A Critique of Canada’s Divisive Reorganization Rules: Should Breaking Up Be So Hard To Do?

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PRÉCIS
Le Canada a adopté une approche surtout administrative aux réorganisations croisées. Ce fait, conjugué à des dispositions législatives mal rédigées et au manque de jurisprudence dans ce domaine, de nombreuses questions techniques demeurent sans réponse. Les quelques règles en vertu des lois qui existent traitent principalement des opérations qui sont interdites avant, durant et après une réorganisation croisée.

Cet article traite des règles existantes sur les réorganisations croisées, et les dispositions visant les réorganisations par fractionnement en vigueur au Canada et aux États-Unis y sont comparées. En se fondant sur cette analyse, l’auteur propose une réforme des règles sur les réorganisations croisées visant à en faciliter le respect par les contribuables tout en maintenant les objectifs de la politique. Une approche législative et administrative conjointe est recommandée, car elle procure souplesse et certitude tant aux contribuables qu’aux autorités fiscales.

Les modifications législatives proposées comprennent

- l’adoption d’un nouveau mécanisme de roulement croisé qui permettrait la réduction du nombre d’étapes nécessaires pour effectuer une distribution d’actions ou une scission;
- l’élimination des termes vagues;
- la simplification des réorganisations par fractionnement transfrontalières auxquelles participe une société cessionnaire étrangère.

Les modifications proposées aux pratiques administratives englobent

- la modification de la règle du un pour cent afin qu’elle soit mieux adaptée à la taille de la société cédante et au pourcentage de participation dans la société cessionnaire;
- l’abolition de l’approche du conduit consolidé;

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ABSTRACT
Canada has adopted a predominantly administrative approach to butterfly transactions. This, in combination with poorly drafted legislative provisions and a lack of jurisprudence in the area, has left many technical questions unanswered. The few statutory rules that do exist primarily deal with transactions that are prohibited before, during, or following a butterfly reorganization.

This paper examines the existing butterfly rules and compares and contrasts the Canadian and US divisive reorganization provisions. On the basis of this analysis, proposals are developed for reform of the butterfly rules to make them simpler for taxpayers to adhere to while supporting existing policy objectives. A combined legislative and administrative approach is recommended because it can provide both flexibility and certainty for taxpayers and revenue authorities alike.

The proposed legislative changes include

• the enactment of a new butterfly rollover mechanism that would permit a spinoff or split-up to be effected in fewer corporate steps;
• the elimination of vague statutory language; and
• the facilitation of cross-border divisive reorganizations involving a foreign transferee corporation.

The proposed changes in existing administrative practice include

• modification of the 1 percent rule to be more flexible to the size of the distributing corporation and the percentage of the particular transferee corporation’s shareholdings;
• abolition of the consolidated lookthrough approach; and
• consolidation and publication in an interpretation bulletin of the administrative practice of the Canada Customs and Revenue Agency pertaining to butterfly reorganizations.

Keywords: Butterfly transactions; comparative analysis; corporate reorganizations; demergers; tax policy; US-Canada.

INTRODUCTION
History of the Butterfly
The term “butterfly” was first used in reference to divisive corporate reorganizations at the 1977 annual conference of the Canadian Tax Foundation.1 Subsequently, the Canada Customs and Revenue Agency (“the CCRA,” formerly known
as Revenue Canada) became concerned that taxpayers were able to use the butterfly to separate business and investment properties, as well as sell any asset, on a tax-deferred basis at the corporate level.²

In 1981, John Robertson, then director general of the CCRA’s Corporate Rulings Directorate, presented a paper at the annual conference of the Canadian Tax Foundation setting out the CCRA’s concerns.³ He indicated that the CCRA would apply subsection 55(1) of the Income Tax Act⁴ (as it then read) to tax as a capital gain any tax-deferred intercorporate dividend where the parties were seeking to avoid tax on the unrealized gain on the shares of a taxable Canadian corporation.⁵

In an attempt to remedy weaknesses in subsection 55(1), the Department of Finance (“the department”) codified the nucleus of Robertson’s comments with specific legislation that was enacted in 1981. The rules, under new subsection 55(2), allowed the intercorporate transfer of income on which tax had already been paid at the corporate level after 1971. This came to be known as “safe income.” The department also enacted two exceptions to the anti-avoidance rule in subsection 55(2) that would serve as the divisive reorganization provisions in the Act. The first exception, set out in paragraph 55(3)(a), applied in situations where the parties did not deal at arm’s length with each other. The second exception, in paragraph 55(3)(b), applied in situations where the parties involved in the transaction dealt at arm’s length with each other (“the butterfly”).⁶ A further amendment was made in 1982 which essentially prohibited the so-called purchase butterfly (described below).⁷ Intriguingly, the 1981 and 1982 amendments did not include a specific rollover to effect a butterfly. Instead, the department chose to rely on existing rollover provisions⁸ and CCRA administrative practice.⁹

In 1984, however, the department passed legislation that permitted the purchase butterfly.¹⁰ The new rules effectively allowed a change in ownership of the shares of the corporation making the butterfly distribution of property (“the distributing corporation”).¹¹ There were two main reasons for this revision of the butterfly rules:¹²

1) to permit property to pass from the distributing corporation to the new corporate shareholder(s) in the same series of transactions that included the butterfly, where the principal purpose of the series was not to effect a disguised sale of assets that would otherwise be subject to corporate income tax; and

2) to remove many of the reasons for the taxpayer to obtain an advance tax ruling and rely on the CCRA’s administrative practice.

Thus, the department had wanted to introduce more of a legislative, as opposed to an administrative, approach to the butterfly.

Over the next decade, the department became aware of additional abuses and losses of revenue at the corporate level. In particular, the department was concerned that resident and non-resident taxpayers were misusing the purchase butterfly to transform what would normally be a taxable sale of assets into a tax-
deferred event at the corporate level. Draft legislation released on November 24, 1994 proposed, inter alia, the following changes to the butterfly rules, which are still in effect today:13

- Paragraph 55(3)(a) would apply only to transactions in which all parties involved were related to each other. The existing rule was that paragraph 55(3)(a) would apply to parties not dealing at arm’s length with each other.
- Purchase butterflies14 and partial butterflies15 would be eliminated.
- Only two types of butterflies would be available: the spinoff butterfly16 and the split-up butterfly.17

Interestingly, the department chose to legislate more provisions detailing prohibited transactions18 as opposed to statutory rules on the butterfly rollover. The result of this approach was that taxpayers would increasingly rely on the CCRA’s administrative practice for guidance.

Underlying Policy Considerations
As noted above, there are no statutory rules that describe the mechanism for the butterfly rollover. Consequently, in order for a taxpayer to carry out a valid butterfly transaction, adherence to the CCRA’s administrative practice is paramount. Most butterflies are in fact accomplished on the basis of an advance tax ruling.19 From a practical standpoint, it is important for the taxpayer to understand the policy concerns that underlie the CCRA’s administrative practice with respect to butterfly transactions.

The CCRA has stated20 that the butterfly rules are designed to prevent

- disguised sales or barter transactions that would otherwise be taxable,21
- the tax-free cashing out of any shareholder,22 or
- the achievement of any undue tax advantage.23

Assessment of the Administrative Approach and Comparison with the US Statutory Regime
An advantage of the administrative, as opposed to a legislative, approach to butterfly transactions is that it avoids the problem of drafting copious and complex legislation to deal with all the possible transactions that could involve a particular tax provision.24 Another advantage is that, in the absence of specific statutes, it is more difficult for tax practitioners to devise strategies for circumventing the rules. The administrative approach allows the CCRA, via the rulings process, to be both flexible and timely in responding to various issues raised by proposed transactions of taxpayers.

There are, however, a number of disadvantages to such heavy reliance on administrative practice. Many technical questions remain unresolved, despite the CCRA’s published statements. This is the consequence of both vague statutory
language—section 55 is very difficult to interpret—and a lack of jurisprudence in this area. In addition, the CCRA’s interpretation of the rules is not always clear, and it is subject to change from time to time. The CCRA has further adopted policies for each step of a butterfly transaction, which in some cases are administratively favourable to the taxpayer and in other cases are not. Taxpayers are not always able to discern the rationale for differences in treatment. Ultimately, the administrative approach creates inequity among taxpayers, since only the sophisticated have the resources to keep abreast of current practice.

By contrast, the United States has adopted a legislative approach to the application of its equivalent divisive reorganization provision, section 355 of the Internal Revenue Code. In particular, the United States has legislated detailed conditions for a corporation to meet in order to be eligible for IRC section 355. Of particular importance is the rule that IRC section 355 is available only for corporations of a controlled group ("the controlled restriction"). The rationale for this restriction is that a controlled group is recognized in US tax law as a single economic unit, on the basis of the judicial doctrine of substance over form. Hence, the United States permits intragroup transfers via IRC section 355 because the economic ownership of the particular asset remains intact.

Unlike subsection 55(3) of the Act, IRC section 355 is not an exception to an anti-avoidance provision. In the United States, a corporation is indifferent between receiving an intercorporate dividend and receiving a capital gain, because the tax rates are similar. Thus, IRC section 355 is not concerned with the kind of policy objectives underlying the Canadian butterfly rules because there is no incentive to convert what would otherwise be a capital gain into an intercorporate dividend.

This paper will examine in detail the existing butterfly rules, comment on any deficiencies noted, and make recommendations for improvement. In addition, IRC section 355 will be analyzed in relation to the Canadian rules. The purpose of this comparison and analysis is to develop criteria for butterfly transactions that would be simpler for a wider base of taxpayers to adhere to, while not violating existing tax policies.

THE BUTTERFLY HAS TO SHARE ITS WINGS

Preliminary to the analysis of the current butterfly rules, it is helpful to briefly summarize the steps involved in a butterfly transaction. The steps that will be described are those involved in a spinoff transaction, which are not radically different from those involved in a single-wing or double-wing split-up butterfly.

The Basic Steps of the Butterfly

Step 1: The shareholders of a distributing corporation (DC) will transfer a percentage of their common shares into a newly incorporated transferee corporation (TC) and take back common shares of the TC.

Step 2: The DC will roll over the assets of the business it wishes to spin off into the TC and take back preferred shares of the TC.
Step 3: The DC will repurchase for cancellation its common shares held by the TC and issue a promissory note as consideration to the TC. The TC will receive a deemed dividend and a deduction from part I tax.

Step 4: The TC will redeem its preferred shares held by the DC and issue a promissory note as consideration. The DC will receive a deemed dividend and a deduction from part I tax.

Step 5: The notes will be set off against each other in both the DC and the TC. Since they will be of equal fair market value (FMV), there should be no tax consequences to either the DC or the TC. The original shareholders of the DC now hold shares in both the DC and the TC.

**Comparison with the US System**

Many corporate steps are required to achieve a butterfly because the Act provides no specific butterfly rollover mechanism. Taxpayers must rely on other tax provisions (such as section 85, subsection 84(3), and subsection 112(1)) that are often used for other types of corporate reorganization. The additional legal requirements entailed complicate matters for the taxpayer. The CCRA, for its part, appears to fight with the taxpayer over each step rather than consider whether the entire butterfly is acceptable from a policy point of view.

A spinoff or a split-up is relatively easy to implement in the United States because the IRC has a specific mechanism to facilitate the divisive reorganization. The parent corporation’s assets can be rolled into its controlled corporation on a tax-deferred basis for share consideration of the latter. Then the parent’s shares of the controlled corporation are distributed on a non-recognition basis to its former shareholders in satisfaction of their previous shareholdings. Concomitantly, debt of the parent is distributed to the debt holder in exchange for shares or debt of the controlled corporation. Thus, in the United States, the spinoff or split-up transaction can occur in two steps as opposed to five steps for a Canadian butterfly. On the other hand, the butterfly can be used in companies with more diverse shareholdings, whereas IRC section 355 is subject to the controlled restriction. That is, only a parent corporation and a subsidiary (or subsidiaries) in which the parent directly holds at least 80 percent of both the total voting power and at least 80 percent of the total number of shares of all classes can participate in an IRC section 355 reorganization.

**Recommendation**

Canada should legislate a two-step mechanism to effect a butterfly, similar to the mechanism available in the United States. It is not recommended that the controlled restriction in IRC section 355 be adopted, since such a limitation would discourage divisive reorganizations. A two-step mechanism would provide obvious advantages to taxpayers. It would perhaps also serve as an incentive for the CCRA to assess whether the butterfly, as a whole, conforms to legislative and administrative requirements since there would be fewer corporate steps to attack.
With the introduction of a statutory rollover, there would no longer be any cross-redemption of DC and TC shares (as indicated in the aforementioned steps 3 and 4). Consequently, the following concerns that must currently be addressed when planning a butterfly would no longer have to be considered:

- Part IV.1 tax\(^{44}\) for the dividend recipient and part VI.1 tax\(^{45}\) for the dividend payer.\(^{46}\)
- Potential circularity problems with refundable dividend tax on hand (RDTOH) and part IV tax.\(^{47}\)
- The need for the taxpayer to decide whether to execute the butterfly on a gross asset or net asset basis. Although the Act expressly permits only a gross asset butterfly, the CCRA allows for a net asset butterfly\(^{48}\) in order to comply with the pro rata test (discussed below). This administrative concession would be unnecessary because the liabilities of the DC would be exchanged on a tax-deferred basis via the butterfly rollover.\(^{49}\)

All the aforementioned factors would reduce the current complexity for the taxpayer in complying with the butterfly rules, without violating their policy objectives.

DIFFICULTIES WITH A DISTRIBUTION

The Pro Rata Test

One of the more important criteria for a butterfly is that there must be a valid distribution. A distribution occurs when a TC receives its pro rata share of each type of property transferred by the DC which is equal to or approximates the relative FMV of the TC’s shareholdings of the DC before the butterfly (“the pro rata test”).\(^{50}\) The Act does not define the types of property that may be involved in a distribution.\(^{51}\) For administrative purposes in applying the butterfly rules, the CCRA maintains that there are three types of property: cash and near cash, business assets, and investment assets.\(^{52}\) The purpose of the pro rata test is to prevent the tax-deferred cashing out of the TC at the corporate shareholder level.\(^{53}\)

There could be practical difficulties in ensuring that a TC received its exact pro rata FMV share of each type of property from the DC. For example, the business assets of the DC may not be divisible for allocation of the pro rata amount to the TC. Furthermore, the CCRA has indicated in private rulings that it will grant a favourable ruling only if the pro rata test is satisfied without any adjustments under a price adjustment (PA) clause.\(^{54}\) All these factors make the pro rata test difficult for the taxpayer to comply with.

Comparison with the US System

The US system is simpler than its Canadian counterpart in that there is only one type of property and there does not have to be a pro rata distribution.\(^{55}\) The
allocation of property between the controlled corporations is irrelevant since the economic relationship between the parties is substantially the same as it was before the distribution. Thus, the substance of the ownership has not changed because the assets are still owned by the original shareholders of the DC.

**Recommendation for the Pro Rata Test**

Under the Canadian rules, the types of property test and the pro rata distribution requirement are critical in achieving one of the central policy objectives of the butterfly rules: to prevent a TC from cashing out on a tax-deferred basis. Unlike the US approach, the Canadian tax system is based not on business substance but rather on legal form. It would be a breach of Canadian tax policy if a distinct legal entity received a disproportionate amount of cash, notwithstanding that the property would remain in the same economic group. Thus, Canada should maintain the types of property test and the pro rata distribution requirement in the butterfly rules.

**The 1 Percent Rule**

Some latitude in the pro rata requirement appears to be provided in the definition of “distribution,” which includes the phrase “or approximates” in respect of the relative FMV of the TC’s shares. In providing an advance tax ruling, the CCRA has interpreted this phrase to mean 1 percent above or below the TC’s pro rata FMV of each type of the DC’s property (“the 1 percent rule”). This administrative position is harsh given that even the most up-to-date property valuations will likely not be so accurate as to meet the pro rata test within the parameters of the 1 percent rule. FMV is not an exact number but rather a range of values that in most cases has a deviation of more than 1 percent.

Further practical problems with the 1 percent rule can be illustrated by a simple example. Assume that there is a DC with two TCs, TC1 and TC2. TC1 owns 30 percent of the common shares of DC and TC2 owns the remaining 70 percent of DC’s common shares. DC has $20 of cash, $100 of business assets, and $200 of investment assets. DC will undergo a single-wing split-up butterfly and distribute to TC1 its pro rata share of each type of property. TC1’s pro rata share of each type of property consists of $6 of cash, $30 of business assets, and $60 of investment assets. The CCRA will permit the following ranges for each type of property: $5.94-$6.06 for cash; $29.70-$30.30 for business assets; and $59.40-$60.60 for investment assets. The first observation that can be made is that the 1 percent rule represents a very narrow range of compliance for the taxpayer. Second, there is no de minimis test in determining whether the pro rata test is applicable. In the above example, this means that the taxpayer would have to comply with the pro rata test for an insignificant asset like cash. If the pro rata test were not adhered to for cash, the entire butterfly distribution for each type of property would be broken, and subsection 55(2) could apply to both of the dividends previously described in steps 3 and 4 of a butterfly.
The basic problem with the 1 percent rule is its arbitrary nature. In the case of a large multinational public company, it may be impractical for the company to classify and allocate its assets with the degree of precision required by the CCRA. Depending on the size of a DC, a discrepancy in FMV that exceeds 1 percent may not, from a policy perspective, represent a cashing out of the TC that would be significant enough for the CCRA to be concerned with.

**Recommendation for the 1 Percent Rule**

It is recommended that the CCRA modify its 1 percent rule to be more flexible to the size of the DC and the percentage of the TC’s shareholdings. In particular, the percentage deviation from the pro rata test should be the product of these two variables. The indicators for the size of the DC (assets versus sales) and the TC’s shareholdings (voting rights versus FMV of shares) would have to be developed by the CCRA. The modified 1 percent rule should apply in direct proportion to the DC’s size and the TC’s shareholdings because these two factors are indicative of the magnitude of a particular TC’s claim on a DC’s property. The modified 1 percent rule also conforms with the following CCRA statement: “There is no hard and fast rule with respect to the interpretation of the words ‘equal to or approximated’ [sic] and each case will be considered on a case by case basis.”

**Consolidated Lookthrough Approach**

The CCRA’s administrative position is that the types of property of a DC must be determined using the consolidated lookthrough approach. This approach looks through the investments in other corporations to assess the character of their underlying assets. The CCRA states that the consolidated lookthrough approach is mandatory for Canadian and foreign shares of corporations in which the DC has an interest and over which it exercises significant influence. The prevailing accounting guideline states that the existence of significant influence is a question of fact, but it is presumed to exist where a shareholder has a 20 percent or greater interest. This consolidation of property can be performed on a gross or a net basis.

The consolidated lookthrough approach runs counter to one of the fundamental principles of Canadian taxation: tax is levied on separate legal entities and not on economic groups of companies. Canadian jurisprudence has long upheld the separate entity concept of taxation and has in fact frowned upon any tax consolidation scheme that abuses the framework of the Act. Furthermore, this tax policy is legislated in the Act: “For greater certainty, it is hereby declared that, unless specifically required, neither the equity nor the consolidation method of accounting shall be used to determine any amount for the purposes of this Act.” The CCRA may argue that the consolidated lookthrough approach falls within the exception of subsection 248(24) because it is specifically required to analyze the economic substance of the corporation(s) holding the types of property. Further, this consolidated approach of categorizing types of property is obviously meant to discourage
shuffling property within a related group so as to meet the pro rata test in the particular DC.

**Recommendation**

The butterfly provisions expressly permit intragroup transfers of property as long as they are within a controlled group. Further, the assets of companies that are only under the DC’s significant influence should not be consolidated with the DC’s assets. In most cases, because of a lack of voting power, the DC would not be able to exercise economic or legal control over these particular corporations to warrant a consolidation of assets. Thus, the elimination of the consolidation look-through approach would not violate any policy objectives. In fact, its removal from the CCRA’s administrative practice would conform to the basic Canadian tax principle of separate entity taxation. As well, it would eliminate one significant element of complexity for the taxpayer in trying to plan a butterfly reorganization.

**AMBIGUITY IN THE LANGUAGE OF THE BUTTERFLY PROVISIONS**

**Meaning of “in the Course of a Reorganization”**

One major area of complexity in the butterfly rules lies in their vague statutory language. For example, paragraph 55(3)(b) begins with the phrase “if the dividend was received... in the course of a reorganization in which... a distributing corporation made a distribution to one or more transferee corporations [emphasis added].” It is critical to define precisely what is meant by “in the course of a reorganization” because it is within those parameters that a valid butterfly distribution must be made. However, the phrase is not a defined term in the Act. There has also been little judicial consideration of the term “reorganization” in Canada. In *Kennedy v. MNR*, Cattanach J described a reorganization as follows:

> If an undertaking of some definite kind is being carried on but it is concluded that this undertaking should not be wound up but should be continued in an altered form in such manner that substantially the same persons will continue to carry on the undertaking, that is what I understand to be a reorganization. It is that same business carried on by the same persons but in a different form.

English jurisprudence is also of some assistance. The English courts use the term “reconstruction” synonymously with “reorganization.” In *Re South African Supply and Cold Storage Company*, Buckley J stated that the term “reconstruction” was a commercial term that had no precise legal meaning. Reconstruction involved the carrying on of a project in an altered form, but it was not necessary that all of the assets of the former business or all of the shareholders of the former corporation remain intact. It would be sufficient if “substantially the same business shall be carried on and substantially the same persons shall carry it on.”

**A CRITIQUE OF CANADA’S DIVISIVE REORGANIZATION RULES**

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The CCRA’s views regarding the meaning of the phrase “in the course of a reorganization” are based on the aforementioned sources of case law and are as follows:

In our view, the limited Canadian jurisprudence which exists with respect to the meaning of the word “reorganization” suggests that a reorganization involves the continuation of a business in a modified form by substantially the same persons who previously carried it on. The application of this concept to paragraph 55(3)(b) would require that each shareholder-transferee retain its pro rata share of the property transferred to it by the particular corporation for some period.71

A butterfly would qualify as a reorganization because it would alter the existing business in its legal form while retaining predominantly the same persons as shareholders. In the previously discussed spinoff example,72 the altered form of the original DC is the newly incorporated TC, which has the spunoff assets, and the DC, which retains the remaining assets. The original DC’s shareholders are now the shareholders of both the DC and the TC.

Whether a transaction occurs “in the course of a reorganization” is considered by the CCRA to be a question of fact.73 The CCRA’s view is that transactions involving the DC and any of its TCs and any distribution of property of the DC will ordinarily be considered to occur “in the course of a reorganization in which property of a particular corporation was transferred.”74 Any transfer of property (including dividends and taxable and non-taxable transfers) by the DC to its corporate shareholders or to corporations related to such shareholders would normally be part of the reorganization and would be included in the distribution.75

Both the statutory language and the CCRA’s supporting commentary are quite broad with respect to transactions that are considered to be “in the course of a reorganization.” Nevertheless, the taxpayer must understand the precise parameters of the butterfly reorganization so as to determine what will be considered to be part of the distribution. This difficult task is further complicated by the fact that even transactions that are not directly part of the butterfly, but are in the same series of transactions as the butterfly, could be considered part of the butterfly reorganization.76

Careful attention must be paid to any transfer of property between the DC and the TC within the specified time period of the reorganization or a related series of transactions. The taxpayer must calculate the FMV of each type of property that was transferred to the particular TC before the actual butterfly distribution. As well, the taxpayer must calculate how much additional property must be distributed on the actual butterfly distribution in order to meet the pro rata test. It is clear that in the normal course of operations of a corporation, meeting the pro rata test is a complicated task. However, the difficulty in meeting the test lies in defining the period of the reorganization to which it applies and not in the actual test itself.

There is no logic in the CCRA’s administrative position to warrant such complexity. Taxable transactions of property between the DC and the TC should not be considered to be part of the distribution because they are not tax-deferred. No
tax is being avoided at the corporate level by these taxable transactions. Why, then, should they be included in the pro rata test to determine the types of property to be transferred via the butterfly? The CCRA’s current administrative practice is incorrect because it commingles property acquired in taxable transactions with property that will be transferred via a tax-deferred transaction. Logically, only those properties that will be distributed by the DC to the TC(s) via the butterfly should be used in applying the pro rata test.

Comparison with the US System

The language of IRC section 355 is clearer than that of paragraph 55(3)(b) of the Act, and it avoids vague terms like “in the course of a reorganization.” As a result, it is easier for taxpayers to understand the terms of the provision and its application. IRC section 355 refers to a very specific event: the distribution of stock and/or securities to the original shareholder(s) of the original DC. In contrast to the Canadian rule, there is no specified framework, such as a reorganization, within which the distribution must occur. Under the US rule, the actual distribution of property by the DC to its controlled corporations is the all-encompassing event.

Recommendation

Currently, the Canadian statute must incorporate broad language (such as “in the course of a reorganization”) because taxpayers must rely on a number of other provisions in order to effect a butterfly. The department should replace the phrase “in the course of a reorganization” with clear and precise wording similar to that of IRC section 355. The replacement wording should refer to the specific event of the distribution from the DC to the TC(s). This change would eliminate the problem of classifying transactions between the DC and the TC that are not part of the actual distribution. More succinct language would be easier for the department to legislate if a specific tax-deferral mechanism were to be implemented for the butterfly, as previously suggested.

The department has attempted in the past to make paragraph 55(3)(b) less ambiguous. In 1994, the main reason for the introduction of the term “permitted redemption” was to clarify which dividends were exempted from subsection 55(2). Specifically, the department wanted to stress that only the deemed dividends in steps 3 and 4 of the butterfly sequence were eligible for the exemption from subsection 55(2). Any other dividends that occurred in the course of the reorganization but were not part of the “permitted redemption” would not be exempt. Further revision of paragraph 55(3)(b), as recommended above, is fully justified by the problems that arise under the current wording.

Meaning of “in Contemplation of”

Paragraph 55(3.1)(a) prohibits property from becoming property of the DC “in contemplation of” a butterfly in order for paragraph 55(3)(b) to be operational.
The phrase “in contemplation of” is not defined in the Act, nor is there any tax jurisprudence that addresses its meaning.84

Outside the realm of tax law, in Scene Estate Ltd. v. Amos,85 it was held that the words “in contemplation of” are stronger than “made in expectation of.” The court further held that an agreement is not made “in contemplation of” the occurrence of another event unless there is a power and obligation to consummate that event. In Re Roach,86 the words “in contemplation of death” were held to refer to an imminent death. Both of these cases suggest that an initial transaction is made in contemplation of a second transaction or event if the first transaction was entered into for the purpose of the second, and the second transaction will very likely occur.

The CCRA’s comments on this matter appear, at first glance, to be helpful. Initially, the CCRA had interpreted the phrase “in contemplation of” as preventing an acquisition of property only when there is some connection between the acquisition and the subsequent butterfly.87 If it could be established by the taxpayer that the DC would have acquired a particular property whether or not the butterfly had occurred, paragraph 55(3.1)(a) would not apply. However, subsequent pronouncements have confused the intended meaning of the phrase. For example, at the 1991 annual tax conference, the CCRA stated:

[I]t is not necessary for a corporation that is contemplating a butterfly reorganization to virtually freeze its operations until after the implementation of the proposed butterfly. . . . Where, however, the structure or timing of a transaction that occurs before a butterfly reorganization is affected by considerations relating to the butterfly reorganization, we would normally consider the transaction as being in contemplation of the butterfly reorganization.88

These comments contradict the CCRA’s earlier clarification, as well as the jurisprudence cited above. Why would it matter if the butterfly influenced the structure and timing of the transaction if the transaction proceeded before the butterfly? The basic issue should be whether the taxpayer could demonstrate that the first transaction would have transpired regardless of the butterfly. The timing of the transaction could very well be altered because of the butterfly for non-tax-avoidance reasons. For example, the intended reorganization could pose significant disruptions to the business that would warrant purchasing certain property before the butterfly at a time that was earlier than originally intended so as to generate more revenue. As this example demonstrates, the timing of a particular transaction can be altered without changing the inevitability of its occurring before the butterfly.

What is more puzzling is that the CCRA would consider it reasonable to invoke paragraph 55(3.1)(a) where the structure of the transaction could be considered to have been altered because of the butterfly. The structure of the transaction is merely indicative of legal form. It does not serve to forge a link between the acquisition of property and the subsequent butterfly.

The meaning of the word “affected” in the context of the 1991 comments is unclear. The CCRA does not provide guidelines as to when a butterfly may be
considered to influence the timing and structure of a transaction. Further, it is not clear what the CCRA meant by “considerations relating to the butterfly,” given the multiplicity of legal, accounting, and business implications that a butterfly entails. The entire statement is so broad that, in effect, any prior transaction could be questioned by the CCRA. In other words, any direct or indirect effect that a butterfly has on the structure and timing of a transaction in advance of the butterfly can trigger the application of paragraph 55(3.1)(a). By the 1991 comments, the CCRA has managed to significantly distort, rather than clarify, the meaning of “in contemplation of.”

**Recommendation**

The foregoing discussion on the meaning of “in contemplation of” illustrates the problems associated with an administrative, as opposed to a legislative, approach to the butterfly. Far too many technical questions remain because of the poorly worded statute and the lack of jurisprudence in this area. The CCRA’s interpretations of this phrase serve to increase, and not reduce, the confusion. The solution would be to legislate the meaning of “in contemplation of” in the Act. The central idea would not be difficult to draft: property was acquired by the DC (“the first transaction”) to be distributed to a TC (or TCs) (“the second transaction”) for the primary purpose of tax avoidance. The department has in the past legislated a definition of a phrase that had previously been subject to judicial and administrative consideration. Thus, the department has the experience and the technical justification to enact a statutory definition of “in contemplation of” in order to dispel the present confusion around its meaning.

**PROBLEMS WITH PARAGRAPH 55(3.1)(a)**

**Taxable Acquisitions Are Caught**

As discussed previously, the policy objective of paragraph 55(3.1)(a) is to prevent disguised sales of assets that would otherwise be taxable. This provision precludes the DC, a corporation controlled by it, or a predecessor corporation (“the particular corporation”) from acquiring property in contemplation of a butterfly, subject to certain exceptions. One of these exceptions in clause 55(3.1)(a)(iv)(C) provides that in contemplation of and before a butterfly distribution, the particular corporation may dispose of a property for consideration that consists only of money, non-convertible indebtedness, or any combination thereof. The rationale for this exception is that since the property is disposed of on a taxable basis, there is no disguised sale that would avoid corporate income tax.

There is, however, no similar rule for a taxable acquisition by a DC. Thus, if such an acquisition occurred “in contemplation of” a distribution, the butterfly may be broken. In a large public company, it is impossible to determine with absolute certainty whether or not a particular acquisition occurred in contemplation of a butterfly because of the large volume of transactions being entered into.
In fact, the only way the butterfly may be preserved would be if the acquisition by the DC occurred by way of a disposition by a particular corporation. However, depending on the overall corporate structure of the group, these particular intercompany transactions may be insignificant.

Another solution may be to erect a one-way information barrier so that those persons responsible for the corporate acquisitions are not aware of the upcoming butterfly. It can be argued that paragraph 55(3.1)(a) has not been violated if those persons planning the butterfly are aware of any acquisitions because the butterfly was made in contemplation of the acquisition and not vice versa. There are, however, a number of practical difficulties associated with the implementation of such an information barrier, including the following:

- The tax adviser must be involved with the client at an early stage to ensure that information concerning the butterfly is not disseminated to particular persons.
- In a public company scenario, such information would be difficult to conceal from particular persons given that the company would be required to publicly announce the butterfly well ahead of its occurrence.
- In a private company scenario, such information would be difficult to withhold from certain people because there would generally be little segregation of duties between those planning the butterfly and those making the acquisitions.

**Recommendation**

There is no sound policy justification for bringing taxable acquisitions within the scope of paragraph 55(3.1)(a), since double taxation will result. This is because both the vendor and the purchaser (the DC) of the property will be taxed on the capital gain arising from the disposition of the property. Like taxable dispositions, taxable acquisitions are not disguised sales or barter transactions that avoid corporate income tax. Thus, taxable acquisitions should be excluded from paragraph 55(3.1)(a) because they do not violate the provision’s underlying policy objective.

**Convertible Consideration Is Caught**

Another problem with clause 55(3.1)(a)(iv)(C) is that its application is restricted to circumstances where the consideration received is only money, non-convertible indebtedness, or a combination thereof. As discussed above, the policy objective of this provision is to prevent disguised sales or barter transactions that would otherwise be taxable at the corporate level. A transaction would be taxable whether the consideration received was convertible or non-convertible. Why, then, is convertible consideration, such as convertible shares or rights, considered offensive from a tax policy perspective?
Recommendation
Clause 55(3.1)(a)(iv)(C) does not accommodate the existence and continuing evolution of innovative financial instruments, even though it was introduced as recently as 1994. This provision should be modified to include convertible properties received as consideration in a taxable disposition, since no policy objective would be violated by such inclusion.

No De Minimis Test
In contrast to the operation of paragraphs 55(3.1)(c) and (d), there is no de minimis threshold to restrict the application of paragraph 55(3.1)(a). Where paragraph 55(3.1)(a) applies, the butterfly exception is denied for both of the dividends referred to earlier in steps 3 and 4 of the butterfly sequence, and the dividends may be recharacterized as capital gains to both the TC and the DC. In the absence of a de minimis provision, any prohibited acquisition of property, regardless of its value, can disqualify the butterfly. This rule seems quite harsh since, depending on the size of the DC, there may be some acquisitions by the DC in contemplation of the butterfly that would not be significant enough to violate the policy objective of paragraph 55(3.1)(a). In contrast, paragraphs 55(3.1)(c) and (d) will affect only one of these two dividends, and each of these provisions has a de minimis threshold.

Recommendation
Paragraph 55(3.1)(a) should be modified to include a de minimis test comparable to that provided in paragraphs 55(3.1)(c) and (d).

Comparison with the US System
The United States does not have a pre-butterfly continuity-of-assets rule like that applied in Canada. Instead, the tax-deferred rollover under IRC section 355 is allowed only if the trade or business of the DC was actively conducted throughout the five-year period ending on the date of the distribution ("the five-year rule"). Moreover, to prevent abuse of the rollover through strategic "late" acquisitions, a deferral of tax is denied on the distribution of stock of a controlled corporation acquired within the five-year period. The five-year rule applies to the DC and the two controlled corporations, in the case of a spinoff, or the two controlled corporations in the case of a split-up. The Internal Revenue Service has ruled that a holding company is considered to be engaged in an active trade or business if at least 5 percent of its assets consist of shares of controlled corporations that are engaged in an active trade or business.

The continuity-of-active-trade-or-business requirement is arbitrary and ignores business realities. For example, a DC may have sound business reasons for implementing a spinoff or split-up reorganization within the first five years of its existence. Nevertheless, the tax-deferred rollover under IRC section 355 would not be
available. Because of the apparent inequity of this restriction, it is not recommended that Canada adopt a similar five-year rule for butterfly reorganizations.

PROBLEMS WITH PARAGRAPHS 55(3.1)(c) AND (d)

Paragraphs 55(3.1)(c) and (d) are similar in language and in policy intent. The only significant difference between them is that paragraph 55(3.1)(c) applies with respect to property acquired by a particular TC on a butterfly, while paragraph 55(3.1)(d) applies with respect to property retained by the DC after the distribution. More particularly, these provisions apply where, as part of a series of transactions that includes a dividend,

1) property received by a TC on a butterfly distribution or retained by the DC, respectively, and
2) property more than 10 percent of the FMV of which was attributable to property (other than money or non-convertible indebtedness) described in point 1 at any time after the distribution and before the end of the series of transactions

was acquired by a person who was unrelated, or ceased to be related, to the TC or DC, respectively.

These rules prevent direct or indirect post-distribution acquisitions by unrelated persons of property that exists at the time of the distribution, subject to de minimis rules and exceptions. The two policy objectives of the rules are

1) to ensure that, following a butterfly reorganization, the shareholders of a DC maintain its continuity of assets in the DC’s underlying business; and
2) to prevent the avoidance of tax through a butterfly distribution of the DC’s assets to a TC before the sale of those assets to a third party.

The Meaning of “in the Ordinary Course of Business”

An exception to paragraph 55(3.1)(c) and (d) is provided where the property acquired by the TC or retained by the DC is disposed of “in the ordinary course of business” to an unrelated party. Although this phrase is not a defined term in the Act, there is a considerable body of case law that is on point. In Downs Distributing Co. Pty. Ltd. v. Associated Blue Star Stores Pty. Ltd. (In Liquidation), the court stated that the phrase “in the ordinary course of business” supposes “that according to the ordinary and common flow of transactions in affairs of business there is a course, an ordinary course.” In Robitaille v. American Biltrite (Canada), the court expressed the following view:

It is apparent from these authorities, it seems to me, that the concept we are concerned with is an abstract and that it is the function of the courts to consider the circumstances of each case in order to determine how to characterize a given transaction. This in effect reflects the constant interplay between law and fact.
Whether a particular disposition by a DC or a TC takes place “in the ordinary course of business” must be determined on the facts and will be measured against the common occurrences in the day-to-day business activities of the taxpayer. In practice, determining whether a particular disposition is “in the ordinary course of business” may not be a simple task. For example, the taxpayer’s business may involve a large volume of transactions, or the taxpayer may have a number of businesses of different sizes. Despite this complexity, the rule is justified since it ensures that the sale of inventory by either a DC or a TC is not caught by the butterfly denial rules. The rationale is that the DC or TC would be disposing of property “in the ordinary course of business” for the purpose of increasing its revenues, and not for the purpose of avoiding corporate income tax.

**Recommendation**

The above exception to the post-distribution continuity-of-assets rule should be retained, despite the inherent difficulties in satisfying its conditions.

**The Fair Market Value Issue**

One of the major difficulties with paragraphs 55(3.1)(c) and (d) is to ensure accurate valuations of property at various points in time. An implicit assumption of these provisions is that the FMV of each asset at the time of distribution can be determined precisely, whereas, in practical terms, a range of values may exist. Moreover, the de minimis threshold is strictly enforced: paragraphs 55(3.1)(c) and (d) will apply if the FMV of the assets received by the TC or retained by the DC and sold to an unrelated party exceeds the 10 percent limit by as little as one dollar. Thus, a taxpayer will generally be conservative and sell only assets that are definitely well below the 10 percent threshold.

FMV must be determined at several points in time in order to comply with the two tests in paragraphs 55(3.1)(c) and (d). Under the first test, initially the FMV at the time of acquisition must be determined for each property that is to be sold.¹⁰⁵ That FMV must then be compared with 10 percent of the FMV, determined at the time of distribution, of all property retained by the DC or transferred to the TC,¹⁰⁶ for purposes of the de minimis rule. If the FMV of the property has changed from the time of acquisition, the de minimis test may not be met. This is not logical because the FMV at the time of acquisition of the property to be sold is being divided by the FMV of property retained by the DC or received by the TC at the time of distribution.

Under the second FMV test, the FMV of the property that was sold to an unrelated party at any time after the distribution and before the end of the series of transactions must not exceed 10 percent of the FMV of all the property received by the TC or retained by the DC, as the case may be.¹⁰⁷ Implicit in this denominator is that the FMV is determined at the time immediately after the distribution. There is a chance that the de minimis tests will not be met if the FMVs fluctuate at any point in time from the distribution to the end of the series of transactions.
Recommendation

The numerator for the first test should be the FMV of the property to be sold at the time of distribution for two reasons:

1) A comparison of the FMVs determined at the same point in time will produce a more meaningful ratio, because the market conditions affecting the FMVs in both the numerator and the denominator will be similar.

2) The point in time of interest is the time of distribution and not the acquisition date of the particular property. This is because paragraphs 55(3.1)(c) and (d) centre on the time “immediately after the distribution.” Some commentators have interpreted this phrase to mean the instant of time after the distribution. In most cases, the FMV will be the same at the time of distribution and at the instant of time after the distribution.

For the two reasons set out above, the numerator and denominator for the second test should be changed to the FMV at the time of distribution.

Comparison with the US System

Instead of having a post-butterfly continuity-of-assets rule, the United States has a post-distribution continuity-of-active-trade-or-business rule. Both the DC and the controlled corporations must be engaged in an active trade or business immediately after the distribution. The major disadvantage of this requirement considered in a Canadian context is that it is too restrictive. For example, immediately after a double-wing split-up butterfly, the shareholders of one of the TCs may want to wind up the TC and sell the assets personally. On the basis of the US rules, because the TC did not continue the business of the original DC immediately after the distribution, the butterfly would be disqualified. From a policy perspective, this seems unjust, since tax legislation should not dictate to a taxpayer whether or nor he should carry on a business.

Canada should therefore retain its post-butterfly continuity-of-assets rule rather than adopt the US continuity-of-active-trade-or-business rule. All the recommended changes for paragraphs 55(3.1)(c) and (d) would reinforce the policy objective of ensuring that the underlying economic relationship between the owner and the assets remains essentially intact after the butterfly.

PROBLEMS WITH PARAGRAPH 55(3.1)(b)

Paragraph 55(3.1)(b) generally prevents

- the sale to an unrelated party of shares of a DC or a TC held by a specified shareholder,
- the acquisition of control of a DC or a TC, and
- in contemplation of a distribution by a DC, an acquisition of the DC’s shares by a TC, a person who acquired control of the DC, or a person not...
Paragraph 55(3.1)(b) was introduced in 1994 in order to curtail perceived abuses with purchase butterflies, and a consequent loss of tax revenue at the corporate level. The targeted transactions were butterfly reorganizations that effected any change in the shareholdings of a DC or a TC in the course of the series of transactions that included the butterfly.

The “Specified Shareholder” Problem

The basic definition of “specified shareholder” is modified for the purposes of subparagraph 55(3.1)(b)(i). The modification narrows the definition to apply to a shareholder who owns 10 percent of the issued shares of any class of the capital stock of a corporation or of a related corporation “that has a significant direct or indirect interest in any issued shares of the capital stock of the corporation.”

It is relatively easy to identify and obtain undertakings from specified shareholders not to purchase or dispose of shares of a TC or a DC in a butterfly of a private corporation in order to avoid the application of paragraph 55(3.1)(b). It may be more difficult to identify a specified shareholder in a public company context. This is because the shares are freely traded, and the information found in reports required to be filed by securities legislation will not contain the kind of broad information required by the definition of specified shareholder.

Another problem is that investors who are not involved in the planning of a butterfly reorganization can easily obtain 10 percent ownership of a public company. Examples of such investors include financing shareholders, minority shareholders, and speculators who are attracted by the prospect of making money from the intended butterfly. It would be difficult to ask such investors, particularly speculators, not to sell their shares. These investors will not be concerned that the corporation will be subject to subsection 55(2) on the dividend received in the course of the butterfly because they themselves will bear no additional tax on the disposition of their shares. The tax on their capital gain will be the same whether or not the corporation has its butterfly disqualified. Nonetheless, on the basis of the plain meaning of paragraph 55(3.1)(b), it appears that a sale of shares by such investors holding 10 percent of the DC or TC may cause denial of the butterfly reorganization.

The solution to this problem is similar to the rationale underlying the introduction of new “types of property” rules for public company spinoffs: modify the butterfly rules for scenarios with specific needs. The department could legislate a new rule stating that in the case of public company spinoffs and split-ups, the original specified shareholder definition will be modified, for the purposes of subparagraph 55(3.1)(b)(i), to have a new minimum ownership percentage greater than 10 percent (“the new percentage”). The department would determine the exact value of the new percentage after public consultations. The new percentage,
for the purposes of subparagraph 55(3.1)(b)(i), would reflect a minimum voting
threshold of a person who could participate in and influence the planning of a
butterfly in a public corporation.

International Butterfly Reorganizations

With the enactment of paragraph 55(3.2)(h) in 1997, the ability of a foreign multi-
national corporation (FMNC) to effect a tax-deferred spinoff in Canada was almost
entirely eliminated. Paragraph 55(3.2)(h) deems each corporation that is a spe-
cified shareholder of a DC to be a TC. Thus, if the deemed TC were a multinational
corporation and one of its specified shareholders sold a share of the TC to an
unrelated person in the same series of transactions as the distribution, the butterfly
would be broken. Practically, cross-border butterflies would not be possible
because it would be likely that a specified shareholder would sell his shares of
the FMNC in the same series of transactions as the distribution.

This result is not equitable, particularly in light of the introduction of new
rules that will allow for a tax deferral in respect of certain distributions of spinoff
shares of a foreign corporation received by its Canadian-resident shareholders.
The inequity is that Canada is encouraging outbound but not inbound investment.
An FMNC may well be discouraged from investing in a Canadian corporation if a
tax-deferred exit strategy is not available. The department’s policy on this issue is
not in Canada’s best interests, since an important source of investment capital is
not being fully utilized. Instead, in order to encourage bilateral international trade
within Canada, the department should develop a mechanism for encouraging a
cross-border butterfly.

Comparison with the US System

The United States has a continuity-of-interest rule that is somewhat similar to
Canada’s. Under the US rule, the historical shareholders of a DC must generally
maintain at least a 50 percent voting interest in each of the controlled corporations.
This requirement is similar to that in subparagraph 55(3.1)(b)(ii) of the Act, which
prohibits an acquisition of control of a DC or a TC. The Canadian continuity-
of-interest rule seems harsher than its US counterpart because the butterfly will
also be broken if a specified shareholder sells his shares of a DC or a TC, in the
same series of transactions as the distribution, to an unrelated person. There is
no similar rule in the United States.

The United States has enacted tax rules to promote inbound investment. For
eexample, a Canadian resident is permitted to obtain the benefit of the IRC section
355 tax deferral if certain conditions are met. Coupled with the Canadian policy
of allowing Canadian residents to obtain a tax deferral on IRC section 355 spinoff
shares, there is a complete deferral of both Canadian and US tax.
Recommendation

Canada should partially adopt the US system’s continuity-of-interest rule. The department should legislate a new rule applicable to a foreign corporate shareholder of a Canadian company and providing that paragraph 55(3.2)(h) applies only in conjunction with subparagraph 55(3.1)(b)(ii). This change would be consistent with the original policy intent of the provision134 and would not render portions of paragraph 55(3.1)(b) useless in the foreign context.135 Under the new rule, a foreign specified shareholder of a DC would be deemed to be a TC only when there was an acquisition of control of the FMNC or the DC, in the same series of transactions as the distribution. This change would also bring Canada’s cross-border butterfly legislation into closer harmony with the US rules. Moreover, the proposed new rule would strengthen the foreign policy objective of paragraph 55(3.1)(b). As discussed earlier, the purpose of this provision is to ensure that a continuity of interest is preserved in the DC and the TC after the distribution in order to prevent a disguised sale of assets that would not be subject to corporate income tax. Under the new rule, a butterfly would be disqualified only if there were an acquisition of control of the foreign corporation or the DC, which represents more of a change of the DC’s and the TC’s “continuity of interest” than does a sale of its shares by a specified shareholder.136 Finally, paragraph 55(3.1)(b) should include a de minimis test similar to the test in paragraphs 55(3.1)(c) and (d).137

CONCLUSION

An interesting pattern has emerged in the evolution of the butterfly. In 1981, the butterfly rules did not allow for the purchase butterfly but were more administrative in nature. With the 1984 amendments, the purchase butterfly was legislated, in part, with the hope that the taxpayer could rely more on the statutes as opposed to advance tax rulings. The 1994 amendments effectively restored the approach that existed before 1984. Concomitantly, taxpayers came to rely increasingly on the CCRA’s administrative practice because the new rules dealt with prohibited, and not accepted, butterfly transactions. Today, the butterfly rules are still plagued by technical uncertainty and inconsistency, so that they are among the most complex tax provisions to analyze and interpret. The complexity of the rules is even more puzzling given that it is simple for a corporation to acquire an eligible asset138 on a tax-deferred basis from another corporation.139 The question is, why is it so difficult to remove an asset on a tax-deferred basis from one corporation to another?

The answer lies primarily in the predominantly administrative approach adopted by the department and the CCRA for butterfly transactions. There must be a change in this approach. The author is not advocating a legislative approach as statute-driven as that of the United States. The main disadvantage of the US approach is that it becomes too restrictive in certain situations because of the numerous conditions set out in IRC section 355. As discussed earlier, Canada
should not adopt the US controlled restriction. Notwithstanding its inherent exclusion of a wide variety of corporate groups, the policy objective of this rule is predicated on the US judicial doctrine of substance over form. However, Canada’s tax system is based on legal form and recognizes each corporation as a separate entity and not part of an economic group. Thus, the butterfly should continue to be, in theory, available to a wide variety of corporate groups.

A balance needs to be struck between an administrative and a legislative approach, while adhering to the butterfly’s underlying policy objectives. These policy objectives are important because they essentially prevent a capital gain from being converted into a tax-deferred intercorporate dividend. The US concepts of disproportionate distribution and one type of property cannot be accepted in the Canadian butterfly because they violate its policy objectives.

As part of the proposed butterfly reform, the current administrative practice must be retooled to make it more comprehensible and accessible to taxpayers. The modified 1 percent rule should be considered because, being flexible, it would make the CCRA’s pro rata test available to a wider group of taxpayers. The consolidated lookthrough approach should be eliminated because it violates the separate entity concept of Canadian taxation and is theoretically questionable. These changes would strengthen the pro rata test and support its policy objective of preventing a taxpayer from cashing out on a tax-deferred basis from a DC. All of the CCRA’s important administrative practices pertaining to butterflies should be consolidated and published in an interpretation bulletin (IT), so that they would be readily available to all taxpayers. The exercise of compiling the IT would necessarily eliminate inconsistencies currently found in the CCRA’s scattered rulings, comments, and pronouncements, and the prevailing state of uncertainty would be, to some extent, alleviated.

New butterfly rules have to be legislated to further reduce technical uncertainty. The legislation of a butterfly rollover is of paramount importance. The rollover should not be as restrictive as IRC section 355 since divisive reorganizations need to be facilitated and not discouraged. However, the legislation should state clearly that the rollover may be used only in the case of a spinoff or a split-up. The effects of this amendment would include the following:

- The new statutory mechanism would be less ambiguous and more concise than the existing provisions. Vague language such as “in the course of a reorganization” need not be used because the actual distribution effected by the butterfly rollover would be succinctly described.
- A myriad of other related issues that must be currently considered because of the cross-redemption of shares described in steps 3 and 4 of the butterfly sequence could be ignored.

Other changes need to be made to the existing tax law in order to remove technical anomalies and/or support other policy objectives. The most significant
change discussed in this paper is the amendment of paragraph 55(3.2)(h) such that it would apply only in conjunction with subparagraph 55(3.1)(b)(ii). The effect of this amendment would be to encourage inbound investment into Canada by making available to foreign corporate investors a tax-deferred means of effecting a spinoff or a split-up.

The proposed administrative and legislative changes would simplify butterfly reorganizations for taxpayers while supporting existing policy objectives. Both the administrative and the legislative approaches are needed for optimum flexibility and certainty. It is the author’s hope that this paper will serve as a catalyst to improve both aspects of the butterfly regime.

Notes
1 At that conference, A.R.A. Scace in his presentation, “Going Public and Deconglomeration,” described a diagram for a public company spinoff that was nicknamed a “butterfly” by his co-panelist P.N Geer. The term “butterfly” was used in Scace’s remarks but does not appear in the text of his paper. This background is provided by Robert J. Dart, “Demergers,” in Report of Proceedings of the Forty-Third Tax Conference, 1991 Conference Report (Toronto: Canadian Tax Foundation, 1992), 13:1-38, at 13:3.


4 RSC 1952, c. 148, as amended by SC 1970-71-72, c. 63, and as subsequently amended. Unless otherwise stated, references to statutory provisions in this paper are to the current version of the Income Tax Act, RSC 1985, c. 1 (5th Supp.), as amended (herein referred to as “the Act”).


6 Ibid., at 4:3.

7 Ibid., at 1455-56.

8 The operation of these provisions in the execution of a butterfly will be discussed below under the heading “The Basic Steps of the Butterfly.”

9 The CCRA’s administrative practice with respect to butterfly transactions will be discussed below under the heading “Underlying Policy Considerations.”


11 Ibid.

12 Ibid.

13 See Carr and Monaghan, supra note 5, at 4:6.

14 This was legislated in paragraph 55(3.1)(b), a broad continuity-of-interest rule that will be discussed in greater detail below under the heading “Problems with Paragraph 55(3.1)(b).”

15 This was legislated in the definition of “distribution” in subsection 55(1).
Subsection 55(1), the definition of “permitted exchange.” The spinoff butterfly would commonly be used to transfer assets of a business on a tax-deferred basis from the original public company into a newly formed company.

Subsection 55(1), the definition of “permitted exchange.” The split-up butterfly would commonly be used to divide the assets of an investment company or to separate the interests of dissenting shareholders.

Paragraphs 55(3.1)(a), (b), (c), and (d). These four provisions will be discussed in greater detail below.

Information Circular 70-6R4, “Advance Income Tax Rulings,” January 29, 2001, paragraph 6. An advance tax ruling is a written statement provided by the Rulings Directorate to a taxpayer stating how the CCRA will interpret and apply specific provisions of income tax law to a transaction or a series of transactions that the taxpayer is contemplating. A ruling is binding on the CCRA and, in the case of a favourable ruling, provides assurance to the taxpayer that the transaction(s) he is contemplating will not be in conflict with the CCRA’s administrative practice. This assurance is, of course, dependent on the taxpayer’s disclosure of all material facts to the CCRA. Published advance tax rulings, although not legally binding, provide an important source of information to taxpayers regarding the CCRA’s interpretation of the butterfly rules.


This policy objective is reflected in paragraph 55(3.1)(a). For a more detailed discussion, see below under the heading “Problems with Paragraph 55(3.1)(a).”

This policy objective is reflected in the CCRA’s administrative position on the types of property test found in the definition of “distribution” in subsection 55(1). See the discussion below under the heading “Difficulties with a Distribution.”


For example, the debt forgiveness and restructuring provisions of section 80.

The following is an example of such an administrative change. On a section 85 transfer, the corporation can assume liabilities (“boot”) of the transferee as part of the consideration. Under paragraph 85(1)(b), the elected transfer price cannot be less than the boot. This can result in a taxable transaction if the boot exceeds the cost of the transferred property. At the “Revenue Canada Round Table,” in the 1984 Conference Report, supra note 10, 783-847, question 47, at 819, CCRA officials indicated that paragraph 85(1)(b) would not apply in the following scenario. A capital property to be transferred is subject to a mortgage. The mortgage exceeds the adjusted cost base of the property. Paragraph 85(1)(b) will not apply if the excess amount of the debt is allocated among several assets to be transferred provided that the amount allocated to each asset is not greater than the elected transfer price of each asset. However, in “Revenue Canada Forum,” in Income Tax and GST Planning for the Purchase, Sale, and Canada-US Expansion of a Business, 1996 Corporate Management Tax Conference (Toronto: Canadian Tax Foundation, 1996), 24:1-21, question 7, at 24:9-10, the CCRA indicated that its administrative position on this matter was under review. In Roy Shultis, Michael Hiltz, Vance Sider, and Judith Woods, “Judicial and Administrative Developments,” in Report of Proceedings of the Fifty-Second Tax Conference, 2000 Conference Report (Toronto: Canadian Tax Foundation, 2001), 36:1-21, at 36:17-18, CCRA officials announced that the review is complete and that its policy with respect to the application of paragraph 85(1)(b) will be amended as follows:

Where, after 2000, a property (“the first property”) is transferred pursuant to the provisions of section 85, and:

(2001), Vol. 49, No. 4 / no 4
1) the purchaser assumes an obligation of the vendor as consideration for the acquisition of a second property (for example, a note of the vendor) and the purchaser subsequently disposes of that property to the vendor,
2) the purchaser assumes an obligation of the vendor as consideration for the redemption or acquisition by the purchaser of its shares held by the vendor, or
3) the purchaser subscribes for shares of the vendor,
the obligation so assumed or the property so contributed will be regarded as consideration for the first property.

26 An example of a favourable administrative position is the net asset butterfly. An example of an unfavourable administrative position is the 1 percent rule. These administrative positions will be discussed below.

27 Internal Revenue Code of 1986, as amended (herein referred to as “IRC”).

28 The major conditions will be discussed below.

29 A corporation is considered to be in a controlled group where a parent corporation owns at least 80 percent of the corporation’s total combined voting power and at least 80 percent of the total number of shares of all the other classes of its stock: IRC section 368(c).

30 This information was obtained in a conversation with Jonathane Ricci, a US corporate income tax specialist with KPMG LLP, Toronto.

31 A single-wing split-up butterfly occurs when a distribution is made to one transferee corporation. A double-wing split-up butterfly occurs when a distribution is made to two transferee corporations.

32 A transferee corporation is a corporation that receives a butterfly distribution of property from another corporation (the distributing corporation).

33 Subsection 85(1). The fair market value (FMV) of the common shares of the DC held by the TC should, in theory, equal the FMV of the preferred shares of the TC held by the DC described in step 2.

34 Ibid.

35 Subsection 84(3).

36 Subsection 112(1).

37 Subsection 84(3).

38 Subsection 112(1).


40 Joint Committee on Taxation of the Canadian Bar Association and the Canadian Institute of Chartered Accountants, “Submission to Department of Finance and Department of National Revenue: Taxation of Divisive Reorganizations,” October 5, 1990.

41 IRC section 361.

42 IRC section 355.

43 Robertson, supra note 3, at 97. The CCRA should nonetheless heed the following comments made in Robertson’s 1981 paper, instead of persisting with its piecemeal approach to the butterfly: “There are no hard and fast rules. Where there is no attempt to use the butterfly transaction to disguise a sale or barter transaction or to achieve any undue tax advantage, an effort will be made to make the transaction work with an acceptable result to both the taxpayer and the Department.”

44 Section 187.1.

45 Section 191.
As a corollary, one would not need to determine whether these shares are taxable preferred shares or term preferred shares because no deemed dividend would arise.

For example, if both the DC and the TC had an RDTOH balance, on the cross-redemption the DC would receive a dividend that would increase its RDTOH balance. Concomitantly, the DC would pay a dividend to the TC that would reduce its RDTOH balance. The TC would receive a dividend that would increase its RDTOH balance and then pay a dividend to the DC that would reduce its RDTOH balance. The cycle would then begin anew.

Harris, supra note 39, at 14:2-6. A net asset butterfly occurs when the liabilities of the DC are netted against its different types of property in a manner described by the CCRA as “the full consolidated lookthrough approach” (discussed further below).

See the previous discussion of IRC section 355 under the heading “The Butterfly Has To Share Its Wings—Comparison with the US System.”

Subsection 55(1).

Robertson, supra note 3, at 96. The discussion of types of property in this paper excludes the new amendment for public company spinoffs in subsection 55(3.02), which categorizes all property as one type.

Robertson, supra note 3, at 96.

Ibid. In other words, the CCRA wants to prevent a TC from extracting a disproportionate amount of cash from the DC on a tax-deferred basis as part of a butterfly reorganization.

Harris, supra note 39, at 14:15.

IRC section 355.

This concept is governed in the United States by a continuity-of-interest rule, discussed in more detail below under the heading “Problems with Paragraph 55(3.1)(b)—Comparison with the US System.”

Harris, supra note 39, at 14:9.

This is especially true in light of the consolidated lookthrough approach that is applied by the CCRA in determining the types of property of the DC.

The rationale of this approach is used in Quebec to determine its scientific research and experimental development (SR & ED) investment tax credits (ITCs). The Quebec SR & ED ITC is calculated as a percentage that is indirectly proportional to the gross assets of the corporation making the SR & ED claim.

Robertson, supra note 3, at 99.

Harris, supra note 39, at 14:1-7.

Canadian Institute of Chartered Accountants, CICA Handbook (Toronto: CICA) (looseleaf), section 3050.

See, for example, OSFC Holdings Ltd. v. The Queen, 99 DTC 1044 (TCC).

Subsection 248(24).

Clauses 55(3.1)(a)(iv)(A) and (B).

Control in this case means de jure control, which, on the basis of Canadian jurisprudence, means greater than 50 percent voting control of the corporation with the ability to elect the majority of the board of directors.

72 DTC 6357, at 6362 (FCTD), aff’d. in part 73 DTC 5359 (FCA). The Federal Court of Appeal confirmed Cattanach J’s analysis of the term “reorganization” but partially reversed the decision on other grounds.

Marc N. Ton-That and Vance Sider, Understanding Section 55 and Butterfly Reorganizations (North York, ON: CCH Canadian, 1999), 116.

(2001), Vol. 49, No. 4 / n° 4
69 [1904] 2 Ch. 268 (Ch. D.).
70 Ibid., at 286.
72 See above under the heading “The Basic Steps of the Butterfly.”
74 Read, supra note 20, at 18:11.
76 Subsection 248(10).
77 The following is an excerpt from IRC section 355:

(a) EFFECT ON DISTRIBUTEEES.—
(1) GENERAL RULE.—If—

(A) a corporation (referred to in this section as the “distributing corporation”)  
(i) distributes to a shareholder, with respect to its stock, or  
(ii) distributes to a security holder, in exchange for its securities,  
solely stock or securities of a corporation (referred to in this section as “controlled corporation”) which it controls immediately before the distribution,

(B) the transaction was not used principally as a device for the distribution of the earnings and profits of the distributing corporation or the controlled corporation or both (but the mere fact that subsequent to the distribution stock or securities in one or more of such corporations are sold or exchanged by all or some of the distributees (other than pursuant to an arrangement negotiated or agreed upon prior to such distribution) shall not be construed to mean that the transaction was used principally as such a device),

(C) the requirements of subsection (b) (relating to active businesses) are satisfied, and

(D) as part of the distribution, the distributing corporation distributes—  
(i) all of the stock and securities in the controlled corporation held by it immediately before the distribution, or  
(ii) an amount of stock in the controlled corporation constituting control within the meaning of section 368(c), and it is established to the satisfaction of the Secretary that the retention by the distributing corporation of stock (or stock and securities) in the controlled corporation was not in pursuance of a plan having as one of its principal purposes the avoidance of Federal income tax,

then no gain or loss shall be recognized to (and no amount shall be includible in the income of) such shareholder or security holder on the receipt of such stock or securities.

78 Examples of tax provisions that are clearly written and provide a tax-deferral mechanism to the taxpayer include subsection 85(1), section 86, and section 51.
79 “Permitted redemption” is defined in subsection 55(1).
80 See the discussion above under the heading “The Basic Steps of the Butterfly.”
81 Subparagraph 55(3)(b)(ii).
82 For example, a dividend exceeding the safe income of the DC that was paid before the butterfly would not be protected by paragraph 55(3)(b). If the recommendation in this paper to implement
a butterfly rollover mechanism were followed, there would be no need for clarification of the permitted redemption under paragraph 55(3)(b).

83 The term “in contemplation of” is also used in subparagraph 55(3.1)(b)(iii).

84 Paragraph 55(3.1)(a) does not have a “series of transactions” test but rather an “in contemplation of” test. The phrase “in contemplation of” is not to be confused with the expression “in the same series of transactions.” There is some recent tax jurisprudence in respect of the latter phrase in the context of section 55, but none in respect of the former. Although the two expressions are broadly similar in concept, “in contemplation of” is the narrower of the two since it serves as no more than a direct cause-and-effect link between two transactions. Thus, the basic question to ask in determining whether the first transaction was carried out in contemplation of the second transaction is whether the first transaction would have occurred regardless of the second. However, in order to determine whether two separate events or transactions are in the same series of transactions, one must look at the fact pattern of the case to see whether there has been interdependence between the two events. The interdependence between the two events may be that of a direct cause-and-effect relationship between the two transactions, as in the phrase “in contemplation of,” or it may be related to other factors, such as whether two independent transactions were carried out for an underlying, common purpose. See Les Placements E. & R. Simard Inc. v. The Queen, 97 DTC 1328 (TCC), for an analysis of the term “series of transactions” in the context of the definition of “safe-income determination time” in subsection 55(1). The phrase “series of transactions” will not be discussed further in this paper because it is dependent on the facts of a particular case, whereas this paper is centred on a more general policy discussion of the butterfly.

85 [1957] 2 QB 205 (CA).
86 (1905), 10 OLR 208 (HCJ).
87 Hiltz, supra note 71, question 16, at 20:42-43.
88 Harris, supra note 39, at 14:10.
89 For example, the phrase “carrying on a business” was legislated in section 253 notwithstanding the considerable body of jurisprudence on the topic.
91 Clause 55(3.1)(a)(iv)(B).
92 Nikolakakis, supra note 90, at 16:14.
93 Recall that an acquisition must have occurred in contemplation of a butterfly for paragraph 55(3.1)(a) to come into effect.
94 Nikolakakis, supra note 90, at 16:14.
95 Ibid., at 16:16.
96 These provisions will be discussed in the next section of the paper.
97 The de minimis test in paragraph 55(3.1)(a) could specify that property acquired in contemplation of a butterfly may be less than 10 percent of the FMV of the total property of the DC before the distribution.
100 The de minimis rule for paragraph 55(3.1)(c) is that the particular paragraph will not apply for the subsequent sale to an unrelated person of property received by the TC on a butterfly distribution.
where the FMV of the property does not exceed 10 percent of the FMV of the total property received by the TC on such distribution. The de minimis rule for paragraph 55(3.1)(d) is that the particular paragraph will not apply for the subsequent sale to an unrelated person of property retained by the DC on a butterfly distribution where the FMV of the property does not exceed 10 percent of the FMV of the total property retained by the DC.


102 Clauses 55(3.1)(c)(i)(A) and 55(3.1)(d)(i)(A). Another exception arises where the consideration received is money or non-convertible indebtedness: subparagraph 55(3.1)(c)(ii) and 55(3.1)(d)(ii). See the previous discussion in the context of paragraph 55(3.1)(a) regarding the unwarranted exclusion of convertible property. A share of the capital stock of a TC or a DC is also an exception found in subparagraphs 55(3.1)(c)(ii) and 55(3.1)(d)(ii), respectively. However, they are both caught under paragraph 55(3.1)(b).

103 (1948), 76 CLR 463, at 477 (HC).


105 See the preambles of paragraphs 55(3.1)(c) and (d).

106 See the postambles of paragraphs 55(3.1)(c) and (d).

107 Clauses 55(3.1)(c)(ii)(B) and 55(3.1)(d)(ii)(B).

108 The phrase “immediately after” appears in the preambles of paragraphs 55(3.1)(c) and (d).

109 See, for example, Ton-That and Sider, supra note 68, at 244.

110 Burke, supra note 98, at 271-72.

111 Ibid. Alternatively, if the DC was a holding company, both of the controlled corporations must be engaged in an active trade or business.

112 Subparagraph 55(3.1)(b)(i).

113 Subparagraph 55(3.1)(b)(ii).

114 Subparagraph 55(3.1)(b)(iii).

115 One example of a purchase butterfly that concerned the CCRA was the situation where the purchaser acquired shares of the DC in anticipation of receiving property of the DC from the distribution in exchange for those shares. Through this arrangement, the purchaser deferred the corporate income tax that would otherwise arise on the distribution.

116 Subsection 248(1).

117 Subsection 55(3.3).

118 Ibid.

119 Carr and Monaghan, supra note 5, at 4:36. The definition of “specified shareholder” in subsection 55(3.3) may cause a shareholder who owns less than 10 percent of the shares of a corporation to be a specified shareholder.

120 The CCRA has stated that it will use the plain meaning approach in interpreting the butterfly rules. Hiltz, supra note 71, at 20:32.


122 Subsection 55(3.02).

123 Ton-That and Bilodeau, supra note 121, at 11:46.


125 The implications of being a specified shareholder are quite broad since the definition includes direct and indirect holdings of the deemed TC.
This is because of the application of subparagraph 55(3.1)(b)(i).

For instance, the specified shareholder may want to cash in on the increased gain on his shares created by the news of the Canadian spinoff.

Section 86.1. See infra note 133 for further elaboration on the operation of section 86.1.

Section 86.1 See infra note 133 for further elaboration on the operation of section 86.1.

IRC reg. section 1.355-2(c)(1).

Supra note 66.

Subparagraph 55(3.1)(b)(i).

IRC section 367. A detailed examination of these rules is beyond the scope of this paper. For a basic analysis of the rules, see Ton-That and Bilodeau, supra note 99, at 18:17-19.

So long as both corporations are US residents and the transaction effected was carried out pursuant to IRC section 355 in a tax-deferred manner, section 86.1 will provide a tax deferral for the Canadian shareholders, provided that certain conditions are met.

Ton-That and Bilodeau, supra note 121, at 11:50.

This is because paragraph 55(3.2)(h) would deem a foreign corporation that is a specified shareholder of a DC to be a TC. Thus, subclause 55(3.1)(b)(i)(A)(I) would automatically be operative, and subclause 55(3.1)(b)(i)(A)(II) would be rendered useless.

This would apply with the interaction of paragraph 55(3.2)(h) with subparagraph 55(3.1)(b)(i), as previously discussed.

See the discussion above under the heading “Problems with Paragraph 55(3.1)(a)—No De Minimis Test.” A possible de minimis test for paragraph 55(3.1)(b) could be that the shares of a DC or a TC sold by a specified shareholder cannot exceed 10 percent of the FMV of the total shares of the DC or TC, respectively.

Subsection 85(1.1).

Subsection 85(1).

This would mark the first time that legislation was drafted on how to effect a butterfly.

Pursuant to subsection 55(1), the definition of “permitted exchange.”