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Canada's 88(1)(d) Tax Cost Bump: A Guide for Foreign Purchasers

by Steve Suarez

Steve Suarez is with Borden Ladner Gervais LLP in Toronto.

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The increase (or bump) in the cost of property permitted under paragraph 88(1)(d) of the Income Tax Act (Canada) is one of the most powerful and complex tax planning tools in the Canadian income tax system. Commonly known as the 88(1)(d) bump, this cost basis increase reduces or completely eliminates accrued gains that would otherwise be taxed on a disposition of property. It is particularly relevant to foreign purchasers of Canadian corporations, although it is often unavailable to those foreign purchasers in transactions in which something other than money (that is, shares or other securities of the foreign purchaser) is used to pay for the acquisition. This article gives the reader an understanding of the basic parameters of the 88(1)(d) bump: the intent behind the provision, when it can be used, its most common applications, and its major limitations.

I. Overview of the 88(1)(d) Bump

Most taxation systems record the amount paid by a taxpayer to acquire a property as the taxpayer's cost of the property for tax purposes (tax cost), which may or may not correspond to its cost for accounting purposes. When the property is disposed of, any sale proceeds the taxpayer receives (or is deemed to receive) are measured against the taxpayer's tax cost of the property to determine 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 realized on a future disposition of that property.

The 88(1)(d) bump is available only in one specific situation: when one taxable Canadian corporation (the parent) owning all the shares of another taxable Canadian corporation (the subsidiary) causes the subsidiary to wind up or merge into the parent. Such a wind-up or merger is referred to herein as the wind-up. The general rule in the ITA on wind-ups is that the parent acquires all the subsidiary's property at whatever tax cost the subsidiary had in that property without any gain or loss being realized on the wind-up:[1] that is, the parent steps 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 certain property acquired from the subsidiary on the wind-up, potentially up to an amount equal to the property's fair market value as of the time the parent acquired control of the subsidiary. This opportunity arises when the parent's tax cost of its shares in the subsidiary (sometimes called the outside basis) is greater than the subsidiary's aggregate net tax cost of all of its property (inside basis). On a wind-up, the parent's outside basis is eliminated when its subsidiary shares are canceled. Without an 88(1)(d) bump, if the outside basis exceeds the subsidiary's inside basis, the parent simply loses the excess basis and is disadvantaged by the wind-up in terms of lost tax cost.[2] The 88(1)(d) bump effectively permits the

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

[2]There are many 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

(Footnote continued on next page.)

Table 1. 88(1)(d) Bump Summary

- Applicable only when a wholly owned taxable Canadian corporation (subsidiary) winds up or merges into its parent taxable Canadian corporation (parent) on a tax-deferred basis.
- Permits the parent to push down its cost basis in its subsidiary shares into cost basis of eligible nondepreciable capital property acquired from the subsidiary upon wind-up or merger.
- Reduces or eliminates capital gains otherwise realized when the parent disposes of property acquired from its subsidiary (for example, on completing a third-party sale, reorganizing an internal group, or managing new foreign affiliate dumping rules).
- Cost basis of property cannot be increased above its fair market value at the time the parent acquired control of subsidiary.
- May be optimized by planning undertaken by the subsidiary before the parent acquires control of the subsidiary (that is, pre-closing planning on a friendly acquisition).
- No 88(1)(d) bump allowed on *any* property if former subsidiary shareholders (or non-arm's-length persons) acquire prohibited property as part of the relevant series of transactions.

parent to apply some of its excess outside basis to increase the tax cost of the eligible subsidiary assets acquired on the wind-up, and thus mitigates what could otherwise be an unfavorable tax consequence of a wind-up.

Figure 1 illustrates the basic result of the 88(1)(d) bump. A Canadian corporation (CanAcquireCo) purchases all 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 increase. Immediately before the acquisition, CanCo's eligible property has an FMV of $60 and a tax cost of $20 (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.

II. Applications of the 88(1)(d) Bump

The benefit of increased tax cost in eligible property is realized only when the property is disposed of, reducing any gain otherwise recognized. Consequently, the benefit of the 88(1)(d) bump in any particular case depends on the facts of the situation — that is, the size of any accrued gain on eligible property, and how soon a disposition is likely to occur.

A. Sale to Third Party

CanAcquireCo may 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 some of CanCo's eligible property that it views as being non-core assets or outside the scope of management's ability to effectively administer. CanAcquireCo may need to sell some of CanCo's property to finance the purchase of CanCo.[3] Acquirers may also find that antitrust laws require them to divest some of the property owned by a corporation they have acquired in order to preserve competition within an industry. In any of these circumstances, the 88(1)(d) bump will be of immediate benefit and may be essential to completing the acquisition.

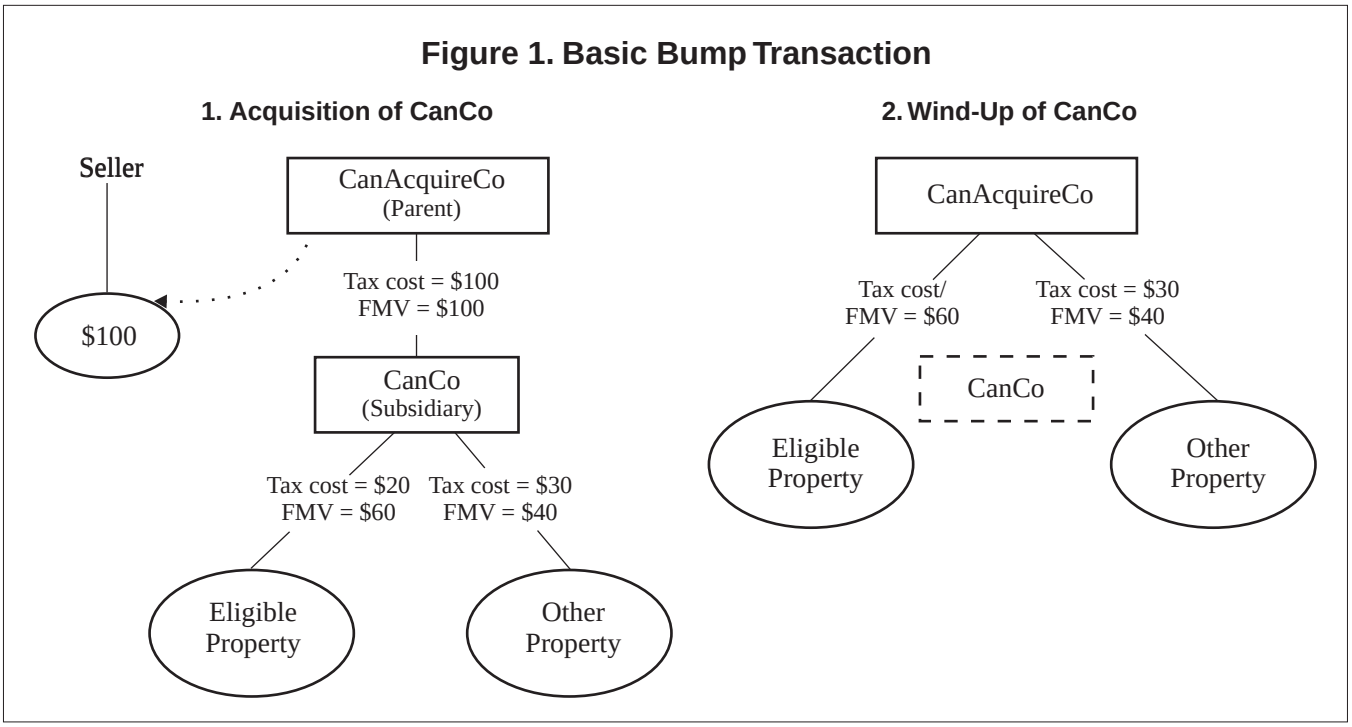
B. Internal Reorganization

Even when no third-party disposition is planned, the 88(1)(d) bump may be of immediate benefit. In cross-border takeovers, it is common for Canadian target corporations to have foreign subsidiaries in other countries. It is generally not tax efficient for a foreign acquirer to hold those foreign subsidiaries through a Canadian entity, since in those circumstances the resulting sandwich structure creates an extra taxing jurisdiction:

- whose controlled foreign corporation rules must be managed;
- which will potentially seek to tax any future accrued gains; and
- through which dividends and other amounts may need to flow in order to redeploy funds within the group.

the subsidiary's income for tax purposes. Canada does not have a group relief or consolidation tax system. The government was examining possible new rules for the taxation of corporate groups, but it announced in its 2013 federal budget that ''moving to a formal system of corporate group taxation is not a priority at this time.''

[3]An 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.



The 88(1)(d) bump makes it possible to move the subsidiary's foreign affiliates out from under the Canadian tax system without incurring Canadian capital gains tax.

Returning to the example in Figure 1, if CanCo owns shares of foreign affiliates with significant accrued gains, such shares are generally eligible property and the 88(1)(d) bump can 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 (U.S. Parent) has created CanAcquireCo and funded it with $100 to purchase all 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 (U.S. SubCo) up to $60, eliminating the accrued gain. CanAcquireCo can then distribute the U.S. SubCo shares to U.S. Parent by effecting a return of capital for Canadian corporate law purposes (that is, not a dividend). As long as the amount of the distribution ($60) does not exceed the tax cost and the paid-up capital (PUC)[5] of U.S. 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). The adverse tax implications of a sandwich structure are thereby avoided using the 88(1)(d) bump.

The introduction of the foreign affiliate dumping (FAD) rules in 2012[6] makes the 88(1)(d) bump more important than ever to foreign purchasers. The FAD rules create significant adverse (and ongoing) Canadian tax consequences for foreign-controlled Canadian corporations with foreign subsidiaries, and they effectively encourage Canadian group members to dispose of existing foreign affiliates whenever possible. Amendments made to the version of the FAD rules enacted in late 2012 facilitate the use of the 88(1)(d) bump in these circumstances, and when the 88(1)(d) bump is available to reduce or eliminate Canadian CGT on shares of foreign affiliates (and there are no tax impediments in the foreign affiliate's home country), it will generally be the primary tool used by foreign purchasers of a

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

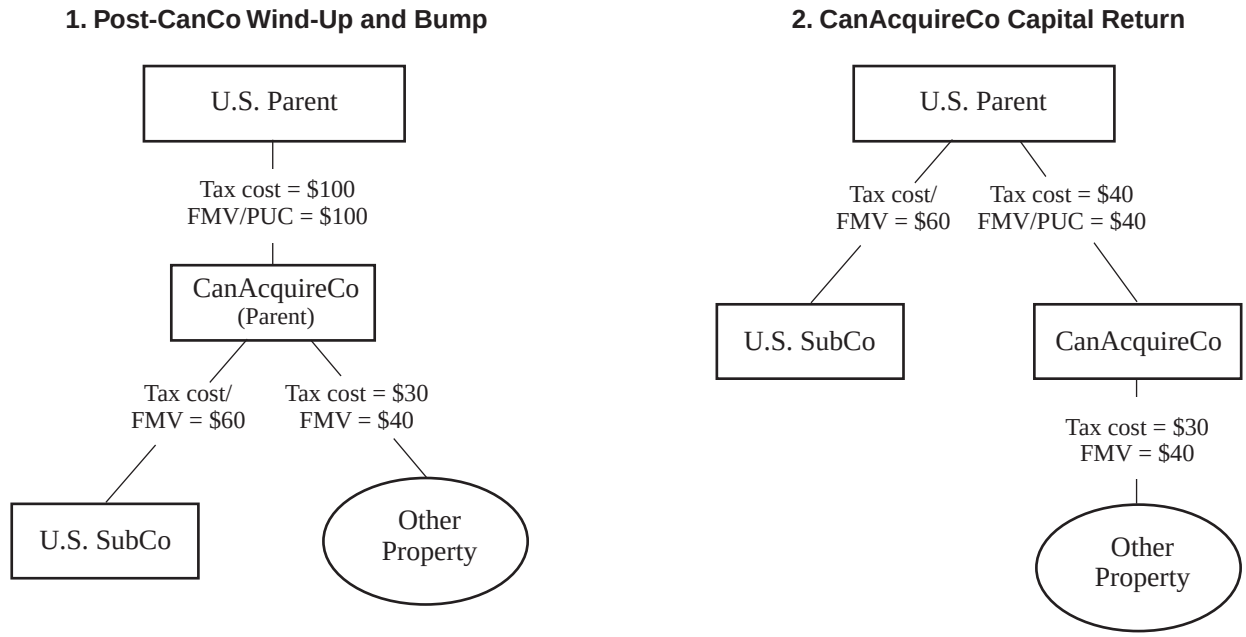
[5]PUC represents amounts received by a corporation on the issuance of its shares, and it is essentially the tax version of the corporate law concept of share capital. In this example, in which

(Footnote continued in next column.)

U.S. Parent delivers $100 to CanAcquireCo in exchange for CanAcquireCo shares to fund its purchase of CanCo shares, the tax cost and (subject to the foreign affiliate dumping rules) 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 corporate distributions being deemed to come first out of earnings and profits.

[6]*See* Steve Suarez, ''New Foreign Affiliate 'Dumping' Rules Constitute Major Canadian Tax Policy Change,'' *Tax Notes Int'l*, Dec. 17, 2012, p. 1145.

Figure 2. Foreign Subsidiary Extraction



Canadian corporation that owns foreign subsidiaries to avoid having to contend with the FAD rules on an ongoing basis.

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.

III. 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 core requirements, as illustrated in Figure 3:

- *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.
- *Determination of Eligible Property*. Not all property is eligible for the 88(1)(d) bump; there are rules governing which items are eligible properties.
- *Calculation of Maximum Bump*. There are limits on the amount that the tax cost of any eligible property can be increased, and on the overall increase in the tax cost of all the subsidiary's eligible properties.
- *Compliance With Bump Denial Rule*. There is an overarching ''bump denial'' rule that if contravened, completely eliminates any 88(1)(d) bump for *all* property of the subsidiary. This technical and complex requirement can deny an 88(1)(d) bump even when there is no clear tax policy basis for doing so. Among its other consequences, this rule generally forces foreign acquirers wanting to use the 88(1)(d) bump to structure acquisitions so that either (1) the shareholders of the Canadian target corporation receive exclusively cash in exchange for their shares, or (2) the foreign acquirer is so much larger than the Canadian target corporation that post-acquisition, the Canadian target corporation will represent no more than 10 percent of the foreign acquirer's equity value.

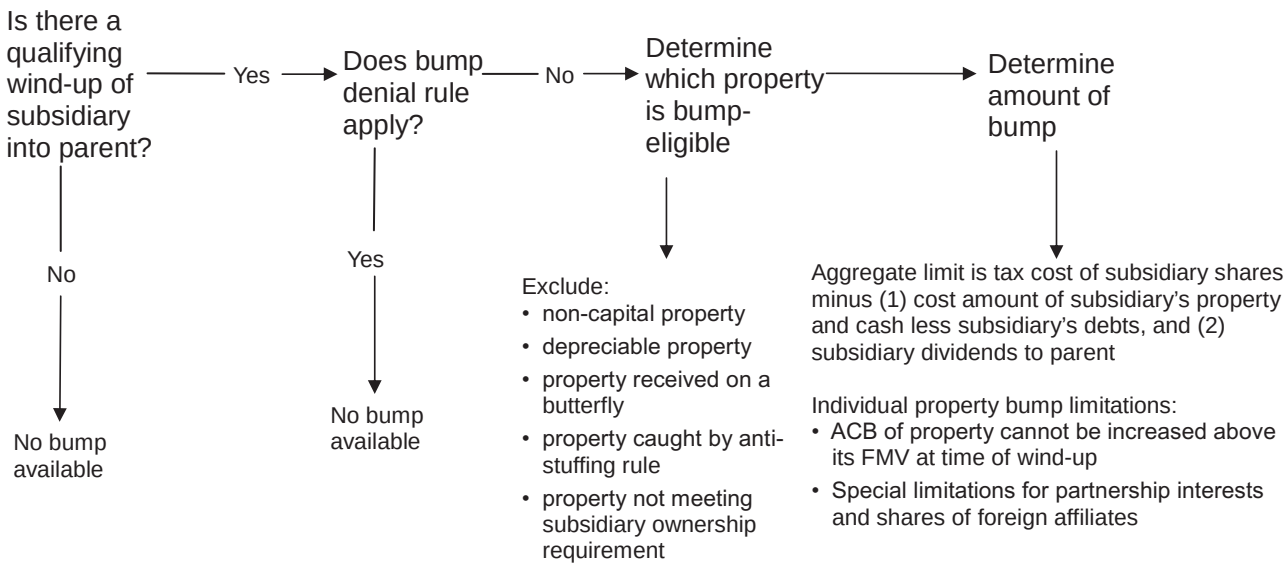
Before discussing these four requirements in greater detail, it is useful to briefly review a few core concepts that recur throughout the 88(1)(d) bump rules.

A. Related Persons

An important element of the 88(1)(d) bump is the concept of related persons. A natural person is related to his 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.[7] The term ''control'' generally means ownership of enough shares to elect a majority of the corporation's board of directors. In most cases, that means shares that command a majority of the votes attributable to all the corporation's

[7]Subsection 251(2) of the ITA.

Figure 3. Bump Overview: Summary of Bump Analysis



shares. The test is one of de jure or legal control, rather than de facto control. In some 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).[8]

B. 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.[9] 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.

C. 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 ownership of enough shares to elect a majority of the corporation's board of directors. A special provision in the 88(1)(d) bump rules states that for most purposes of these rules, if the parent acquires control of the subsidiary from another person that is NAL with the parent, the parent is deemed to have acquired control at the earlier time when the NAL person acquired control of the subsidiary.[10]

D. Series of Transactions

Some of the 88(1)(d) bump rules refer to the ''series of transactions'' that includes the parent's AOC 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, both the Canada Revenue Agency and the jurisprudence to date have interpreted the term rather broadly.

The determination of what constitutes a series of transactions involves the common-law definition of the term ''series of transactions,'' 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

[8]Para. 251(5)(b) of the ITA.

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

[10]Para. 88(1)(d.2) of the ITA. This deeming rule can affect other relevant rules (*see, e.g.,* the discussion associated with note 20, *infra*).

order ordained.''[11] Subsection 248(10) of the ITA extends the scope of the term to include related transactions or events completed ''in contemplation of'' the common law series. The Supreme Court of Canada has taken a fairly expansive view of this extended meaning of the phrase ''series of transactions,'' holding that a transaction completed ''in contemplation of'' a series of transactions can include a transaction occurring either before or after the rest of the series — that is, the test ''allows either prospective or retrospective connection of a related transaction to a common law series.''[12]

Further, a ''strong nexus'' between a transaction and the series is not necessary to satisfy the test, although the test requires more than a ''mere possibility'' or a connection with ''an extreme degree of remoteness,'' and each case must be decided on its own facts.[13] The Supreme Court noted that relevant facts could include the occurrence of intervening events or the passage of time between the series and the related transaction.

Based on the jurisprudence to date, it does not appear possible to conclude that a transaction is not part of the same series of transactions that includes other transactions simply because at the time of the first transaction, the other transactions were not anticipated. 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.

For ease of reference, Table 2 contains a glossary of many of the relevant terms used herein.

Table 2. Glossary

88(1)(d) bump	Increase in tax cost of eligible property permitted under section 88(1)(d) of the ITA
Parent	Taxable Canadian corporation claiming the 88(1)(d) bump
Subsidiary	Taxable Canadian corporation that owns eligible property
Wind-up	The wind-up or merger of the subsidiary into the parent
Eligible property	Property that is eligible for the 88(1)(d) bump
Distributed property	Property owned by the subsidiary that is acquired by the parent on the wind-up
AOC	Acquisition of control of the subsidiary by the parent
AOC series	The series of transactions that includes the AOC
Tax cost	Cost basis of property to the owner for tax purposes
FMV	Fair market value
NAL	Non-arm's-length (related persons are deemed to deal at NAL)

IV. Qualifying Wind-Up or Amalgamation

As noted above, the 88(1)(d) bump is available only on the wind-up or amalgamation of one taxable Canadian corporation into another. A wind-up in this sense 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. A qualifying amalgamation for 88(1)(d) bump purposes requires that the parent acquire all the property and assume all the liabilities of the subsidiary, other than any shares of one owned by the other or liabilities owed by one to the other.[14] In an 88(1)(d) context, an amalgamation also requires that all the subsidiary's shares be canceled. Amalgamations are generally faster and easier to carry out than wind-ups, and so are seen much more frequently. In either case, the parent must own all the shares of the subsidiary immediately before that time.[15]

V. 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.

A. 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 using it (for example, 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

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

[12] *Copthorne Holdings Ltd. v. The Queen*, 2011 DTC 5007 (SCC), at para. 56.

[13] *Id.* at para. 47.

[14] Subsection 87(11) and (1) of the ITA.

[15] For a wind-up (but not an amalgamation), the parent must 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) of the ITA). Practically, however, in almost all qualifying wind-ups, the parent owns all of the shares of the subsidiary.

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).[16]

Some capital property is eligible for an annual deduction from 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.[17] 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.

B. 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.[18] This means that a snapshot is taken of what property the subsidiary directly owns at the time of the AOC, and only that property can qualify.[19] 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 (for example, wind up a corporation whose shares it owns). 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.

The time of the AOC is therefore very important. A special rule[20] provides that when the parent acquires 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 amount of the possible 88(1)(d) bump (which is based on the property's FMV at the earlier time). This rule prevents 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 can 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 (or its shareholders) before the AOC to prevent the subsidiary from taking any actions that would impair the 88(1)(d) bump, or to require the subsidiary to take reasonable actions to enhance the 88(1)(d) bump. This form of agreement can add significant value to the parent.

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

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) that includes assets that cannot be eligible property (for example, depreciable property), it may be useful for the target to transfer that property to a separate subsidiary before the AOC, typically on a tax-deferred basis. This leaves the target holding shares in the new subsidiary, rather than existing properties, at the time of the AOC. If those shares of the new subsidiary are eligible property (as is usually the case), the acquirer can apply an 88(1)(d) bump to increase its tax cost of those shares

[16]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).

[17]Subpara. 88(1)(c)(iii) of the ITA. 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 logical to limit eligible property to nondepreciable capital property.

[18]Para. 88(1)(c) of the ITA. 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.

[19]The continuous ownership requirement is not violated if the subsidiary amalgamates with another corporation following the AOC, because of a special rule (subsection 88(4) of the ITA) providing that the resulting corporation is deemed to be a continuation of the subsidiary. However, that provision also deems no AOC to have occurred on an amalgamation (except in limited circumstances). As such, acquisitions involving an amalgamation must be structured so as to include a distinct AOC of the subsidiary, in order to establish the time of the AOC for purposes of determining which property was directly owned by the subsidiary at that time (as well as the FMV of such property at that time for purposes of calculating the maximum 88(1)(d) bump).

[20]Para. 88(1)(d.2) of the ITA.

when the target is wound up or amalgamated into the acquirer. This leaves the acquirer free to dispose of the shares in the new subsidiary without realizing any gain.

This is illustrated in the example at Figure 4, 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 ineligible property to SubCo on a tax-deferred basis in exchange for shares of SubCo.[21] If CanCo holds the SubCo shares as capital property, they would generally be eligible property.[22] On the wind-up, CanAcquireCo could apply the 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 ineligible property into eligible property (the SubCo shares). CanAcquireCo can dispose of the SubCo shares, whether 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.

C. Not Acquired as Part of AOC Series

Another rule is meant to prevent the parent from transferring property with accrued gains to a subsidiary on a tax-deferred basis before the AOC and eliminating those gains on the wind-up through the 88(1)(d) bump. This ''anti-stuffing'' rule disqualifies any property that the subsidiary acquires (as part of the AOC series) from either the parent or a person dealing NAL with the parent. 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.[23]

D. 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.[24]

E. 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.

VI. Calculation of Maximum Bump

While the simple example in Figure 1 is useful as a general illustration of what the 88(1)(d) bump can achieve, the limits on the amount of the tax cost increase are more complex than described there. There are generally 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. Some types of eligible property are also subject to specific per-property bump limits.

A. Per-Property Limit

1. General Limitation. The general limit on the amount by which the 88(1)(d) bump can increase the tax cost of any particular eligible property is simple to express: The property's tax cost cannot be increased to an amount in excess of its FMV at the time of the AOC.[25] 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 CanCo shares that disappeared on the wind-up ($100). The difference ($10) is lost.

More specifically, the general per-property limit on the amount of any 88(1)(d) bump to an eligible property is the excess of its FMV at the time of the AOC over its tax cost to the subsidiary at the time of the wind-up. Because the per-property limit is based on the property's 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

[21]This can generally be achieved under subsection 85(1) of the ITA.

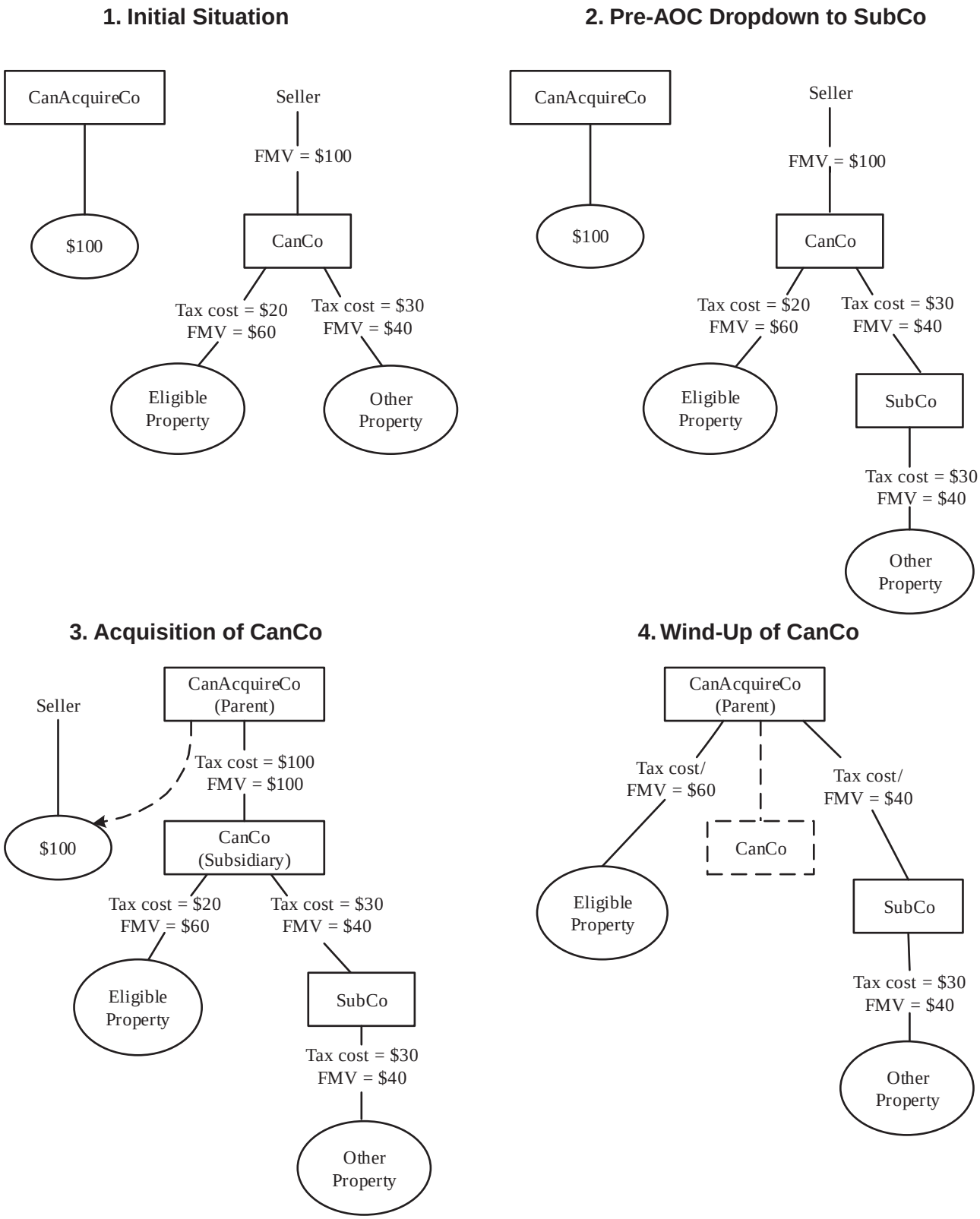
[22]Shares of a wholly owned subsidiary are normally considered to be capital property to the holder. The efficacy of any prepackaging transaction must be considered on its particular facts to ensure that all of the 88(1)(d) bump requirements are met — for example, that the parent and the subsidiary are dealing at arm's length at the time, that the property is capital property, and that no technical anomaly precludes the bump.

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

[24]Subpara. 88(1)(c)(iv) of the ITA.

[25]Subpara. 88(1)(d)(ii) of the ITA.

Figure 4. Bump Prepackaging Transaction



FMV increases. Going back to Figure 1 again, if CanAcquireCo winds up CanCo immediately, 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 of the property 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's FMV increased to $70, the 88(1)(d) bump could not increase the property's 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.

Under amendments to the ITA announced on December 21, 2012, and before Parliament as Bill C-4 as of late 2013, the per-property limit was amended to respond to perceived avoidance transactions that reduced the subsidiary's tax cost of property before the wind-up. The amount by which the tax cost of any particular eligible property can be increased using the 88(1)(d) bump has been restated as the amount by which the FMV of the particular property at the time of the AOC exceeds the greater of:

- the subsidiary's tax cost of that particular property at the time of the AOC; and
- the subsidiary's tax cost of that property at the time of the wind-up.

This amendment targeted some transactions occurring after the AOC and before the wind-up, which reduced the subsidiary's tax cost of certain property, thereby increasing the accrued gain on that property and potentially the amount that its tax cost could be increased under the 88(1)(d) bump rules. Such transactions can otherwise result in the 88(1)(d) bump sheltering post-AOC increases in the FMV of the subsidiary's eligible property, which is outside the legislative intent of this provision.

2. Partnership Interests. The tax status of partnerships as transparent entities for Canadian tax purposes[26] creates various planning opportunities, some of which tax authorities perceive to be inappropriate. Under an amendment to the 88(1)(d) bump rules introduced in 2012, a specific rule limits the maximum permissible increase in the tax cost of interests in a partnership. Unfortunately, its application goes beyond tax planning considered to be objectionable.

This amendment reduces the maximum amount of any 88(1)(d) bump on a partnership interest to the extent that the accrued gain on the partnership interest is attributable to accrued gains on non-eligible property owned by the partnership.[27] This is achieved by deeming (for this purpose) the FMV of the partnership interest at the time of the AOC (which constitutes the upper limit of the per-property bump under the general limitation described above) to be a lower amount than it actually is. Expressed conceptually, the FMV of the partnership interest is deemed to be reduced by an amount representing that portion of the subsidiary's accrued gain on the partnership interest that is attributable to the sum of:

- the FMV of Canadian or foreign resource property[28] owned by the partnership (directly or through other partnerships); and
- the difference between the FMV and cost amount of other forms of non-eligible property (for example, depreciable property or inventory) owned by the partnership, either directly or through other partnerships.[29]

For example, consider the case of a partnership interest held by the subsidiary at a tax cost of $70 and whose FMV is $100 (that is, a $30 accrued gain). If the partnership itself owns an eligible property with a tax cost of $5 and an FMV of $10, and a non-eligible property with a cost amount of $65 and an FMV of $90, for purposes of the general limitation in Section VI.A.1 above, the FMV of the partnership interest would be deemed to be $75 instead of $100.[30] This means that the maximum 88(1)(d) bump on such partnership interest would be $5 ($75-$70).

Before this amendment, it was not uncommon to see a subsidiary transfer non-eligible property to a partnership as part of the prepackaging described in Section V.B above, in anticipation of the subsidiary itself

[26]A partnership computes its income as if it were a taxpayer, but it is not a taxable entity and instead its income and loss are attributed to its partners and included in computing the income and loss of the partners.

[27]Para. 88(1)(d)(ii.1) of the ITA, added by the 2012 federal budget, effective for amalgamations that occur and wind-ups that begin after March 28, 2012. The 2012 federal budget also introduced an antiavoidance rule in paragraph 88(1)(e), which reduces the FMV of a subsidiary's partnership interest for the purpose of the calculation in subparagraph 88(1)(d)(ii.1) when certain tax-deferred transfers of property were made on or before the AOC in order to increase the bump limitation regarding the partnership interest.

[28]Resource properties are generally interests in mining or oil and gas properties.

[29]The Department of Finance explanatory notes accompanying the relevant provisions of the ITA make clear that this rule does not reduce the amount of an 88(1)(d) bump regarding an interest in a partnership that owns shares of a corporation simply because the corporation owns non-eligible property.

[30]The reduction in the FMV of the partnership interest is computed as the portion of the accrued gain on that property that is attributable to the notional gains on non-eligible property. Since the notional gains on the non-eligible property represent five-sixths ($25 / ($5 + $25)) of the total accrued gain ($30), for this purpose the FMV of the partnership interest ($100) is reduced by $25 (five-sixths of the $30 accrued gain on the partnership interest).

being acquired, so that the resulting partnership interest could be the subject of an 88(1)(d) bump. The Department of Finance was concerned that this could produce objectionable results when, for example, the partnership interest was transferred to a nonresident of Canada or to a tax-exempt entity such as a pension fund.

While the 2012 amendment to the maximum 88(1)(d) bump for a partnership interest will certainly impede such planning (for pre-AOC transfers to partnerships, not to corporations), it will also affect other transactions without such motivations, including 88(1)(d) bumps on partnership interests that were acquired by the subsidiary well before any acquisition of the subsidiary was contemplated.[31] It is not obvious why the scope of the amendment could not have been more precisely targeted to achieve its aims. Indeed, the partnership bump limitation represents one of a number of recent amendments in the past few years that have the cumulative effect of making partnerships much more difficult to use from a Canadian tax perspective.

3. Foreign Affiliate Shares. Shares of a foreign affiliate[32] are likewise subject to an additional specific limitation. This limitation is intended to prevent perceived duplication of favorable tax attributes that might otherwise occur following the parent's AOC of the subsidiary if the subsidiary owns shares of a foreign affiliate.

Earnings of a foreign affiliate of a Canadian resident corporation fall into various categories of surplus for Canadian income tax purposes, some of which can be repatriated back to the Canadian corporation free of Canadian tax and as such are effectively equivalent to tax cost in the shares of the foreign affiliate.[33] When control is acquired of a Canadian corporation that owns shares of a foreign affiliate, Canadian tax authorities perceive it as being duplicative to allow (in very general terms) the sum of the tax cost of the Canadian corporation's shares of the foreign affiliate and the amount of this ''good'' surplus the Canadian corporation has in the foreign affiliate to exceed the FMV of the Canadian corporation's shares of the foreign affiliate.

Accordingly, when the subsidiary owns shares of a foreign affiliate, an 88(1)(d) bump is not permitted to result in the sum of (1) the parent's tax cost of those shares and (2) the good surplus[34] of the foreign affiliate at the time of the AOC exceeding the FMV of those shares. A comparable rule applies when the subsidiary owns shares of a foreign affiliate through a partnership. Reverting back to the example in Figure 2, if USCo had $10 of exempt surplus at the time of the AOC and CanCo's tax cost in the USCo shares was $20, the maximum 88(1)(d) bump permitted on those shares (assuming their FMV was $60) would be $30, not $40, with the result that CanAcquireCo would have a post-88(1)(d) bump tax cost of $50 (not $60) in the USCo shares (plus the existing $10 of exempt surplus). Effectively, good surplus is treated as equivalent to tax cost.

When a foreign purchaser intends to cause the Canadian target corporation to distribute the shares it owns in one or more foreign affiliates out to the foreign purchaser as illustrated in Figure 2 above, the concern over duplication of tax attributes does not exist, since the surplus balances of the foreign affiliate (USCo) become irrelevant once it is no longer owned by a Canadian resident. As such, the CRA has stated[35] that it will not require that a foreign affiliate's ''good'' surplus be calculated in connection with a bump of the foreign affiliate's shares if all the following conditions are met:

- the foreign affiliate (USCo) shares are transferred to U.S. Parent by CanAcquireCo within a reasonable time after the takeover of CanCo;
- the maximum permissible 88(1)(d) bump is otherwise large enough to increase the tax cost of the U.S. SubCo shares to their FMV; and

[31]This amendment is supported by other provisions affecting tax-deferred transfers of partnership interests or of property to a partnership occurring as part of the relevant series of transactions.

[32]Generally, a corporation resident outside Canada will be a foreign affiliate of a Canadian resident taxpayer if:

- the Canadian resident taxpayer owns at least 1 percent of the foreign corporation's shares (directly or indirectly); and
- the Canadian resident taxpayer and all persons related to that taxpayer collectively own at least 10 percent of the foreign corporation's shares (directly or indirectly).

[33]For more on the types of surplus earned by a foreign affiliate of a Canadian corporation and their implications, see http://miningtaxcanada.com/investment-outside-of-canada.

[34]Subpara. 88(1)(d)(ii) of the ITA and subsection 5905(5.4) of the Income Tax Regulations, applicable to wind-ups that begin, and amalgamations that occur, after December 20, 2012. ''Good'' surplus of a wholly owned foreign affiliate is generally the total of:

- the foreign affiliate's consolidated exempt surplus;
- the portion of the foreign affiliate's hybrid surplus that would be 100 percent deductible if repatriated to Canada; and
- the portion of the foreign affiliate's taxable surplus that would be sheltered from Canadian tax upon repatriation by the grossed-up amount of underlying foreign tax paid by the foreign affiliate on its taxable surplus.

The determination of ''good'' surplus for this purpose takes into account the separate rule in subsection 5905(5.2) of the Income Tax Regulations, which applies on the AOC of a Canadian corporation that directly owns shares of a foreign affiliate to reduce the exempt surplus balance regarding that affiliate to the extent that the aggregate of the tax cost of that affiliate's shares and the good surplus of that affiliate exceeds the FMV of that affiliate's shares immediately before the AOC (that is, tax cost plus good surplus cannot exceed FMV).

[35]CRA document 2011-0404521C6, May 19, 2011.

- neither CanCo nor CanAcquireCo receives (or is deemed to receive) any dividends from U.S. SubCo after the AOC.

B. Overall Limit

The overall limit on the 88(1)(d) bump is described as follows:[36]

	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 (ignoring 251(5)(b) rights)

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 higher the parent's tax cost of the subsidiary shares is, the greater the potential 88(1)(d) bump. In structuring takeovers, an acquirer must consider that offering tax deferral opportunities to target shareholders (that is, qualifying share-for-share exchanges that defer gains on target shares)[37] may reduce the acquirer's tax cost of target shares, and therefore reduce the overall limit on the amount of any potential 88(1)(d) bump.

The second element of the formula (net tax cost) is essentially the tax cost of all the subsidiary's assets less all its liabilities and some reserves taken for tax purposes immediately before the wind-up.[38] The third element of the formula (tax-free dividends)[39] 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. If the overall bump limit is less than the accrued gains on CanCo's eligible property, 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.

VII. The Bump Denial Rule

The bump denial rule[40] looms over any analysis of whether the 88(1)(d) bump is available for a particular wind-up. If this rule is contravened for even a single property, even of minimal value, no 88(1)(d) bump can be claimed for *any* property distributed on that wind-up. This penalty is more severe than it needs to be for the bump denial rule to achieve its tax policy objective, and the rule's complexity is such that even the most experienced practitioners can easily overlook something that triggers it. Moreover, even with the recent introduction of some important relieving amendments, there are technical anomalies in the legislation that deny the 88(1)(d) bump when there is no obvious tax policy concern.

The policy behind the bump denial rule is deceptively simple: The parent should not be able to buy and wind up the subsidiary, claim an 88(1)(d) bump on its property, and then sell some of that property back to the subsidiary's former shareholders. Expressed very generally, that result could be viewed as inconsistent with Canada's rules governing divisive reorganizations of Canadian corporations.

The tax policy concern is that allowing an 88(1)(d) bump in such circumstances effectively amounts to a divisive reorganization of the subsidiary, which may trigger a realization of any gains 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 own property, since the wind-up is tax deferred and the 88(1)(d) bump increases the tax cost of some or all of the subsidiary's property. Hence, the bump denial rule is intended to prevent backdoor divisive reorganizations that achieve results that are comparable to (but are not subject to the statutory limitations applicable to) the tax-deferred divisive reorganizations permitted under subsection 55(3) of the ITA. The bump denial rule is not phrased in such simple terms however.

The bump denial 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

[36]Para. 88(1)(d) of the ITA.

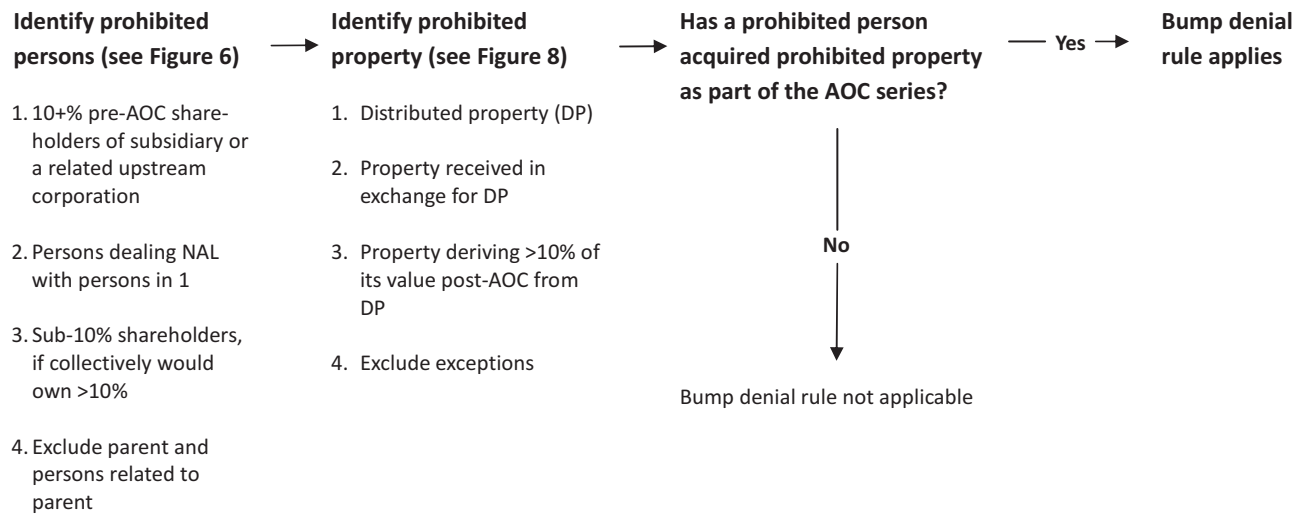
[37]It is generally possible for a shareholder with, say, $60 of tax cost in shares of one Canadian corporation to exchange them for shares of a second Canadian corporation such that no gain is realized and the shareholder's tax cost of the shares of the second corporation and the second corporation's tax cost in the shares of the first corporation is $60.

[38]If this element of the formula is negative (that is, liabilities exceed tax cost of assets), it is treated as nil. Because the net tax cost of the subsidiary's assets (which reduces the overall bump limit) generally increases over time if the subsidiary is profitable, this creates a further incentive to effect the wind-up quickly after the AOC.

[39]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.

[40]Subpara. 88(1)(c)(vi) of the ITA.

Figure 5. Bump Denial Rule Summarized



AOC series (as noted above, the AOC series is the series of transactions that includes the parent's AOC of the subsidiary). Keeping this core concept in mind makes it more manageable to explore the bump denial rule's intricacies in more detail. The complexity of the bump denial rule lies in the breadth of what constitutes prohibited persons and prohibited property. At a core level:

- prohibited persons are shareholders of the subsidiary at a time that is both before the AOC and during the AOC series; and
- prohibited property is property distributed to the parent on the wind-up (that is, acquired from the subsidiary when it is merged or wound up into the parent).

The basic thrust of the bump denial rule is that property of the subsidiary that is distributed to the parent on the wind-up (herein, distributed property) should not, as part of the AOC series, be acquired by persons who were significant subsidiary shareholders at a time during the AOC series and before the parent acquired control of the subsidiary. The term ''significant'' for this purpose essentially means holding 10 percent or more of a class of the subsidiary's shares, individually or collectively.

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 bump denial rule may defeat avoidance schemes designed to circumvent the basic prohibition, it makes the rule very complex (even by tax standards) and can result in the 88(1)(d) bump being denied inappropriately. As a result, on any given transaction, one must consider very carefully the three key elements of the bump denial rule that prohibited persons not acquire prohibited property as part of the AOC series.

A. 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,[41] and the subsidiary itself is also deemed not to be a prohibited person.

The most useful way to illustrate the wide range of potential prohibited persons is by using the example shown in Figure 6, as annotated by the discussion in the text accompanying footnotes 42-47 and 51.

1. Persons Owning (or Deemed to Own) 10-Plus Percent of a Relevant Class of Shares Pre-AOC. The prohibited persons concept centers on persons who are specified shareholders of the subsidiary at a time that is both before the AOC and during the AOC series (herein, 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

[41]If the parent is incorporated during the AOC series (as is often the case) and the relevant time is before that incorporation, each person who is related to the parent throughout the period that begins when the parent is incorporated and ends at the time immediately before the wind-up is deemed not to be a prohibited person. Absent this deeming rule in subparagraph 88(1)(c.2)(i) of the ITA, no person could be related to the parent before its incorporation (since the parent would not exist at that time).

corporation's shares.[42] However, the ''specified shareholder'' definition is expanded as follows:

- *Deemed Share Ownership*: anyone dealing at NAL with the actual owner of shares is also deemed to own those shares, subject to limited exceptions. As a result, it is 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.[43]
- *Ownership of Shares in Related Upstream Corporations*: 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 any other corporation that both:
  - — is related to the first corporation; and
  - — has a ''significant direct or indirect interest'' in the first corporation — that is, an ''upstream'' related corporation.[44]

As such, there are many ways in which a person can be a pre-AOC subsidiary specified shareholder: While persons who own 10-plus percent of a class of the subsidiary's shares before the AOC constitute the starting point of the analysis, NAL persons and related upstream corporations widen the scope considerably.

2. Other Prohibited Persons. The prohibited person definition goes beyond pre-AOC subsidiary specified shareholders to include the following persons:

(a) any number of persons whose collective share ownership, if aggregated in the hands of one person, would make that one person a pre-AOC subsidiary specified shareholder[45];

(b) a corporation, other than the subsidiary, in which a pre-AOC subsidiary specified shareholder is, at any time after the AOC and during the AOC series, a specified shareholder[46]; or

(c) a corporation, other than the subsidiary, if:

- — persons described in (a) 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.[47]

Again, in all cases, the parent and anyone dealing at NAL with the parent will not be a prohibited person.

3. Prohibited Persons: Discussion. Two situations in which the scope of prohibited persons is considerably expanded are when:

- there is a controlling shareholder of the subsidiary before the AOC; and
- 251(5)(b) rights to acquire shares exist (described in Section III.A), which can cause unrelated persons to be related (and therefore deal at NAL), which in turn causes additional persons to be deemed to own shares they do not in fact own.

In particular, if the subsidiary has a controlling shareholder before the AOC (as opposed to being a widely held public corporation, for example), there can often be many pre-AOC subsidiary specified shareholders. This is because if a controlling shareholder exists (for example, ControlCo in Figure 6), any corporation controlled by the subsidiary will itself be related to (and deemed to deal at NAL with) that controlling shareholder, and thereby be deemed to own the controlling shareholder's shares of the subsidiary. This can produce anomalous and unintended results. In Figure 6, for example (and subject to the comments that follow), SubCo 1, SubCo 2, and SubCo 3 are deemed to own the shares of Subsidiary that are owned by ControlCo, the entity that controls (and thereby deals at NAL with) Subsidiary, SubCo 1, SubCo 2, and SubCo 3.

The December 21, 2012, amendments to the 88(1)(d) bump rules created two relieving exclusions in determining whether a person is a specified shareholder of a corporation, both of which will be particularly helpful when:

- the subsidiary/target has a pre-AOC controlling shareholder; and

[42]For example, ControlCo and DCo in Figure 6 are pre-AOC subsidiary specified shareholders. Ownership of some fixed-value nonvoting preferred shares is ignored for this purpose.

[43]*See, e.g.*, NAL Person 1 in Figure 6, who deals NAL with ControlCo and so is deemed to own ControlCo's shares of the subsidiary.

[44]''Specified shareholder'' definition in subsection 248(1) and clause 88(1)(c.2)(iii)(A) of the ITA. *See, e.g.*, Investor and NAL Person 2 in Figure 6. 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.

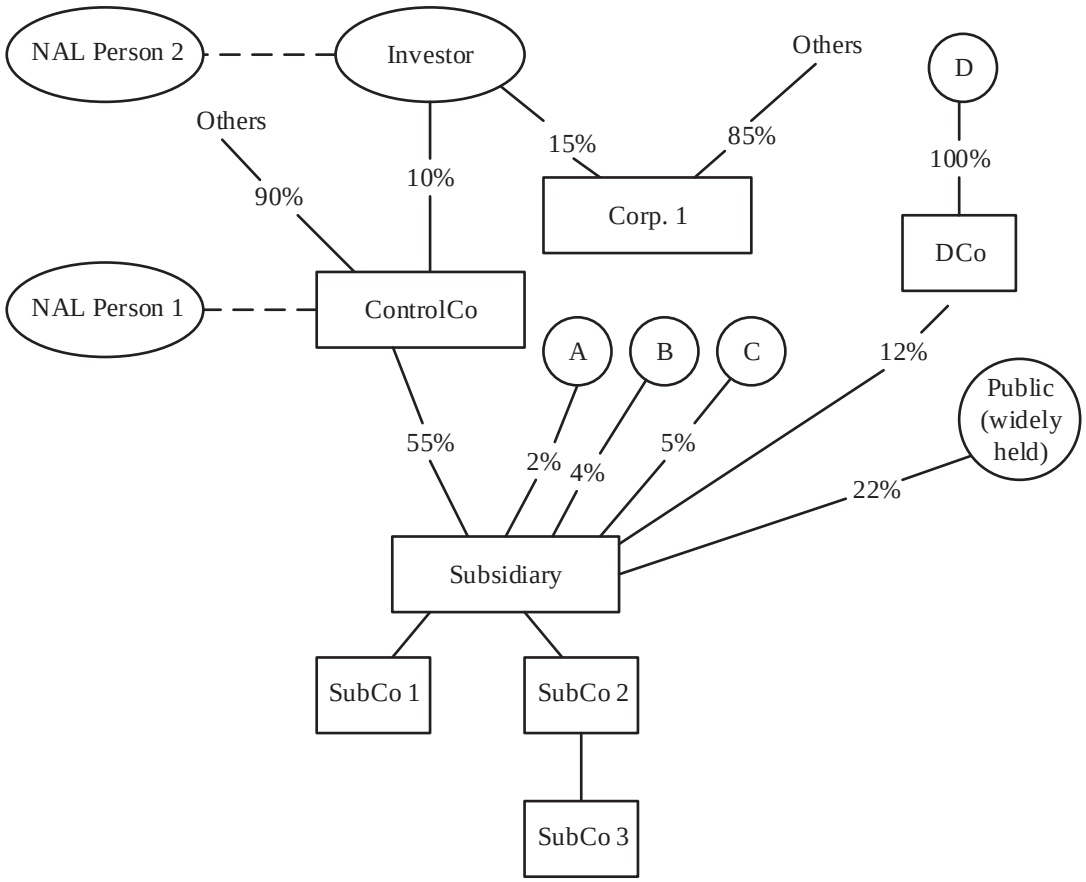
NAL Person 2 (who deals at NAL with Investor) is deemed to own Investor's shares of ControlCo, and is thus in the same position as Investor.

[45]For example, see A, B, and C collectively in Figure 6 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. If A, B, and C all acquired any prohibited property as part of the AOC series, the bump denial rule would apply.

[46]*See, e.g.*, Corp. 1 in Figure 6, 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.

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

Figure 6. Prohibited Persons



- the parent that is acquiring control of the subsidiary plans to sell a corporation controlled by the subsidiary to an arm's-length third party.

First, a person who has 251(5)(b) rights to acquire a corporation controlled by the subsidiary and who would as a result otherwise be deemed to own shares of the subsidiary (for example, because of being deemed to be related to the subsidiary's controlling shareholder) will not be so deemed to own shares of the subsidiary.[48] This amendment will prevent a third party from becoming a prohibited person merely by virtue of entering into an agreement with the parent to acquire shares of a corporation that is controlled by the subsidiary, and thereby becoming related to (and being deemed to own the subsidiary shares owned by) the subsidiary's controlling shareholder.

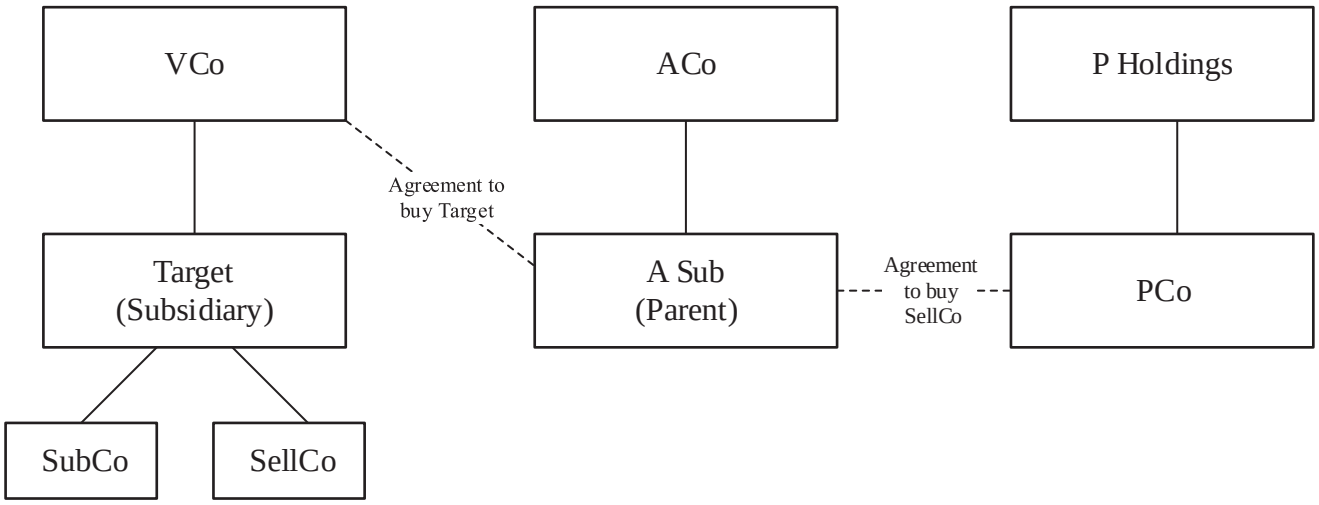
Second, for purposes of the rule that deems persons to own shares if they deal at NAL with the actual owner of the shares, corporations will generally *not* be deemed to own shares of a corporation that controls them. Thus, for example, in Figure 6, SubCos 1, 2, and 3 will not be deemed to own the shares of Subsidiary that are owned by ControlCo, the entity that controls (and thereby deals at NAL with) Subsidiary, SubCo 1, SubCo 2, and SubCo 3.[49]

[48] *See* clause 88(1)(c.2)(iii)(A.2) of the ITA. Subsection 251(3) of the ITA deems two corporations that are each related to a third corporation to themselves be related, meaning that if a third-party buyer enters into an agreement to acquire a corporation controlled by the subsidiary and thereby becomes related to the corporation that controls the subsidiary, that controller and the third-party buyer are deemed to be related, the third-party buyer is deemed to own the controller's shares of the subsidiary, and the third-party buyer thereby becomes a prohibited person.

(Footnote continued in next column.)

[49] *See* clause 88(1)(c.2)(iii)(A.1) of the ITA.

Figure 7. December 21, 2012, Specified Shareholder Amendment



The impact of this amendment is illustrated in Figure 7, in which A Sub (the parent on the wind-up) intends to acquire Target from VCo and then sell SellCo to PCo. Absent this amendment, PCo would be a prohibited person by virtue of acquiring SellCo, and PCo's acquisition of the SellCo shares (which are distributed property on the wind-up of Target into A Sub) would cause the bump denial rule to deny A Sub an 88(1)(d) bump on the SellCo shares, a result clearly outside the policy intent of the bump denial rule.[50]

These two amendments usefully illustrate the difficulties that can arise in dealing with the scope of the ''prohibited persons'' concept and are welcome in terms of reducing the number of anomalous results that can occur. The prohibited persons 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), the beneficial owner of the shares may not be the same person as the registered holder of the shares, and it is virtually impossible to determine the identity of sub-10 percent shareholders (who generally hold their shares through an intermediary).
- Significant numbers of shares are bought and sold every day, changing the shareholder base continually.
- There is typically no way of knowing with certainty who deals at NAL with shareholders or who may have 251(5)(b) rights to acquire or control shares.

The complexity of the rules and the various deeming provisions that are relevant for this purpose can produce strange results, and a careful and detailed analysis of the law and the facts is needed to identify who constitutes prohibited persons in any situation.[51]

B. Prohibited Property

The core of the ''prohibited property'' element of the bump denial rule is distributed property. Actions

[50]Specifically, SellCo and VCo would be related by virtue of VCo controlling Target (and indirectly SellCo), causing SellCo to be a specified shareholder of Target by virtue of being deemed to own VCo's Target shares. Following the AOC and sale of SellCo, P Holdings and SellCo would be related by virtue of P Holdings controlling PCo (and indirectly SellCo), causing SellCo to be a specified shareholder of PCo by virtue of being deemed to own P Holdings' PCo shares. The result is that PCo would be a prohibited person by virtue of being a corporation in which SellCo, a pre-AOC subsidiary specified shareholder of Target, is a specified shareholder. (*See* Section VII.A.2(b).)

[51]Corporations controlled by the subsidiary can also be deemed to be prohibited persons when subsidiary shareholders receive shares of the parent as consideration for their subsidiary shares. Assume the public shareholders of the subsidiary in Figure 6 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 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.

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 hence what constitutes distributed property. Distributed property is always prohibited property, with one exception: When a person acquires distributed property before the AOC but does not own that property at any time after the AOC, that person will be deemed not to have acquired such distributed property, effectively exempting it from being prohibited property regarding that person.[52]

Prohibited property also includes two additional forms of property (herein, substituted property) that are based on distributed property:[53]

- property acquired by any person in exchange for distributed property; and
- property owned by a person following the AOC which, at that time, derives more than 10 percent of its FMV from distributed property.[54]

Properties meeting one (or both) of these conditions are nonetheless excluded from being substituted property if they fall within limited exceptions (see below under Section VII.B.3), further complicating the analysis. These exceptions make it necessary to determine whether a property is a substituted property with reference to a particular owner of the property — the same property could be a substituted property regarding one owner and not another person who later owns the same property. Figure 8 summarizes the prohibited property analysis described in Section VII.

1. Property Acquired in Exchange for Distributed Property. Once all distributed property has been identified, it is necessary to assess whether any property has been acquired by any person ''in exchange for'' distributed property. For example, if the subsidiary acquired Property 1 from another person in exchange for Property 2 and held Property 1 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.[55]

Note that the relevant question when testing whether a property is a substituted property is whether *any* person exchanged that property for distributed property, not merely the particular prohibited person being tested. Thus, once such an exchange occurs, the exchanged property will be a substituted property regarding all owners unless one of the five exceptions provided for in paragraph 88(1)(c.3) of the ITA described below applies. Substituted property can be created on any such transfer, either before or after the wind-up, although the bump denial rule applies only if the other two elements of the test are also met (the property was acquired by a prohibited person and as part of the AOC series).

2. Property Deriving More Than 10 Percent of Its FMV From Distributed Property Post-AOC. Typically, the main concern with the scope of prohibited property is property that derives more than 10 percent of its FMV from distributed property at a time following the AOC and when owned by the prohibited person (herein, 10 percent-plus property). One of the most common examples of 10 percent-plus property is shares of an acquirer of the subsidiary (or of that acquirer's own controlling shareholder). For example, if the parent purchases the subsidiary and delivers parent shares or debt (or shares or debt of that parent's own parent company) to subsidiary shareholders in payment, the subsidiary shareholders will own property (parent securities) that derives its value post-AOC partly from the subsidiary's own property (which is by definition distributed property on the wind-up). If the parent securities derive more than 10 percent of their FMV from the subsidiary's properties, the parent shares are deemed to be substituted property and prohibited property unless an exception to the rule applies.

Some properties specified in the ITA that are 10 percent-plus property are excluded from being deemed substituted property. Such property (specified property) consists of the following:[56]

- a share of the parent or another taxable Canadian corporation that wholly owns the parent, if issued on the acquisition of shares of the subsidiary by the parent, the other taxable Canadian corporation, or a wholly owned Canadian subsidiary of the parent;
- a share of the parent issued for consideration consisting exclusively of money;

[52]Subpara. 88(1)(c.2)(iv) of the ITA.

[53]Another form of deemed substituted property also exists, but it is generally interpreted as being limited to property that derives substantially all its value from distributed property, based on the Department of Finance technical notes describing this provision (subpara. 88(1)(c.3)(ii) of the ITA).

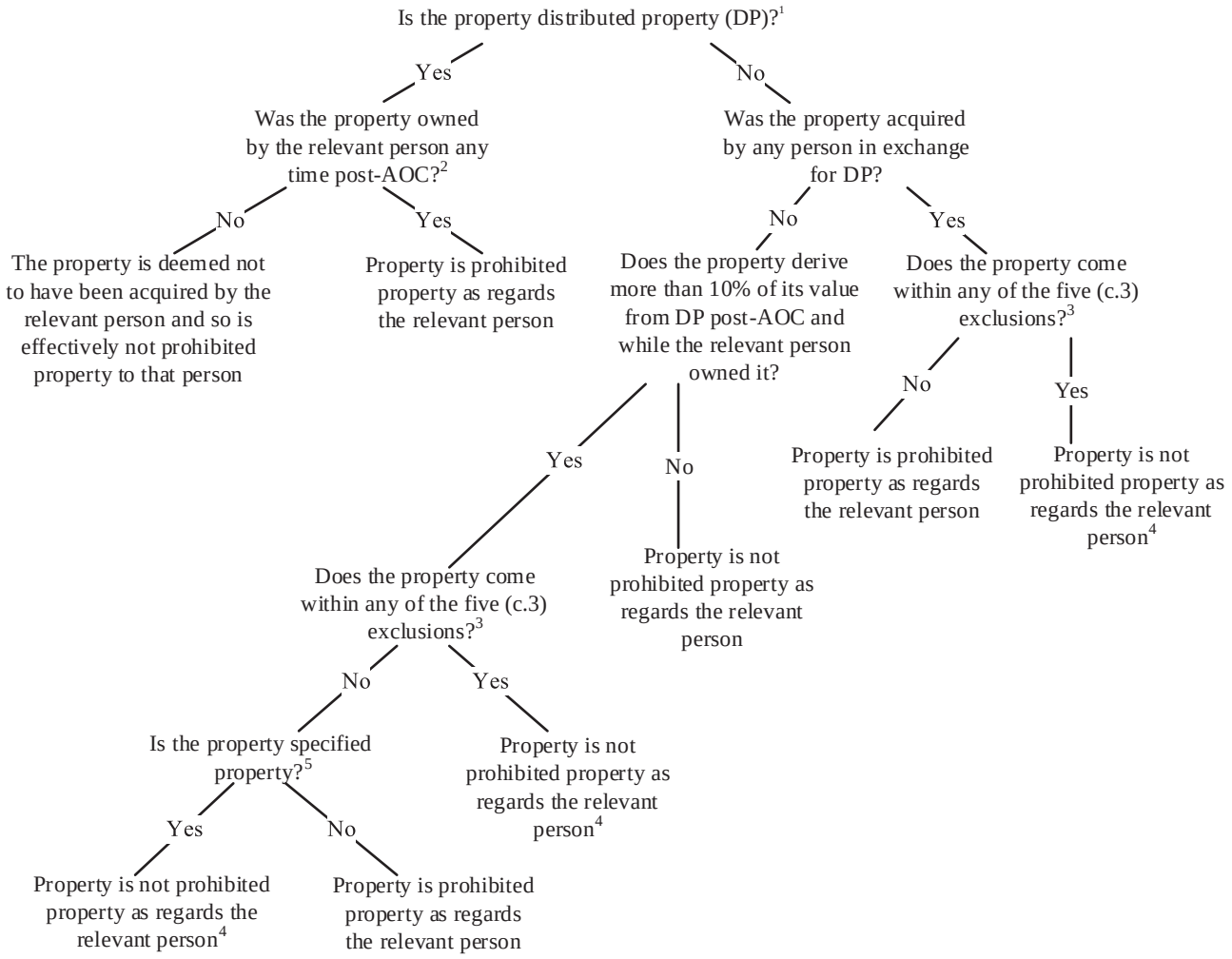
[54]Before December 21, 2012, this was phrased more broadly to include property whose FMV (any time following the AOC) was wholly or partly attributable to distributed property — that is, no 10 percent threshold.

[55]Since only at the time of the wind-up will it be known for sure what the distributed property is, 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 therefore substituted property.

(Footnote continued in next column.)

[56]These exceptions are contained in paragraph 88(1)(c.4) of the ITA. In the context of these exceptions, ''wholly owned'' means owning shares representing at least 90 percent of votes and value.

Figure 8. Prohibited Property Analysis



1. DP is property of subsidiary acquired by parent on the wind-up of subsidiary.

2. AOC is parent's acquisition of control of subsidiary.

3. The five (c.3) exclusions are (1) money, (2) property not owned by the relevant person any time post-AOC, (3) property that derives more than 10% of its value from DP post-AOC solely because a "specified property" (see note 5) was received in exchange for subsidiary shares, (4) a share or debt of subsidiary owned by parent immediately pre-wind-up, and (5) a share or debt of a corporation that derives no part of its value post-wind-up from DP.

4. Assuming the property's FMV post-AOC and while the relevant person owned it is not determinable primarily by reference to the FMV or sale proceeds of DP.

5. "Specified property" consists of (1) shares or debt of parent (or another taxable Canadian corporation that wholly owns parent) issued in exchange for subsidiary shares, (2) parent shares issued for cash, (3) debt issued for cash, or (4) where subsidiary is involved in an amalgamation "squeeze-out" of minority shareholders, parent shares and certain subsidiary shares redeemable for cash or parent shares. For this purpose, "shares" include options to acquire shares.

- a debt of the parent issued as consideration for the acquisition of shares of the subsidiary by the parent;
- a debt issued for consideration consisting exclusively of money;
- a debt issued by a taxable Canadian corporation as consideration for the acquisition of shares of the subsidiary by that taxable Canadian corporation or by the parent (if that other corporation wholly owns the parent); and
- if issued on some amalgamations by which minority shareholders of the subsidiary are ''squeezed out,'' a share of the parent, or a share of the subsidiary that is either exchanged for parent shares or redeemed exclusively for money or parent shares.

These are important exceptions, since they allow, for example, the parent to issue shares or debt in exchange for money in order to finance an acquisition of the subsidiary, without having to worry about whether the persons acquiring the shares or debt are prohibited persons. They also allow a taxable Canadian corporation to issue shares of itself directly in exchange for shares of the subsidiary, which permits Canadian acquirers to use their shares as currency to acquire the subsidiary without creating prohibited property.[57]

Unfortunately, none of these exceptions apply to shares or debt issued by non-Canadian corporations (other than the exception for debt issued solely for money). As such, securities of a foreign entity that is the direct or indirect acquirer of the subsidiary will generally constitute deemed substituted property, unless either:

- the securities are debt issued in exchange for money; or
- the foreign entity is so much larger than the Canadian target subsidiary that the foreign entity's securities cannot be said to derive more than 10 percent of their value from the Canadian target subsidiary's assets (that is, distributed property).

The result is that Canadian acquirers have an advantage over foreign acquirers in that they can use their shares and debt to pay for the shares of Canadian targets and still be able to claim the 88(1)(d) bump. If Canadian target shareholders who collectively hold 10 percent or more of the Canadian target's shares receive shares or debt of a foreign acquirer for their Canadian target shares, and if those foreign acquirer shares or debt derive more than 10 percent of their value from the Canadian target's properties, persons who in aggregate constitute a pre-AOC subsidiary specified shareholder will have received prohibited property, and the bump denial rule will apply. Hence, a foreign acquirer can generally use the 88(1)(d) bump only if it pays cash or if it acquires a Canadian corporation representing less than 10 percent of the acquirer's own value.

3. Substituted Property Excepted From Being Prohibited Property. Certain substituted property owned by a person that would otherwise be considered prohibited property (either by virtue of having been received in exchange for distributed property or being 10 percent-plus property) is specifically excluded from being prohibited property:[58]

- money;
- property not owned by that person any time after the AOC;
- property that is 10 percent-plus property solely because a specified property[59] was received in exchange for a share of the subsidiary;
- shares or debt of the subsidiary owned by the parent at the time of the wind-up; 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.

Also, the CRA has stated that the following would generally not be substituted property:

- a right under an earn-out clause in a share purchase and sale agreement used solely to establish the FMV of the shares[60];
- a price adjustment clause providing for a post-closing adjustment solely to ensure that the purchase price reflects the exact amount of a liability of the target at closing[61]; and
- a guarantee of a party's obligations under a purchase and sale agreement given by the party's ultimate parent corporation.[62]

This article cannot describe in detail the full scope of the prohibited property definition. Suffice it to say that it is a broad concept that goes well beyond distributed property. Figure 9 illustrates some of the typical problems that can arise when a foreign acquirer (Foreign Parent) acquires a public Canadian target (CanCo) in exchange for Foreign Parent shares, using a Canadian corporation (CanAcquireCo):

[57]Moreover, since for these purposes a ''share'' includes a right to acquire a share (paragraph 88(1)(c.9) of the ITA), employee stock options to acquire subsidiary shares can be exchanged for employee stock options to acquire parent shares. Note, however, that this exception does not extend to stock options issued for other consideration — for example, options issued to subsidiary employees as an incentive to remain with the company post-AOC.

[58]Subparas. 88(1)(c.3)(iii)-(vii) of the ITA.

[59]*See* Section VII.B.2, above.

[60]CRA document no. 1999-0010965 (Jan. 31, 2000).

[61]CRA document no. 2007-0243261C6 (Oct. 5, 2007).

[62]CRA document no. 2009-0340351R3 (Dec. 18, 2009).

- Foreign Parent shares would be prohibited property if more than 10 percent of their post-AOC FMV is attributable to CanCo's property.[63]
- Holders of CanCo employee stock options who exchange their options for Foreign Parent stock options will have acquired deemed substituted property (and thus prohibited property) if more than 10 percent of the options' post-AOC FMV is attributable to CanCo's property.
- A Foreign Parent receivable acquired by a lender as part of the AOC series would be a prohibited property if more than 10 percent of its post-AOC FMV is attributable to CanCo's property, unless it was issued solely for money.
- If after the wind-up, Foreign Parent disposes of SubCo 1 (a distributed property) to Buyer, it is important that Buyer not be a prohibited person. Buyer's own securities will also become prohibited property if they derive more than 10 percent of their FMV from the SubCo 1 shares (which are distributed property), creating the need to determine if Buyer's shareholders include former CanCo shareholders (prohibited persons).[64] This is an important issue since one of the primary uses of the 88(1)(d) bump is on the post-wind-up sale of distributed property to third parties.

C. 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 such property by those persons occurs as part of the AOC series is an important limitation on the scope of the bump denial rule.

As noted in Section III.D above, the series of transactions concept is quite broad and fact dependent. In some cases, it will be obvious that property is acquired as part of the AOC series (for example, property received from the parent by subsidiary shareholders in exchange for their subsidiary shares). In other cases, the answer is not so clear. For example, while one would think the AOC series does not include 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 legal certainty on this point. There is no way of preventing such third parties from doing something that may taint the 88(1)(d) bump. It is enough for present purposes to observe that when CanCo is widely held or 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.

VIII. 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 the Canadian tax system (see Figure 2), a strategy that is now especially important for foreign purchasers since the enactment of the FAD rules. 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 successfully using it often 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 bump is generally 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

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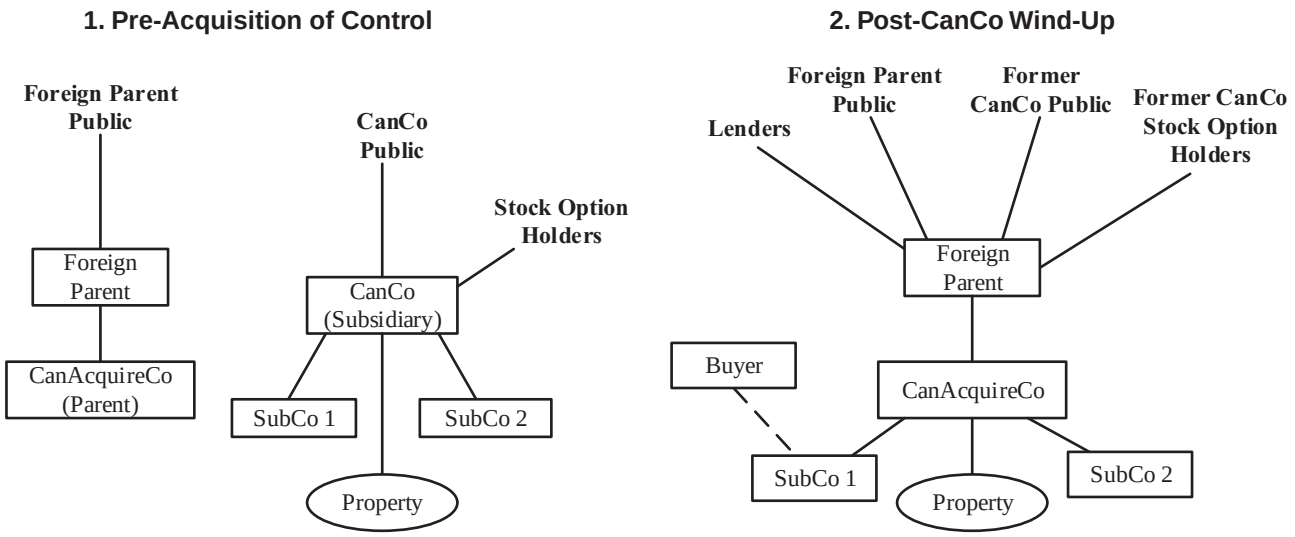
[63]In ''exchangeable share'' transactions, CanCo shareholders receive exchangeable shares of CanAcquireCo that track the value of, and will ultimately be exchanged for, Foreign Parent shares. In such circumstances, while CanAcquireCo exchangeable shares may be ''specified property'' and thereby excepted from being prohibited property, the ultimate exchange of exchangeable shares for Foreign Parent shares would generally trigger the application of the bump denial rule if those Foreign Parent shares are 10 percent-plus property so as to be prohibited property. The CBA-CICA Joint Committee's Feb. 15, 2013, submissions to the Department of Finance included a specific recommendation on how to apply the 10 percent FMV test in the context of exchangeable share transactions. For more on exchangeable shares, see Suarez and Samtani, ''Using Exchangeable Shares in Inbound Canadian Transactions,'' *Tax Notes Int'l*, Dec. 24, 2007, p. 1281.

[64]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, the 88(1)(d) bump will be tainted. As described in Section VII.A.2, Buyer will itself 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 (regardless of whether that shareholder acquired its Buyer shares as part of the AOC series); or
- as part of the AOC series, 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 to make a single holder of them a specified shareholder of Buyer following the AOC.

Figure 9. Common Issues With Prohibited Property



permits the scope of eligible property to be optimized (see Figure 4). 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 aware of this rule because it often 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 are deceptively simple at a conceptual level, but sometimes do not fit easily within 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. Purchasers of a Canadian business who have a good understanding of both how to structure an acquisition so as to be entitled to an 88(1)(d) bump, as well as the benefits of so doing, are well positioned to make that acquisition in the most tax-efficient manner. ◆