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by Steve Suarez

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Special Reports

Canada's Tax Cost Step-Up: What Foreign Purchasers Should Know

by Steve Suarez

This article discusses the step-up, or "bump," in the cost of property under paragraph 88(1)(d) of the Income Tax Act (Canada). Commonly known as the "88(1)(d) bump," this step-up in cost is a powerful tax planning tool under the appropriate circumstances because it reduces or eliminates accrued gains that would otherwise be taxed on disposition. It is particularly relevant to foreign purchasers of Canadian corporations, although for them typically in acquisitions paid in cash rather than shares or debt of the foreign purchaser. A review of the circumstances under which the 88(1)(d) bump is available is best done at a conceptual level because the relevant provisions are complex. Although a technically precise analysis of those rules is beyond the scope of this article, an understanding of the basic parameters of the 88(1)(d) bump can be developed by examining the intent behind the provision, its most common applications, and its major limitations.

Overview of the 88(1)(d) Bump

A basic feature of most tax systems is the concept of gains. When a property is acquired, the amount paid by the taxpayer is recorded as the property's cost for tax purposes (tax cost), which may not be the same as its cost for accounting purposes. When the property is disposed of, whatever sale proceeds the taxpayer receives, or is deemed to receive, are typically measured against the property's tax cost for the purpose of determining whether the taxpayer has realized a gain or a loss. The benefit of the 88(1)(d) bump is to increase the tax cost of property and thus reduce or eliminate the amount of any gain on a future disposition of that property.

The 88(1)(d) bump is available only when one taxable Canadian corporation (the parent) owns all the shares of another corporation (the subsidiary), and the subsidiary winds up or merges into the parent and ceases to exist as a separate entity. In either case, the event is referred to as the wind-up. When this occurs, the general rule in the ITA is that the parent acquires all of the subsidiary's property at whatever tax cost the subsidiary had in that property and without any gain or loss realized on the wind-up.[1] The parent is said to "step into the shoes" of the subsidiary, inheriting any accrued gains or losses. When applicable, however, the 88(1)(d) bump allows the parent to increase the tax cost of some property acquired from the subsidiary on the wind-up. This opportunity arises when the parent's tax cost of its shares in the subsidiary (the outside basis) is greater than the subsidiary's aggregate tax cost in all its property (inside basis). The parent's outside

[1]Subsection 88(1). These rules also provide that the parent's shares in the subsidiary usually disappear without any gain or loss realized.

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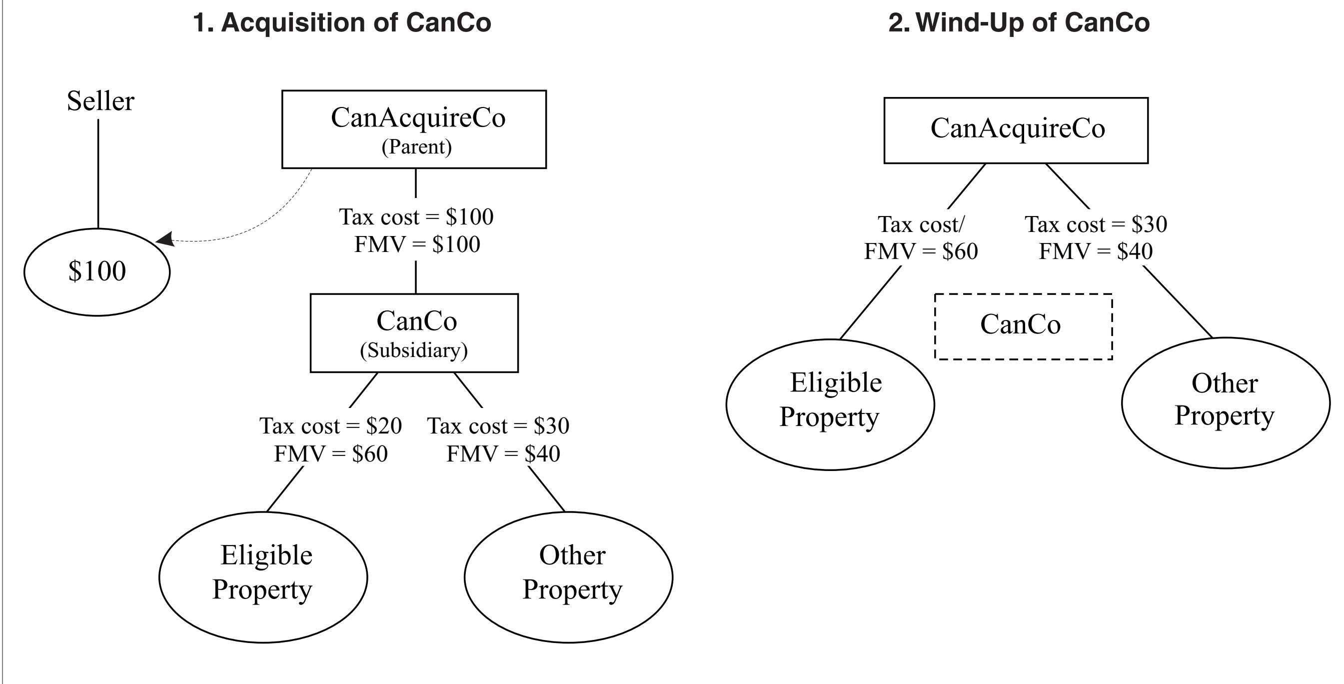

basis is eliminated when its subsidiary shares are canceled on the wind-up. If the outside basis exceeds the subsidiary's inside basis normally inherited by the parent, the parent will be disadvantaged in terms of losing tax cost.[2] The 88(1)(d) bump effectively permits the parent to apply some of its excess outside basis to increase the tax cost of the subsidiary assets acquired on the wind-up.

Figure 1 illustrates the basic result of the 88(1)(d) bump. A Canadian corporation (CanAcquireCo) purchases all of the shares of another Canadian corporation (CanCo) from an unrelated third party for $100, which represents CanAcquireCo's tax cost of its CanCo shares. CanCo owns property eligible for the 88(1)(d) bump (eligible property), as well as other property that is not eligible for the step-up. Immediately before the acquisition, CanCo's eligible property has a fair market value of $60 and a tax cost of $20, for an accrued gain of $40. Following the acquisition, CanAcquireCo winds up CanCo, acquiring its property. Ordinarily, CanAcquireCo's $100 tax cost would disappear on the wind-up and its tax cost of the acquired property would be the same as CanCo's tax cost ($20 and $30, respectively). Subject to various limitations, the 88(1)(d) bump allows CanAcquireCo to increase its tax cost of the eligible property up to an amount not exceeding its FMV ($60), reducing or eliminating the accrued gain.

Applications of the 88(1)(d) Bump

The benefit of increased tax cost in property eligible for the 88(1)(d) bump is realized only when the property is disposed of, reducing any realized gain. Consequently, the advantage of the 88(1)(d) bump depends on the facts of each situation and the intentions of each taxpayer as to when it plans to dispose of the property. There are various circumstances in which the increased tax cost offered by the 88(1)(d) bump is of significant value.

Sale to Third Party

CanAcquireCo may, for any number of reasons, intend to sell some of CanCo's eligible property to a third party as quickly as possible following its acquisition of the CanCo shares. It may not want to keep all of CanCo's eligible property if it views some of the property as being noncore assets or outside the scope of management's ability to effectively

[2]There are various reasons why the parent may wish to merge with the subsidiary, including to consolidate the parent's expenses (for example, interest and other financing charges) with the subsidiary's income for tax purposes. Canada does not have a group relief or consolidation tax system.

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administer. More simply, CanAcquireCo may need to sell some of CanCo's property to finance the purchase of CanCo.[3] It is also common for acquirers to find that antitrust laws require them to divest some of the property owned by a corporation they acquired. In those circumstances, the 88(1)(d) bump will be of immediate benefit.

Internal Reorganization

Even when no third-party disposition is planned, the 88(1)(d) bump may be of immediate benefit. In cross-border takeover bids, it is common for Canadian target corporations to have foreign subsidiaries in other countries. In many cases, it is not tax-efficient for a foreign acquirer to hold those foreign subsidiaries through a Canadian entity, particularly when some of the Canadian entity's foreign subsidiaries are in the same country as the foreign acquirer or the foreign acquirer's own subsidiaries.

If CanCo owns shares of foreign affiliates with significant accrued gains, the 88(1)(d) bump is useful to eliminate those gains for Canadian tax purposes, allowing those shares to be distributed out of Canada to the foreign acquirer without realizing any capital gains in Canada. Consider, for example, the fact pattern in Figure 2, in which the foreign acquirer (US Parent) has created CanAcquireCo and funded it with $100 to purchase all of the shares of CanCo.[4] Following the wind-up of CanCo, CanAcquireCo can use the 88(1)(d) bump to increase the tax cost of CanCo's U.S. subsidiary (US SubCo) up to FMV, eliminating the accrued gain as demonstrated in Figure 1. CanAcquireCo can then distribute the US SubCo shares to US Parent by effecting a return of capital for Canadian corporate law purposes. As long as the amount of the distribution ($60) does not exceed the tax cost and the paid-up capital (PUC)[5] of US Parent's shares of CanAcquireCo ($100), no capital gain or dividend arises for Canadian tax purposes and the amount of the distribution reduces these tax attributes (to $40).

There are other potential applications of the 88(1)(d) bump that are beyond the scope of this discussion, but the foregoing examples illustrate the potential of this provision.

Qualifications and Restrictions

While the 88(1)(d) bump rules are complex and technical, at a conceptual level, they can be broken down into four requirements:

1. *Qualifying Wind-Up or Amalgamation*. The 88(1)(d) bump arises only on a wind-up or amalgamation of one taxable Canadian corporation into another that meets certain requirements.

2. *Calculation of Maximum Step-Up*. There are limits on the amount the tax cost of any eligible property can be increased and on the overall increase in the tax cost of all the subsidiary's properties.

3. *Determination of Eligible Property*. Not all property is eligible for the 88(1)(d) bump; there are rules governing which items are eligible properties.

4. *Compliance With Denial Rule*. There is an overarching "bump denial" rule that, if contravened, eliminates any 88(1)(d) bump for all property. This requirement is technical and complex and can deny an 88(1)(d) bump in circumstances for which there is no clear tax policy basis for doing so. This rule generally prevents foreign acquirers from accessing the 88(1)(d) bump in most takeovers unless substantially all of the consideration is cash.

The balance of this article will review those four requirements, but it is useful to review a few core concepts that recur in the discussion of the 88(1)(d) bump rules.

Related Persons

An important element of the 88(1)(d) bump is the concept of related persons. A natural person is related to his or her spouse and blood relatives (children, parents, and siblings). A corporation is related to a shareholder who controls it and to any person related to that controlling shareholder. Two corporations are related if one controls the other, if both are controlled by the same person, or if each is controlled by a person or group of persons that is related to the other's controlling shareholder or group of shareholders.[6] "Control" means ownership of enough shares to elect a majority of the corporation's board of directors. In most cases, that means

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[3]A recent example of this is the 2005 agreement between Barrick Gold Corp. and Goldcorp Inc., in which Barrick's takeover bid for Placer Dome Inc. was based on Barrick's selling to Goldcorp over $1 billion of property owned by Placer and acquired by Barrick following the successful completion of the takeover in early 2006.

[4]Foreign purchasers of Canadian corporations usually structure acquisitions through a Canadian purchaser corporation for a variety of tax and nontax reasons, including the 88(1)(d) bump.

[5]PUC represents amounts received by a corporation on the issuance of its shares, and it is essentially the tax version of the corporate law concept of share capital. In this example, in which US Parent delivers $100 to CanAcquireCo in exchange for CanAcquireCo shares to fund its purchase of CanCo shares, the tax cost and the PUC of the CanAcquireCo shares issued will be $100. Unlike in many other countries, including the United States, a distribution made by CanAcquireCo as a return of capital on its shares will not be treated as a dividend as long as it does not exceed the PUC of those shares. In Canada there is no concept of distributions being deemed to come first out of earnings and profits.

[6]Subsection 251(2).

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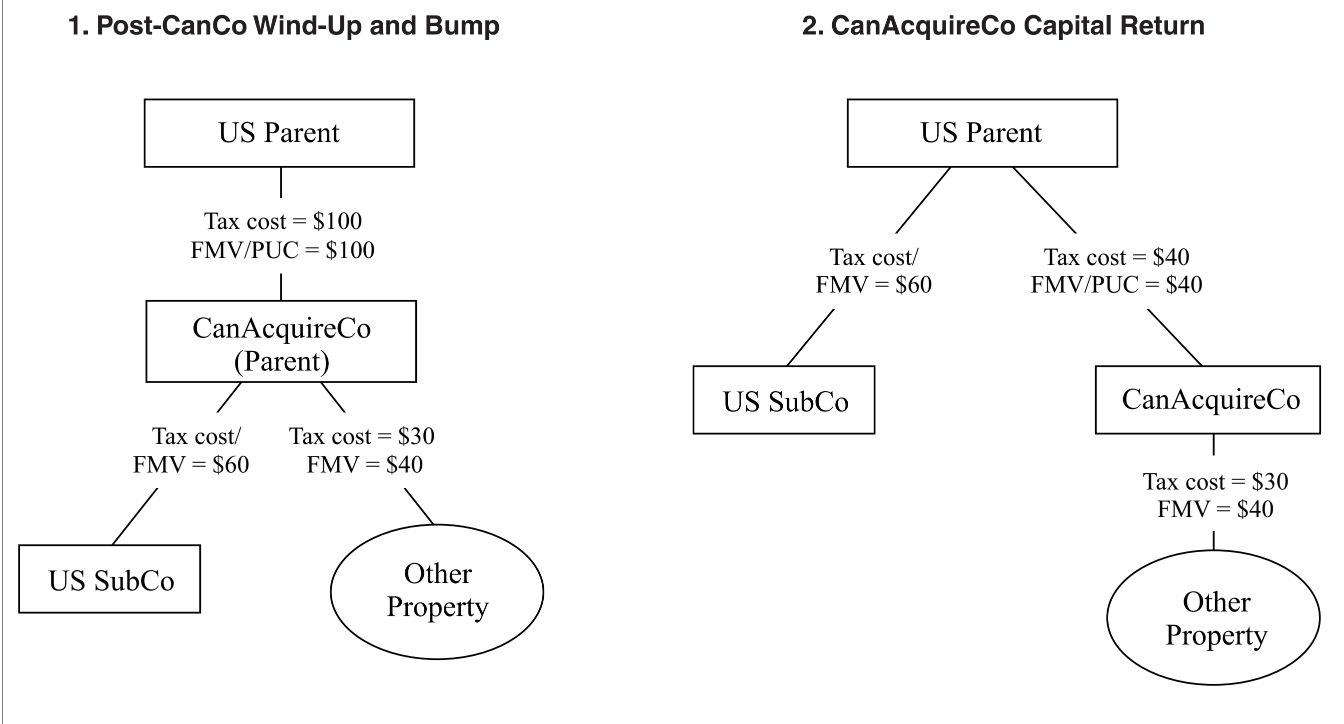

shares that command a majority of the votes attributable to all of the corporation's shares. The test is one of *de jure* or legal control, rather than de facto control. In certain cases, for purposes of determining whether persons are related, control is determined not only with reference to shares owned but also to any rights a person may have to acquire shares or control how they are voted (251(5)(b) rights).[7]

Non-Arm's-Length Persons

Another key concept is that of persons not dealing at arm's length. If two persons are related (see above), they are deemed to be non-arm's length (NAL). If they are not related, it is a factual question whether they deal at arm's length.[8] Unrelated persons can be considered NAL if one exercises sufficient control or influence over the other, or if both are subject to common control such that they are acting in concert or cannot be considered to have separate interests. An example of how unrelated persons could be considered to be NAL might be a 40 percent shareholder of a public corporation who has de facto control, but not legal control, of the corporation because the other 60 percent is widely held, meaning the 40 percent shareholder will usually be able to control selection of the directors.

Acquisition of Control

Various aspects of the 88(1)(d) bump rules are premised on the time of the parent's acquisition of control (AOC) of the subsidiary. For these purposes, a person is generally considered to acquire control of a corporation when it obtains enough shares to elect a majority of the board of directors. A special provision in the 88(1)(d) bump rules states that if the parent acquires control of the subsidiary from another person that is NAL with the parent, then the parent is deemed to have acquired control when the NAL person acquired control of the subsidiary.[9]

Series of Transactions

A number of the 88(1)(d) bump rules make reference to the "series of transactions" that includes the

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[7]Para. 251(5)(b).

[8]Subsection 251(1). The arm's-length concept was discussed recently by Stacey Long, "Canadian Courts Consider Arm's-Length Dealings," *Tax Notes Int'l*, Sept. 18, 2006, p. 987.

[9]Para. 88(1)(d.2). This deeming rule can affect a number of relevant rules (see, for example, the discussion associated with note 22).

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parent's acquisition of control of the subsidiary (the AOC series). While the degree of connection necessary to make two events part of the same series of transactions is unclear, some of the limited jurisprudence to date has interpreted the term rather broadly, as has the Canada Revenue Agency.

The determination of what constitutes a series of transactions involves the common-law definition of the term "series," which has been held to mean transactions that are "preordained in order to produce a given result" with "no practical likelihood that the pre-planned events would not take place in the order ordained."[10] Subsection 248(10) extends the term to include transactions completed in contemplation of the common-law series. The jurisprudence has taken a fairly expansive view of what constitutes a series of transactions. Simply because a transaction would have occurred whether or not other transactions occurred appears insufficient to conclude that the transactions are not part of a series. However, when two transactions are unconnected in the sense of neither affecting the decision to undertake the other or the objectives of the other, it seems unlikely a court would conclude they form part of the same series.

Qualifying Wind-Up or Amalgamation

As noted earlier, the 88(1)(d) bump is available only on the wind-up or amalgamation of one taxable Canadian corporation into another, such that the latter no longer exists as a separate entity. A wind-up is the voluntary dissolution of a corporation, with its property distributed to its shareholders. An amalgamation is the merger of two corporations to form a single entity that is a continuation of both predecessors. A qualifying amalgamation for 88(1)(d) bump purposes requires that the parent acquire all of the property and assume all of the liabilities of the subsidiary, other than any shares of one owned by the other or liabilities owed by one to the other.[11] Amalgamations are generally faster and easier to carry out than wind-ups.

In either case, the parent must own all of the shares of the subsidiary immediately before that time.[12] As mentioned, a wind-up or amalgamation that meets those basic requirements is, for the purposes of this discussion, referred to as the wind-up.

Calculation of Maximum Step-Up

While the simple example in Figure 1 is useful as a general illustration of what the 88(1)(d) bump can achieve, the quantitative limits on the amount of the step-up are more complex than described. There are two relevant limitations on the amount of any 88(1)(d) bump for any given wind-up: a limit on the amount that the tax cost of any particular eligible property may be increased, and an overall limit on the amount the parent can increase the tax cost for all eligible properties.

The per-property limit on any eligible property is simple to calculate: Its tax cost cannot be increased to an amount in excess of the property's FMV at the time of the AOC.[13] Returning to Figure 1, CanAcquireCo cannot increase the tax cost of CanCo's eligible property to an amount in excess of $60, so the 88(1)(d) bump is limited to $40. This result holds, even though CanAcquireCo's total stepped-up tax cost in the acquired property ($90) may be less than the tax cost of the shares that disappeared on the wind-up ($100). The difference ($10) is lost.

Because the per-property limit is based on the FMV at the time of the AOC, it is usually advantageous for the parent to effect the wind-up soon after the AOC to minimize the risk of intervening FMV increases. Going back to Figure 1 again, if CanAcquireCo winds up CanCo immediately, then it will be in a position to transfer eligible property (either within the group or to a third party) without any gains being realized since the FMV will not exceed its tax cost. However, if CanAcquireCo were to wait a year before effecting the wind-up, and during that year the eligible property FMV increased to $70, the 88(1)(d) bump could not increase its tax cost to more than $60, being the FMV at the time of the AOC a year earlier. CanAcquireCo would be left with an accrued gain of $10 on the eligible property and would not be able to transfer it freely without realizing that accrued gain. In most cases, maximum flexibility is achieved by causing the wind-up to occur as soon as possible following the AOC.

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[10] *OSFC Holdings Ltd. v. The Queen*, 2001 DTC 5471 (FCA). This formulation was recently endorsed by the Supreme Court of Canada in *Canada Trustco Mortgage v. Canada*, 2005 SCC 54 (SCC).

[11] Subsections 87(11) and (1).

[12] For a wind-up (but not an amalgamation), the test is that the parent own at least 90 percent of the outstanding shares of each class of the subsidiary's shares, with any other shares being owned by persons dealing at arm's length with the parent (subsection 88(1)). Practically speaking, qualifying (Footnote continued in next column.) wind-ups are almost always done in situations in which the parent owns all of the shares of the subsidiary.

[13] Subpara. 88(1)(d)(ii). More precisely, the amount of the 88(1)(d) bump cannot exceed the excess of the property's FMV at the time of the AOC over the subsidiary's tax cost of the property at the time of the wind-up.

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The overall limit on the 88(1)(d) bump is described as follows:[14]

	Parent's tax cost of Subsidiary shares immediately before the Wind-up
less	Net tax cost of Subsidiary's assets immediately before the Wind-up
and less	Tax-free dividends paid by Subsidiary to Parent or an NAL corporation

The first element of the formula (the parent's tax cost) corresponds to the $100 in Figure 1 that CanAcquireCo pays for the CanCo shares. The point is that the higher the parent's tax cost of the subsidiary shares, the greater the potential 88(1)(d) bump. In structuring takeovers, an acquirer offering tax deferral opportunities to target shareholders (that is, qualifying share-for-share exchanges that defer gains on target shares)[15] must consider the lower tax cost of target shares and reduced 88(1)(d) bump potential.

The second element of the formula (net tax cost) is essentially the tax cost of all of the subsidiary's assets less all of its liabilities and certain reserves taken for tax purposes immediately before the wind-up.[16] The third element of the formula (tax-free dividends)[17] supports the second element by ensuring that dividends, which have the effect of reducing the net tax cost of the subsidiary's assets, cannot be used to artificially increase the overall 88(1)(d) bump limit.

Returning to the simplified example in Figure 1, the overall 88(1)(d) bump limit would be $50 ($100 tax cost of CanCo shares less $50 pre-wind-up tax cost of CanCo assets), assuming CanCo had no debts and had paid no dividends to CanAcquireCo. Since there is only $40 of accrued gains on eligible property, $10 of the available 88(1)(d) bump amount ($50) goes unused. CanAcquireCo may choose how to allocate the bump amount among the eligible properties in its tax return for the tax year that includes the wind-up.

Determination of Eligible Property

It is important in any wind-up to identify which properties are eligible for the 88(1)(d) bump. There are a number of rules governing what constitutes eligible property.

Nondepreciable Capital Property

Canadian tax law distinguishes between capital property and all other property. While the determination is highly judgmental, in general terms, capital property is acquired for the purpose of producing income from holding or use (production equipment), as opposed to property held for resale (inventory). The concept of capital property is similar but not identical to the accounting principle of a capital asset. The most common forms of capital property include land, buildings, and machinery and equipment, as well as investment securities (corporate shares or interests in a partnership or trust).[18] Note that the eligibility requirement is that the property be capital property to the *subsidiary*; that the parent may intend to sell it is irrelevant.

Some kinds of capital property are eligible for an annual deduction for income for tax purposes corresponding to the accounting concept of depreciation — that is, tax cost is deducted from income over a period of years. Such depreciable property, which includes most buildings and machinery and equipment, is not eligible for the 88(1)(d) bump.[19] Only nondepreciable capital property can be eligible property. In most cases, this restricts eligible property to land, shares of corporations, and interests in partnerships or trusts.

Owned by Subsidiary and Held Until Wind-Up

Eligible property is limited to property directly owned by the subsidiary at the time of the AOC and held continuously thereafter until the time of the wind-up and distribution to the parent.[20] This

[14]Para. 88(1)(d).

[15]It is generally possible for a shareholder with, say, $60 of tax cost in shares of one Canadian corporation to exchange them for shares of a second Canadian corporation such that no gain is realized and the shareholder's tax cost of the shares of the second corporation and the second corporation's tax cost in the shares of the first corporation is $60. A similar rule dealing with the exchange of shares of a Canadian corporation for shares of a foreign corporation has been proposed but not enacted by the Department of Finance.

[16]If this element of the formula is negative (that is, liabilities exceed tax cost of assets), it is treated as nil. Because this amount (which reduces the overall bump limit) generally increases over time if the subsidiary is profitable, it represents a further reason why it is generally advisable to effect the wind-up quickly after the AOC.

[17]Generally, dividends paid by one Canadian corporation to another are fully deductible for Canadian income tax purposes. In determining whether a corporation deals NAL with the parent for this purpose, 251(5)(b) rights to acquire shares are not considered.

[18]The same property can be either capital or noncapital property depending on its use, for example, land acquired for the purpose of building a production facility, versus land acquired for the purpose of resale.

[19]Subpara. 88(1)(c)(iii). Since the subsidiary shares eliminated on the wind-up (the tax cost of which is effectively pushed down to eligible property under the 88(1)(d) bump) would not be eligible for tax depreciation, it is not unreasonable to limit eligible property to nondepreciable property.

[20]Para. 88(1)(c). The requirement that the subsidiary hold any eligible property continuously until the wind-up is another reason to try to minimize the amount of time between the AOC and the wind-up.

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means that one takes a snapshot of what property the subsidiary directly owns at the time of the AOC, and only that property can qualify.[21] There is no look-through or consolidation concept that allows property owned by another entity in which the subsidiary has an interest to become the subject of an 88(1)(d) bump. However, if property that would otherwise be eligible property is not directly owned by the subsidiary on the AOC and is instead located somewhere in the subsidiary's corporate group, it can be made eligible property in some cases. For example, before the AOC the subsidiary could change the property it owns directly. Following the AOC, it may also be possible to obtain an 88(1)(d) bump on property held down the corporate chain by effecting a series of sequential qualifying wind-ups and 88(1)(d) bumps.

This rule makes establishing the time of the AOC very important. As noted earlier, a special rule[22] provides that, when the parent acquired control of the subsidiary from someone dealing NAL with the parent, the AOC is deemed to have occurred at the earlier time the NAL person acquired control of the subsidiary. Deeming the AOC to have occurred at that earlier time can affect the determination of eligible property (the subsidiary is required to own the property at the earlier time) and the size of the possible 88(1)(d) bump, which is based on the FMV at the earlier time. This rule is meant to prevent the use of NAL transfers to manipulate the time of the AOC.

The requirement that eligible property be owned directly by the subsidiary at the time of the AOC means that the subsidiary has a significant ability to influence whether an 88(1)(d) bump will be available to the parent following the AOC and which properties would be eligible properties. Before the AOC, the subsidiary can change which properties it owns directly, sell or acquire properties, or take other steps to affect the parent's ability to claim an 88(1)(d) bump. It is often in the parent's interests to conclude an agreement with the subsidiary before the AOC to prevent the subsidiary from taking any actions impairing the 88(1)(d) bump, or to require the subsidiary to take reasonable actions to enhance the 88(1)(d) bump. If done correctly, this form of agreement can add significant value to the parent.

For public companies, corporate acquisitions in Canada are usually conducted through takeover bids governed by local securities laws. In a "friendly" transaction, the acquirer and target often conclude a merger agreement in which the former makes an offer with agreed terms, and the latter recommends the offer to its shareholders and conducts business in a specified manner until the offer date expires. Those agreements provide an opportunity to obtain the target's cooperation for maximizing the value of the 88(1)(d) bump.

> ***Establishing the time of the AOC is very important.***

It is not uncommon for a friendly acquirer to ask the target to "prepackage" property in a way that optimizes the 88(1)(d) bump. For example, if the acquirer proposes to dispose of some of the target's property (say, a particular division or business), including assets that cannot be eligible property (depreciable property), it may be useful for the target to transfer that property to a separate entity before the AOC. This leaves the target holding an interest in the new entity, rather than existing properties, at the time of the AOC. If that interest in the new entity is eligible property (as is usually the case), the acquirer can apply an 88(1)(d) bump to increase its tax cost of that interest when the target is wound up or amalgamated into the acquirer. This leaves the acquirer free to sell the interest in the new entity without any gain being realized.

This is illustrated in the example at Figure 3, in which CanCo has property with an accrued gain that is not eligible for the 88(1)(d) bump. Before the AOC, CanCo incorporates a new Canadian subsidiary (SubCo) and transfers the other property to SubCo on a tax-deferred basis in exchange for shares of SubCo.[23] If CanCo holds the SubCo shares as capital property, in most cases they would be eligible property.[24] On the wind-up, CanAcquireCo would be able to apply an 88(1)(d) bump to increase the tax cost of the SubCo shares up to their FMV ($40), permitting it to dispose of them freely. In effect, CanCo has prepackaged its property to change what it holds directly from noneligible property into eligible property (the SubCo shares). CanAcquireCo can dispose of the SubCo shares, whether

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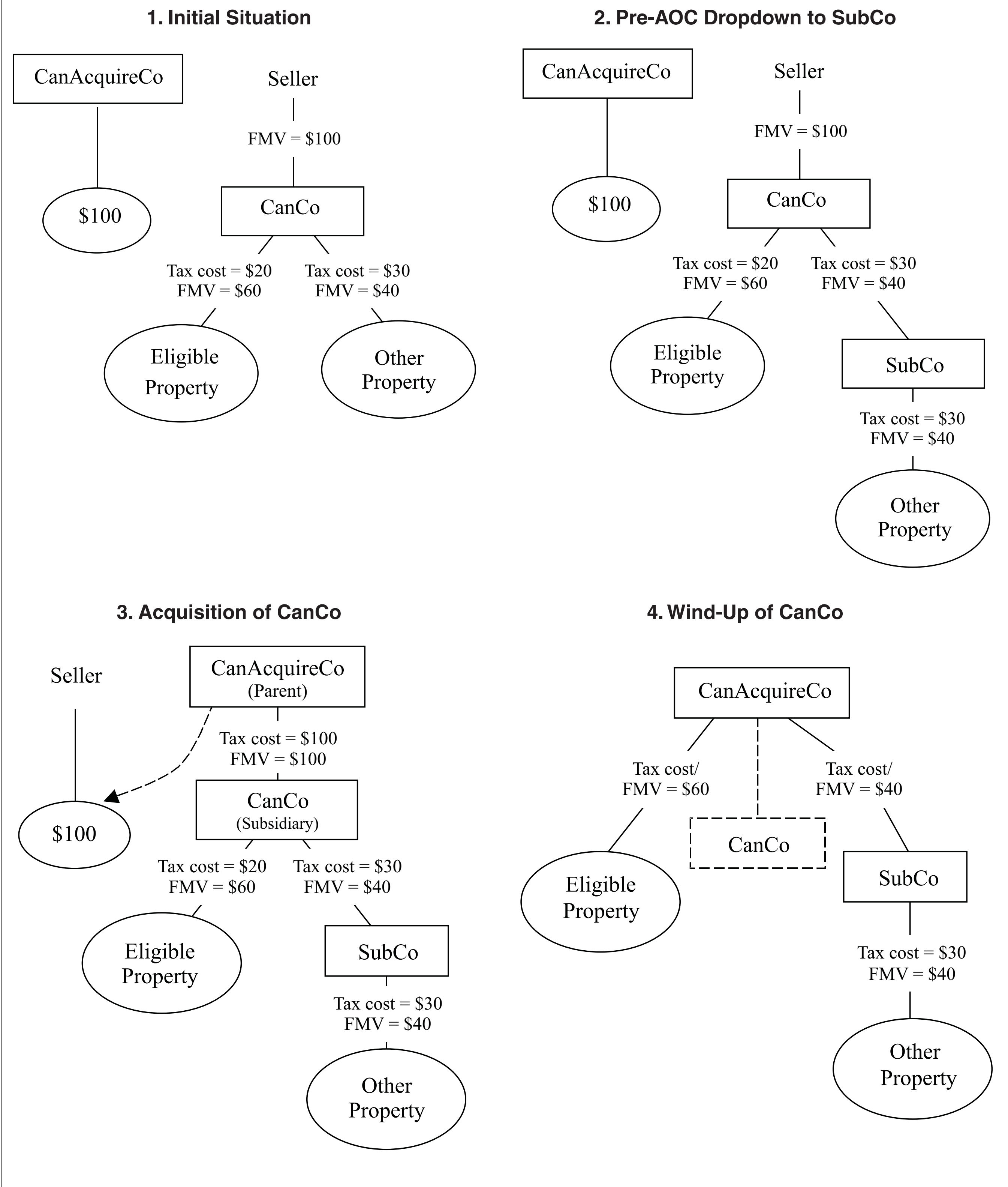
[21]When the subsidiary amalgamates with another corporation following the AOC, a special rule — subsection 88(4) — provides that the amalgamation will not cause the resulting corporation to be considered a different entity from the subsidiary that would run afoul of the continuous ownership requirement.

[22]Para. 88(1)(d.2).

[23]This can generally be achieved under subsection 85(1).

[24]Shares of a wholly owned subsidiary are normally, but not always, considered to be capital property to the holder. The efficacy of any prepackaging transaction must be considered on its particular facts to ensure that all of the 88(1)(d) bump requirements are met, for example, that the parent and the subsidiary are dealing at arm's length at the time and that the property is capital property.



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to a third party or on an internal group reorganization, without realizing any gain.

While there are several different ways a target's cooperation can enhance an 88(1)(d) bump, this simple example illustrates the basic principle.

Not Acquired as Part of AOC Series

Another rule is meant to prevent the parent from transferring property with accrued gains to a subsidiary before the AOC and eliminating those gains on the wind-up through the 88(1)(d) bump. This rule disqualifies any property that is acquired by the subsidiary both from the parent, or a person dealing NAL with the parent, and as part of the AOC series. That property, as well as any property acquired by the subsidiary in substitution for such property (an issue discussed below), is excluded from being eligible property.[25]

Not Transferred on Butterfly Reorganization

A "butterfly" reorganization is a particular form of divisive reorganization under Canadian income tax law. It allows properties held in one Canadian corporation to be divided between two or more Canadian corporations with the same shareholders as the existing corporation, without gains being realized at the corporate or shareholder levels. Property transferred to the parent as part of a distribution made on a butterfly reorganization will not qualify as eligible property.[26]

Summary

The scope of eligible property can be summarized as property distributed to the parent on the wind-up that is:

- nondepreciable capital property;
- owned directly by the subsidiary at the time of the AOC and held continuously thereafter until the wind-up;
- not acquired by the subsidiary from the parent (or a person dealing NAL with the parent) as part of the AOC series, or property acquired in substitution for such property; and
- not distributed as part of a butterfly reorganization.

The Denial Rule

Looming over any analysis of whether the 88(1)(d) bump is available for a particular wind-up is the bump denial rule.[27] If this rule is contravened for a single property, even of minimal value, no 88(1)(d) bump can be claimed for *any* property distributed on that wind-up. The bump denial rule is a harsh provision, more so than it needs to be to achieve its tax policy objective. Its severity is exacerbated by its extreme complexity, such that even the most experienced practitioners can easily overlook something that invokes this rule. Moreover, technical anomalies exist in the legislation that deny the 88(1)(d) bump in situations in which there is no evident tax policy reason for doing so.

> ***The bump denial rule is a harsh provision, more so than it needs to be to achieve its tax policy objective.***

The policy behind the bump denial rule is deceptively simple: The parent should not be able to buy the shares of the subsidiary, wind the subsidiary up and claim an 88(1)(d) bump on its property, and then sell some of that property back to the former subsidiary shareholders. Put very generally, allowing this would be inconsistent with Canada's rules governing divisive reorganizations of Canadian corporations. Such a transaction, if permitted, may involve a realization of gains (if any) at the level of the subsidiary's shareholders — that is, on the sale of the subsidiary to the parent — but not an appropriate realization of the accrued gains on the subsidiary's property, since the wind-up is tax-deferred and the 88(1)(d) bump increases the cost of some or all of the subsidiary's property.

The problem is that the bump denial rule is not phrased in such simple terms. The rule can be paraphrased as denying an 88(1)(d) bump on *all* property distributed on a wind-up if, either before or after the AOC, *a prohibited person acquires prohibited property as part of the AOC series*. At a conceptual level:

- *prohibited persons* are shareholders of the subsidiary before the parent's acquisition of control of the subsidiary; and
- *prohibited property* is property distributed to the parent on the wind-up.

The basic thrust of the bump denial rule is that property distributed to the parent on the wind-up (distributed property) should not be acquired as part of the AOC series by persons who were significant subsidiary shareholders before the parent acquired control of the subsidiary.

[25]Subpara. 88(1)(c)(v). For this purpose, 251(5)(b) rights to acquire shares are ignored in determining whether a person deals NAL with the parent.

[26]Subpara. 88(1)(c)(iv).

[27]Subpara. 88(1)(c)(vi).

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This bump denial rule is, unfortunately, more complex than this. The range of prohibited persons includes far more than just pre-AOC shareholders of the subsidiary, and prohibited property comprises much more than just distributed property. While the breadth of the rule may defeat avoidance schemes designed to circumvent the basic prohibition, it makes the bump denial rule very complex (even by tax standards) and can result in the 88(1)(d) bump being denied in situations for which it should be available. As a result, on any given transaction, one must consider the three key elements of the bump denial rule that *prohibited persons* not acquire *prohibited property* as part of *the AOC series*.

Prohibited Persons

The first step in the analysis is to identify those persons whose acquisition of property could trigger the bump denial rule. In all cases, the parent and anyone related to the parent (other than by virtue of 251(5)(b) rights) at the relevant time are deemed not to be prohibited persons, as is the subsidiary. While it is not possible to depict all prohibited persons, Figure 4 (as annotated by the discussion in footnotes 28-33) illustrates the wide range of persons who could be prohibited persons.

The concept is centered on persons who are specified shareholders of the subsidiary before the AOC and during the AOC series (a pre-AOC subsidiary specified shareholder). In simple terms, a specified shareholder of a corporation is a person who owns 10 percent or more of any class of the corporation's shares.[28] However, the definition is expanded as follows:

- Anyone dealing NAL with the actual owner of shares is also deemed to own those shares. It is thus possible to be a specified shareholder of a corporation while owning less than 10 percent of the corporation's shares (or without actually owning any shares) if NAL persons own sufficient shares of the corporation.[29]
- A person is deemed to be a specified shareholder of a particular corporation if that person meets the 10 percent share ownership (or deemed share ownership) threshold in that corporation, or in any other corporation that is both related to the first corporation and has a "significant direct or indirect interest" in the first corporation, that is, an "upstream" related corporation.[30]

While 10-plus percent shareholders form the starting point of the analysis, NAL persons and related corporations widen the scope of prohibited persons, particularly since 251(5)(b) rights (rights to acquire or control shares) are considered for this purpose, making it easier to be related to other people.

As broad as the range of pre-AOC subsidiary specified shareholders is, the prohibited person definition goes on still further to include the following persons:

1. any aggregation of persons whose collective share ownership, if aggregated in the hands of one person, would make that one notional person a pre-AOC specified shareholder;[31]
2. a corporation, other than the subsidiary, in which a pre-AOC specified shareholder is, at any time *after* the AOC and during the AOC series, a specified shareholder;[32] or
3. a corporation, other than the subsidiary, if:
   - persons described in point 1, above, acquired shares as part of the AOC series, and
   - those acquired shares would, if aggregated in the hands of one person, make that single notional person a specified shareholder of that corporation at any time *after* the AOC and during the AOC series.[33]

[28]For example, ControlCo and DCo in Figure 4 are pre-AOC subsidiary specified shareholders. Ownership of certain fixed-value nonvoting preferred shares is ignored for this purpose.

[29]*See*, for example, NAL Person 1 (who deals NAL with ControlCo), D, and SubCos 1, 2, and 3 in Figure 4. D is deemed to deal NAL with DCo by virtue of having legal control of DCo. SubCos 1, 2, and 3 are related to ControlCo (since ControlCo has legal control of the subsidiary, which controls the three of them), are thereby deemed to deal NAL with ControlCo, and are thus deemed to own ControlCo's subsidiary shares.

[30]"Specified shareholder" definition in subsection 248(1) and clause 88(1)(c.2)(iii)(A). See, for example, Investor and NAL Person 2 in Figure 4. Investor owns 10 percent of the shares of a corporation (ControlCo) that is related to the subsidiary (since ControlCo has legal control of the subsidiary) and has a significant direct or indirect interest in the subsidiary. NAL Person 2 (who deals NAL with Investor) is deemed to own Investor's shares and is thus in the same position as Investor.

[31]For example, see A, B, and C collectively in Figure 4 since their shareholdings would, if aggregated, make the holder a specified shareholder of the subsidiary by virtue of owning more than 10 percent of its shares. That means that, if A, B, and C *all* acquired any prohibited property as part of the AOC series, the bump denial rule would apply.

[32]*See*, for example, Corp. 1 in Figure 4, which is a corporation more than 10 percent of the shares of which are owned by a pre-AOC subsidiary specified shareholder (Investor) following the AOC.

[33]For example, any corporation of which A, B, and C collectively own 10 percent or more of the shares, if they acquired those shares as part of the AOC series.

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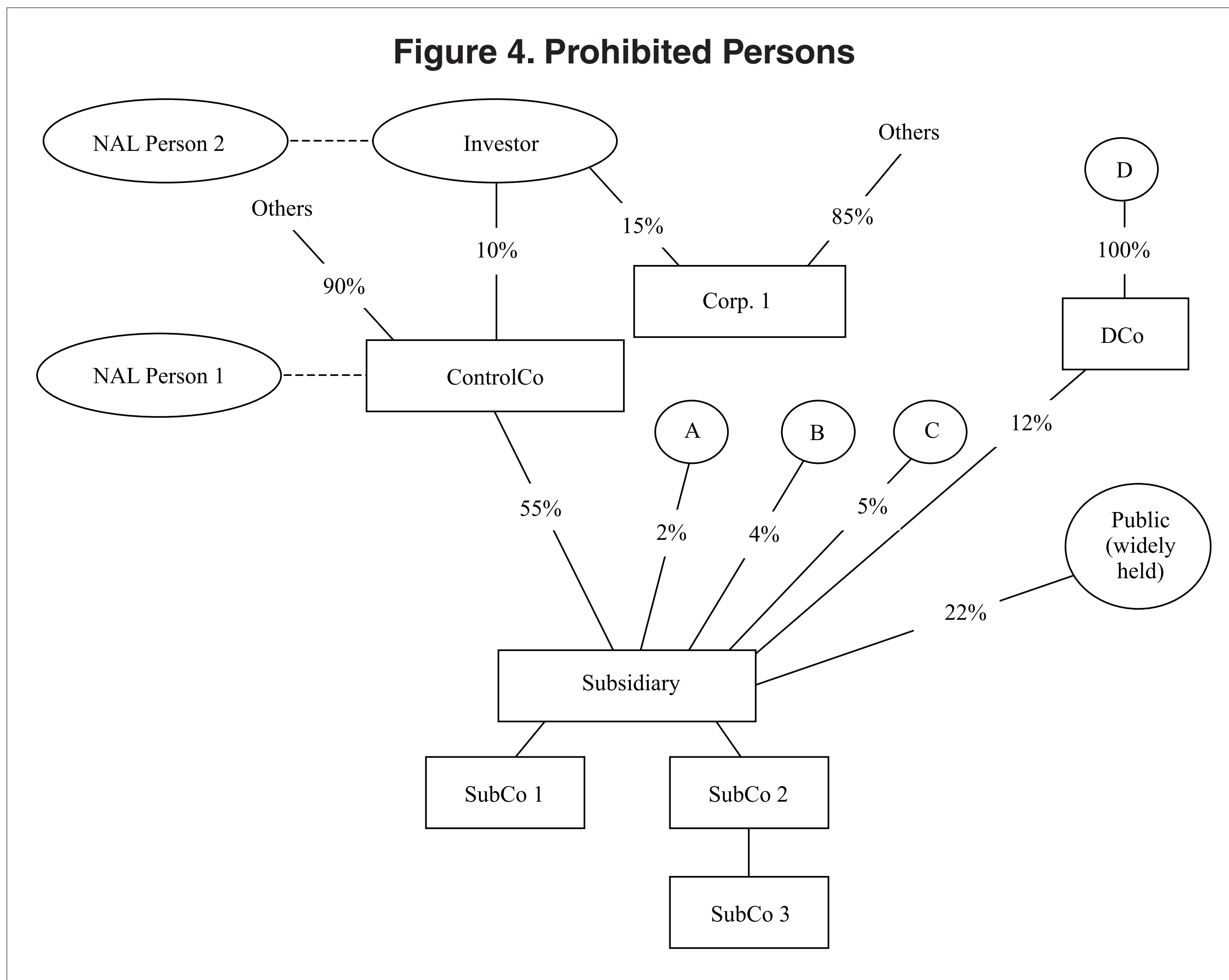

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The ambit of prohibited persons is broad indeed. The analysis is especially difficult in public company transactions for various reasons:

- While securities laws may require the identification of major shareholders (those owning more than 10 percent of a corporation's shares), it is difficult to determine the identity of smaller shareholders, who often hold their shares through an intermediary.
- Significant numbers of shares are bought and sold every day, changing the shareholder base continually.
- There is virtually no way of knowing who deals NAL with shareholders or who may have 251(5)(b) rights to acquire or control shares.

The tax policy reason why some persons are included as prohibited persons (for example, corporations controlled by the subsidiary in some circumstances)[34] is not always obvious.

[34]Corporations controlled by the subsidiary can be deemed to be pre-AOC subsidiary specified shareholders when there is a pre-AOC controlling shareholder of the subsidiary (such as ControlCo), as described in note 29, or when subsidiary shareholders receive shares of the parent as consideration for their subsidiary shares. Assume the public shareholders of the subsidiary in Figure 4 sold their subsidiary shares to the parent in exchange for parent shares representing 10 percent or more of all parent shares. Former subsidiary shareholders collectively holding 10 percent or more of the subsidiary shares pre-AOC would have acquired 10 percent or more of the shares of the parent as part of the AOC series, making them collective post-AOC specified shareholders of the parent. Because, following the AOC, the parent will be a corporation that is related to SubCos 1, 2, and 3 (by virtue of

(Footnote continued on next page.)

Prohibited Property

The core of the prohibited property element of the bump denial rule is distributed property, which is always prohibited property; there are no exceptions under current law. Actions taken before the wind-up (transfers of property, payments of liabilities, and the like) may affect what the subsidiary owns directly at the time of the wind-up and what constitutes distributed property. Prohibited property also includes two additional forms of property (substituted property) that are based on distributed property:

- property acquired by any person in exchange for distributed property; and
- property whose FMV (any time following the AOC) is wholly or partly attributable to distributed property.

While certain properties are excepted from being substituted property,[35] the difficulty is that substituted property is defined broadly and the exceptions are phrased narrowly.

Once all distributed property has been identified, it is necessary to assess whether any property has been acquired in exchange for distributed property. For example, if the subsidiary acquired Property 1 from another person in exchange for Property 2 and held it until the wind-up, Property 1 would be distributed property, making Property 2 substituted property (that is, acquired in exchange for a distributed property). Each time a distributed property is transferred in exchange for property, a new substituted property (and potential prohibited property) is created.[36] While substituted property can be created on any such transfer, either before or after the wind-up, the bump denial rule applies only if the other two elements of the test are also met (the transfer occurred as part of the AOC series and the recipient was a prohibited person).

The primary concern with the scope of prohibited property, however, is the second element of substituted property. Property owned by any person after the AOC is deemed to be substituted property if that property's FMV is wholly or partly attributable to distributed property.[37] One of the most common examples of such deemed substituted property is shares of an acquirer (or of that acquirer's own parent). For example, if the parent purchases the subsidiary and, instead of delivering cash consideration, it delivers parent shares or debt (or shares or debt of that parent's own parent) to subsidiary shareholders in payment, the subsidiary shareholders will own property (parent securities) that derives its value partly from the subsidiary's own property, which will become distributed property on the wind-up. This makes the parent shares deemed substituted property and prohibited property unless an exception to the rule applies.

There is an exception to the deemed substituted property rule for shares or debt of: (i) the parent, which must always be a Canadian corporation to have a qualifying wind-up; or (ii) another Canadian corporation that directly owns all of the parent's shares.[38] Because only shares or debt issued by a Canadian corporation qualify for the exception, this means shares or debt of a foreign acquirer received as consideration for subsidiary shares will always be prohibited property.[39]

The result is that Canadian acquirers have an advantage over foreign acquirers in that they can use their shares and debt to pay for Canadian targets and still be able to claim the 88(1)(d) bump. In most cases, foreign acquirers can use only the 88(1)(d) bump if they pay cash. If Canadian target shareholders, holding in aggregate 10 percent or more of the Canadian target's shares, receive shares or debt of a foreign acquirer for their Canadian target shares, then persons who in aggregate constitute a specified shareholder will have received prohibited property and the bump denial rule will apply.

This article cannot describe the full scope of the prohibited property definition. Suffice it to say that

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controlling the subsidiary) and that has a significant indirect interest in them, the former subsidiary shareholders would appear to be collective post-AOC specified shareholders of SubCos 1, 2, and 3 by virtue of being collective post-AOC specified shareholders of the parent.

[35]A narrow range of properties are excluded from being substituted property: money, property not owned any time after the AOC, and shares or debt of a corporation that at no time following the start of the wind-up derive any part of their value from distributed property (subparas. 88(1)(c.3)(iii)-(vii)).

[36]What makes this particularly difficult is that, since what constitutes distributed property is known for certain only at the time of the wind-up, on a pre-wind-up exchange of property, the parties may not realize that a transferred property was (that is, would later become) distributed property and that the property acquired in exchange was thus substituted property.

[37]Subpara. 88(1)(c.3)(i). Another deeming rule in subparagraph 88(1)(c.3)(ii) also exists, but it is typically narrowly construed to be limited to property that derives substantially all of its value from distributed property, based on the Department of Finance technical notes describing this provision.

[38]Para. 88(1)(c.4).

[39]That is because those shares or debt will derive their value partly from distributed property following the AOC, and the exception for shares and debt of Canadian corporations described above will not apply.

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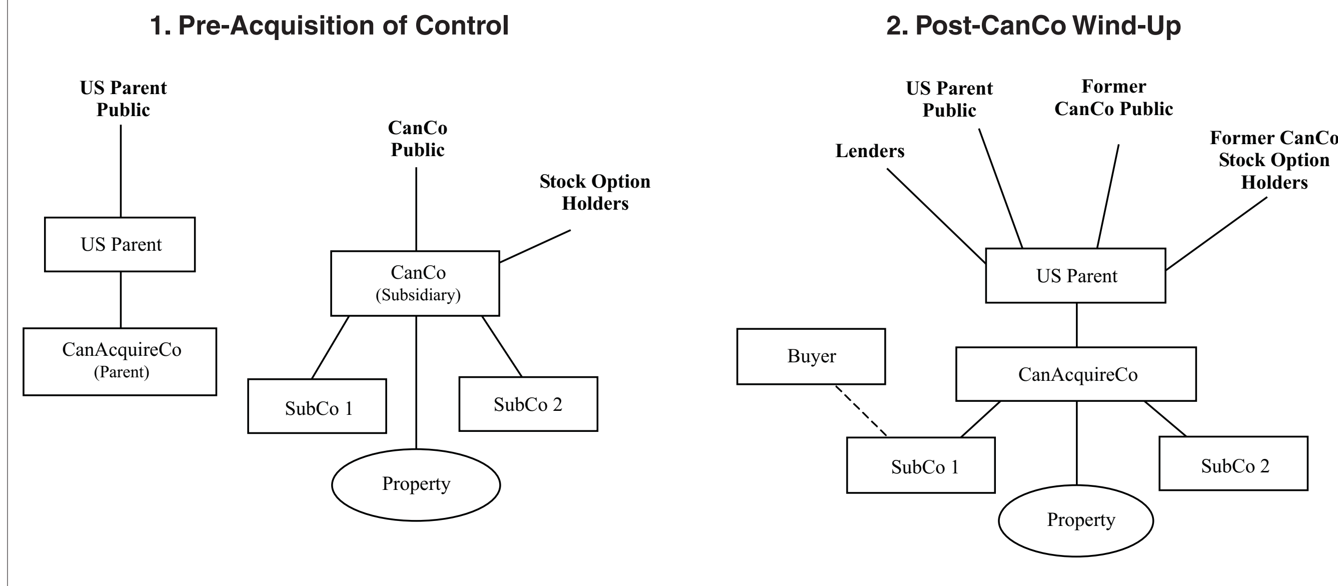

it is a broad concept that goes well beyond distributed property. Figure 5 illustrates some of the typical problems that can arise when a foreign acquirer (US Parent) acquires a public Canadian target (CanCo) in exchange for US Parent shares, using a Canadian corporation (CanAcquireCo):

- As noted above, US Parent shares will be prohibited property because they derive their value partly from distributed property held by CanAcquireCo following the wind-up.[40]
- For the same reason, holders of CanCo employee stock options who exchange these for US Parent stock options will also have acquired deemed substituted property (and thus prohibited property), as will lenders who acquire a US Parent receivable as part of the AOC series.[41]
- If after the wind-up, US Parent plans to dispose of SubCo 1 (a distributed property) and enters into an agreement with Buyer to do this, Buyer will have deemed substituted property, that is, rights under the sale agreement that derive their value from distributed property (SubCo 1 shares). This makes it important that Buyer not be a prohibited person. Buyer's own securities will also become prohibited property since they too will now derive part of their value from the SubCo 1 shares by virtue of those rights, creating the need to determine if Buyer's shareholders include former CanCo shareholders (prohibited persons).[42] This is an important issue since one of the primary applications of the 88(1)(d) bump is the post-wind-up sale of property to third parties.

[40]As described above, shares or debt of a Canadian corporation can be excepted from being prohibited property. In "exchangeable share" transactions in which CanCo shareholders receive exchangeable shares of CanAcquireCo that track the value of, and will ultimately be exchanged for, US Parent shares, the prevailing view is that the bump denial rule will likely apply because of the likelihood that the holders of the exchangeable shares will eventually receive US Parent shares (which are prohibited property).

[41]Although the Department of Finance has agreed that the bump denial rule ought not to apply in at least some of these cases, it remains to be seen how broadly any new exception will be drafted.

[42]If Buyer securities are acquired as part of the AOC series by a single pre-AOC CanCo specified shareholder (a prohibited person) or by a number of smaller pre-AOC CanCo shareholders whose collective shareholdings would make a single holder of them a pre-AOC CanCo specified shareholder, those Buyer securities will generally be prohibited property (unless an exception applies) and the bump will be tainted. Buyer will be a prohibited person (tainting the bump if the purchase of Subco 1 is part of the AOC series) if either a single pre-AOC CanCo specified shareholder is also a post-AOC specified shareholder of Buyer (whether or not the shareholder acquired its Buyer shares as part of the AOC series), or a number of smaller pre-AOC CanCo shareholders whose collective shareholdings would make a single holder of them a pre-AOC CanCo specified shareholder acquire enough Buyer securities as part of the AOC series to make a single holder of them a specified shareholder of Buyer following the AOC.

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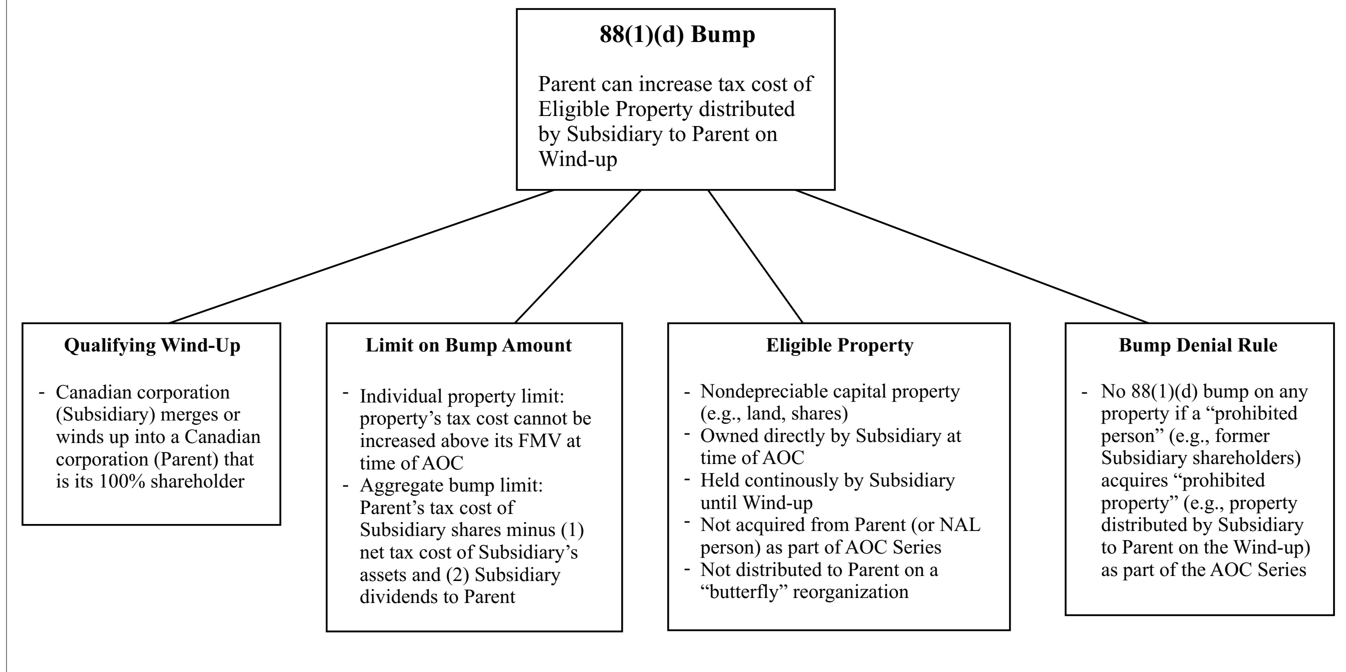

Particular caution must be exercised in situations in which CanCo's own subsidiaries have been deemed to be prohibited persons (as described above), because those entities are more likely than third parties to be involved in transactions with distributed property.

Acquired as Part of AOC Series

If prohibited persons have acquired prohibited property, it must be determined whether they did so as part of the AOC series. Because the prohibited person and prohibited property concepts are very broad, the further requirement that any acquisition of that property by those persons occurs as part of the AOC series is an important limitation on the scope of the bump denial rule.

> ***The series of transactions concept is still developing in the jurisprudence.***

As noted earlier, the series of transactions concept is still developing in the jurisprudence. In some cases, it will be obvious that property is acquired as part of the AOC series (property received from the parent by subsidiary shareholders in exchange for their subsidiary shares). In other cases, the answer is not so clear. It is uncertain whether the AOC series includes the actions of persons over whom neither the parent nor the subsidiary have any control, such as arbitrageurs who may acquire significant subsidiary shareholdings that make them prohibited persons. There is no way of preventing such persons from doing something that may taint the 88(1)(d) bump. It is enough for present purposes to observe that when the acquisition of CanCo is part of a larger series of transactions (such as a sale of some of CanCo's property to a third party), the range of transactions that must be tested under the bump denial rule expands considerably.

Conclusion

The 88(1)(d) bump is a powerful planning tool. The ability to increase the tax cost of a subsidiary's eligible property up to its FMV offers the potential for enormous tax savings, especially when a sale of such property is contemplated in the near future. The elimination of accrued gains on eligible property at the corporate level also creates opportunities for additional tax savings by facilitating the restructuring of the subsidiary's corporate group. A foreign purchaser can often take particular advantage of those opportunities by causing the parent to distribute the subsidiary's non-Canadian affiliates to the foreign purchaser and thereby remove them from

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the Canadian tax system (see Figure 2). Other useful planning strategies may also be available, depending on the facts of each particular situation.

That said, the 88(1)(d) bump has significant limitations and, in many situations, successfully using it requires considerable effort. Because several of the relevant rules are based on the time of the parent's acquisition of control of the subsidiary, the tax cost step-up is effectively limited to takeover situations, and the qualifying wind-up requirement limits its application to Canadian corporations. The rules governing what properties are eligible for the 88(1)(d) bump also create important constraints, although timely planning (such as prepackaging) often permits the scope of eligible property to be optimized (see Figure 3). The bump denial rule is an important limitation on the 88(1)(d) bump, especially in public company transactions. Foreign acquirers in particular need to be cognizant of this rule because it generally prevents them from claiming the 88(1)(d) bump if they use their own securities to pay for Canadian target shares, which puts them at a relative disadvantage to Canadian acquirers. Considerable analysis is required to be confident that the bump denial rule will not apply, and the consequences of even a minor violation of that rule are draconian — no 88(1)(d) bump at all.

The rules governing the 88(1)(d) bump, summarized in Figure 6, are deceptively simple at a conceptual level, but in many cases they do not work well with the practical realities of commercial transactions. The Department of Finance and the CRA have acknowledged many of the technical anomalies with the rules and generally seek to apply them in a manner consistent with the underlying policy, which is helpful. Hopefully, the rules will continue to be refined in a way that makes them easier to work with on a practical level, as they constitute an important part of Canada's corporate tax system. ◆

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