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• PRACTICE AND PLANNING TIPS •

New 88(1) Comfort Letter Addresses Bump Anomaly

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The paragraph 88(1)(*d*) bump (the "Bump") allows one taxable Canadian corporation (Parent) to increase the adjusted cost base of eligible non-depreciable capital property acquired on the wind-up of another taxable Canadian corporation (Subsidiary) in certain circumstances. It is an extremely useful tax planning tool, and is used in many merger and acquisition transactions. The Bump has a variety of important applications in post-acquisition planning, including: (1) eliminating gains on property sold to a third party following the acquisition, and (2) facilitating the restructuring of the Subsidiary group, which in the case of a cross-border acquisition often includes bumping the shares of Subsidiary's foreign subsidiaries and extracting them out from under Canada such that they are held directly by Parent's foreign parent.[1]

Unfortunately the Bump provisions are extremely complex, and it is not uncommon to encounter anomalous results in applying these rules to actual transactions. The bump denial rule in subparagraph 88(1)(*c*)(vi) tends to be especially troublesome, due to its complexity, the catastrophic consequences of its application (the Bump is completely denied on all Subsidiary property), and the various deeming rules that apply to its interpretation. A recent comfort letter issued by the Department of Finance dated August 13, 2007 (the "Letter") illustrates the unintended results that the bump denial rule can have in reasonably common fact patterns.

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DESCRIPTION OF ANOMALY

The bump denial rule in subparagraph 88(1)(*c*)(vi) denies the Bump in situations where a prohibited person acquires prohibited property as part of the series of

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transactions that includes the wind-up of Subsidiary into Parent. The problem dealt with in the Letter relates to subclause 88(1)(*c*)(vi)(B)(III), which deems a corporation to be prohibited person in certain circumstances.

Essentially the issue addressed in the Letter is the scope of description 1 of subclause 88(1)(*c*)(vi)(B)(III), and the manner in which that provision incorporates the "specified shareholder" definition. A few short-forms are useful for discussion purposes:

- **the AOC**: Parent's acquisition of control of Subsidiary;
- **the Wind-up**: the wind-up of Subsidiary into (or amalgamation with) Parent;
- **the Series**: the series of transactions or events that includes the AOC and the Wind-up;
- **(B)(I) Person**: a person described in subclause 88(1)(*c*)(vi)(B)(I), being a person (other than a specified person)[2] who is specified shareholder of Subsidiary at any time before the AOC and during the Series;
- **Subsidiary Subs**: corporations controlled by Subsidiary pre-AOC; and
- **(B)(III)(1) Corporation**: a corporation described in description 1 of subclause 88(1)(*c*)(vi)(B)(III).

Expressed very roughly, description 1 of subclause 88(1)(*c*)(vi)(B)(III) deems a corporation (other than a specified person) to be a prohibited person if a (B)(I) Person is a specified shareholder of the corporation at any time post-AOC and during the Series. The problem is that in situations where there is a pre-AOC controlling shareholder of Subsidiary ("Controller"), Subsidiary Subs will generally be (B)(I) Persons due to the scope of the "specified shareholder" definition.[3] As a result, Subsidiary Subs are included in the range of persons who will cause a corporation to be a (B)(III)(1) Corporation if they are specified shareholders of the corporation during the Series and post-AOC. Consequently, if an arm's-length third party ("P Co") unrelated to Parent purchases a Subsidiary Sub as part of the AOC Series, the introduction of that Subsidiary Sub into the P Co group can result in that Subsidiary Sub being deemed to be a specified shareholder of P Co group members and make P Co group members (B)(III)(1) Corporations (see the discussion of the Letter below for a more detailed explanation). As someone completely unrelated to Subsidiary and its pre-AOC shareholders should not be a prohibited person in concept, P Co and its affiliates becoming prohibited persons (as (B)(III)(1) Corporations) solely as a result of acquiring a Subsidiary Sub is clearly an unwarranted result. The Letter proposes to correct this by ensuring that P Co will not be a (B)(III)(1) Corporation in such circumstances, effective for windings-up beginning after August 2004.

FACTS & ANALYSIS

The circumstances described in the Letter are as follows (V Co, Target, Subco, A Co and P Co are all taxable Canadian corporations):

- V Co owns shares of Target representing *de jure* control, with the balance of Target's shares being widely held. Target owns all of the shares of Subco and Sellco 1; Subco in turn owns all of the shares of Sellco 2 (see Figure 1).
- A Co (which deals at arm's-length with V Co, Target and P Co) incorporates A Sub; A Sub acquires all of the Target shares for cash.
- Target is amalgamated or wound up into A Sub; A Sub applies the Bump to step up the tax cost of the shares of Subco and Sellco 1 ("Wind-up 1").
- Subco is then in turn amalgamated or wound up into A Sub, which applies the Bump to step up the tax cost of the Sellco 2 shares ("Wind-up 2") (see Figure 2).
- P Co (controlled by P Holdings), which deals at arm's-length with V Co and A Co, purchases the shares of Sellco 1 and Sellco 2 from A Sub for cash (see Figure 3).

Applying the analysis described above, Sellco 1 and Sellco 2 are (B)(I) Persons in respect of Wind-up 1 and Wind-up 2, by virtue of being related to V Co and Target pre-AOC and thereby deemed to own V Co's Target shares in respect of Wind-up 1 and Target's Subco shares in respect of Wind-up 2. Sellco 1 and Sellco 2 will not be specified persons at any time pre-AOC or during the post-AOC period following their sale to P Co.

Once the shares of Sellco 1 and Sellco 2 have been acquired by P Co, they will be related to P Co and P Holdings. Sellco 1 and Sellco 2 will thereby be deemed to own P Holdings' shares of P Co under the share ownership attribution rule in paragraph (*a*) of the definition of "specified shareholder" in subsection 248(1) (the "Deemed Share Ownership Rule"), and will be specified shareholders of P Co post-AOC and during the Series. The consequence of this is that P Co (which is never a specified person) will be a (B)(III)(1) Corporation in respect of both Wind-up 1 and Wind-up 2, since a (B)(1) Person (Sellco 1 and Sellco 2) will be a specified shareholder of P Co (by virtue of being deemed to own P Holdings' P Co shares) post-AOC and during the Series. P Co's acquisition of distributed property in respect of Wind-up 1 (Sellco 1 shares) and Wind-up 2 (Sellco 2 shares) as part of the Series would thereby disentitle A Sub from claiming the Bump in respect of Wind-up 1 or Wind-up 2 under subparagraph 88(1)(*c*)(vi).

DISCUSSION

There can be little doubt that from a tax policy viewpoint, there is no reason why P Co, as a person unrelated to V Co or Target's other pre-AOC shareholders, should be a prohibited person simply by virtue of purchasing the shares of a Target or Subco subsidiary. P Co's acquisition of distributed property is entirely within the object and spirit of the Bump, and indeed the primary application of the Bump would be to eliminate the gains otherwise realized on just such a sale as A Sub's sale to P Co. Finance's undertaking to recommend a suitable amendment to the Act is entirely appropriate.

The source of the problem in this case is the Deemed Share Ownership Rule. It is this provision that makes Sellco 1 and Sellco 2 (B)(I) Persons in the first place, by deeming them to own V Co's shares of Target and Target's shares of Subco. The Deemed Share Ownership Rule then deems Sellco 1 and Sellco 2 to be specified shareholders of P Co, resulting in P Co being a (B)(III)(1) Corporation. Where P Co subsequently (and as part of the Series) acquires Sellco 1 and Sellco 2, the acquired corporations act in an almost virus-like manner, tainting all of the members of the P Co group (except the ultimate controller, P Holdings) because of the Deemed Share Ownership Rule and description 1 of subclause 88(1)(*c*)(vi)(B)(III).

The anomaly remedied by the Letter would appear to arise where the following circumstances are present:

- there is a pre-AOC controlling shareholder of Subsidiary, such that the controller's shares of Subsidiary are attributed to Subsidiary Subs under the Deemed Share Ownership Rule, making Subsidiary Subs (B)(I) Persons;

- following the AOC *and as part of the Series*, a third party (*i.e.*, P Co) acquires (directly or indirectly) a controlling interest in a Subsidiary Sub that constitutes prohibited property (*viz.* distributed property or any other property acquired by any person in substitution therefor). Acquisitions of prohibited property other than a direct or indirect controlling interest in Subsidiary Sub shares would not seem to create this issue; and

- there is a controlling shareholder of the third party acquiror (*i.e.*, P Holdings), such that someone exists who will become related to the acquired Subsidiary Sub and who owns sufficient shares of the third party acquiror to be (and to make the acquired Subsidiary Sub under the Deemed Share Ownership Rule) a specified shareholder of the third party acquiror.

This fact pattern is by no means uncommon, so the relief being proposed by Finance is most welcome.

It is interesting to note that the phenomenon addressed by the Letter is one that arises whether or not P Co enters into any agreement to acquire the Sellco 1 and Sellco 2 shares prior to the AOC. A previous comfort letter dated August 13, 2004 dealt with a situation in which P Co had become a prohibited person under clause 88(1)(*c*)(vi)(B)(I) by virtue of paragraph 251(5)(*b*) rights arising from a pre-AOC agreement to acquire a Subsidiary Sub. In the present case, the problem arises from a different element of the prohibited person definition (description 1 of subclause 88(1)(*c*)(vi)(B)(III)), and in fact if the P Co in the 2004 comfort letter had a controlling shareholder, it would still be a prohibited person due to the anomaly addressed in the Letter, notwithstanding the relief provided in the 2004 letter.

[*Editor's note*: Steve Suarez is a partner at Osler, Hoskin & Harcourt LLP with a practice focused exclusively on the area of income tax.]

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1 For a discussion of the Bump and its applications, see S. Suarez, "Canada's Tax Cost Step-Up: What Foreign Purchasers Should Know", Tax Notes International, Vol. 44, No. 10, December 4, 2006.

2 A "specified person" is defined in subpara. 88(1)(*c*.2)(i) as Parent and anyone related to Parent without regard to rights described in para. 251(5)(*b*).

3 Because para. (*a*) of the "specified shareholder" definition in s. 248(1) deems a person to own any shares owned by someone dealing non-arm's-length with that person, and since a controlling shareholder of Subsidiary will be related to and deal non-arm's-length with any corporations controlled by Subsidiary, Subsidiary Subs will be deemed to own the controlling interest in Subsidiary owned by Controller, making them specified shareholders.

FIGURE 1

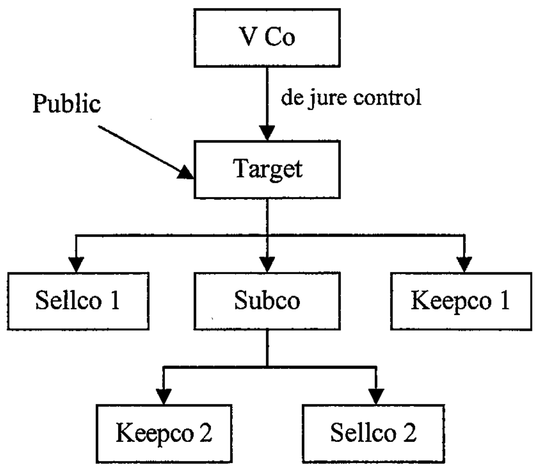


FIGURE 2

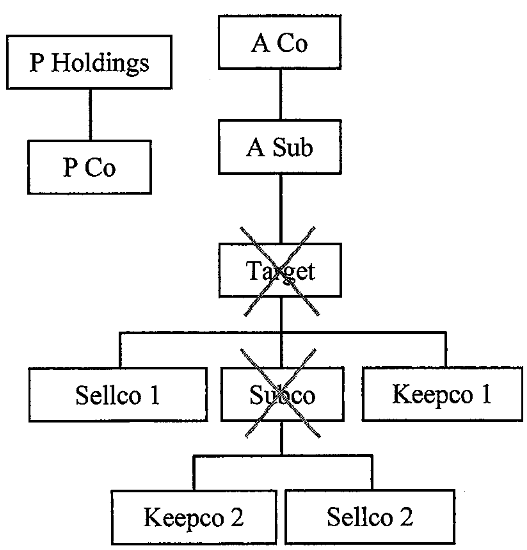
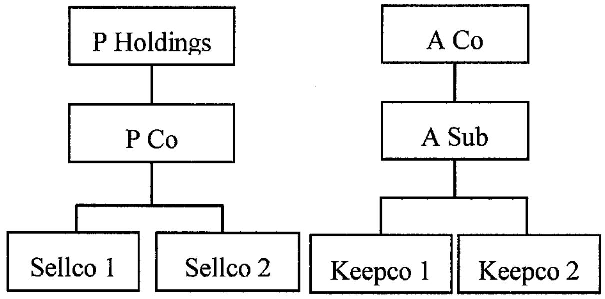


FIGURE 3



• COMMENTARY •

"*Attending*" University via the Internet

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With the new academic year looming large, it is a fitting time to reflect upon issues regarding the assistance provided to university students through the tuition tax credit. Introduced in the 1960 budget speech to alleviate the financial problems faced by university students,[1] the tuition fee deduction was initially available to students studying in universities in Canada.[2] The original provision required a student to be in "full-time attendance" at a university, college or other institution "in Canada". It was not until 1964 that the government introduced a provision to provide assistance to students studying abroad. An extract from the 1964 budget speech suggests that the government was actually preoccupied with the unavailability of tax relief to part-time students. Hence, the law was amended to broaden the tuition fees in respect of which students were allowed to deduct amounts paid to an educational institution in Canada.[3] At the same time, a separate provision was introduced to address the needs of students studying in universities outside Canada.[4]

It is interesting to note that while the amended provision available to students paying fees to an educational institution in Canada now required only that a student be "enrolled", the new provision for studies outside Canada was available to students paying fees to "universities" only and more importantly, it contained the requirement for "full-time attendance". In dealing with the issue of the type of institutions for which tax relief was available in *Gilbert v. Canada*,[5] Justice Mogan recognized that the requirements of the provision dealing with studies abroad were more stringent than those for studies within Canada. He stated:[6]

> Parliament has created a broader spectrum of institutions which a person can attend at the post-secondary level within Canada and still get the tuition credit, but Parliament has restricted the number of institutions outside Canada for which a tuition credit can be achieved.... I speculate that the distinction is to place some control on the kind of post-secondary institutions which may exist in countries outside of Canada where it would be impossible to determine whether they were truly of an educational nature in that they grant a degree. I think the legislation is more confining in paragraph *(b)* to give some measure of control as to the kinds of tuition paid to institutions outside Canada which will give the payer or parent a tax credit.

Clearly, the wording used in the two provisions differed from the outset and presumably, the legislator intended that the requirements imposed upon taxpayers studying abroad be different and more restrictive. However, I think it is fair to say that the politicians and policy makers of the day did not contemplate the reality of modern technology which now allows Canadians to study abroad from the comfort of their homes in Canada via the Inter-