READING 4-1

Amalgamation

LEVEL 1

General

The rules applying to the amalgamation of two or more taxable Canadian corporations facilitate the combination of Canadian corporations by limiting the tax consequences of amalgamations.

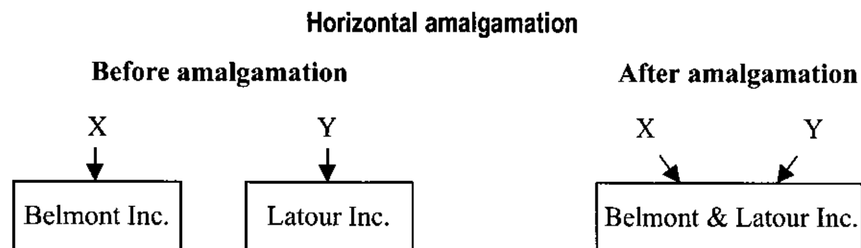
From a legal standpoint, an amalgamation must be in accordance with the relevant corporate legislation. Under the *Canada Business Corporations Act* (a federal law), an amalgamation is possible only if all the corporations to be amalgamated are governed by this Act. Consequently, a corporation incorporated under the *Canada Business Corporations Act* may not be amalgamated with a corporation incorporated under provincial legislation, such as Quebec's *Companies Act*.

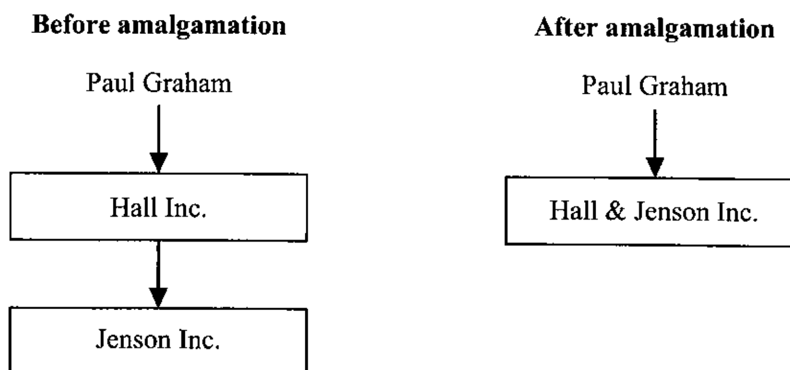
In certain cases, this difficulty may be overcome. A corporation incorporated in one jurisdiction may be continued in another jurisdiction. The provisions of the relevant corporate legislation should be reviewed to determine if such continuance is possible.

The ITA does not address the continuance of corporations. However, CRA has often expressed the opinion that the continuance of a corporation does not involve any tax consequences.

In an amalgamation of two or more corporations, the corporations are combined to form a single entity. The amalgamation may be horizontal or vertical. Under a horizontal amalgamation, two or more corporations whose shares are held by third parties are combined. Under a vertical amalgamation, a parent company is combined with one (or more) subsidiaries. Exhibit 4-1 provides an example of a horizontal amalgamation and a vertical amalgamation.

EXHIBIT 4-1





On a horizontal amalgamation, the shareholders of the amalgamated corporation receive shares of the new corporation resulting from the amalgamation. On a vertical amalgamation, the subsidiary's shares are cancelled without the issuance of new shares, except to third parties that may have held shares in the subsidiary.

Conditions of section 87

From a tax standpoint, an amalgamation of two or more corporations is subject to the provisions of section 87 if the conditions set out in subsection 87(1) are met:

1. There must be a merger of two or more taxable Canadian corporations (predecessor corporations).
2. The purpose of the merger must be to form one corporate entity (new corporation).
3. All of the property (except amounts receivable from a predecessor corporation or shares of the capital stock of a predecessor corporation) of the predecessor corporations immediately before the merger becomes property of the new corporation under the merger.
4. All of the liabilities (except amounts payable to a predecessor corporation) of the predecessor corporations immediately before the merger become liabilities of the new corporation under the merger.
5. All of the shareholders (except any predecessor corporation) of the predecessor corporations immediately before the merger must receive shares of the new corporation because of the merger.
6. The merger must take effect otherwise than as a result of the acquisition of property of one corporation by another, pursuant to the purchase of such property by the other corporation, or as a result of the distribution of such property to the other corporation upon the winding-up of the corporation.

There are few, if any, tax consequences under section 87 on an amalgamation. Consequently, it is important that the amalgamation of taxable Canadian corporations meet the preceding criteria.

Under subsection 87(1.1), a short-form amalgamation that consists of:

- the merger of a corporation and one or more of its wholly-owned subsidiaries

or

- the merger of two or more corporations, each of which is a wholly-owned subsidiary of the same corporation,

is an eligible amalgamation provided conditions 1 to 4 and condition 6 are otherwise respected. Under subsection 87(1.1), any share of a predecessor corporation that is not cancelled in this type of amalgamation is deemed to be a share of the new corporation, received by the shareholder by virtue of the merger. According to this presumption, condition 5 is satisfied.

A "subsidiary wholly-owned corporation" is defined in subsection 87(1.4). It is a corporation all the outstanding shares of which belong to

(a) the parent

(b) a corporation that is a subsidiary wholly-owned corporation of the parent

or

(c) any combination of persons each of which is a person described in (a) or (b)

The amalgamation of Hall Inc. and Jenson Inc. illustrated in Exhibit 4-1 is a short form amalgamation.

Tax consequences for the corporations

For tax purposes, the corporation resulting from the amalgamation is generally considered to be a new corporation [paragraph 87(2)(a)]. However, it will be deemed to be a continuation of the predecessor corporations for certain purposes. [Refer to, for example: 87(1.2), 87(2)(f), 87(2)(j) to (j.93), 87(2)(l), 87(2)(z.1), 87(2.1).] This assumption enables the corporation resulting from the amalgamation to claim deductions that the amalgamated corporations were allowed, such as certain reserves or loss carryovers. But is also requires the new corporation to include in its income amounts that would have been taxable for the amalgamated corporations.

Under the provisions of section 87, the tax accounts of the predecessor corporations as well as their assets and liabilities are generally transferred to the new corporation without tax consequences. Some of these rules follow.

Taxation year under paragraph 87(2)(a)

On an amalgamation, the taxation year of each predecessor corporation is deemed to have ended immediately before the amalgamation and the new corporation is deemed to have commenced its taxation year at the time of the amalgamation. The new corporation may select its year end without CRA's authorization. (See paragraph 10 of IT-474R2 for further detail.)

Example 4-1 illustrates the rule for the taxation year end when there is an amalgamation.

EXAMPLE 4-1

Jupiter Inc. has a taxation year ending November 30 and Saturn Inc. has a taxation year ending August 31. These two corporations amalgamated on December 1, 2008 to form Solar Inc.

Tax consequences

For Jupiter Inc.:

Under paragraph 87(2)(a), Jupiter Inc. has a taxation year that ends on November 30, 2008, its usual year end.

For Saturn Inc.:

Under paragraph 87(2)(a), Saturn has a taxation year that ends on November 30, 2008.

Thus, Saturn Inc. has two fiscal periods ending in 2008: a 12-month fiscal period ending on August 31, 2008 and a 3-month fiscal period ending on November 30, 2008. This short fiscal period may have major consequences for some tax attributes, such as the carryforward period for losses, as you will see further on.

For Solar Inc.:

Solar Inc. can choose the date for the end of its taxation year like any other new corporation, without regard to the year ends of Jupiter Inc. and Saturn Inc. Thus, it might choose April 30, in which case its first taxation year would be for the period from December 1, 2008 to April 30, 2009. When choosing the date for the end of the taxation year, the rule that a corporation's fiscal period cannot extend beyond 53 weeks should be kept in mind.

Inventory under paragraph 87(2)(b)

The tax value of the inventory of the predecessor corporations at the end of the taxation year that ended immediately before the amalgamation becomes the value of the new corporation's opening inventory. That is, the closing inventory of the predecessor corporations is the opening inventory of the new corporation.

If a predecessor corporation carried on a farming business that computed its income on the cash basis under section 28, the inventory acquired from this corporation by the new corporation is deemed to have been acquired at a nil value or any other value selected by the predecessor corporation under paragraph 28(1)(b) at the end of its taxation year that ended immediately before the amalgamation plus the mandatory adjustment to the inventory of the predecessor corporation, determined under paragraph 28(1)(c) at the end of the predecessor corporation's taxation year ending immediately before the amalgamation. As you will recall, an adjustment under paragraph 28(1)(c) is required only if there is a loss from a farming business.

Method adopted for computing income under paragraph 87(2)(c)

Paragraph 87(2)(c) ensures that if the method (cash or accrual) on which either of the predecessor corporations differs from that of the amalgamated corporation, adjustments will be made to income and deductions to ensure all income is fully recognized for tax purposes and no double taxation occurs.

Depreciable property under paragraphs 87(2)(d) and (d.1)

Property transferred to the new corporation in the course of the amalgamation is deemed to have a capital cost equal to that of the predecessor corporations. In addition, the UCC of the classes of property acquired by the new corporation on the amalgamation is equal to the total of the UCC of such classes for the predecessor corporations. Consequently, on a subsequent disposition of property acquired on the amalgamation, recapture of CCA will be computed on the original cost as if the new corporation had always owned the property. Thus, the new

corporation may be taxed on the CCA it claimed as well as the CCA claimed by the predecessor corporations.

When the new corporation acquires the property of a predecessor corporation with which it does not deal at arm's length at the time of the amalgamation [see subsections 251(3.1) and (3.2) to determine if they are related], the property acquired remains in the prescribed classes under REG 1102(14). Where the corporations are dealing at arm's length, the new corporation must include the property in the class applicable at the time of acquisition. The amount to be included in the class with respect to a given property is the cost amount of the property for the predecessor corporation.

The new corporation may depreciate property acquired from a predecessor corporation starting in its first taxation year without regard to the half-year rule if

- the predecessor corporation and the new corporation do not deal at arm's length at the time of the amalgamation

and

- the property was owned continuously by the predecessor corporation for the period from a day that was at least 364 days before the end of the new corporation's first taxation year and that ends on the day that it was acquired by the new corporation [REG 1100(2.2)]

If the new corporation's first taxation year is less than 12 months, CCA must be prorated using the number of days in the taxation year divided by 365 [REG 1100(3)].

Predecessor corporations are not deemed to have disposed of the property immediately before the amalgamation; they may therefore claim CCA in computing their income for the taxation year ending immediately before the amalgamation. If this taxation year is less than 12 months, CCA must be prorated using the number of days in the taxation year divided by 365.

Non-depreciable capital property under paragraph 87(2)(e)

The ACB of each non-depreciable capital property for the predecessor corporations becomes the ACB of the property for the new corporation.

If the property was owned by a predecessor corporation on December 31, 1971, the tax-free zone is transferred to the new corporation under ITAR 26(5.1).

Eligible capital property under paragraph 87(2)(f)

If the new corporation continues to carry on the business carried on by the predecessor corporation, the cumulative eligible capital (CEC) of the predecessor corporation immediately before the amalgamation is added to the CEC of the new corporation. In fact, under paragraph 87(2)(f), for purposes of determining any amount relating to CEC, a cumulative eligible capital amount (CECA), an eligible capital expenditure (ECE) or eligible capital property (ECP), the new corporation is deemed to be the same corporation as, and a continuation of, the predecessor corporations. Thus the new corporation is in the same tax position as the predecessor corporation with regard to the ECP of a business that the predecessor corporation carried on but which is now carried on by the new corporation.

Where the ECP acquired is a government right (such as a licence) owned by the predecessor corporation on December 31, 1971, the new corporation may take advantage of the relief provided in ITAR 21(2.1) on the subsequent disposition of a right under ITAR 21(2.2).

Predecessor corporations may claim a CECA deduction for their taxation year ending immediately before the amalgamation. If the business carried on by the predecessor corporation is not carried on by the new corporation, a deduction for the balance of the CEC may be claimed by predecessor corporations under subsection 24(1).

Reserves under paragraphs 87(2)(g), (h), (i), (j), 87(2)(m), and 87(2)(ll)

Reserves deducted by predecessor corporations are deemed to have been claimed by the new corporation. Consequently, the new corporation is required to include in its income for its first taxation year, the reserves claimed by the predecessor corporations at the end of the taxation year ending immediately before the amalgamation.

The new corporation may deduct a new reserve for debts and loans acquired from the predecessor corporations under the regular rules relating to bad debts.

With respect to capital gains reserves [subparagraph 40(1)(a)(iii)] and reserves for instalment sales or sales of land inventory [paragraph 20(1)(n)], the new corporation may continue to claim the reserve as if it had disposed of the property itself.

Capital dividend account under paragraph 87(2)(z.1)

The CDA balances of predecessor corporations, whether negative or positive, are added to form the CDA of the new corporation provided the new corporation is a private corporation.

Refundable dividend tax on hand under paragraph 87(2)(aa)

Where the new corporation is a private corporation immediately before the amalgamation, the refundable dividend tax on hand (RDTOH) balances of the predecessor corporations at the end of their last taxation year, less any dividend refund received for that last year, are added to the RDTOH of the new corporation. No amount is added with respect to a predecessor corporation that was not a private corporation immediately before the amalgamation.

Investment tax credits under paragraph 87(2)(oo)

Unused investment tax credits of predecessor corporations are transferred to a new corporation that is deemed to be a continuation of the predecessor corporations. However, the rules applicable on the acquisition of control of a corporation should be reviewed to determine if they restrict the credits [subsections 127(9.1) and (9.2)].

General rate income pool (GRIP) and low rate income pool (LRIP) under paragraphs 87(2)(vv) and (ww)

Where the new corporation is a CCPC, its GRIP is determined according to the provisions of subsection 89(5). If a predecessor corporation was a CCPC, the GRIP of the new corporation is increased by the GRIP of the predecessor corporation at the end of its last taxation year less any eligible dividends that the predecessor corporation paid during that last year. If the predecessor corporation was not a CCPC, the GRIP of the new corporation is increased by an amount determined according to a complex calculation designed to determine the retained earnings, for tax purposes, that were taxed at the general rate. This calculation takes various factors into account, including but not limited to liquidities, the cost amount of the property, debts, the PUC of issued shares, loss carryforwards, the CDA, and the GRIP.

Where the new corporation is not a CCPC, its LRIP must be determined in accordance with subsection 89(9). If a predecessor corporation is not a CCPC, the LRIP of the new corporation is increased by the LRIP of the predecessor corporation. If the predecessor corporation is a CCPC throughout the taxation year ending before the amalgamation, the LRIP of the new corporation is increased by an amount determined according to a complex calculation designed to determine the retained earnings, for tax purposes, that were taxed at the low rate. This calculation takes various factors into account, including but not limited to liquidities, the cost amount of the property, debts, the PUC of issued shares, loss carryforwards, the CDA, and the GRIP.

Instalments under REG 5301(4)

The instalments of the new corporation are determined by taking into account the income tax payable by the predecessor corporations for the two taxation years preceding the amalgamation, adjusted to an annual basis. Therefore, an amalgamation cannot be used to reduce or eliminate instalments.

Other

Subsection 87(2) contains many other rules applicable to tax accounts and different situations. Generally, the new corporation will be deemed to be the continuation of predecessor corporations and the tax consequences that would have applied to the predecessor corporations will apply to the new corporation.

Inter-company debts under subsection 80.01(3)

Sections 80 to 80.04 deal with the rules that apply where a debt of a taxpayer is settled or extinguished without any payment by the taxpayer or by a payment of an amount less than the principal amount.

At this point, it is sufficient to keep in mind that, on an **amalgamation**, it sometimes happens that a debt of a predecessor corporation owing to another predecessor corporation is extinguished without any payment so that the settlement of debt rules can apply. However, under subsection 80.01(3), such a debt that is extinguished on amalgamation is deemed to have been settled immediately before the amalgamation for an amount equal to the creditor's cost amount of the debt. For purposes of subsection 80.01(3), the cost amount of the debt is equal to the ACB if it is a capital property, or the creditor's cost if it is any other property.

Therefore, if the creditor's cost amount of the debt is equal to its principal amount, the settlement of debt rules contained in section 80 do not apply to inter-corporate debts settled upon amalgamation. However, they may apply to a debt extinguished on an amalgamation if the debt was acquired from a third party at a price lower than the principal amount of the debt.

Example 4-2 shows the application of rules on the settlement of inter-company debts in an amalgamation.

EXAMPLE 4-2

Brandy Ltd. owes Rummy Ltd. $15,000. Rummy Ltd. acquired the debt due by Brandy Ltd. (with a principal balance of $15,000) from Suzie Mak in 2006, at a cost of $5,000. In 2008, Brandy Ltd. and Rummy Ltd. amalgamate. No interest is owed on the debt at the time of the amalgamation.

Tax consequences

Settlement of the debt:

Principal amount of the debt	$ 15,000
Amount of the settlement, equal to the ACB of the debt under 80.01(3)	(5,000)
Amount subject to the settlement of debt rules (section 80)	$ 10,000

Note that the unpaid interest on the debt included in computing the income of the predecessor corporation is added to the cost amount provided that it has not been deducted as a bad debt. Therefore, there is no consequence in terms of the settlement of debt rules on the portion of

the debt represented by the unpaid interest that was included in the predecessor corporation's income for tax purposes.

Losses carried forward under subsection 87(2.1)

Amalgamation of Canadian corporations is often considered between a viable corporation and a corporation with accumulated losses, since it is possible under certain conditions for the new corporation created by the amalgamation to use the losses accumulated by the predecessor corporation.

Subsection 87(2.1) governs the transfer of losses of predecessor corporations to the new corporation.

Consequently,

- non-capital losses
- net capital losses
- farm losses
- restricted farm losses
- limited partnership losses

of predecessor corporations are transferred to the new corporation which is deemed to be the same corporation as, and a continuation of, each predecessor corporation. As a result, the timing and nature of the losses transferred are retained.

It should be noted that an amalgamation results in a year end for the predecessor corporations and reduces the carryforward period by one year, even if the taxation year was only one day. Consequently, if there are significant loss carryforwards, the amalgamation should take place at the end of the predecessor corporation's taxation year. In fact, the effective date of the amalgamation should be the day after the normal taxation year end of the predecessor corporation as discussed in paragraph 10 of IT-474R2.

Acquisition of control

The rules applicable on the acquisition of control of a corporation may apply on an amalgamation. At this point it need only be noted that these rules may restrict or prevent the use of the losses of a predecessor corporation where there is an acquisition of control of that predecessor corporation in the context of the amalgamation. Under paragraph 256(7)(b), control of a predecessor corporation is deemed to have been acquired where the person who controls the new corporation immediately after the amalgamation did not control the predecessor corporation immediately before the amalgamation. This rule does not apply when the person who controls the new corporation immediately after the amalgamation would not have been considered to have acquired control of the predecessor corporation if he had acquired all of its shares immediately before the amalgamation. This exemption ensures that the benefit of paragraph 256(7)(a) applies to an amalgamation.

Paragraph 256(7)(a) provides that there is no acquisition of control of a corporation in circumstances where

- the person acquiring control was related to the person from whom the shares were acquired;
- the person acquiring control was related [within the meaning of subsection 251(2)] to the corporation before the acquisition of control;
- shares fall into the estate of a deceased person by reason of that person's death; or,
- shares were inherited from a related person.

For example, Morales Ltd. is controlled by Antonio Morales, and Blanco Ltd., a corporation with considerable non capital losses, is controlled by Antonio's child. Morales Ltd. and

Blanco Ltd. amalgamate. After the amalgamation, the new corporation is controlled by Antonio. But for the exemption, Antonio would be considered as having acquired the control of Blanco Ltd. before the amalgamation. Under the exemption, Antonio will not be considered as having acquired the control of Blanco Ltd. If Antonio had acquired all the shares of Blanco Ltd. before the amalgamation, there would not have been an acquisition of control by Antonio as provided for in clauses 256(7)(a)(i)(A) and (B) since Antonio was related to Blanco Ltd. and the child.

Example 4-3 illustrates the application of the rules governing the transfer of losses in an amalgamation and the importance of making a good choice as to the date of the amalgamation.

EXAMPLE 4-3

Arnold Ltd. is a Canadian corporation incorporated under the *Canada Business Corporations Act*. Arnold Ltd.'s taxation year ends on June 30 and its non-capital losses carried forward are as follows:

2002	$100,000
2005	$ 8,000
2006	$ 15,000
2007	$ 12,000

Arnold Ltd. does not expect profits before 2010 or 2011.

Georgia Ltd. is also a Canadian corporation incorporated under the *Canada Business Corporations Act*. Its taxation year ends on July 31 and it is a profitable company.

Arnold Ltd. and Georgia Ltd. are controlled by Clément Simard, who decides to amalgamate Arnold Ltd. and Georgia Ltd. and apply Arnold Ltd.'s losses against Georgia Ltd.'s future income. The amalgamation takes place on August 1, 2008.

Tax consequences

1. For Arnold Ltd.:

   The amalgamation on August 1, 2008, results in a one-month fiscal period, from July 1 to July 31, 2008. (See IT-474R2, paragraph 10.) Therefore, the carryforward period of all losses is reduced by one taxation year due to this short fiscal period. The 2002 loss is therefore lost, because the seven-year carryforward period expires with the addition of this period.

   Note: Losses that arise in 2006 and subsequent taxation years may be carried forward 20 years. The loss-carryforward period for non-capital losses that arise in taxation years that end after March 22, 2004 and before January 1, 2006 is ten years. The ten-year period does not apply to existing losses realized prior to March 23, 2004 for which the carryforward period remains at seven years.

2. For the new corporation:

   Because control of Arnold Ltd. was not acquired on the amalgamation (Clément controlled Arnold Ltd. before the amalgamation and the new corporation after the amalgamation), Arnold Ltd.'s losses may be used to reduce the income of the new corporation without restriction, other than the reduction in the carryforward period of the losses.

If the amalgamation had taken place on July 1, 2008, rather than August 1, 2008, the 2002 loss could have been applied against the income of the new corporation for its first taxation year. As this example illustrates, determining the amalgamation date is very important.

Note that there is no rule whereby losses incurred by the new corporation may be carried back and deducted from the income of the predecessor corporations, except for subsection 87(2.11), which allows losses of the new corporation to be carried back and deducted from the income of the parent in the amalgamation of a parent corporation and one or more wholly-owned subsidiaries. Subsection 87(2.11) will be studied further on.

Effect on paid-up capital

The PUC of a particular class of the capital stock of the new corporation is computed under subsection 87(3). The purpose of the computation is to restrict the PUC of the new corporation following an amalgamation to the total of the PUC of the predecessor corporations immediately before the amalgamation, without regard to the shares of a predecessor corporation owned by any other predecessor corporation and cancelled on amalgamation.

The PUC of a share for tax purposes is generally equal to its legal PUC. However, sometimes the PUC is reduced by various provisions of the ITA, such as section 84.1 or subsections 51(3), 85(2.1), 85.1(2.1), and 86(2.1), which you have studied previously.

From a legal standpoint, the capital of the new corporation is generally equal to the total capital of the predecessor corporations, after eliminating the shares owned by predecessor corporations. If the PUC of a predecessor corporation was reduced by any tax provision so that it does not correspond to the legal PUC, the legal PUC of the shares of the new corporation will be higher than the total PUC of the predecessor corporations. This is unacceptable to the tax authorities because the PUC may generally be paid to the shareholders tax free.

Consequently, where the PUC of the shares issued by the new corporation on amalgamation exceeds the PUC of the predecessor corporations, the excess will reduce the PUC of the shares of the various classes of the capital stock of the new corporation. The reduction will be allocated among the classes of shares based on their respective PUC.

On the redemption or cancellation of a share of a particular class of which the PUC has been reduced, an amount is added to the PUC of that class to avoid double taxation on the same amount as a dividend. The increase in the PUC is equal to the amount of the deemed dividend on the redemption that is attributable to the PUC reduction.

Example 4-4 illustrates a situation in which it is necessary to reduce the PUC of the shares of the corporation resulting from the amalgamation. It shows how this reduction is attributed to the various classes of shares issued on the amalgamation.

EXAMPLE 4-4

Lidor Ltd. and Falcon Ltd. were amalgamated to form Licon Ltd. The following information has been obtained with respect to the shares issued and the PUC of the predecessor corporations.

Common shares

	Tax PUC	Legal PUC
Lidor Ltd.	$ 80,000	$100,000
Falcon Ltd.	40,000	40,000
	$120,000	$140,000

The difference between the tax PUC and the legal PUC of the shares of Lidor Ltd. is due to a reduction in the PUC under subsection 85(2.1) resulting from a previous transaction.

On the amalgamation, Licon Ltd. issued 1,000 Class A shares and 1,000 Class B shares redeemable at $100. The legal PUC was allocated between the two classes of shares as follows:

Class A shares	$ 40,000
Class B shares	100,000
	$140,000

Subsequently, Licon Ltd. redeemed 500 Class B shares.

Tax consequences

1. PUC of the shares of Licon Ltd.:

Reduction of PUC [87(3)(a)]

Legal PUC of Licon Ltd.	$140,000
Less: PUC of Lidor Ltd. and Falcon Ltd.	(120,000)
PUC reduction to be allocated to the Class A and Class B shares	$ 20,000

Computation of PUC of Class A shares

Legal PUC of the Class A shares	$ 40,000
Reduction: $\frac{\$40,000}{\$140,000} \times \$20,000$	(5,714)
PUC of the 1,000 Class A shares	$ 34,286
PUC of 1 Class A share	$ 34.29

Computation of PUC of Class B shares

Legal PUC of the Class B shares	$100,000
Reduction: $\frac{\$100,000}{\$140,000} \times \$20,000$	(14,286)
PUC of the 1,000 Class B shares	$ 85,714
PUC of 1 Class B share	$ 85.71

2. Deemed dividend on the redemption of 500 Class B shares [84(3)]:

Redemption amount (500 × $100)	$ 50,000
PUC of 500 redeemable shares (500 × $85.71)	(42,855)
Deemed dividend	$ 7,145

3. PUC of the remaining Class B shares following redemption:

Increase in PUC [87(3)(b)]

The lesser of:

a. the excess of	
• the deemed dividend on redemption	$ 7,145
over	
• the deemed dividend on redemption if there had not been a reduction under 87(3)(a) ($50,000 – $50,000)	—
	$ 7,145
b. reduction under 87(3)(a)	$ 14,286

PUC of the remaining 500 Class B shares

Legal PUC of the remaining 500 Class B shares	$ 50,000
PUC reduction [87(3)(a)]	(14,286)
	35,714
Increase in PUC [87(3)(b)]	7,145
PUC of the 500 Class B shares — outstanding	$ 42,859
PUC of 1 Class B share	$ 85.72

The adjustment increases the PUC of the Class B shares to $85.72, being the amount of the PUC for each share held before the redemption.

According to subsection 87(3), the reduction in the PUC is distributed among all the shares of the new corporation, as was seen in Example 4-4. This result is sometimes undesirable, especially when the PUC deficiency is attributable to a specific class of shares of a predecessor corporation.

This situation may be avoided if

- each class of shares (other than classes of shares all of the shares of which were cancelled on the amalgamation) of each predecessor corporation is exchanged for a separate class of shares of the new corporation (substituted class);
- immediately after the amalgamation,
  - the number of shareholders of each substituted class,
  - the number of shares of each substituted class owned by each shareholder,
  - the number of issued shares of each substituted class,
  - the terms and conditions of each substituted class, and
  - the legal PUC of each substituted class

  are identical to what they were for the exchanged class immediately before the amalgamation;

and

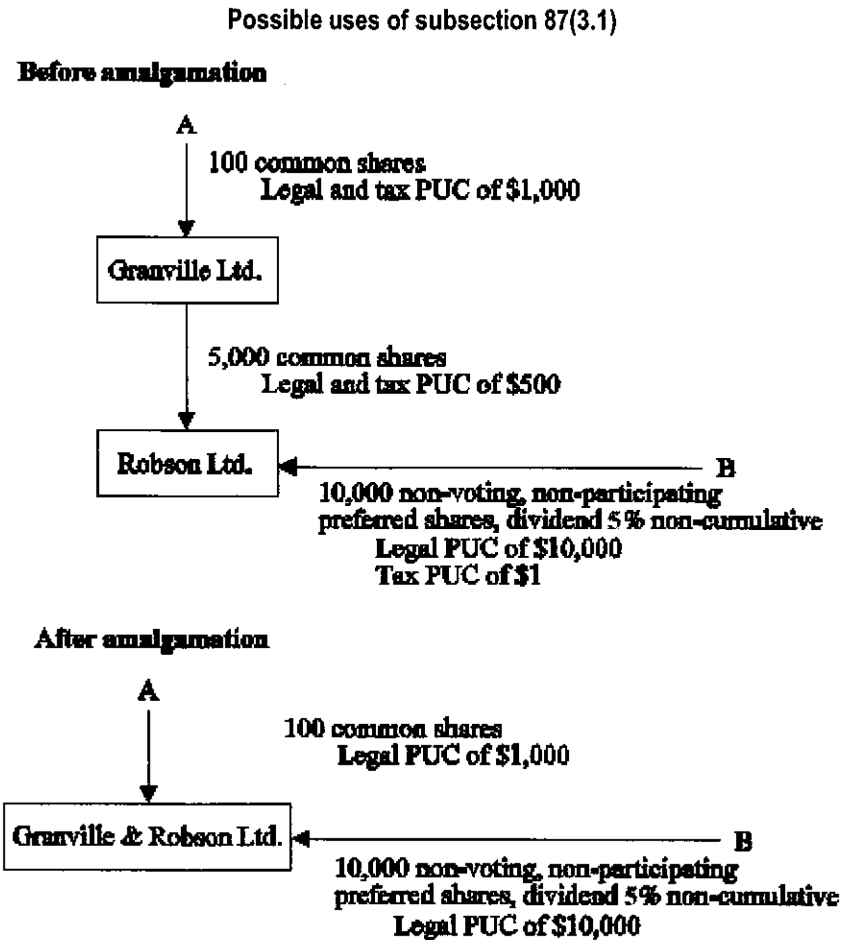
- the new corporation makes the election provided for in subsection 87(3.1) in its first income and benefit tax return.

If all the conditions are met and the election under subsection 87(3.1) is made, each class of shares of the new corporation is deemed to be the same as and a continuation of the exchanged class. In other words, each class retains its particular tax characteristics, with the result that a class of shares with a PUC deficiency is the only one to support this deficiency.

In practice the election under subsection 87(3.1) is fairly limited, since in the amalgamation of two unrelated corporations it is seldom possible to arrange a share-for-share exchange that will meet the conditions set out in subsection 87(3.1), owing to the difference in the value and structure of the capital stock of the predecessor corporations.

Exhibit 4-2 illustrates a situation in which it might be possible to use the provisions of subsection 87(3.1).

EXHIBIT 4-2



If the election under subsection 87(3.1) is made, the PUC of the common shares would be $1,000 and the PUC of the preferred shares would be $1, since each class of shares of the new corporation is deemed to be the same and a continuation of the class of the predecessor corporation.

If the election under subsection 87(3.1) is not made, subsection 87(3) will apply, and the $9,999 deficiency of the PUC on the preferred shares of Robson Ltd. will be distributed among the common shares and the preferred shares issued by Granville & Robson Ltd. as a result of the amalgamation.

Tax consequences for shareholders and creditors

Shares — general rule

Under subparagraph (b)(iii) of the definition of "disposition" in subsection 248(1), the conversion of shares on an amalgamation constitutes a disposition of property. Thus, in the absence of specific rules, a capital gain or loss could be realized on the amalgamation equal to the difference between the ACB of shares exchanged (old shares) and the FMV of the shares (or other property) received from the new corporation.

However, under subsection 87(4), there is a rollover if the following conditions are met:

- the old shares were capital property of the shareholder

and

- the shareholder received no consideration other than shares of the new corporation

When these conditions are met, the shareholder is deemed to have

- disposed of the old shares for an amount equal to their ACB immediately before the amalgamation,

and

- acquired the new shares at a cost equal to the ACB of the old shares. If the shareholder received more than one class of shares of the new corporation, the ACB of the old shares will be allocated among the classes of new shares received in proportion to the FMV, immediately after the amalgamation, of the shares of a particular class to the FMV, immediately after the amalgamation, of all the shares received.

IT-474R2 states that the subsection 87(4) rollover will not be disallowed if a cash payment of less than $200 is made to a shareholder for fractions of shares received on the amalgamation. We suggest that you read paragraph 37 of IT-474R2 to learn about the tax treatment of the amount received in such a case.

If the shares of a class of shares of a predecessor corporation were owned on December 31, 1971, and the shareholder receives shares of only one class as a result of the amalgamation, the tax-free zone is transferred to the new shares under ITAR 26(21).

Shares — gift or deemed benefit

On an amalgamation, if a benefit is conferred on a related person, the rollover rules provided in subsection 87(4) do not apply. In addition, the tax-free zone will not be transferred under ITAR 26(21).

Thus, if a shareholder exchanges old shares for shares of the new corporation having an FMV less than the FMV of the old shares, and it is reasonable to regard any portion of the excess as a benefit that the shareholder desired to have conferred on a related person, the following rules apply [paragraphs 87(4)(c), (d), and (e)]:

- the shareholder will be deemed to have disposed of the old shares for POD equal to the lesser of
  - the total of the ACBs of the old shares plus the gift portion
  - the FMV of the old shares immediately before the amalgamation
- a capital loss cannot be recognized on the disposition of such shares
- the ACB of the new shares will be equal to the lesser of
  - the total ACBs of the old shares
  - the total of the FMV, immediately after the amalgamation, of all the new shares plus any capital loss incurred on the disposition of the old shares

Note that the rules are identical to those in subsection 51(2), examined previously with reference to convertible property. Example 4-5 illustrates how the rules apply when a benefit is conferred on a related person during an exchange of shares in an amalgamation.

EXAMPLE 4-5

Martha Jones owns 100% of the shares of Joly Inc. and her son Adelard owns 100% of the shares of Beau Inc. The two corporations operate a beauty products distribution business. Martha is now 65 and wants to retire and turn the business over to her son. She and Adelard agree to amalgamate the two corporations. Adelard will hold all the common shares of the new corporation and Martha will receive non-participating, non-voting Class A preferred shares retractable for $500,000.

Before the amalgamation, Martha held 1,000 common shares of Joly Inc., having an ACB of $10,000 and a FMV of $750,000.

Tax consequences

Paragraphs 87(4)(c), (d), and (e) apply, since

- Martha exchanges shares worth $750,000 for Class A preferred shares worth $500,000 and
- It is reasonable to believe that Martha wants her son (a person related to her) to benefit from the difference, namely $250,000 ($750,000 – $500,000).

The following is a breakdown of the tax consequences of the transaction.

For Martha:

Capital gain

POD [87(4)(c)]

The lesser of:		
(i) ACB + the excess of the FMV of the convertible shares over the FMV of the shares received $10,000 + ($750,000 – $500,000)	$260,000	
(ii) FMV of the shares of Joly Inc.	$750,000	$260,000
ACB		(10,000)
Capital gain		$250,000
Taxable capital gain (1/2)		$125,000

Cost of Class A preferred shares [87(4)(e)]

The lesser of:		
(i) ACB of the convertible common shares	$ 10,000	
(ii) FMV of the Class A preferred shares	$500,000	$ 10,000

The above result is to tax immediately the portion of Martha's accrued gain corresponding to the benefit conferred, that is, $250,000, and to roll over the balance of the accrued gain into the new Class A preferred shares.

Stock options

Where a taxpayer had stock options in a predecessor corporation and, on the exchange, he receives stock options in the new corporation, the ACB of the exchanged options is rolled over [subsection 87(5)].

Bonds and other claims

If a taxpayer owned bonds, debentures, notes, mortgage loans receivable, or other similar obligations of a predecessor corporation, and on the amalgamation, this taxpayer receives in exchange bonds, debentures, notes, mortgage loans receivable, or other similar obligations of the new corporation, he will be entitled to a rollover of ACB provided the amount payable on maturity is the same as the amount that would have been paid by the predecessor corporation on maturity [subsection 87(6)].

Amalgamation of a corporation and a wholly-owned subsidiary

The vertical amalgamation of a parent corporation and one or more wholly-owned subsidiaries has several interesting features.

Carrybacks to the parent corporation

Normally, when there is an amalgamation, the tax attributes of the predecessor corporations move to the new corporation. However, the tax attributes of the new corporation cannot be carried back against the income or the tax payable of a predecessor. Under subsection 87(2.11), when there is an amalgamation between a parent and a wholly-owned subsidiary, it is possible to carry back against the income of the parent and the tax payable by the parent, certain tax attributes that can be carried back to previous years. The following attributes can be carried back to the parent corporation:

- losses carried back [section 111]
- foreign tax credits [section 126]
- investment tax credits [subsections 127(5) to (26)]
- unused surtax credits that can be used to reduce Part I.3 tax [subsections 181.1(4) to (7)]
- unused Part I tax credits that can be used to reduce Part VI tax [subsections 190.1(3) to (6)]

Disposition of the shares and acquisition of the assets of the wholly-owned subsidiary

Furthermore, special rules apply for the POD of the shares of the wholly-owned subsidiary and the cost of the property acquired from the wholly-owned subsidiary. These rules are similar to those for winding up a subsidiary owned 90% or more. In effect, subsection 87(11) refers to the provisions of subsection 88(1), which deals with the winding-up of a subsidiary owned 90% or more.

Under paragraph 87(11)(a), the parent corporation is deemed, immediately before the amalgamation, to have disposed of the shares of the wholly-owned subsidiary for an amount equal to the greater of the following amounts:

i) the lesser of the following amounts

- the PUC of the shares that it holds
- the cost amount of the property of the wholly-owned subsidiary transferred to the new corporation less the debts of the subsidiary assumed by the new corporation and certain reserves deducted by the subsidiary in the taxation year ending before the amalgamation

ii) the ACB of the shares for the parent corporation immediately before the amalgamation

Thus, the parent corporation can realize a capital gain if it has acquired the shares of the wholly-owned subsidiary for an amount less than their PUC, but it will not be able to realize any capital loss.

In addition, if the ACB of the shares held by the parent corporation exceeds

- the cost amount of the property of the subsidiary transferred to the new corporation less the debts assumed by the new corporation and certain reserves deducted by the subsidiary in the year of the amalgamation

and

- the total amount of taxable dividends, capital dividends and life insurance capital dividends received by the parent corporation or a corporation related to it,

it is possible, under paragraph 87(11)(b), to adjust the ACB of certain capital property of the new corporation. This is property which belonged to the subsidiary at the time the parent corporation acquired control of it for the last time and which the subsidiary has held without interruption since that date. Excluded, however, are:

- depreciable property;
- property acquired from the parent corporation or a person with whom the subsidiary did not deal at arm's length; and
- property of which the new corporation subsequently disposes of in a series of transactions the purpose of which is to sell certain assets of a corporation to a corporation with which it deals at arm's length.

The ACB of an eligible property may be increased up to the FMV of the property on the date when the parent corporation acquired control of the subsidiary for the last time. Thus, if the parent has always controlled the subsidiary, no adjustment is possible. The increase for all eligible property must not exceed the excess amount computed previously. In tax parlance, the increase of the cost amount of the property is often referred to as a "bump-up."

The property and amounts covered by an adjustment must be designated by the new corporation in its first tax return.

Example 4-6 illustrates the tax consequences of the amalgamation of a parent corporation and its wholly-owned subsidiary in the case where the parent has always controlled the subsidiary.

EXAMPLE 4-6

On February 15, 1991, Montfort Inc., incorporated under the *Canada Business Corporations Act*, subscribed for 100 common shares of Kimball Inc., which was also incorporated under the *Canada Business Corporations Act,* for $100,000. The amount of $100,000 was recorded in the issued and outstanding share capital account of the corporation.

Additional information:

- Montfort Inc. has always been the sole shareholder of Kimball Inc.
- Each corporation's fiscal year end is September 30.
- For its period ending September 30, 2008, Kimball Inc. claimed a doubtful debt reserve of $2,000.
- On October 1, 2008, Montfort Inc. and Kimball Inc. amalgamated and formed Kimfort Inc.
- On December 31, 2005, Kimball Inc. paid Montfort Inc. a dividend of $20,000.
- At the time of the amalgamation on October 1, 2008, the assets and liabilities of Kimball Inc. were as follows:

ASSETS

	Cost amount
Cash	$ 3,000
Receivables	10,000
Equipment[1]	35,000
Investment[2]	30,000
	$ 78,000

LIABILITIES

Payables	$ 8,000

[1] The equipment is included in class 8 and has a cost of $75,000. It has an FMV of $40,000 as at September 30, 2008.

[2] The investment consists of listed shares that were acquired in 2000 and have an FMV of $150,000 as at September 30, 2008.

- For its first taxation year ending September 30, 2009, Kimfort Inc. registered a loss of $25,000.
- Montfort Inc. has always operated at a profit. Its taxable income for 2006, 2007, and 2008 was:

2006	$ 17,000
2007	$ 3,000
2008	$ 55,000

Tax consequences

1. For Kimball Inc. (predecessor corporation):

   There are no tax consequences resulting from the amalgamation.

2. For Montfort Inc. (predecessor corporation):

   Deemed disposition of the shares of Kimball Inc.

   POD [87(11)(a)]
   The greater of the following amounts:

i)	The lesser of:			
	• PUC of the shares of Kimball Inc.		$ 100,000	
	or			
	• Cost amount of the property of Kimball Inc.	$ 78,000		
	less:			
	◦ Liabilities	(8,000)		
	◦ Reserve [20(1)(l)]	(2,000)	$ 68,000	
				$ 68,000
or				
ii)	ACB of the shares			**$ 100,000**

   Capital gain

POD	$ 100,000
ACB	(100,000)
Capital gain	$ —

Carryback of Kimfort Inc.'s loss for 2009 [87(2.11)]

Kimfort Inc.'s $25,000 loss may be carried back against the income of Montfort Inc. for the three previous years, since Kimfort Inc. resulted from the amalgamation of Montfort Inc. and its wholly-owned subsidiary, Kimball Inc.

3. For Kimfort Inc. (corporation resulting from the amalgamation):

Kimfort Inc. is deemed to have acquired the properties of the predecessor corporations at their cost amounts. In the case of the equipment of Kimball Inc., Kimfort Inc. is deemed to have a capital cost of $75,000 for this property and to have deducted $40,000 in CCA.

Since Montfort Inc. has always controlled Kimball Inc., no adjustment, or bump-up, of the cost of the capital property acquired from Kimball Inc. is possible, even though the net tax value of the property of Kimball Inc. ($68,000), plus the $20,000 dividend paid by Kimball Inc. to Montfort Inc., result in an amount less than the ACB of the shares for Montfort Inc.

Using an amalgamation

Often, an amalgamation will be planned in order to utilize the losses in a corporate group given that, under subsection 87(2.1), the new corporation may deduct the losses of a predecessor corporation (subject to the acquisition of control rules). Under this planning technique, a loss corporation will be amalgamated with another corporation in the group that has significant income so that the losses of the first corporation are claimed against the future income of the amalgamated corporation. It should be kept in mind that generally an amalgamation can be planned only if the corporations are governed by the same law.

READING 4-2

Winding up a subsidiary owned 90% or more

LEVEL 1

General

Subsection 88(1) contains rollover provisions where a taxable Canadian corporation, at least 90% of the shares of which are owned by another taxable Canadian corporation (the parent), is wound up.

In IT-126R2, paragraph 3, CRA stipulates that, for the purposes of section 88, a corporation is deemed to have been wound up

a. where it has followed the procedures for winding-up and dissolution provided by the appropriate federal or provincial companies Act or winding-up Act

or

b. where it has carried out a winding-up, other than by means of the statutory procedures contemplated in (a), and has been dissolved under the provisions of the incorporating statute

This IT also indicates that, where the formal dissolution of a corporation is not complete but there is substantial evidence that the corporation will be dissolved within a short period of time, for the purpose of section 88, the corporation is considered to have been wound up. Evidence confirming the proposed dissolution would generally include an application for dissolution or surrender of the corporation's charter made under the incorporating statute and evidence that the following requirements for dissolution have been met:

- the debts, obligations or liabilities of the corporation have been extinguished or provided for, or the creditors have given consent to the dissolution;
- after satisfying the interests of all creditors, all remaining property of the corporation has been distributed among its shareholders.

Conditions

Where the following conditions are met, subsection 88(1) applies automatically on the winding-up of a subsidiary:

- the subsidiary and the parent are both taxable Canadian corporations
- the parent owns at least 90% of the shares of each class of the capital stock of the subsidiary immediately before the winding-up

and

- all the shares of the subsidiary that are not owned by the parent are owned by persons with whom the parent was dealing at arm's length

Subsection 88(1) specifies the tax consequences:

- for the subsidiary, on the transfer of its property and liabilities to the parent
- for the parent, on the disposition of the investment held in the subsidiary and on the acquisition of the subsidiary's assets

Tax consequences for the subsidiary

Property distributed to the parent corporation

Under paragraph 88(1)(a), the subsidiary will be deemed to have disposed of the property transferred to the parent on winding-up at the following amounts:

Property	**Deemed POD**
Canadian or foreign resource property	Nil
Other property:	Cost amount defined in 248(1):
• inventory	• value for tax purposes
• depreciable property	• UCC
• non-depreciable capital property	• ACB
• ECP	• 4/3 × CEC

Under paragraph 88(1)(a.2), the subsidiary will be deemed not to have disposed of any interest in a partnership. Consequently, if the ACB of the partnership interest is negative, the subsidiary will not realize a capital gain on the winding-up. With respect to the interest in the partnership, the parent is deemed to be a continuation of the subsidiary and will ultimately realize a gain on the disposition of the interest. There is an exception to this rule where the subsidiary and the parent corporation were the only members of the partnership prior to the winding-up, and the partnership thus ceases to exist as a result of the winding-up and subsection 98(5) applies.

Consequently, there are generally no tax consequences on the transfer of the subsidiary's property to the parent.

Given that the subsidiary disposes of its property to the parent, it may not claim CCA in the year in which the property is transferred to the parent because it no longer owns the property at the end of this taxation year. [See Regulation 1100(1)(a).]

The expression **on the winding-up** as used in subsection 88(1) means that period of time during which the winding-up takes place. This period generally commences with a resolution of shareholders authorizing or requiring that the corporation be wound up and ends at dissolution. (See paragraphs 7 and 8 of IT-126R2.)

Property distributed to other shareholders

If property of the subsidiary is distributed to other shareholders (if any) on winding-up, under subsection 69(5), the subsidiary will be deemed to have disposed of the property at its FMV.

Liabilities of subsidiaries

The transfer of the liabilities of the subsidiary to the parent on the winding-up does not generally have any tax effect if those liabilities are assumed by the parent in the course of the distribution of the subsidiary's assets on winding-up and the amount payable on maturity remains unchanged [paragraph 88(1)(e.2) with reference to subsection 87(7)].

Where there is a debt owing to the parent (or vice versa) that is extinguished on the winding-up without any payment or with a payment of an amount less than the principal of the debt, the settlement of debt rules contained in section 80 may be avoided or their effect may be reduced by making the election under subsection 80.01(4). By virtue of this election, the subsidiary (or parent) is deemed to have settled the debt at its cost amount. Thus, if the cost amount of the debt for the parent (or subsidiary) is equal to the principal of the debt, the rules will be avoided. If the cost amount is less than the principal, the amount subject to these rules will be limited to the excess of the principal over the cost amount of the debt. The election is

made by filing Form T2027 no later than the date on which the parent company's income tax return for the year in which the debt is settled or extinguished is required to be filed.

Note that any unpaid interest on the debt included in computing the income of the corporation is added to the cost amount of the debt provided that it has not been deducted as a bad debt. Therefore, there is no consequence in terms of the settlement of debt rules on the portion of the debt represented by the unpaid interest that was included in the corporation's income for tax purposes.

Taxation year

Note that the commencement of winding-up and the transfer of property on the winding-up does not result in a year end for the subsidiary. Its taxation years continue to end on their usual date until the corporation ceases to exist, at which date marks the end of its last taxation year.

Reserves

Furthermore, under paragraph 88(1)(e.1), the subsidiary, for the taxation year during which its assets were transferred to the parent and its obligations were assumed by the parent, may claim any reserve that would have been allowed if the transfer had not taken place. This reserve is added to the income of the parent for the taxation year during which it received the assets from the subsidiary. At the end of that taxation year, the parent can claim a new reserve if it qualifies.

Tax consequences for the parent

Cost of property acquired from the subsidiary

Under paragraph 88(1)(c), the parent acquires the subsidiary's assets for an amount equal to their POD for the subsidiary. Paragraph 88(1)(f) provides that where the POD of a depreciable property of the subsidiary are less than its capital cost, the parent is deemed to have acquired the property at the subsidiary's capital cost and to have claimed the difference as CCA. Consequently, on a subsequent disposition, the parent will be taxed on any recapture of CCA claimed by the subsidiary. Similarly, for eligible capital property, under paragraph 88(1)(c.1), deductions claimed by the subsidiary under paragraph 20(1)(b) are included in the amount that may eventually be the object of a recapture for the parent.

If the property was owned by the subsidiary on December 31, 1971, the tax-free zone is transferred to the parent [ITAR 26(5)].

Disposition of the shares of the subsidiary

Under paragraph 88(1)(b), the parent is deemed to have disposed of its shares in the subsidiary for proceeds equal to the greater of

i) the lesser of:

- the PUC of the shares
- the cost amount of the property distributed to or received by the parent less the debts assumed by the parent and certain reserves claimed by the subsidiary in the year of distribution [this is the amount determined under subparagraph 88(1)(d)(i) as referred to in subparagraph 88(1)(b)(i)]

ii) the ACB of the shares for the parent immediately before the winding-up

Under this computation, the parent may realize a capital gain if it acquired the subsidiary's shares for an amount less than their PUC, but it may not realize a capital loss.

Increase in the cost of certain property

Under paragraphs 88(1)(c), (d), and (d.2), if the ACB of the shares owned by the parent exceeds

- the cost amount of the subsidiary's property distributed to the parent less the debts assumed by the parent and certain reserves claimed by the subsidiary in the year of the distribution

and

- the total taxable dividends, capital dividends, and life insurance capital dividends received by the parent or a related corporation,

the ACB of certain capital property received by the parent on the winding-up may be adjusted. Such property must have been owned by the subsidiary at the time the parent last acquired control and must have been held thereafter by the subsidiary without interruption. However, the following are excluded:

- depreciable property
- property transferred to the parent as part of a butterfly reorganization
- property acquired from the parent or from a person with whom the subsidiary did not deal at arm's length
- property subsequently disposed of by the parent as part of a series of transactions designed to sell certain assets of a corporation to a corporation with which it deals at arm's length

The ACB of an eligible property may be increased or in tax parlance bumped up, to the FMV of the property on the date the parent last acquired control of the subsidiary. Thus if the parent has always controlled the subsidiary, no adjustment is possible. The increase for all eligible property must not be greater than the amount of the excess computed in the preceding paragraph. The increase is intended to compensate the parent for its loss, if any, in the tax cost in the shares of the subsidiary on the winding-up.

The property and the amounts of the adjustments must be designated by the parent in its income tax return for its taxation year in which the subsidiary was wound up.

Example 4-7 illustrates the tax consequences of winding up a wholly-owned subsidiary, including possible adjustments of the ACB of certain property under paragraph 88(1)(d).

EXAMPLE 4-7

On June 30, 1996, Castafiore Ltd. acquired all the shares of Bianca Ltd. for $1,000,000. The PUC of the shares of Bianca Ltd. is $30,000. Castafiore Ltd. and Bianca Ltd. are both taxable Canadian corporations having a fiscal year ending on December 31.

Additional information:

- On September 1, 2001, Bianca Ltd. paid a dividend of $500,000 to Castafiore Ltd. On December 31, 2008, Bianca Ltd. was wound up.

- For its taxation year ending December 31, 2008, Bianca Ltd. claims a doubtful debt reserve of $10,000 under paragraph 20(1)(l).

- On winding-up, Bianca Ltd. has the following assets and liabilities:

ASSETS

	Cost amount
Cash	$ 30,000
Accounts receivable	23,000
Investments[1]	10,000
Land A[2]	60,000
Land B[3]	40,000
Building[4]	150,000
	$313,000

LIABILITIES

Accounts payable	$ 5,000
Other liabilities	15,000
	$ 20,000

[1] The investments were acquired by Bianca Ltd. in 1990 for $10,000. They had an FMV of $100,000 on June 30, 1996, and $200,000 on December 31, 2008.

[2] Land A was acquired in 1991 for $60,000. It had an FMV of $200,000 on June 30, 1996, and $250,000 on December 31, 2008.

[3] Land B was acquired on August 4, 1997, at a cost of $40,000. It had an FMV of $75,000 on December 31, 2008.

[4] The building was acquired in 1993 at a cost of $200,000. CCA of $50,000 had been claimed up to December 31, 2008. The FMV of the building was $220,000 on June 30, 1996, and $300,000 on December 31, 2008.

Tax consequences

The provisions of subsection 88(1) apply to the winding-up of Bianca Ltd., since all the conditions set out in it are met:

- Bianca Ltd. and Castafiore Ltd. are taxable Canadian corporations.
- Castafiore Ltd. holds 100% of the shares of Bianca Ltd., and therefore the criterion of holding 90% or more is satisfied.
- The third criterion concerning the holding of shares by other shareholders does not apply, since Bianca Ltd. is wholly owned by Castafiore Ltd.

The application of subsection 88(1) has the following tax consequences for the parties concerned:

1. For Bianca Ltd.:

   There are no tax consequences because, under paragraph 88(1)(a), Bianca Ltd. will be deemed to have disposed of each of its assets at their cost amounts.

2. For Castafiore Ltd.:

   i) Acquisition cost of the property received from the subsidiary

      Castafiore Ltd.'s acquisition cost is determined under paragraph 88(1)(c) and is equal to the cost amount of the property for Bianca Ltd., other than Land A and the investments which will be bumped up under paragraph 88(1)(d). These properties are non-depreciable capital properties that Bianca Ltd. held on the acquisition of control by Castafiore Ltd. on June 30, 1996, and were held without interruption since that time.

Maximum possible adjustment [88(1)(d)]

ACB of the shares of Bianca Ltd. for Castafiore Ltd.		$ 1,000,000
Less the total of:		
a. Cost amount of all of Bianca Ltd.'s property plus cash	$ 313,000	
Bianca Ltd.'s liabilities	(20,000)	
Reserve under 20(1)(l)	(10,000)	(283,000)
b. Dividend received by Castafiore Ltd. from Bianca Ltd.		(500,000)
Maximum possible adjustment [88(1)(d)]		$ 217,000

Investments

FMV as at June 30, 1996	$ 100,000
Less: Cost amount (ACB)	(10,000)
Maximum increase [88(1)(d)(ii)]	$ 90,000

Land A

FMV as at June 30, 1996	$ 200,000
Less: Cost amount (ACB)	(60,000)
Maximum increase [88(1)(d)(ii)]	$ 140,000

However, because the total possible bump-up on the investments and Land A ($90,000 + $140,000 = $230,000) exceeds $217,000, subparagraph 88(1)(d)(ii) restricts the bump-up in the cost of the property to $217,000. Castafiore Ltd. may choose to allocate this amount between the investments and Land A as it wishes, provided that it does not exceed the FMV of the property on June 30, 1996, being the date on which Castafiore Ltd. acquired control of Bianca Ltd.

Assuming that Castafiore Ltd. has elected to allocate the maximum amount to the investments and the balance to the land, the cost amount for Castafiore Ltd. of the property received from Bianca Ltd. would be

Accounts receivable	$ 23,000
Investments ($10,000 + $90,000)	100,000
Land A ($60,000 + $127,000)	187,000
Land B	40,000
Building*	150,000

* Under paragraph 88(1)(f), the capital cost of the building for Castafiore Ltd. is $200,000 and Castafiore Ltd. is deemed to have claimed CCA of $50,000.

ii) Disposition of the shares of Bianca Ltd.

POD [88(1)(b)]

The greater of the following amounts:

a. The lesser of the following amounts:		
• PUC of the shares	$ 30,000	
• Amount determined under 88(1)(d)(i)	$ 283,000	$ 30,000
b. ACB		$ 1,000,000

Capital gain

POD [88(1)(b)]	$ 1,000,000
ACB	(1,000,000)
Capital gain	$ —

Transfer of tax accounts

Paragraphs 88(1)(e.2) to 88(1)(e.8) contain rules for transferring reserves and tax accounts [capital dividend account (CDA), RDTOH, investment tax credit (ITC), GRIP or LRIP, and so on] from the subsidiary to the parent similar to those applicable to amalgamations. The parent is generally treated as a continuation of the subsidiary.

Transfer of losses

The winding-up of a subsidiary that has accumulated losses may allow the parent corporation to deduct these losses from its future income under certain conditions.

Subsections 88(1.1) and 88(1.2) deal with the transfer of a subsidiary's losses to the parent. The types of losses transferred to the parent are

- non-capital losses
- net capital losses
- farm losses
- restricted farm losses
- limited partnership losses

Provided:

a. they have not been deducted in computing the subsidiary's taxable income

and

b. they would have been deductible by the subsidiary in a taxation year commencing after the commencement of the winding-up, on the assumption that it had such a taxation year and that it had sufficient income for that year

If these above conditions are met, the subsidiary's losses are deemed to be the parent's losses for the taxation year in which the subsidiary's loss occurred.

In addition, the subsidiary's losses may be claimed against the parent's income only for taxation years commencing after the commencement of the winding-up of the subsidiary.

Note that the parent can claim the losses of the subsidiary only when the subsidiary has been wound up. In a 2001 technical interpretation, CRA stated that for the purposes of subsection 88(1.1), it does not apply the winding-up presumption referred to in IT-126R2 as described at the beginning of this document under the heading *General*. For the purposes of subsection 88(1.1), CRA does not consider that a corporation has been wound up so long as it has not

been formally dissolved. However, CRA states that once the subsidiary is formally dissolved, the parent can claim the losses of the subsidiary by filing an amended income tax return for any taxation year commencing after the start of winding-up for which a return was filed before the subsidiary was formally dissolved.

Rules restricting the use of losses on the acquisition of control of the subsidiary or the parent are contained in paragraph 88(1.1)(e) and subsection 88(1.2).

Non-capital losses of the subsidiary are deductible by the parent corporation after the acquisition of control, provided that

- the business that incurred the loss was carried on by the corporation for profit or with a reasonable expectation of profit throughout the given year

and

- the loss is deducted up to the amount of the income of the parent corporation derived from the business that generated the loss and the income for the year of any other business of which substantially all the income was derived from sale, leasing, rental, or development, or the rendering of similar services

Net capital losses of the subsidiary are not deductible by the parent corporation after the acquisition of control.

Example 4-8 illustrates both how the loss carryforwards of the subsidiary may be used by the parent on the winding-up of a wholly-owned subsidiary and how important the date on which the winding-up commences is for the use of these losses.

EXAMPLE 4-8

Venus Inc., a CCPC, has owned 100% of the shares of Jupiter Inc. since Jupiter Inc. was incorporated. Jupiter Inc.'s fiscal period ends September 30 and that of Venus Inc. ends December 31.

Jupiter Inc. has the following non-capital loss carryforwards:

September 30, 2002	$20,000
September 30, 2003	$25,000
September 30, 2006	$60,000
September 30, 2008	$15,000

Venus Inc. realizes substantial profits each year. To take advantage of the losses, a decision is made to wind up Jupiter Inc. under the provisions of subsection 88(1), and a shareholders' resolution authorizing the winding-up is passed on November 1, 2008.

Tax consequences

Since Venus Inc. has controlled Jupiter Inc. since its incorporation, the rules on acquisition of control do not affect the losses.

Under subsection 88(1.1), the losses of Jupiter Inc. are deemed to be losses of Venus Inc. for its taxation year during which the year of the loss incurred by its subsidiary ended, namely

December 31, 2002	$20,000
December 31, 2003	$25,000
December 31, 2006	$60,000
December 31, 2008	$15,000

Venus Inc. will be able to uses the losses of Jupiter Inc. for taxation years commencing after November 1, 2008, and hence its taxation year ending December 31, 2009. Of course, to

deduct this loss, Jupiter Inc.'s winding-up must be completed (that is, Jupiter Inc. is formally dissolved).

However, the losses of Jupiter Inc. are not deductible by Venus Inc. unless they were deductible for Jupiter Inc. in a taxation year commencing after the beginning of the winding-up, assuming that such a year exists and that there are sufficient income and capital gains for that year. In the present case, the loss for 2002 cannot be used by Venus Inc. since that loss could not have been used by Jupiter Inc. in its taxation year following the one in which the winding-up began. On the other hand, if the shareholders' resolution authorizing the winding-up had been passed on September 30, 2008, the loss for 2002 could have been used by Venus Inc. in its taxation year ending December 31, 2009.

Note: Losses that arise in 2006 and subsequent taxation years may be carried forward 20 years. The loss-carryforward period for non-capital losses that arise in taxation years that end after March 22, 2004 and before January 1, 2006 is ten years. The ten-year period does not apply to existing losses realized prior to March 23, 2004 for which the carryforward period remains at seven years.

Using a subsection 88(1) winding-up

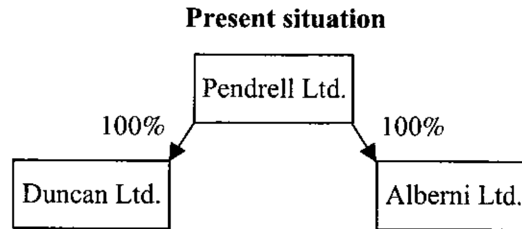
A subsection 88(1) winding-up is generally used to combine corporations within a group of related corporations, often to use losses incurred by one of the corporations in the group.

Where the corporation to be wound up is not a 90%-owned subsidiary of the corporation into which it is to be wound up, the shares of the first corporation may be rolled over to the second corporation under subsection 85(1) and thus create a 90% subsidiary relationship. The first corporation would then be wound up under subsection 88(1). Example 4-9 illustrates such an arrangement.

EXAMPLE 4-9

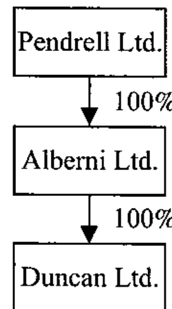
Pendrell Ltd. owns 100% of the shares of Duncan Ltd. and 100% of the shares of Alberni Ltd. The directors of Pendrell Ltd. wish to combine the operations of Duncan Ltd. and Alberni Ltd. Because Duncan Ltd. and Alberni Ltd. were not incorporated in the same jurisdiction, they cannot be amalgamated. A winding-up under subsection 88(1) is therefore required.

Present situation



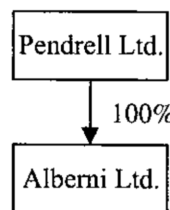
Step 1

Pendrell Ltd. rolls over its shares in Duncan Ltd. to Alberni Ltd. under section 85 in exchange for shares of Alberni Ltd.



Step 2

Duncan Ltd. is wound up into Alberni Ltd. Since it is a 100%-owned subsidiary of Alberni Ltd., the provisions of subsection 88(1) apply.



A winding-up under subsection 88(1) is also used for business acquisitions where the vendor wishes to sell the shares of the corporation rather than the assets of the enterprise. If the purchaser does not want to retain a separate corporation for operations, the corporation may be wound up following the acquisition of the shares. As we have seen, the cost amount of certain capital property received from the subsidiary on the winding-up may be adjusted.

Comparing an amalgamation and a subsection 88(1) winding-up

Corporations carrying on a business within the same group of companies may use the provisions of either section 87 or subsection 88(1) to combine all or some of companies in the group. The choice between the two methods is based on differences in how these provisions apply. Exhibit 4-3 sets out the main factors that should be taken into consideration.

EXHIBIT 4-3

Amalgamation or Winding-up

AMALGAMATION — 87	WINDING-UP — 88(1)
Governing law	
The corporations seeking to amalgamate must be governed by the same law.	The corporations may be governed by different laws.
Taxation year	
Predecessor corporations: The taxation year ends immediately before the amalgamation.	**Subsidiary:** Its taxation years continue as usual until it is wound up.
New corporation: A new taxation year begins and a new year end is selected.	**Parent corporation:** No effect.
CCA in the year of amalgamation or winding-up	
Predecessor corporations: They may claim CCA for the portion of the year preceding amalgamation.	**Subsidiary:** The subsidiary disposes of its property and therefore cannot claim CCA in the year of the winding-up.
New corporation: It may claim CCA with respect to property acquired in its first taxation year.	**Parent corporation:** It may claim CCA with respect to property received in the year.
Revaluation of assets	
In certain cases, the cost of non-depreciable capital property may be increased in the amalgamation of a parent corporation and its wholly-owned subsidiary [see 87(11)].	In certain cases, the cost of non-depreciable capital property may be increased [see 88(1)(c) and (d)].
Settlement of inter-company debts	
Predecessor corporations: Inter-company debts are settled at their cost amount without any election [see 80.01(3)].	**Subsidiary:** Inter-company debts are settled at their cost amount **if** an election is made by filing form T2027 [see 80.01(4)].
Loss carryforwards	
New corporation: Subject to the rules regarding acquisition of control, the new corporation may claim the losses of	**Parent corporation:** Subject to the rules regarding acquisition of control, the parent corporation may claim the losses of

the predecessor corporations starting in its first taxation year. The expiry date of the losses of the predecessor corporations remain unchanged, because the new corporation is deemed to be a continuation of each of the predecessor corporations [see 87(2.1)].

the subsidiary starting in the first taxation year after the commencement of the winding up of the subsidiary. A subsidiary's losses will be deductible by the parent corporation only where the subsidiary could have deducted them in its first taxation year following the commencement of the winding-up, if it had had sufficient income at that time. Lastly, a subsidiary's losses for a particular taxation year become losses of the parent corporation for the taxation year of the parent corporation which includes the end of the subsidiary's taxation year in which the loss was incurred.

Losses incurred later

New corporation:
Only in the case of an amalgamation of a corporation with its wholly-owned subsidiary, the losses incurred by the new corporation after the amalgamation may be deducted from the income of the parent corporation.

Parent corporation:
The losses incurred by the parent corporation following the winding-up of its subsidiary are deductible from its income before the winding-up.

READING 4-3

Winding up a Canadian corporation

LEVEL 1

General

The winding-up of a Canadian corporation [other than a subsidiary owned 90% or more to which subsection 88(1) applies] has tax consequences for the corporation and its shareholders. Those consequences are determined by various provisions that should be studied jointly, namely subsections 69(5), 84(2) and 88(2). Interpretation bulletins IT-126R2 and IT-149R4 should also be studied.

Note that the comments are directed toward Canadian corporations that do not have a special status and that references to non-resident-owned investment corporations have been omitted.

Corporation

Under subsection 69(5), a corporation that distributes its property to a shareholder on a winding-up is deemed to have disposed of such property for its FMV immediately before the winding-up. As a result, there may be capital gains or losses, recapture of CCA or a terminal loss or any other gain or loss, depending on the nature of the property disposed of. All losses, whatever their nature, will be deductible even if the property is transferred to a shareholder who controls the corporation, since by virtue of paragraph 69(5)(d), subsections 13(21.2), 14(12), 18(15), 40(3.4) and 40(3.6), whose effect is to defer the recognition of a loss in transactions between affiliated persons, do not apply to the winding-up.

Shareholders

Acquired property

Under paragraphs 69(5)(b) and (c), shareholders are deemed to have acquired the property at a cost equal to its FMV immediately before the winding-up. Under paragraph 69(5)(c), moreover, subsections 52(1) and 52(2), which have the effect of increasing the cost of property in certain cases, do not apply. Thus, the cost of the property for shareholders is still its FMV.

Under subsection 84(2), the shareholders will be deemed to have received a dividend equal to the excess of the value of funds or property distributed over the reduction in PUC of the shares of the corporation. The computation must be carried out for each class of shares with the excess being allocated among the shareholders based on the number of shares owned.

Deemed dividend

Subsection 88(2) contains special rules to facilitate the distribution of the capital dividend account (CDA) and the pre-1972 capital surplus on hand (CSOH) on winding-up.

Paragraph 88(2)(a) states that, for purposes of computing the CDA and pre-1972 CSOH, at the time immediately before the final distribution of the property of the corporation:

- the taxation year of the corporation is deemed to have ended at that time and a new taxation year is deemed to have commenced at that time

and

- each property distributed on the final distribution is deemed to have been disposed of at its FMV immediately before the end of the taxation year deemed to have ended before the final distribution

Under these rules, any capital gains existing before the final distribution are included in the CDA and pre-1972 CSOH.

Paragraph 88(2)(b) specifies the conditions for taxing the deemed dividend under subsection 84(2) to take into account the CDA and the pre-1972 CSOH computed above. These conditions are as follows:

- An amount not exceeding the CDA of the corporation immediately before the date of the final distribution may be considered as a separate dividend from the CDA provided the appropriate election is made under subsection 83(2). Form T2054, "Election For a Capital Dividend Under Subsection 83(2)," must therefore be filed within the required time limits.
- If the deemed winding-up dividend exceeds the separate CDA dividend, an amount from the pre-1972 CSOH is deemed not to be a dividend.
- If there remains a balance after the CDA dividend and the pre-1972 CSOH deduction, the excess is a taxable dividend.

Each shareholder is deemed to have received a separate dividend from the CDA or a taxable dividend in proportion to the number of shares held. The CDA is defined in subsection 89(1).

The definition and computation of the pre-1972 CSOH is contained in subsections 88(2.1) and (2.2). Briefly defined, the pre-1972 CSOH is

- the corporation's 1971 capital surplus computed under specific rules

plus

- the portion of the capital gains realized on the disposition of capital property owned on December 31, 1971, attributable to the period before December 31, 1971

less

- capital losses incurred on property owned on December 31, 1971, attributable to the period before December 31, 1971

Generally, corporations incorporated after December 31, 1971, would not have pre-1972 CSOH.

Regarding the portion of the deemed dividend that is a taxable dividend, it will be necessary to determine whether it can be designated as an eligible dividend. If the corporation is a CCPC and has a GRIP, the dividend may be designated as an eligible dividend up to the amount in this pool. If the corporation is not a CCPC, the amount of the dividend that exceeds its LRIP may be designated.

Disposition of shares

A shareholder whose share is cancelled on the winding-up is considered to have disposed of that share for proceeds equal to the value of the property received less the amount of the CDA dividend and the taxable dividend [see paragraph (j) of the definition of proceeds of disposition in section 54].

Example 4-10 deals with the winding-up of a corporation that is not at least a 90%-owned subsidiary, illustrating the tax consequences for both the corporation wound up and the shareholders.

EXAMPLE 4-10

Sylvie Michaud is the sole shareholder of Kana Ltd., a Canadian-controlled private corporation (CCPC). She owns 1,000 Class A shares that have an ACB of $10,000 and a PUC of $1,000. Since cash and a rental property are the only remaining assets in Kana Ltd., Sylvie decides to wind up Kana Ltd.

On the date of the distribution of property, Kana Ltd.'s balance sheet shows:

Assets

Cash		$100,000
Capital assets		
Land (cost)	$ 10,000	
Building (net of accumulated amortization)	15,000	25,000
		$125,000

Shareholder's equity

Capital stock	
1,000 Class A shares	$ 1,000
Retained earnings	124,000
	$125,000

Additional information:

- The property was acquired by Kana Ltd. in 1968 at a cost of $40,000 allocated as follows:
  - Land $ 10,000
  - Building $ 30,000
- As at December 31, 1971, the property was valued at $80,000. This value is allocated as follows:
  - Land $ 18,000
  - Building $ 62,000
- The present FMV of the property is $200,000 allocated as follows:
  - Land $ 50,000
  - Building $150,000
- The UCC of the building is $10,000.
- The PUC of the 1,000 shares is equal to capital stock for accounting purposes of $1,000.
- Kana Ltd. has the following tax surplus before the winding-up:
  - CDA $ 10,000
  - CSOH pre-1972 $ 20,000
- Kana Ltd. does not have any RDTOH.
- Kana Ltd.'s fiscal year is the calendar year.
- The winding-up takes place on December 31, 2008.
- Kana Ltd. pays income taxes on its investment income at a rate (combined federal/provincial) of 52%. It does not have any active business income and its GRIP is nil.

Tax consequences

1. For Kana Ltd.:

Disposition of property at FMV [69(5)]

Land	
POD	$ 50,000
ACB under the median rule	(18,000)
Capital gain	$ 32,000
Taxable capital gain (1/2)	$ 16,000
Building	
POD under ITAR 20	
$30,000 + ($150,000 – $62,000)	$118,000
Capital cost	(30,000)
Capital gain	$ 88,000
Taxable capital gain (1/2)	$ 44,000
CCA recapture	
The lesser of capital cost and POD	$ 30,000
UCC	(10,000)
Recapture	$ 20,000

The capital gain and CCA recapture represent investment income for Kana Ltd.

Income taxes payable

Taxable capital gains		
Land	$ 16,000	
Building	44,000	$ 60,000
CCA recapture		20,000
Taxable income		$ 80,000
Income taxes (52%)		$ 41,600
RDTOH (26.67%)		$ 21,336

Value of assets available on the winding-up

Cash	$100,000
FMV of the land and building	200,000
	300,000
Income taxes payable	(41,600)
	258,400
Dividend refund*	21,336
	$279,736

* A corporation is entitled to the dividend refund of all refundable tax on hand only if there is a sufficient taxable dividend on the winding-up as is the case in this example. See paragraph 4 of IT-243R4 for the dividend refund procedures that apply in a winding-up. The dividend refund is $1 for each $3 of dividend paid.

Effect on surplus

	CSOH	CDA
Opening balance	$ 20,000	$ 10,000
Deemed disposition		
Land		
$18,000 – $10,000	8,000	
1/2 × $32,000		16,000
Building		
$62,000 – $30,000	32,000	
1/2 × $88,000		44,000
Balance on the winding-up	$ 60,000	$ 70,000

2. For Sylvie:

Deemed dividend [84(2)]

Value of property received	$279,736
PUC of the 1,000 Class A shares	(1,000)
Deemed dividend	$278,736

Allocation of the dividend under 88(2)

Deemed dividend	$278,736
Dividend from the CDA if the 83(2) election is made	(70,000)
	208,736
Amount deemed not to be a dividend — equal to the pre-1972 CSOH	(60,000)
Taxable dividend	$148,736

Under paragraph 82(1)(b), this dividend must be grossed up by 1/4 and included in Sylvie's income. This dividend cannot be designated as an eligible dividend, since Kana Ltd. has no GRIP.

Capital gain on the disposition of shares

Value of property received		$279,736
Less: CDA dividend	$ 70,000	
Taxable dividend	148,736	(218,736)
POD under 54 equal to the PUC plus the pre-1972 CSOH		61,000
ACB		(10,000)
Capital gain		$ 51,000
Taxable capital gain (1/2)		$ 25,500

Summary

Increase in value for Sylvie ($279,736 – $10,000)	$269,736
Taxed as follows:	
Non-taxable dividend from the CDA	$ 70,000
Taxable dividend	148,736
Capital gain	51,000
	$269,736

Example 4-10 illustrates a situation in which the wound-up corporation existed in 1971 and had a pre-1972 CSOH. In most cases, the wound-up corporation will be a corporation created after 1971 that has no pre-1972 CSOH, and therefore it will be simpler to determine the tax consequences of the winding-up.

Using a winding-up under subsection 88(2)

A winding-up under subsection 88(2) may be used whenever a corporation's existence no longer seems necessary.

Planning may be undertaken to reduce or eliminate the immediate tax consequences of the winding up vis-à-vis shareholders that are individuals. Each shareholder would roll over his shares of the corporation to be wound up to a personal corporation under subsection 85(1). Subsequently, the taxable dividend on winding-up would be received by the corporation rather than the individual and would not be subject to Part I tax. It would also be exempt from Part IV tax, provided the corporations are connected before the winding-up and the wound-up corporation does not receive any dividend refund. If the wound-up company obtains a dividend refund, the corporate shareholder must pay Part IV tax on the portion of the dividend that gave rise to a refund. Where the winding-up is part of a series of transactions or events, this planning must be done with care in order to avoid the possible application of subsection 55(2).

Clearance certificates

Under subsection 159(2), every assignee, liquidator, administrator, and any other like person (except a trustee in bankruptcy) must request and obtain a clearance certificate before distributing any property under his control if he wishes to avoid being held personally liable for the unpaid income taxes, interest and penalties of a corporation pursuant to subsection 159(3). A clearance certificate is issued on Form TX21, "Clearance Certificate for Final Distribution."

Where a corporation is wound up or dissolved, a clearance certificate must be obtained. Read IC 82-6R6 regarding clearance certificates. To request a certificate it is necessary to use the prescribed Form TX19.

Deemed proceeds or capital gain under subsection 55(2)

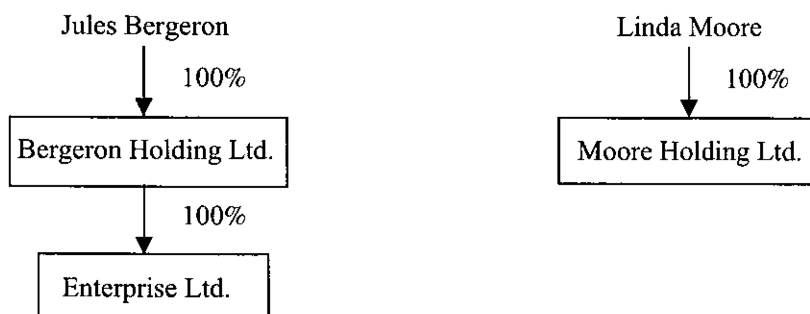
LEVEL 1

General

Subsection 55(2) should be considered every time an attempt is made to convert a capital gain to an inter-corporate dividend exempt from tax.

Example 4-11 illustrates the type of transaction covered by subsection 55(2).

EXAMPLE 4-11



Moore Holding Ltd. wishes to acquire the shares of Enterprise Ltd. for $2,000,000. Linda Moore and Moore Holding Ltd. deal at arm's length with Jules Bergeron, Bergeron Holding Ltd., and Enterprise Ltd. At this time, Enterprise Ltd.'s balance sheet is as follows:

Assets		**Liabilities**	
Cash	$ 800,000	Accounts payable	$ 150,000
		Shareholders' equity	
Capital assets	200,000	Capital stock	1,000
		Retained earnings	849,000
			850,000
	$ 1,000,000		$ 1,000,000

The difference of $1,150,000 between the book value of the shares and the price of $2,000,000 is the increase in value allocated to goodwill. Bergeron Holding Ltd.'s ACB of the shares of Enterprise Ltd. is $1,000. The sale of the Enterprise Ltd. shares to Moore Holding Ltd. for $2,000,000 would therefore give rise to a capital gain of $1,999,000 ($999,500 taxable) for Bergeron Holding Ltd. Assuming that the tax rate (combined federal/provincial) is 52%, Bergeron Holding Ltd. would be required to pay income taxes of $519,740. If it is a CCPC, it would be entitled to a refundable dividend tax of $266,567 ($999,500 × 26.67%).

To avoid paying tax of $519,740, the sale of shares to Moore Holding Ltd. could be structured this way:

1. Moore Holding Ltd. subscribes for $1,199,000 ($2,000,000 less Enterprise Ltd.'s cash of $800,000 and $1,000 corresponding to the ACB of Enterprise Ltd.'s shares) in preferred shares of Enterprise Ltd.

2. Enterprise Ltd. pays a dividend of $1,999,000 to Bergeron Holding Ltd. This dividend is exempt from Part I tax under the deduction provided in subsection 112(1) and is exempt from Part IV tax provided Enterprise Ltd. does not have any RDTOH since the corporations are connected.

3. The FMV of the shares of Enterprise Ltd. is reduced by the amount of the dividends. Bergeron Holding Ltd. sells the shares of Enterprise Ltd. for $1,000, and thus avoids any tax consequences on the sale.

4. Moore Holding Ltd. now owns 100% of Enterprise Ltd. and Bergeron Holding Ltd. has not paid any tax.

Subsection 55(2) was introduced to restrict planning techniques, such as the one described in this example, for the purpose of avoiding a capital gain on arm's length transfers of property by converting the capital gain to a tax-free inter-corporate dividend. The effect of subsection 55(2) is to deem the offensive dividend to be proceeds of disposition of the shares thereby re-establishing the capital gain which the taxpayer is trying to avoid.

Conditions and rules under subsection 55(2)

Subsection 55(2) applies when the following conditions are met:

- a taxable dividend must have been received by a corporation resident in Canada
- the dividend received must be deductible by the corporation under subsection 112(1) or 138(6)
- the dividend must have been received as part of a transaction or event or a series of transactions or events of which one of the purposes [or, in the case of a dividend under subsection 84(3), one of the results] was to effect a significant reduction in the portion of the capital gain that, but for the dividend, would have been realized on a disposition at FMV of a share immediately before the dividend
- the capital gain could reasonably be considered to be attributable to anything other than income earned or realized by the corporation after 1971, commonly known as safe income

If the preceding conditions are met

- the taxable dividend is deemed not to be a dividend received by the corporation
- where a corporation has disposed of a share, the amount of the dividend is deemed to be POD of the share

and

- where the corporation has not disposed of a share, the amount of the dividend is deemed to be a capital gain of the corporation for the year in which the dividend was received from the disposition of a capital property

Subsection 55(2) provides that, where Part IV tax applies on a portion of the dividend, that portion of the dividend is not considered as POD or a capital gain, depending on the case, except if the Part IV tax is refunded as a consequence of the payment of a dividend to a corporation as part of the series of transactions or events.

This subsection does not apply to the corporation paying the dividend. Thus the dividend paid is not considered to be an acquisition cost and does not increase the ACB of the property acquired; it retains its dividend status for the payer corporation.

Under the terms of the subsection, the dividend must have been received as part of a transaction, or series of transactions. Under subsection 248(10), a series of transactions or events includes related transactions or events completed in contemplation of the series.

For subsection 55(2) to apply, one of the *purposes* of the series of transactions or events must be to reduce significantly the capital gain that would have been realized on the disposition of a share. In the case of a dividend under subsection 84(3), one of the *results* of the transaction, or series of transactions, must be to effect a significant reduction in the capital gain realized on the disposition of a share. CRA has stated that a significant reduction should be measured in dollars, not percentages.

The test of "purpose" and the test of "result" referred to in subsection 55(2) differ in their thrust. According to legal precedent, the test of "purpose" must be interpreted subjectively. The actual intent of the parties must be analyzed. If the taxpayer shows that none of the purposes of the series of transactions or events was to reduce the capital gain, subsection 55(2) does not apply, even if the series of transactions or events had the result of reducing the capital gain that would otherwise have been realized on the disposition of shares.

The test of "result" that applies where there is a deemed dividend under subsection 84(3), when shares are either purchased or cancelled by the corporation, is an objective test. The intent of the parties is not important, and only the result of the transaction must be considered.

In order for subsection 55(2) to apply, the capital gain that was reduced must be attributable *to anything other than income earned or realized by the corporation after 1971*. It is thus necessary to determine what portion of the capital gain reduced by the payment is attributable

1. to income earned or realized after 1971 (the computation of earned or realized income attributable to a share will be studied further on),

and

2. to something else, such as the accrued gain not realized on assets including goodwill.

If the difference between the capital gain otherwise determined and the capital gain actually realized on the payment of the dividend is greater than the income earned or realized after 1971 on the share disposed of, the *entire* dividend (other than the portion subject to Part IV tax as mentioned above) will be considered to be POD or a capital gain, depending on the case. Example 4-12 illustrates how subsection 55(2) applies.

EXAMPLE 4-12

Return to Example 4-11 and assume that income earned or realized after 1971 with respect to the shares of Enterprise Ltd. is equal to the undistributed earnings of $849,000.

Tax consequences

Subsection 55(2) would apply if the series of transactions suggested in order to avoid the income tax payable of $519,740 were carried out, since all the conditions set out in subsection 55(2) would be met.

- Bergeron Holding Ltd., a corporation resident in Canada, receives a taxable dividend.
- Under subsection 112(1), the dividend received by Bergeron Holding Ltd. is deductible from its income.
- The dividend received as part of a series of transactions or events of which one of the *purposes* [the result test is not applicable here, since this is not a deemed dividend under subsection 84(3)] was to reduce that capital gain that would have been realized on the disposition of the shares of Enterprise Ltd.
- The reduction in the capital gain as a result of paying the dividend ($1,999,000) is greater than the amount of income earned or realized after 1971 and attributable to the shares.

Since subsection 55(2) would apply, the entire amount of the dividend ($1,999,000) would, under subsection 55(2), be considered POD of shares, resulting in a capital gain of $1,999,000 for Bergeron Holding Ltd.

Computation of capital gain:

Real POD	$ 1,000
POD [55(2)]	1,999,000
POD	2,000,000
ACB	(1,000)
Capital gain	$ 1,999,000
Taxable capital gain (1/2)	$ 999,500

Subsection 55(2) does not apply to Enterprise Ltd. The dividend of $1,999,000 paid by Enterprise Ltd. is recognized as such.

The effect of subsection 55(2) is to return the vendor to the situation in which he would have been if no dividend had been paid prior to the sale of the shares.

CRA considers that the portion of the capital gain attributable to income earned or realized after 1971 may be reduced by an inter-corporate dividend that must not be greater than the income earned or realized after 1971. It is thus possible to structure transactions in order to reduce the impact of subsection 55(2) and receive the income earned or realized after 1971. Example 4-13 illustrates this type of planning.

EXAMPLE 4-13

Returning to the data in Example 4-11, assume that the income earned or realized after 1971 attributable to the shares is equal to the undistributed earnings of $849,000.

Instead of paying a dividend of $1,999,000 to Bergeron Holding Ltd., Enterprise Ltd. would pay two dividends. The first, in the amount of $849,000, would correspond to the income earned or realized after 1971, and the second, in the amount of $1,150,000, would correspond to the accrued gain on the goodwill. The first dividend, because it does not exceed the income earned or realized after 1971, would not be subject to the provisions of subsection 55(2), whereas the second would be.

Computation of the capital gain:

Real POD	$ 1,000
POD under 55(2)	1,150,000
Adjusted POD	1,151,000
ACB	(1,000)
Capital gain	$ 1,150,000
Taxable capital gain (1/2)	$ 575,000

The dividend of $849,000 would be treated as a dividend exempt from Part I tax under the deduction provided for in subsection 112(1) and exempt from Part IV tax if Enterprise Ltd. received no dividend refund, since the corporations are connected.

In order to facilitate planning to receive income earned or realized after 1971, paragraph 55(5)(f) provides that a corporation that has received a dividend may designate any portion of the dividend received to be a separate taxable dividend; the amount that is in excess of this portion is also deemed to be a separate dividend. This designation allows the corporation receiving the dividend to designate a separate dividend equal to the income earned or realized after 1971, so that this dividend will not be considered to be POD or a capital gain under subsection 55(2). There is no prescribed form for making this designation;

it is made in a letter to be attached to the corporation's income tax return. Example 4-14 illustrates the effects of this election.

EXAMPLE 4-14

Assume that, in Example 4-11, the income earned or realized after 1971 on Enterprise Ltd.'s shares was equal to the retained earnings of $849,000. Bergeron Holding Ltd. may receive a dividend of $1,999,000 and elect under paragraph 55(5)(f) to designate the dividend as consisting of two separate dividends, one of $849,000 followed by a dividend of $1,150,000. This election will enable Bergeron Holding Ltd. to receive an inter-corporate dividend of $849,000. The POD of the shares will be equal to $1,151,000 ($1,000 + $1,150,000), resulting in a capital gain of $1,150,000. This amount is less than the capital gain, which would have been realized if no election had been made.

Since the income earned or realized after 1971 may be computed erroneously, more than one designation may be made, thereby resulting in more than one separate dividend. The first designation would generally be an amount that is clearly less than the income earned or realized after 1971. This would ensure that the designation is covered by the income earned or realized after 1971, even in the case of error. Subsequent designations would be in intervals up to the amount of income earned or realized after 1971. For example, a corporation receives a $100,000 dividend. Even though the corporate accountant is sure that the income earned or realized after 1971 is at least $70,000, he believes that, from his computations, it could be $80,000. The corporation may therefore make a multiple designation under paragraph 55(5)(f): a separate dividend of $70,000 followed by two separate dividends of $5,000 each and a final dividend of $20,000.

Income earned or realized after 1971

The income earned or realized after 1971, commonly referred to as "safe income," corresponds to the tax surpluses accumulated during the period in which the shares are held. It must be computed for each share for the period it was owned. The holding period commences on the most recent of the following dates: January 1, 1972, or the date on which the share was acquired. Thus, if two shares were not acquired at the same time, they will not have the same income earned or realized after 1971. The computation of the income earned or realized after 1971 attributable to the shares ends immediately before the "safe-income determination time," which is defined in subsection 55(1) as being the earlier of the following times:

- the earliest time that a dividend is paid as part of the series of transactions or events,
- the earliest disposition or increase in interest described in any of subparagraphs 55(3)(a)(i) to (v).

The tax policy behind the income earned or realized after 1971 is that each after-tax dollar of income left in the corporation during the holding period increases the FMV of the shares of the corporation by an equal amount and that this amount should be allowed to be distributed to the shareholders as dividends.

The income earned or realized after 1971 by a corporation is defined in paragraphs 55(5)(b) and (c) in the case of Canadian corporations. Under these paragraphs and CRA's interpretation, earned income on hand attributable to shares includes

the total of:

- the taxable income of the corporation for the holding period on the assumption that no amount was deductible as an inventory deduction [20(1)(gg) as it applied prior to its repeal in 1986], or as an additional allowance (section 37.1 as it applied before it was repealed in 1996)

- taxable dividends received during the period, deducted in computing taxable income under subsection 112(1) and arising from income earned or realized after 1971 by the payor corporation
- losses deducted in computing taxable income under section 111 for the period

less the total of:

- losses incurred during the period
- taxable dividends paid during the period
- income taxes paid or payable in respect of income for the period
- other disbursements that take place after net income is determined

Only in the case of a corporation other than a private corporation, the following elements must be added to the calculation:

- the excess of the non-taxable portion of capital gains over non-deductible capital losses for the period
- the non-taxable portion of the gain arising from the disposition of an ECP during the period

The income earned or realized after 1971 by a corporation, as defined in the preceding paragraphs, is then allocated among the shares issued.

Where there is a group of corporations, the income earned or realized after 1971 may be computed on a consolidated basis.

Rollover

Where a corporation acquires a share on a rollover under section 85, the share retains its portion, accrued prior to the rollover, of income earned and realized after 1971. This transfer of income earned and realized after 1971 is allowed because the potential gain of the transferor becomes that of the transferee. Worthwhile tax planning can be done under this rule. Such planning is presented in Example 4-15.

EXAMPLE 4-15

Returning to Example 4-11, assume that Jules has personally held the shares of Enterprise Ltd. since its incorporation and that the retained earnings are equal to the income earned or realized after 1971 on the shares that he holds, namely, $849,000.

If, immediately before the sale of the shares to Moore Holding Ltd., Jules transfers his Enterprise Ltd. shares to Bergeron Holding Ltd. using the rollover rules in section 85, the income earned and realized after 1971 on the shares of Enterprise Ltd. now held by Bergeron Holding Ltd. will be $849,000. The transactions covered in Examples 4-10 and 4-11 can then be made in order to defer immediate taxation on part of the capital gain that would otherwise be realized on the sale of the shares.

Exceptions to subsection 55(2)

Transactions between related persons

Under paragraph 55(3)(a), subsection 55(2) does not apply to a dividend received as part of certain transactions between related parties. *For the purposes of section 55 only*, paragraph 55(5)(e) provides that brothers and sisters are not related. This means that subsection 55(2) applies to transactions between brothers and sisters. Furthermore, persons are unrelated for the purposes of section 55 if the relationship between them exists only owing to the application of paragraph 251(5)(b).

More specifically, subsection 55(2) applies to a dividend received as part of a transaction or event or a series of transactions or events when one of the following occurs:

i) There is a disposition of property to a person or partnership who was unrelated to the dividend recipient, other than a disposition of
   - money for the payment of dividends or the reduction of the PUC of shares
   - property for POD that are not less than its FMV at the time of disposition

   Example 4-16 (following) illustrates a transaction that may be covered by this criterion.

ii) There is a significant increase in the total direct interest in any corporation of one or more persons or partnerships who were unrelated to the dividend recipient, unless the increase resulted from a disposition of shares of a corporation for POD that are not less than the FMV of those shares at the time of the increase.

   The following is an example of a transaction that may be covered by this criterion. Alpha Ltd. and Beta Ltd., two unrelated corporations, each own 50% of the shares of Operator Ltd. Alpha Ltd. wants to divest itself of the shares of Operator Ltd., and have Operator Ltd. redeem the shares held by Alpha Ltd. at their FMV. The redemption results in a deemed dividend under subsection 84(3) for Alpha Ltd. This deemed dividend reduces the POD of the shares of Operator Ltd. disposed of by Alpha Ltd. As a result of this transaction, the direct interest of Beta Ltd. in Operator Ltd. increases to 100%. Since Beta Ltd. is not related to Alpha Ltd., which received the deemed dividend, and since the POD of the shares for Alpha Ltd. are less than their FMV, the deemed dividend received by Alpha Ltd. is subject to the provisions of subsection 55(2).

iii) There is a disposition to a person or partnership who was unrelated to the dividend recipient, of shares of the corporation that paid the dividend (the dividend payer) or property, (other than shares of the capital stock of the dividend recipient), of which more than 10% of the FMV was at any time during the series derived from shares of the dividend payer.

   Example 4-11 illustrates this criterion. Bergeron Holding Ltd., which received a dividend from Enterprise Ltd., disposed of the shares of Enterprise Ltd. to Moore Holding Ltd., a corporation not related to it.

iv) After the time the dividend was received, there is a disposition to a person or partnership unrelated to the dividend recipient, of shares of the dividend recipient or property more than 10% of the FMV of which was at any time during the series derived from shares of the dividend recipient.

   Following is an example of a transaction covered by this criterion. Holdco Ltd., holds 100% of the shares of Opco Ltd., which owns some property that it wants to dispose of and other property that it wants to keep. Opco Ltd. transfers the property that it wants to keep to Opco 2, another subsidiary of Holdco Ltd., using the provisions of subsection 85(1) to avoid any tax consequences at the time of the transfer. Preferred shares with a low PUC are issued by Opco 2 to Opco Ltd. on the transfer. These preferred shares are then redeemed for cash, resulting in a deemed dividend under subsection 84(3). The shares of Opco Ltd. are then sold to an unrelated person at their FMV, including the money received from Opco 2. The deemed dividend resulting from the redemption of the preferred shares of Opco 2 is subject to the provisions of subsection 55(2).

v) There is a significant increase in the total of all direct interests in the dividend payer of one or more persons or partnerships who were unrelated to the dividend recipient.

Again, Example 4-11 illustrates this criterion. The share redemption in (ii) also falls under this criterion.

As you can see, the same transaction or the same series of transactions can fall within more than one of the situations described in paragraph 55(3)(a). This is the case of the transaction illustrated in Example 4-11. However, a transaction or a series of transactions only has to come under one of the situations for subsection 55(2) to apply.

In short, in order for subsection 55(2) to apply, the transactions must involve persons who are not related. Subsection 55(2) does not seek to prevent or restrict family transactions or corporate reorganizations involving corporations in a related group. It should be kept in mind that for the purposes of subsection 55(2), transactions between brothers and sisters are deemed to be carried out between persons who are not related.

Example 4-16 shows how the same transaction may or may not be subject to the provisions of subsection 55(2), depending on whether the persons involved are dealing at arm's length or not.

EXAMPLE 4-16

Latex Ltd. owns land (capital property) having an FMV of $100,000 and an ACB of $25,000. Jute Ltd. wishes to acquire the land from Latex Ltd. Latex Ltd. and Jute Ltd. are corporations resident in Canada.

This transaction is proposed:

1. Latex Ltd. transfers the land in a tax-free transfer to Jute Ltd. using the provisions of subsection 85(1).

   In exchange, Latex Ltd. receives voting preferred shares of Jute Ltd., having a PUC of $25,000 and a redemption value of $100,000. The preferred shares are voting, such that Jute Ltd. is connected to Latex Ltd. under subsection 186(4).

   The agreed amount on the rollover is $25,000, thereby avoiding any tax consequences for Latex Ltd. on the transfer.

2. Subsequently, Jute Ltd. redeems the preferred shares held by Latex Ltd. for $100,000.

Assume the following three unrelated situations:

a. Lily is not related to Guy.
b. Lily is Guy's daughter.
c. Lily is Guy's sister.

Tax consequences

1. For Jute Ltd.:

ACB of the land equal to the agreed amount on the rollover [85(1)(a)]	$ 25,000

2. For Latex Ltd.:

Before subsection 55(2) is applied

Dividend on the redemption [84(3)]

Amount paid	$100,000
PUC	(25,000)
Deemed dividend	$ 75,000

Since this is an inter-corporate dividend, it is deductible from the income of Latex Ltd. under subsection 112(1) and is therefore not subject to Part I tax. If Jute Ltd. does not have any RDTOH, the dividend is not subject to Part IV tax because Jute Ltd. and Latex Ltd. are connected within the meaning of subsection 186(4).

Capital gain

POD [54]	
Amount paid	$100,000
Deemed dividend [84(3)]	(75,000)
	25,000
ACB	(25,000)
Capital gain	$ —

Application of subsection 55(2)

a. If Lily is not related to Guy:

Subsection 55(2) applies because the exception in paragraph 55(3)(a) regarding transactions between related parties does not apply and the conditions set out in subsection 55(2) are met:

- A taxable dividend was received by Latex Ltd., a corporation resident in Canada.
- Under subsection 112(1), the dividend received by Latex Ltd. is deductible from income.
- The dividend was received as part of a series of transactions or events of which one of the *results* [result rather than purpose since the dividend is a deemed dividend under subsection 84(3)] was to reduce the capital gain that would otherwise have been realized on the disposition of the preferred shares.
- The capital gain on the preferred shares is attributable to something other than income earned or realized after 1971; it is attributable to the unrealized increase in the value of the land.

This series of transactions is clearly covered by subparagraph 55(3)(a)(i). Thus:

- the dividend of $75,000 is deemed not to be a dividend received by Latex Ltd. [55(2)(a)]

and

- the POD of the redeemed shares are increased by the amount of the dividend of $75,000 [55(2)(b) and 54] resulting in:

Capital gain

POD [54]		
Amount paid	$100,000	
Dividend under 84(3) which is not subject to 55(2)	—	$100,000
ACB		(25,000)
Capital gain		$ 75,000
Taxable capital gain (1/2)		$ 37,500

No income earned or realized after 1971 is attributable to the preferred shares acquired on the rollover since the increase in value is entirely attributable to the accrued gain on the land transferred. Consequently, an election under paragraph 55(5)(f) cannot be made.

b. If Lily is Guy's daughter:

Subsection 55(2) does not apply because, in this case, the paragraph 55(3)(a) exception applies, since Lily and Guy are related persons. Therefore, the proposed transaction may be advantageous.

c. If Lily is Guy's sister:

Subsection 55(2) applies because, under paragraph 55(5)(e), brothers and sisters are deemed not to be related for purposes of subsection 55(2). See item (a) above for the tax consequences.

Subsection 55(4) was introduced to prevent taxpayers from structuring transactions to make them related to each other for the purpose of avoiding subsection 55(2). Under this subsection, where it may reasonably be considered that the principal purpose of one or more transactions or events was to cause two or more persons to be related or to cause one corporation to control another so as to make subsection 55(2) inapplicable, for the purposes of section 55, those persons are deemed not to be related or the corporation is deemed not to control the other corporation, as the case may be.

Butterfly transactions

Another exception is contained in paragraph 55(3)(b). It applies to what are known as "butterfly" transactions. These transactions are highly complex and are generally carried out after obtaining an advance ruling from CRA. The study of this exception is beyond the scope of this course. You need only know that its purpose is to allow the tax-free distribution of a corporation's assets among the shareholders providing the shareholders the opportunity to return to a situation comparable to their initial situation. Consequently, each shareholder who indirectly owned a proportionate share in the corporation's assets must receive a proportionate share of each type of the corporation's assets.