because of the statutory limitation on the paid-up capital of the new Pubco shares provided for in subsection 86(2.1) (see below), it may be beneficial to ensure that a "disposition" occurs and that section 86 applies even if it were otherwise possible to structure a share exchange spinout so as not to give rise to a disposition.

124 See, for example, Darcy D. Moch and Stanley R. Ebel, "Share Reorganizations and Corporate Takeover Transactions: Using Tax Rollover Provisions," in *Report of Proceedings of the Fifty-Second Tax Conference*, 2000 Conference Report (Toronto: Canadian Tax Foundation, 2001), 8:1-25, at 8:4-5; Ahmed, supra note 2, at 15:33; and Ewens, supra note 122, at 785. In CCRA document no. 9233955, January 13, 1993, the CCRA expresses the view that changes to a corporation's capital structure already provided for by its articles would not generally constitute a reorganization of capital.

125 See, for example, CCRA document no. 2000-0048075, February 22, 2001, in which an exchange of common shares for a promissory note and a newly authorized class of common shares was held to come within section 86 without any requirement that the new shares have different terms and conditions. Numerous butterfly transactions involving preliminary section 86 reorganizations of capital to create special shares of the distributing corporation have been undertaken (and have been the subject of advance tax rulings) where the new class of common shares issued on the section 86 reorganization has the same terms and conditions as the old class of common shares.

126 Cancellation of the old Pubco shares also ensures the non-application of subsections 84(4.2) and (4.3). While the subsection 84(4.1) exception for transactions described in section 86 may also be available in many cases, it has limitations because its applicability depends on the shareholder holding the Pubco shares as capital property. For an example of a situation where the CCRA has limited a ruling as to the non-applicability of subsection 84(4.1) on the basis of the application of section 86 to shareholders holding their shares as capital property, see CCRA document no. 2002-0139013, August 21, 2002.

127 Subsection 86(2.1).

128 See the discussion above under the heading "Paid-Up Capital," and below with reference to subsection 85(1) elections.

129 Which generally will be reduced when the stated capital of the old Pubco shares is reduced under the relevant corporate law: see section 39 of the CBCA and section 35 of the OBCA.

130 Applicable where a Canadian-resident corporation redeems, acquires, or cancels in any manner whatever any of its shares (other than in a transaction described in subsection 84(2)). Note that subsection 84(9) deems old Pubco shares acquired, cancelled, or redeemed by Pubco to have been disposed of "to" Pubco.

131 Subsection 84(5).

132 Subsection 86(2.1).

133 Paragraph 86(1)(a).

134 Paragraph 86(1)(b).

135 Paragraph 86(1)(c). For non-residents, no section 116 certificate will be required for Pubco shares listed on a prescribed stock exchange, which are "excluded property" under paragraph 116(6)(b).

136 See paragraph (j) of the definition of "proceeds of disposition" in section 54.

137 For example, subsections 40(3.6) and 112(3) to (7). Where the new Pubco share is "identical" to the old Pubco share, a capital loss otherwise arising may be denied recognition under subparagraph 40(2)(g)(i) dealing with "superficial losses" or subsections 40(3.3) and (3.4). Corporations, partnerships, and trusts exchanging Pubco shares under section 86 will generally

be denied loss recognition under subsections 40(3.3) and (3.4), because their new Pubco shares are deemed to be identical to their old Pubco shares under paragraph 40(3.5)(b).

138 Subsection 15(1) would not apply to the extent of the reduction of paid-up capital or on the redemption, cancellation, or acquisition of the old Pubco shares, by virtue of paragraph 15(1)(a).

139 Proceeds of disposition would arise as the fair market value of the portion of the old Pubco shares received by Pubco in exchange for the distributed property (as distinct from the portion of the old Pubco shares received by Pubco in exchange for the new Pubco shares). If the fair market value of the distributed property were greater than this amount, Pubco's proceeds would be deemed to be the greater amount under subsection 69(4).

140 Subsection 40(3.3).

141 Regulation 230(3). The reference to "new shares" should presumably be read as that term is defined in subsection 86(1), meaning new Pubco shares.

142 Part II.1 levies a tax on public corporations making distributions in certain circumstances.

143 A subsection 85(1) election displaces subsection 86(1) if both would otherwise apply: subsection 86(3). For a more detailed discussion of subsection 85(1), see Andrew W. Dunn and Kimberley A. Nielsen, "Exchanges of Property for Shares: Section 85—Part 1," The Taxation of Corporate Reorganizations feature (1995) vol. 43, no. 1 *Canadian Tax Journal* 203-21.

144 Paragraph 85(1)(c.1). In addition to the stop-loss rules in subsection 40(3.6) and subsections 112(3) to (7), note that where the new Pubco share is "identical" to the old Pubco share, a capital loss otherwise arising may be denied recognition under subparagraph 40(2)(g)(i) dealing with "superficial losses" or subsections 40(3.3) and (3.4). The deemed "identical property" rule in paragraph 40(3.5)(b) does not encompass share exchanges governed by section 85.

145 See the discussion above under the heading "Paid-Up Capital," with reference to section 26(2) of the CBCA and section 24(2) of the OBCA.

146 See, for example, section 39 of the CBCA and section 35 of the OBCA.

147 Subsection 84(3) does not apply to a transaction or event to the extent that subsection 84(1) has applied to deem a dividend to have been paid: paragraph 84(6)(a).

148 Subsection 84(5).

149 Effectively, a subsection 84(1) deemed dividend on the new Pubco shares translates into additional adjusted cost base on those shares, whereas a subsection 84(3) deemed dividend on the old Pubco shares reduces the proceeds of disposition of those shares: see paragraph 53(1)(b) and paragraph (j) of the definition of "proceeds of disposition" in section 54, respectively.

150 See section 26(2) of the CBCA and section 24(2) of the OBCA.

151 For example, if a new Pubco share were worth \$8 and the distributed property were worth \$2, Pubco would be considered to have issued the new Pubco share in exchange for 80 percent of an old Pubco share.

152 Which presumably equals the fair market value of the new Pubco share. While Canadian corporate law typically prescribes a different stated capital treatment for share conversions, a "conversion" is usually thought of as something occurring pursuant to the terms of the share: see section 35(4) of the OBCA (which actually includes the words "pursuant to its terms") and section 39(4) of the CBCA.

153 See section 26(3)(a)(ii) of the CBCA and section 24(3)(a)(ii) of the OBCA.

154 Question 14 of the October 1992 Revenue Canada Round Table at the Association de planification fiscale et financière conference, released as CCRA document no. 3M05210-14, March 31, 1993.

155 See, for example, subparagraph 55(5)(e)(ii), paragraph 251(5)(c), and subsection 256(1.5). The CCRA takes this position in CCRA document no. 9604655, May 23, 1996, and CCRA document no. 9525957, January 5, 1996.

156 See paragraph 251(1)(c) and CCRA, *Interpretation Bulletin* IT-419R, "Meaning of Arm's Length," August 24, 1995, paragraph 16.

157 See paragraph 13(7)(e.1). To the same effect, see regulation 1100(2.21)(a).

158 "Therefore, in our view a taxpayer who is deemed to have reacquired property as a result of the capital gains election cannot be said to have acquired the property from a non-arm's-length person": CCRA document no. 9525957, January 5, 1996. In another situation, the CCRA stated simply that "it is a question of fact whether, at a particular time, that person is dealing with themself [sic] at arm's length": see CCRA document no. 9604655, May 23, 1996.

159 See Kellough and McQuillan, supra note 63, at 3:46-48.

160 See section 26(3)(b) of the CBCA and section 24(3)(b) of the OBCA.

161 See section 192(4)(e) of the CBCA and section 182(5)(f) of the OBCA.

162 Section 182(6) of the OBCA.

163 See, for example, *Re Olympia & York Developments Ltd.* (1993), 102 DLR (4th) 149, at 164; 18 CBR 176, at 192 (Ont. Gen. Div.): "Thus, even though there are certain requirements that must be adhered to when shares are redeemed as a separate and discrete step in the affairs of a corporation, where the redemption is part of a proposal which qualifies as an arrangement under s. 182 of the OBCA, one looks to that section for guidance and not to the specific provision of the Act under which the 'other steps . . . could be made or taken.' The fact that the shares are being redeemed by an insolvent corporation as part of the overall arrangement does not disqualify the arrangement from approval; once again, it is merely a factor to be considered in the exercise of ascertaining whether the scheme proposed is fair and reasonable and one which a reasonable business person would find logical, sensible and feasible."

164 The general practice is to limit the stated capital addition of the new Pubco shares to the amount of the paid-up capital addition described in subsection 86(2.1).

165 Where a registered retirement savings plan or a registered retirement income fund acquires a non-qualified investment, the annuitant must include the fair market value of the investment in income: see subsections 146(10) and 146.3(7), respectively. A deferred profit-sharing plan that acquires a non-qualified investment is liable to a tax equal to the amount of the investment (subsection 198(1)), while a registered education savings plan that acquires a non-qualified investment is liable to a penalty tax (subsection 207.1(3)) and to having its registration revoked (subsection 146.1(2.1)).

166 See subsection 146(1), definition of "qualified investment," paragraph (a); subsection 146.3(1), definition of "qualified investment," paragraph (a); section 204, definition of "qualified investment," paragraphs (d) and (h); and subsection 146.1(1), definition of "qualified investment," paragraph (a). Regulation 4900 also contains a list of prescribed "qualified investments" for such entities, including shares of a "public corporation" other than a mortgage investment corporation (regulation 4900(1)(b)).

167 As defined in subsection 206(1).

168 The actual computation in subsection 206(2) is somewhat more complex. For a detailed discussion on part XI, see Lincoln K. Schreiner, "A New Foreign Property Rule: New Expectations for Deferred Income Plans as Stakeholders in Canadian Public Companies," International Tax Planning feature (1996) vol. 44, no. 5 *Canadian Tax Journal* 1395-1415.

169 For example, in the recent spinout of MI Developments Inc. by Magna International Inc., a 5-day weighted average trading price (on the "if, as, and when issued" market) was used. In the Brookfield spinout of Brookfield Homes, a 10-day weighted average trading price was used to determine the fair market value of the shares of Brookfield Homes.

170 This principle was established in *Untermeyer Estate v. Attorney-General for British Columbia*, [1929] SCR 84. *Untermeyer* has been cited and followed in numerous Canadian income

tax cases, including *Steen v. The Queen*, 86 DTC 6498, at 6503 (FCTD); *Henderson Estate and Bank of New York v. MNR*, 73 DTC 5471 (FCTD); aff'd. 75 DTC 5332 (FCA); and *National System of Baking of Alberta Limited v. The Queen*, 80 DTC 6178 (FCA).

171 *Untermeyer*, supra note 170, at 91. In *Henderson Estate*, supra note 170, at 5482 (FCTD), the court interpreted a "transient boom" as "a sudden or unusual circumstance not normally contemplated and which will pass away quickly."

172 *Untermeyer*, supra note 170, at 91. See *National System of Baking of Alberta Limited*, supra note 170, at 6181-82, for a discussion of these terms.

173 In *Bendix Automotive of Canada Ltd. v. The Queen*, 78 DTC 6137 (FCA), shares of a corporation were exchanged for other property subject to restrictions on disposition, and the shares were valued on the basis of the value of that property rather than the Toronto Stock Exchange trading price of the shares. Ultimately, the court in *Bendix* seems to have been convinced that the exchange-traded price was not the price that the shareholder could reasonably have received for its block of shares.

174 See *Henderson Estate*, supra note 170, at 5478 (FCTD).

175 See ibid., at 5338 (FCA).

176 *Lawson v. MNR*, 64 DTC 5147, at 5149 (Ex. Ct.).

177 See *National System of Baking of Alberta Limited*, supra note 170, at 6182.

178 See *Henderson Estate*, supra note 170, at 5337 (FCA).

179 For a more detailed discussion of employee stock options, see Stanley R. Ebel and Curtis R. Stewart, "Update on Employee Stock Options and Employee Benefits," in the 2002 Conference Report, supra note 80, 27:1-47; and Howard Wasserman, "New Stock Option Rules," in *2001 Ontario Tax Conference* (Toronto: Canadian Tax Foundation, 2001), tab 8.

180 If the stock option was acquired by the taxpayer under an exchange of stock options governed by subsection 7(1.4), the following conditions must be met in order for the paragraph 110(1)(d) deduction to be available:

- At the time the agreement granting the original option was made, the exercise price of the original option must not have been less than the fair market value (at that time) of the security to be issued on the exercise of the option, less any amount paid by the taxpayer to acquire the option (see clause 110(1)(d)(iii)(C)).
- Immediately after the agreement granting the original option was made, the option holder must have been dealing at arm's length with the corporation granting the option (and, if applicable, certain other persons) (see clause 110(1)(d)(iii)(B)).
- For each exchange under subsection 7(1.4) following the first such exchange, the exercise price of the option being exchanged at the time of such exchange (that is, the old option) must not have been less than the exercise price of the old option at the time the old option was acquired by the taxpayer under the immediately preceding subsection 7(1.4) exchange (see clause 110(1)(d)(iii)(D)). In other words, although the exercise price of an option can be decreased *as a result of* a subsection 7(1.4) exchange, the exercise price of an option cannot be decreased *between* exchanges governed by subsection 7(1.4).
- At the time of exercise, the exercise price of the current option must not be less than the exercise price of the current option immediately after the current option was acquired on the most recent exchange under subsection 7(1.4) (see clause 110(1)(d)(iii)(A)). In other words, the exercise price of the current option cannot have decreased between the time of the last subsection 7(1.4) exchange and the date of exercise.

The discussion below assumes that none of the Pubco options have been acquired by a taxpayer under an exchange of employee stock options governed by subsection 7(1.4).

181 90 DTC 1330 (TCC).

182 The CCRA also takes the position that the repricing of a stock option will generally not be considered to result in a disposition of that stock option. See CCRA document no. 2001-0071485, September 18, 2001; CCRA document no. 9803915, April 27, 1998; CCRA document no. 9724275, October 7, 1997; and CCRA document no. 9725315, October 15, 1997.

183 The foregoing analysis applies in respect of spinout transactions undertaken by way of a dividend in kind or a reduction of capital. On a share exchange spinout, a reduction of the exercise price of an option could generally be accomplished without loss of the paragraph 110(1)(d) deduction, by virtue of subsection 110(1.5) and subparagraph 110(1.6)(a)(ii). Thus, the remainder of the discussion below on this subject applies with reference to a spinout undertaken on a dividend in kind or a reduction of capital.

184 See supra note 12.

185 This requirement is imposed by paragraph 7(1.4)(c), which on an option repricing is incorporated by subsection 110(1.8).

186 Where relevant stock exchange limitations also exist on permissible option repricing, these must also be taken into account in determining the permissible repricing limit. Generally this requires that the exercise price of the option be reduced by the lesser of the limit in the Act and the limit permitted under the rules of the relevant stock exchange (which, in the case of the Toronto Stock Exchange, is similar to the limit in the Act).

187 Were the repricing to occur before the record time, an employee exercising options after the repricing but before the record time would pay a reduced option exercise price to receive a Pubco share entitling the holder to receive the distributed property. This is clearly an inappropriate result.

188 A reduction in the conversion price that is anticipated by the terms of the convertible security should not cause such a fundamental change in the nature of the convertible security that it would be considered to have been disposed of for purposes of the Act.

189 See regulation 6208.

190 If the convertible debt was outstanding for more than five years, the withholding tax exemption in subparagraph 212(1)(b)(vii) would not be lost.

191 For a detailed discussion of safe income and how to utilize it, see Duncan Osborne, "Practical Issues in Computing Safe Income," in the 2002 Conference Report, supra note 80, 42:1-23; and Lori A. Mathison, "Selling a Business: Minimizing the Vendor's Tax," in the 2002 Conference Report, ibid., 41:1-24, at 41:10.

192 Subject to the possible application of subsections 112(2.1) to (2.4).

193 See subparagraph 55(3)(a)(iv).

194 Taking into account the considerable downside associated with the application of subsection 55(2).

195 This argument would not be available in respect of a dividend deemed to arise on the redemption of the Lossco preferred shares, since the application of subsection 55(2) to a deemed dividend arising on a redemption is based on the result of the dividend rather than its purpose.

196 For the sake of simplicity, it is assumed in each case that the amount of borrowed money used to acquire the distributed property is less than both the adjusted cost base of the distributed property to the distributing corporation and the fair market value of the distributed property.

197 See Sandra Jack, Paul Lynch, Brent Perry, and Roy Shultis, "Interest: Where From, Where To, Where Now?" in the 2002 Conference Report, supra note 80, 11:1-18, at 11:7-9, and the accompanying presentation materials handed out to conference attendees.

198 On a share exchange spinout, one would think that the borrowed money has been used as partial consideration to purchase for cancellation the existing shares of the distributing corporation.

199 See supra note 197. The presentation materials handed out to conference attendees state, "We generally accept that capital includes the contributed capital and accumulated profits of a

corporation or partnership." Prior to the 2002 conference, the CCRA's view had been that capital was generally to be determined as capital for accounting purposes, subject to certain adjustments.

200 Foreign income tax considerations might also be relevant in certain circumstances, although in our experience the choice of form of spinout has not generally been relevant for analyzing the US tax consequences to the public corporation or its shareholders.

201 See paragraph 55(3.1)(b).

202 For example, under the arrangement agreement relating to the butterfly transaction undertaken by Canadian Pacific Limited in 2001, each party was required to obtain the consent of the other parties prior to undertaking any transaction that could render inapplicable the tax consequences confirmed in the tax rulings obtained in respect of such butterfly transaction: see Canadian Pacific Limited Arrangement Circular, supra note 71, exhibit E, at E-15 to E-16.

203 A dividend could also arise on a reduction of capital if subsections 84(4.1) to (4.3) applied or on a share exchange spinout where a section 85 election was made and the stated capital of the new Pubco shares was not suitably restricted, both as discussed above.

204 See table 2 above. A similar tradeoff between post-distribution tax cost in the Pubco shares and capital loss occurs where the holder's adjusted cost base exceeds paid-up capital but is less than the value of the distributed property. Where the capital loss produced on a share exchange spinout would be denied recognition under the applicable stop-loss rules, the difference between a reduction of capital and a share exchange spinout is more pronounced.

205 See supra note 183.

206 If there were a significant Canadian corporate shareholder of Pubco, consideration could be given to obtaining an advance income tax ruling that subsection 55(2) would not apply to the dividend.

207 As discussed above, one requirement for the application of subsection 84(2) is that the distribution occur on the "winding-up, discontinuance or reorganization" of the business of the distributing corporation. It is conceivable that the particular circumstances may be such that there is very little uncertainty that subsection 84(2) applies, so that a reduction of capital can be undertaken without an advance income tax ruling. For example, if Pubco directly carries on two separate businesses and transfers the operations of one business to a subsidiary, a distribution of the shares of that subsidiary effected shortly thereafter will clearly occur on the "winding-up, discontinuance or reorganization" of the business of Pubco.

208 Separate class votes would not be required if each class or series of shares of the corporation were treated equally in respect of the reduction of capital. This would normally not be the case if the corporation had any class of preferred shares outstanding.

209 Although Pubco could distribute the Subco shares to Pubco shareholders as a reduction of capital without a prospectus pursuant to section 72(1)(f)(ii) of the Ontario Securities Act, RSO 1990, c. S.5, as amended, the first trade in Subco shares would be deemed to be a distribution unless Subco were a reporting issuer for at least four months. Therefore, to permit Subco shares to be freely tradable in Canada immediately upon distribution, it is necessary to issue a prospectus to qualify the initial distribution.

210 Pub. L. no. 291, 48 Stat. 881 (1934).

211 The advantage of not requiring shareholder approval would still remain.

212 See Brookfield Properties Corporation, "Notice of Special Meeting of Shareholders" (and attached "Management Proxy Circular"), November 22, 2002 (available at www.sedar.com).