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## CORPORATE TAX PLANNING

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### THE BUMP DENIAL RULES REVISITED

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The Income Tax Act contains rules that permit a corporation to increase (“bump”) the tax cost of non-depreciable capital property of a subsidiary corporation when it winds up the subsidiary corporation or amalgamates with a wholly owned subsidiary. The Act also contains specific anti-avoidance provisions that deny the availability of the bump in certain circumstances. These bump denial rules have been subject to criticism based on their complexity, uncertainty as to their application, and various technical deficiencies in the drafting of the legislation. On October 18, 2013, the government introduced proposed legislative amendments that are intended to address some of these concerns.

This article reviews the current bump denial rules at a high level, focusing on several key definitions or concepts, and outlines some practical issues with respect to the application of the rules, including their application where property is acquired by a partnership. The article also reviews the proposed legislative amendments and considers whether, and to what extent, they resolve the issues that they were intended to address.

**KEYWORDS:** BUMP ■ WINDUPS ■ AMALGAMATIONS ■ ACQUISITIONS AND MERGERS ■ AMENDMENTS

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## INTRODUCTION

The “bump” provided by paragraphs 88(1)(c) and (d) of the Income Tax Act<sup>1</sup> is one of the few means available under the Act to increase the tax cost of non-depreciable capital property of a corporation (referred to herein as a “target”) acquired through a share acquisition.<sup>2</sup> The tax cost of the shares of a target acquired in a taxable share acquisition reflects the current market value of such shares; in contrast, the tax cost of the underlying assets of the target reflects the historical cost of such assets. Usually, the fair market value of the shares will exceed the historical tax cost of the assets. (For the purposes of the discussion in this article, it is assumed that this is the case.)

On a windup or an amalgamation<sup>3</sup> (referred to herein as a “merger”) of a subsidiary corporation into a parent corporation,<sup>4</sup> the bump permits the higher “outside”

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1 RSC 1985, c. 1 (5th Supp.), as amended (herein referred to as “the Act”). Unless otherwise stated, statutory references in this article are to the Act. The term “bump” refers to the increase in basis of non-depreciable capital property when paragraphs 88(1)(c) and (d) apply.

2 A corporation can also increase the tax cost of capital property on an acquisition of control by making a designation under paragraph 111(4)(e).

3 Subsection 88(1) applies in respect of a winding up. Subsection 87(11) applies to an amalgamation of a parent corporation and one or more wholly owned subsidiaries. Paragraph 87(11)(b) provides that “the cost to the new corporation of each capital property of the subsidiary acquired on the amalgamation is deemed to be the amount that would have been the cost to the parent of the property if the property had been distributed . . . to the parent on a winding-up of the subsidiary and subsections 88(1) and (1.7) had applied to the winding-up.”

4 Subsection 88(1) requires that both corporations must be taxable Canadian corporations. In addition, the parent must own at least 90 percent of the issued shares of each class of the capital stock of the subsidiary immediately before the winding up, and all of the shares of the subsidiary that were not owned by the parent immediately before the winding up must be owned by persons with whom the parent was dealing at arm’s length. (In the case of an amalgamation, the parent must own all of the shares of the subsidiary (other than directors’ qualifying shares) pursuant to the definition of “subsidiary wholly-owned corporation” in subsection 248(1). It is this definition that is applicable for the purpose of subsection 87(11), rather than the definition in subsection 87(1.4).) Herein, the term “parent,” “bump parent,” or “acquiror” refers to the parent, and the term “target” or “subsidiary” refers to the subsidiary, for the purposes of subsection 88(1).

basis of the shares of the subsidiary held by the parent to be pushed down to increase the tax cost to the parent of the underlying non-depreciable capital property of the target.<sup>5</sup> Since the availability of the bump is limited to non-depreciable capital property of the subsidiary, the bump is most advantageous in circumstances in which non-depreciable capital property (such as shares of a subsidiary, land, or an interest in a partnership that owns shares of a subsidiary or land)<sup>6</sup> is being disposed of to a third-party purchaser, or is being repositioned within a corporate group, following the acquisition.

For example, an acquiror may wish to divest specific assets after the acquisition of the target. The utilization of the bump to increase to fair market value the tax cost of the shares of a subsidiary holding the assets would facilitate the divestiture on a tax-efficient basis.<sup>7</sup> Another typical example in which the bump is advantageous involves an acquiror resident in the United States (for example) acquiring, through a Canadian acquisition corporation, a Canadian target with an existing subsidiary resident in the United States. To eliminate the sandwich structure (US parent, Canadian target, US subsidiary), a bump in the tax cost of the shares of the US subsidiary on the merger of the Canadian acquisition corporation and the Canadian target would facilitate moving the US subsidiary “out from under” Canada on a tax-efficient

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- 5 The bump is available under paragraph 88(1)(c), which provides that the cost to the parent of capital property distributed on the winding up is the subsidiary’s cost amount of such property plus (unless the property is “ineligible property”) the amount determined under paragraph 88(1)(d). Paragraph 88(1)(d) provides that the amount by which the parent may increase the adjusted cost base of capital property acquired on the winding up (the “bump room”) is the amount by which the cost amount of the shares of the subsidiary (which should be the fair market value of such shares immediately following the acquisition of a target) exceeds the total of
1. the amount by which the total cost amount of all properties owned by the subsidiary immediately before the winding up, including the amount of money that the subsidiary has on hand, exceeds the total of
    - a. the debts of the subsidiary outstanding immediately before the winding up, and
    - b. certain reserves deducted in computing the subsidiary’s income for the taxation year, and
  2. the total of all taxable dividends and capital dividends that the parent received on the shares of the subsidiary.

Subparagraph 88(1)(d)(ii) may reduce the bump room available in respect of shares of foreign affiliates (see *infra* note 8).

- 6 Subparagraph 88(1)(d)(ii.1) was recently introduced to limit the availability of the bump in respect of partnership interests to the extent of unrealized gains on partnership property that consists of non-depreciable capital property. See Kevin Yip, “Recent Legislation Affecting Partnerships and Foreign Affiliates—Subsection 88(1) and Section 100,” *Corporate Tax Planning* feature (2013) 61:1 *Canadian Tax Journal* 229-56; and Jocelyn Blanchet, “The Impact of the 2012 Budget on Transactions Involving Interests in Partnerships,” in *Report of Proceedings of the Sixty-Fourth Tax Conference*, 2012 Conference Report (Toronto: Canadian Tax Foundation, 2013), 10:1-19.
- 7 The relevant property must be owned by the subsidiary at the time of the acquisition of control (see the text of paragraph 88(1)(c) immediately following clause (ii)(B) and preceding subparagraph (iii)).

basis.<sup>8</sup> Using the bump in this context to eliminate the sandwich structure avoids the negative consequences that may arise from the application of the foreign affiliate dumping rules.<sup>9</sup>

However, the bump denial rules preclude the possibility of obtaining a bump in some specifically defined circumstances. Generally, the bump denial rules were introduced into the Act to prevent so-called back-door butterflies.

A butterfly transaction permits a corporation to be split up, or its assets spun off, without the incidence of tax at the corporate level. A “purchase butterfly” facilitated the transfer of a portion of the assets of a corporation (“the transferor”) to another corporation (“the transferee”) in conjunction with the sale of the shares of either the transferor or the transferee without the incidence of corporate-level tax.<sup>10</sup> A similar result could be obtained through a bump transaction pursuant to which a purchaser acquired a target corporation from its shareholder, bumped the tax cost of the target corporation’s underlying non-depreciable capital property to its fair market value, and then sold the bumped property back to the shareholder without incurring corporate-level tax.<sup>11</sup>

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8 Pursuant to subparagraph 88(1)(d)(ii), the bump room in respect of shares of a foreign affiliate is reduced pursuant to regulation 5905(5.4) by the amount of the foreign affiliate’s “tax-free surplus balance” as set out in regulation 5905(5.5). The shares of the foreign affiliate can still be distributed to the foreign acquirer without the realization of a capital gain in Canada if an election is filed pursuant to subsection 93(1).

9 The foreign affiliate dumping rules are contained in section 212.3.

10 A purchase butterfly generally took one of two forms: in one type of arrangement, a person purchased the shares of a corporation and the corporation carried out a butterfly; alternatively, a corporation carried out a butterfly and a person purchased the shares of the distributing or transferee corporation. Purchase butterflies are now precluded under various continuity-of-interest rules in subsection 55(3.1). Paragraph 55(3.1)(b) restricts acquisitions of control of the transferor or the transferee, and transactions involving the shares of the transferee or the transferor. Paragraphs 55(3.1)(c) and (d) impose restrictions in respect of dispositions of the underlying assets of the transferee and the transferor. For a more detailed discussion of purchase butterflies and the continuity-of-interest rules, see Catherine A. Craig, “Corporate Retail Therapy: Tax Planning for the ‘Purchase’ of a Private Corporation,” in *2007 Atlantic Provinces Tax Conference* (Toronto: Canadian Tax Foundation, 2007), 17:1-51; Paul Lailey, “Corporate Reorganizations: Tips and Traps,” in *2000 British Columbia Tax Conference* (Toronto: Canadian Tax Foundation, 2000), 16:1-29; Judith Woods and Jerald Wortsman, “The Bump Denial Rule in Subparagraph 88(1)(c)(vi),” in *Report of Proceedings of the Fiftieth Tax Conference, 1998 Conference Report* (Toronto: Canadian Tax Foundation, 1999), 14:1-40; Rick McLean, *Understanding Section 55 and Butterfly Reorganizations*, 3d ed. (Toronto: CCH Canadian, 2010); Jake E. Harms, “Corporate Reorganizations—An Update,” in *1997 Prairie Provinces Tax Conference* (Toronto: Canadian Tax Foundation, 1997), 4:1-35; and Douglas J. Powrie, “Divisive Reorganizations,” in *1994 British Columbia Tax Conference* (Toronto: Canadian Tax Foundation, 1994), 1:1-43.

11 For a more detailed discussion of purchase butterflies, back-door purchase butterflies, and the legislative purposes of the bump denial rules, see (in addition to the sources cited in note 10, supra) the following commentary: Manjit Singh, “An Introduction to the ‘Bump’ Rules,” in

The bump denial rules apply if certain former shareholders of the target corporation (commonly referred to as “prohibited persons”) that are defined by reference to the concept of “specified shareholder”<sup>12</sup> acquire property distributed to the parent on the merger or property substituted therefor (commonly referred to as “prohibited property”), as part of the series of transactions or events that includes the merger.<sup>13</sup> The concepts of prohibited property and prohibited persons are drafted so broadly and in such detail that it can be challenging to analyze the availability of the bump in the context of a particular transaction (or, more accurately, a series of transactions).

In the next section of the article, we examine those concepts as well as the application of the current bump denial rules in respect of acquisitions of property by a partnership. We will then consider the effect of proposed amendments to the current rules included in a notice of ways and means motion introduced on October 18, 2013.<sup>14</sup>

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*Report of Proceedings of the Fifty-Fifth Tax Conference*, 2003 Conference Report (Toronto: Canadian Tax Foundation, 2004), 51:1-31; Marc N. Ton-That, “The Bump Denial Rules: In History and in Practice,” in *Report of Proceedings of the Fifty-Second Tax Conference*, 2000 Conference Report (Toronto: Canadian Tax Foundation, 2001), 27:1-66; and Marc Ton-That and Vance Sider, “Butterfly Revisited,” in *Report of Proceedings of the Fifty-First Tax Conference*, 1999 Conference Report (Toronto: Canadian Tax Foundation, 2000), 24:1-33.

- 12 “Specified shareholder” is defined in subsection 248(1) and generally requires ownership of at least 10 percent of a class of shares. Pursuant to subsection 248(6), each series within a class is considered a separate class for the purposes of the Act.
- 13 Also, pursuant to clause 88(1)(c)(vi)(A), the parent must have acquired control of the subsidiary as part of the series of transactions or events. In the discussion that follows, the relevant series of transactions or events is referred to simply as “the series,” and unless otherwise indicated, it should be assumed that the transactions under discussion are part of the series. For a leading authority on the meaning of “series of transactions” for the purposes of the Act, see *Copthorne Holdings Ltd. v. Canada*, 2011 SCC 63. See also Michael Kande, Brian Bloom, and Olivier Fournier, “The Meaning of ‘Series of Transactions’ as Disclosed by a Unified Textual, Contextual, and Purposive Analysis” (2010) 58:2 *Canadian Tax Journal* 277-330; Brian R. Carr and Duane R. Milot, “Copthorne: Series of Transactions Revisited,” Corporate Tax Planning feature (2008) 56:1 *Canadian Tax Journal* 243-68; Mark D. Brender, “Series of Transactions: A Case for a Purposive Interpretation,” Corporate Tax Planning feature (2007) 55:1 *Canadian Tax Journal* 210-34; David G. Duff, “The Supreme Court of Canada and the General Anti-Avoidance Rule: Canada Trustco and Mathew,” in David G. Duff and Harry Erlichman, eds., *Tax Avoidance in Canada After Canada Trustco and Mathew* (Toronto: Irwin Law, 2007), 1-46; David G. Duff, “Judicial Application of the General Anti-Avoidance Rule in Canada: OSFC Holdings Ltd. v. The Queen” (2003) 57:7 *International Bulletin for Fiscal Documentation* 278-88; and Robert Couzin, “Subsection 245(3): A Framework,” in *Report of Proceedings of the Forty-Ninth Tax Conference*, 1997 Conference Report (Toronto: Canadian Tax Foundation, 1998), 4:1-15.
- 14 Canada, Department of Finance, Notice of Ways and Means Motion To Implement Certain Provisions of the Budget Tabled in Parliament on March 21, 2013 and Other Measures, October 18, 2013 (herein referred to as “the legislative proposals”).

## CONCEPTS AND DEFINITIONS

As noted above, the paragraph 88(1)(d) bump will be denied if distributed property or substituted property is acquired by a prohibited person as part of the series. The concepts of distributed property and substituted property, and the related concept of specified property, are described in turn below. A discussion of specified shareholders and specified persons follows. The application of the bump denial rules to partnerships is also discussed.

### DISTRIBUTED PROPERTY

There is no definition of distributed property in subsection 88(1). The phrase refers to any property distributed to the parent on the merger. The bump will not be available in respect of a particular distributed property if *any* distributed property or substituted property is acquired by a prohibited person. It is not necessary for the tax cost of a property acquired by a prohibited person to have been bumped under paragraphs 88(1)(c) and (d) (or even that such property constitute non-depreciable capital property) to preclude the bump in respect of *all* property distributed by the target corporation on the merger. For example, money could be distributed by a subsidiary to the parent on the merger and therefore could constitute distributed property.<sup>15</sup> If such money was acquired by a specified shareholder, the bump would be denied in respect of all non-depreciable capital property of the subsidiary. This circumstance could arise, for example, if funds of the subsidiary were used for payments to former shareholders of the target corporation or if there was an ongoing relationship between the merged entity and the target's former shareholders, such as a leasing arrangement.

### SUBSTITUTED PROPERTY

The definition of substituted property<sup>16</sup> is inclusive rather than exhaustive. The "ordinary" meaning of property acquired in substitution for other property and the rule in subsection 248(5) that provides for tracing through multiple substitutions<sup>17</sup> are also relevant.

Much of the substantive analysis in determining the availability of the bump engages the definition of substituted property. Subject to certain exceptions, substituted

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15 While money cannot constitute substituted property pursuant to subparagraph 88(1)(c.3)(iii), there is no such exception for distributed property.

16 Defined in paragraph 88(1)(c.3) for the purpose of clause 88(1)(c)(vi)(B).

17 Specifically, subsection 248(5) provides that where property has been disposed of or exchanged in substitution for another property through more than one substitution, the property acquired in any such substitution is deemed to have been substituted for the initial property. (Subsection 248(5) also provides that a share received as a stock dividend is deemed to be property substituted for that share.)

property includes attributable property and determinable property<sup>18</sup> owned at any time after the acquisition of control of the target.<sup>19</sup> Attributable property is property the fair market value of which is, at that time, wholly or partly attributable to distributed property<sup>20</sup> (other than “specified property”). Determinable property is property the fair market value of which is determinable by reference to the fair market value of the distributed property.<sup>21</sup>

18 These terms refer to substituted property described, respectively, in subparagraphs 88(1)(c.3)(i) and (ii). The terms are not used in the legislation itself.

19 Paragraph 88(1)(c.3) lists a number of exclusions from the concept of substituted property, specifically

- money (subparagraph 88(1)(c.3)(iii));
- property that was not owned by a prohibited person at any time after the acquisition of control (subparagraph 88(1)(c.3)(iv));
- property that is attributable property only because a certain specified property was received as consideration for the acquisition of the shares of the target in certain circumstances (subparagraph 88(1)(c.3)(v));
- a share of the target or debt owed by the target that was owned by the parent immediately before the winding up (subparagraph 88(1)(c.3)(vi)); and
- a share of a corporation or debt owed by a corporation, if the fair market value of the share or debt was not, at any time after the beginning of the winding up, wholly or partly attributable to distributed property (subparagraph 88(1)(c.3)(vii)).

These exclusions are relevant to the statutory concepts of attributable property and determinable property, as well as the ordinary meaning of substituted property (taking into account subsection 248(5)). In large part, they were introduced to address specific fact patterns; for example, subparagraphs 88(1)(c.3)(vi) and (vii) were introduced to address technical issues involving safe-income strips. For a discussion, see John A. Chan, “December 20, 2002 Technical Bill—Selected Domestic Topics,” in *2003 Prairie Provinces Tax Conference* (Toronto: Canadian Tax Foundation, 2003), 2:1-22.

20 Subparagraph 88(1)(c.3)(i).

21 Subparagraph 88(1)(c.3)(ii). An important distinction between attributable property and determinable property is that “specified property” is excluded from attributable property, but not from determinable property. This leaves open the possibility that shares of an acquirer that are not attributable property (because they constitute specified property) may constitute determinable property if the fair market value of the shares of an acquisition corporation could be said to be determinable by reference to the fair market value of distributed properties. On a broad construction, the shares of any acquisition corporation could technically be considered determinable property. The Department of Finance technical notes accompanying subparagraph 88(1)(c.3)(ii) and administrative statements by the Canada Revenue Agency (CRA) suggest that generally the definition of determinable property should be limited to tracking property or other property the value of which is dependent on the value of distributed property. (See, respectively, Canada, Department of Finance, *Explanatory Notes Relating to Income Tax* (Ottawa: Department of Finance, December 1997), at subclause 118(6); and Canada Revenue Agency, *Income Tax Technical News* no. 9, February 10, 1997 (now cancelled).) However, the statements also suggest that if a series of steps succeeds in breaking up a corporation without the incidence of corporate-level tax and the vending shareholder ends up holding the majority of shares of a corporation substantially all of the value of which is attributable to distributed property (absent the extracted assets), then these rules will apply.

Any upstream equity interests (such as shares of the parent or other upper-tier corporate or partnership interests) or debt of any upstream entities owned after the acquisition of control will constitute substituted property since the value of such property will be considered wholly or partly attributable to distributed property.<sup>22</sup>

## SPECIFIED PROPERTY

As noted above, substituted property does not include “specified property.”<sup>23</sup> The categories of property included in the definition of specified property reflect to some extent specific policy considerations, at least as far as shares or debt of parent or grandparent corporations is concerned.<sup>24</sup> While shares or debt of a Canadian corporation can be specified property if received as consideration for the acquisition

22 Subparagraph 88(1)(c.3)(i). The exceptions referred to in note 19, *supra*, are not discussed in detail here because they are typically not relevant to the characterization of upstream equity or debt interests as substituted property.

23 Defined in paragraph 88(1)(c.4).

24 For a discussion of the policy concern that the legislation may be attempting to address, see, for example, Angelo Nikolakakis and Alain Léonard, “The Acquisition of Canadian Corporations by Non-Residents: Canadian Income Tax Considerations Affecting Acquisition Strategies and Structure, Financing Issues, and Repatriation of Profits,” in *Report of Proceedings of the Fifty-Seventh Tax Conference*, 2005 Conference Report (Toronto: Canadian Tax Foundation, 2006), 21:1-61, at 21:24-25:

[I]t is clear that this distinction in treatment [between resident and non-resident corporations] is not based on any principled conception of continuing economic proximity between the Target stakeholders and the distributed property (the assets of Target). Indeed, if that were the basis for drawing a principled distinction in this context, we suggest that there is likely to be greater proximity when the transaction consideration consists of shares of a taxable Canadian corporation than when it consists of shares of a non-resident Bidder, on the basis that a non-resident Bidder may be more likely to have assets other than the distributed property, and therefore that a smaller part of the [fair market value] of the shares of a non-resident Bidder may be attributable to the distributed property. What is not at all clear, then, is the basis for this distinction in treatment.

Why is it that shares of a non-resident Bidder should not constitute “specified property”? The answer to this question too seems to have nothing to do with the treatment of the proceeds of disposition to the Target stakeholders. . . .

What is the problem, then, under paragraph 88(1)(c)? The Department of Finance may be considering whether or not it should be concerned about transactions by which non-Canadian assets are removed from Canadian corporate solution against tax attributes generated by consideration paid in foreign equity instead of cash or Canadian equity. At least with share consideration issued by a Canadian Bidder, the assets remain in Canadian corporate solution. In contrast, where non-Canadian assets are bumped and then distributed to a non-resident Bidder, there is no further Canadian tax claim with respect to these assets.

of the shares of the target,<sup>25</sup> under the current law, shares or debt of a foreign corporation cannot constitute specified property.<sup>26</sup>

The effect of these rules is that, under the current law, while it is possible for a Canadian acquiror to use its shares or debt (which would otherwise constitute attributable property) as consideration for the acquisition of a target without compromising the availability of the bump, the bump is not available if a non-Canadian acquiror uses its shares or debt as consideration for the acquisition of the shares of the Canadian target. This is clearly a tax policy decision; one commentator has indicated that the policy consideration underlying these provisions is a concern regarding erosion of the Canadian tax base.<sup>27</sup> The same commentator has suggested the following as an example of a transaction that the Department of Finance sought to prevent.<sup>28</sup>

*Example*

Non-resident shareholders own a Canadian corporate target. The assets of the target consist primarily of shares of foreign corporations. A non-resident acquiror establishes and capitalizes a Canadian acquisition corporation (creating cross-border paid-up capital [PUC]) to acquire the target. The PUC of the Canadian acquisition corporation is equal to the amount used to capitalize the corporation. The Canadian acquisition corporation subscribes for shares of the non-resident acquiror and uses those shares as consideration for the acquisition of the target. Following the acquisition, the target is wound up into the Canadian acquisition corporation, and the tax cost of the shares of the respective foreign corporations is bumped. The shares of the foreign corporations are then distributed by the merged Canadian acquisition corporation to the non-resident acquiror as a return of capital.

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25 Specifically, under the current law, shares of a parent corporation (which must always be a taxable Canadian corporation) received as consideration for the acquisition of shares of the target by the grandparent or parent constitute specified property (clause 88(1)(c.4)(i)(A)), as do shares of a grandparent that is a taxable Canadian corporation received as consideration for the acquisition of shares of the target by the grandparent or parent (subparagraph 88(1)(c.4)(iii)). Similarly, indebtedness issued by the parent corporation as consideration for the acquisition of the shares of the target by the parent is specified property (subparagraph 88(1)(c.4)(ii)), as is indebtedness of a grandparent that is a taxable Canadian corporation received as consideration for the acquisition of shares of the target by the parent or grandparent (subparagraph 88(1)(c.4)(iv)). Specified property also includes shares of the parent issued for consideration that consists solely of money (clause 88(1)(c.4)(i)(B)), and certain other properties described in subparagraphs 88(1)(c.4)(v) and (vi).

26 As discussed below, the legislative proposals, if enacted, will remove this restriction in limited circumstances.

27 Ton-That, *supra* note 11, at 27:27-28.

28 *Ibid.*, at 27:28.

Since the enactment of the bump denial rules, there have been many changes to the income tax regime, including in particular the introduction of comprehensive foreign affiliate dumping rules directed in part at base erosion.<sup>29</sup> Those rules may reduce the cross-border PUC of shares of a Canadian acquisition corporation established by a non-resident if more than 75 percent of the value of the shares of the target is derived from shares of foreign affiliates.<sup>30</sup> However, the rules permit the shares of the foreign affiliates to be distributed to the non-resident as a return of capital through the operation of the PUC reinstatement rules operative immediately before the distribution.<sup>31</sup> It is well understood that this result was a deliberate policy decision by the Department of Finance, since an earlier version of the rules did not contain such a PUC reinstatement rule. Thus, given the enactment of a comprehensive set of rules directed at base erosion through investments in foreign affiliates, including indirect investments through a Canadian corporation the value of which is derived from shares of foreign affiliates, it is not clear that the policy considerations underlying the limitation on the availability of the bump where shares of a non-resident corporation are used as consideration in the acquisition of a Canadian target remain compelling.

### **SPECIFIED SHAREHOLDER**

The concept of prohibited persons incorporates a modified version of the definition of “specified shareholder” in subsection 248(1). Under the bump denial rules, a specified shareholder (and aggregations of persons defined by reference to specified shareholder status), other than a specified person,<sup>32</sup> cannot acquire distributed property or substituted property as part of the series.<sup>33</sup> For this purpose, a specified shareholder of a corporation in a taxation year is a taxpayer that owns at any time in the taxation year at least 10 percent of the issued shares of any class of shares<sup>34</sup> of a corporation or of any related corporation, and that has a significant direct or indirect interest in any issued shares of the corporation.<sup>35</sup> For the purposes of the definition, a lookthrough rule is applicable to partnerships pursuant to which each member of a partnership is deemed to own a proportion of the shares of a corporation that

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29 See generally section 212.3.

30 Paragraph 212.3(10)(f).

31 Subsection 212.3(9).

32 For the purposes of this discussion, unless otherwise indicated, it should be assumed that the relevant persons are not specified persons (discussed in a separate section below).

33 It should be assumed for the purposes of this discussion that the relevant property is not specified property pursuant to paragraph 88(1)(c.4).

34 Certain types of preferred shares are excluded. More particularly, pursuant to subparagraph 88(1)(c.2)(iii), shares of a “specified class” (defined in paragraph 88(1)(c.8)) are not considered in determining whether a person (or aggregation of persons) satisfies the definition of a specified shareholder.

35 Subparagraph 88(1)(c.2)(iii).

are partnership property based on the fair market value of the member's partnership interest relative to the fair market value of all interests in the partnership.<sup>36</sup>

### **Aggregation Rules**

There are different ways in which shareholdings are aggregated for the purposes of the bump denial rules. First, in determining whether a taxpayer is a specified shareholder, the taxpayer is deemed to own each share of the capital stock of a corporation that is owned at the particular time by a person with whom the taxpayer does not deal at arm's length.<sup>37</sup> As a result, all shareholdings within a non-arm's-length group will be aggregated for the purpose of determining whether any taxpayer in the group is a specified shareholder. The bump will be denied if any member (even a member that owns no shares of the target) of a non-arm's-length group that owns in aggregate 10 percent or more of the issued shares of any class of shares of the target acquires distributed property or substituted property.

#### ***Aggregation Rule in Subclause 88(1)(c)(vi)(B)(II)***

In addition, the bump will be denied if distributed property or substituted property is acquired as part of the series by two or more persons (other than specified persons) who, if treated as one notional person, would constitute a specified shareholder of the target at any time during the series and before the parent last acquired control of the target.<sup>38</sup> This means that in analyzing whether the bump is available, in addition to specified shareholders, other persons acquiring prohibited property and their share ownership of the target (if any) should be considered. For example, employees could receive shares of a parent, or be issued employee stock options, as a bonus in the context of an acquisition such that the shares or options would not constitute specified property. If such employees owned in aggregate 10 percent or more of a class of shares of the target prior to its acquisition, the bump would be denied. No connection or relationship between the persons acquiring prohibited property for the purpose of this aggregation rule is necessary.

Moreover, any category of distributed or substituted property acquired as part of the series must be taken into account and aggregated. For example, if the employees referred to above (employees receiving stock options) held in total 6 percent of the shares of the target, and other shareholders of the target that in total held 4 percent of the shares of the target prior to its acquisition also subscribed for shares of an upstream foreign corporation as part of the series, the bump would be denied. In those circumstances, two or more persons who, if treated as one notional person,

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36 Paragraph (c) of the definition of "specified shareholder" in subsection 248(1). Similar rules are applicable in respect of trusts and their beneficiaries. The interaction of this lookthrough rule and the deeming provision in subparagraph 88(1)(c.2)(ii) is discussed below under "Partnerships."

37 Paragraph (a) of the definition of "specified shareholder" in subsection 248(1).

38 Subclause 88(1)(c)(vi)(B)(II).

would be a specified shareholder, would have acquired substituted property. There is also no specific quantification relevant in respect of the distributed property or substituted property acquired by an aggregation of persons. The aggregation of persons need not acquire shares or options in respect of the acquiror that total at least 10 percent of the value of the target (for example). The relevant measure is the percentage of the shares of the target held prior to the acquisition of control by persons acquiring prohibited property as part of the series.

This aggregation rule can be relevant where the ultimate acquiror is a partnership such as a private equity fund. If the partnership raised equity financing for the acquisition by requiring its partners to subscribe for additional partnership units, the bump would be denied if the partners in aggregate held 10 percent or more of the shares of the target before the acquisition of control and as part of the series. Since the partnership units would be substituted property, an aggregation of persons<sup>39</sup> (that, if treated as one notional person, would be a specified shareholder) would acquire substituted property as part of the series. For this reason, a fund will sometimes seek representations from its partners regarding their share ownership of a target if the availability of the bump is an important structuring consideration in the acquisition.

While a discussion of “series” is beyond the scope of this article, the concept for the purposes of the Act is very broad and includes any transaction undertaken in contemplation of the series, in the sense that the person took the series into account when undertaking the transaction.<sup>40</sup> A person subscribing for shares or debt<sup>41</sup> as part of the acquisition financing may well do so as part of the series. In addition, a person purchasing shares or debt in a public market transaction may take into account a proposed acquisition of a target in making its investment decision and thus could be considered to acquire such property as part of the series.

In a recently released technical interpretation,<sup>42</sup> the Canada Revenue Agency (CRA) has provided some comfort on the issue of whether substituted property acquired by persons described in subclause 88(1)(c)(vi)(B)(II) would occur as part of the series. Specifically, in the document, the CRA provided an opinion (but not a ruling) that the acquisition of shares or debt of a parent (and other relevant entities) by persons that would not be described in clause 88(1)(c)(vi)(B) if subclause (II) was ignored (for example, if the persons were not specified shareholders) would “not necessarily” occur as part of the relevant series.<sup>43</sup> This statement is helpful in that there should typically be a residual position that any acquisition of property by persons that had no involvement in the formulation of the series should not be

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39 As described in subclause 88(1)(c)(vi)(B)(II).

40 See the extended meaning of “series of transactions” in subsection 248(10) and the related case law and commentary cited in note 13, *supra*.

41 As discussed *infra* note 59, indebtedness issued solely for cash consideration should constitute specified property under the legislative proposals.

42 CRA document no. 2012-0451421R3, 2012.

43 *Ibid*.

considered to occur as part of the relevant series. While this opinion represents express acknowledgment by the CRA of this position, “not necessarily” is hardly a definitive affirmation of the CRA’s administrative practice.

For the purpose of the application of the aggregation rule in subclause 88(1)(c)(vi)(B)(II), shares held within a non-arm’s-length group are not aggregated. That is, in determining whether a person is a specified shareholder, shareholdings of all non-arm’s-length persons are aggregated. If the 10 percent threshold is met, then all non-arm’s-length group members are specified shareholders of the target. If the 10 percent threshold is not met within the non-arm’s-length group, in applying the aggregation test in subclause 88(1)(c)(vi)(B)(II), only the shareholdings of the persons actually acquiring distributed or substituted property are aggregated (not the shareholdings of non-arm’s-length persons). Consider the following example. One member of a non-arm’s-length group (“member A”) holds 2 percent of the shares of a target, while another member of the group (“member B”) holds 5 percent of the shares of the target. If member A acquires prohibited property (for example, units of an upstream partnership), the shares of the target held by member A must be aggregated with the shareholdings of all other entities acquiring prohibited property as part of the series in determining whether the threshold in subclause 88(1)(c)(vi)(B)(II) is satisfied. The 5 percent shareholding of member B is not taken into account (assuming that member B does not also acquire prohibited property as part of the series). While the definition of specified shareholder provides that a taxpayer is deemed to own each share owned by a non-arm’s-length person, this rule is applicable only for the purpose of that definition. Of course, if member A owned 6 percent of any class of shares of the target and member B owned 5 percent of any class of the target’s shares, then all group members would be specified shareholders, and any acquisition of distributed property or substituted property by any group member would preclude the use of the bump.

Another CRA technical interpretation<sup>44</sup> states that the phrase “all of the shares” in subclause 88(1)(c)(vi)(B)(II) (and presumably in subclause (III), discussed below) does not refer only to shares of the target. In the CRA’s view, the phrase refers to the shares of any corporation. Thus, if an aggregation of persons that acquired prohibited property as part of the series owned 10 percent or more of the shares of a corporation that was related to the target (and that had a significant direct or indirect interest in the target), the bump would be denied. While this interpretation might expand the application of the bump denial rules, as a practical matter it likely would not be relevant to most public company transactions.

### ***Aggregation Rule in Subclause 88(1)(c)(vi)(B)(III)***

Subclause 88(1)(c)(vi)(B)(III) describes further categories of prohibited persons by reference to specified shareholder status and the aggregation rule described above.<sup>45</sup>

44 CRA document no. 2010-0386041C6, November 28, 2010.

45 Specified persons and the target are not prohibited persons under subclause 88(1)(c)(vi)(B)(III).

First, a corporation (other than a specified person) that has a specified shareholder in common with a target is a prohibited person.<sup>46</sup> That is, if a shareholder owns 10 percent of a class of the shares of the target and also owns 10 percent of the shares of an unrelated corporation that is not a specified person, the unrelated corporation cannot acquire distributed or substituted property as part of the series. In the public company context, as a practical matter, if there is a known specified shareholder, it may be prudent to confirm that that specified shareholder does not also own 10 percent or more of the shares of an acquiror (either alone or together with non-arm's-length persons).

Further, where two or more persons (other than specified persons) would, if treated as one notional person, be a specified shareholder of a corporation after the acquisition of control, and such notional person would also be a specified shareholder of the target, such corporation will be a prohibited person.<sup>47</sup> Consider the situation, for example, where (1) shareholder A owns 5 percent of a class of shares of the target and also owns 2 percent of the shares of a particular corporation, and (2) shareholder B owns 5 percent of the same class of shares of the target and also owns 8 percent of the same class of shares of the corporation. If shareholders A and B were treated as one notional person, the notional person would be a specified shareholder of the target and of the corporation. As a practical matter, in the context of public company transactions, it will be virtually impossible in many situations to monitor compliance with this rule.

## SPECIFIED PERSON

A specified person is an otherwise prohibited person that can acquire prohibited property as part of the series without causing the application of the bump denial rules. Consequently, status as a specified person is desirable.

A specified person, at any time, means the parent and each person that would, without regard to paragraph 251(5)(b) rights, be related to the parent.<sup>48</sup> Obviously, to claim the bump, the parent must acquire distributed property as part of the series. The inclusion of related persons in the definition permits intragroup transfers of

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46 Sub-subclause 88(1)(c)(vi)(B)(III)(1). The relevant person must be a specified shareholder of the target before the acquisition of control and a specified shareholder of the other corporation after the acquisition of control.

47 Sub-subclause 88(1)(c)(vi)(B)(III)(2). The notional person would have to be a specified shareholder of the target before the acquisition of control and a specified shareholder of the particular corporation after the acquisition of control. As well, the relevant shareholders must have acquired the shares of the particular corporation as part of the series.

48 Subparagraph 88(1)(c.2)(i). However, a person is deemed not to be related to the parent "where it can reasonably be considered that one of the main purposes of one or more transactions or events was to cause the person to be related to the parent so as to prevent a property that was distributed to the parent on the winding-up from being an ineligible property for the purpose of [the bump]." The legislative proposals would move this anti-avoidance provision (currently in subparagraph 88(1)(c.2)(i)) to new subparagraph 88(1)(c.2)(i.1).

distributed property without regard to whether a related entity was a specified shareholder or otherwise a prohibited person prior to the acquisition of control of the target.

## PARTNERSHIPS

There is some uncertainty in the application of the bump denial rules in respect of the acquisition of property by a partnership. The bump denial rules in subparagraph 88(1)(c)(vi) refer to acquisitions of property by any “person.” Generally, a partnership is not a person for the purposes of the Act (although in some instances a partnership may be deemed to be a person).<sup>49</sup> Uncertainty results because of the interaction of the definition of “specified shareholder” in subsection 248(1) and the deeming rule in subparagraph 88(1)(c.2)(ii), which is applicable for the purposes of paragraph 88(1)(c.2) and subparagraph 88(1)(c)(vi).

Under the lookthrough rules in the definition of “specified shareholder,” a partnership cannot itself be a specified shareholder; rather, as discussed above, each member of a partnership is deemed to own a proportion of the shares of a corporation that are partnership property based on the fair market value of the member’s partnership interest relative to the fair market value of all interests in the partnership.<sup>50</sup> Thus, specified shareholder status is determined at the partner level on a lookthrough basis.

However, subparagraph 88(1)(c.2)(ii) provides that where at any time a property is owned or acquired by a partnership

- the partnership is deemed to be a corporation;
- that corporation is deemed to have one class of issued shares;
- each member of the partnership is deemed to own at that time a proportion of the number of issued shares of the capital stock of the corporation based on the pro rata fair market value of the member’s partnership interest; and
- the property is deemed to have been owned or acquired by the corporation at that time.<sup>51</sup>

This approach (deeming a partnership to be a corporation and referring only to an acquisition of property by a person) contrasts with the continuity-of-interest rules in the butterfly context, which do not deem a partnership to be a corporation and

49 See subsection 66(16), which deems a partnership to be a person for the purposes of the flowthrough share rules. However, relying on the provisions of subsection 96(1), the CRA considers a partnership to be a person for the purposes of income computation at the partnership level: see, for example, “Revenue Canada Round Table,” in *Report of Proceedings of the Forty-Second Tax Conference*, 1990 Conference Report (Toronto: Canadian Tax Foundation, 1991), 50:1-68, question 28, at 50:16.

50 See *supra* note 36 and the related text.

51 Similar rules also apply in respect of trusts and their beneficiaries (see subparagraph 88(1)(c.2)(ii)).

instead refer to an acquisition of property by a “person or partnership.”<sup>52</sup> An earlier iteration of the bump denial rules contained similar language.<sup>53</sup>

As a result of the interaction of subparagraph 88(1)(c.2)(ii) and the definition of “specified shareholder,” it is not clear whether or when the bump denial rules may apply in respect of an acquisition by a partnership. If a partnership owns 10 percent or more of a class of shares of a target corporation, the partnership will be a specified shareholder pursuant to the application of subparagraph 88(1)(c.2)(ii) for the purposes of subparagraph 88(1)(c)(vi), and the partnership cannot acquire distributed property or substituted property as part of the series. However, a partner in a partnership can still be a specified shareholder pursuant to the definition in subsection 248(1) since subparagraph 88(1)(c.2)(ii) does not override the lookthrough rule. Thus, if a partnership owned 40 percent of the shares of a target, a member that had a 25 percent interest in the partnership based on fair market value would be a specified shareholder and could not acquire distributed property or substituted property as part of the series. (The partnership would also be a specified shareholder.)

The aggregation rules in subclause 88(1)(c)(vi)(B)(III) must also be considered having regard to the application of the deeming rule in subparagraph 88(1)(c.2)(ii) in respect of an acquisition of property by a partnership. For example, if a specified shareholder of a target was a member of a partnership and that member’s partnership interest constituted at least 10 percent of the fair market value of all interests in the partnership, the acquisition of distributed property or substituted property by the partnership as part of the series would preclude the bump on the combined basis of sub-subclause 88(1)(c)(vi)(B)(III)(1) and the deeming rule in subparagraph 88(1)(c.2)(ii). That is, a (deemed) corporation of which a specified shareholder of the target was also a specified shareholder would have acquired prohibited property. Further, if two or more shareholders of the target (other than specified persons) whose shareholdings in the target were at least 10 percent in aggregate were members of a partnership and the fair market value of their aggregate partnership interests was at least 10 percent of the fair market value of all partnership interests, the bump would be precluded as a result of the combined operation of sub-subclause 88(1)(c)(vi)(B)(III)(2) and subparagraph 88(1)(c.2)(ii). That is, a deemed corporation of which two or more persons (other than specified persons), if treated as one notional person, would constitute a specified shareholder, and would also constitute a specified shareholder of the target, would have acquired prohibited property. As a result of these rules (as well as the rule discussed below), it may be prudent for a private equity fund to make inquiries of its members regarding their share ownership in a target (assuming that substituted property is acquired as part of the series) if the bump is an important structuring consideration.

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52 See, for example, paragraph 55(3.1)(b). Also see the discussion in note 10, *supra*, and the sources cited therein.

53 See the February 1994 draft legislation introducing subparagraph 88(1)(c)(vi): Canada, Department of Finance, 1994 Budget, Tax Measures: Supplementary Information and Notices of Ways and Means Motions, February 22, 1994, at annex 2.

The acquisition of partnership interests by members of the partnership (that are not themselves partnerships) may still preclude the bump on the basis that the partnership interests are substituted property. The deeming rule in subparagraph 88(1)(c.2)(ii) applies for the purposes of paragraph 88(1)(c.2) and subparagraph 88(1)(c)(vi) in respect of property owned or acquired by a partnership but not in respect of the acquisition of partnership interests (unless the acquirer is itself a partnership).

Notwithstanding the lookthrough rule applicable for the purpose of determining specified shareholder status, a partnership can be a specified person. The preamble of paragraph 88(1)(c.2) expressly applies for the purposes of that paragraph as well as subparagraph 88(1)(c)(vi). Thus, the rule in subparagraph 88(1)(c.2)(ii) that deems a partnership to be a corporation is applicable to the definition of “specified person” (subparagraph 88(1)(c.2)(i)). For example, a partnership (such as a private equity fund) that establishes an acquisition corporation should be a specified person because, as a deemed corporation, the fund should be related to the acquisition corporation. However, if multiple funds are involved in forming the acquisition corporation, it may not be the case that all of those funds will be specified persons. Further, if each fund owns 50 percent or less of the shares of the target, none of the funds may be a specified person. This could be problematic, for example, in circumstances where a fund establishes a toehold position in a target of at least 10 percent, causing it to constitute a specified shareholder prior to the acquisition of control of the target. If the fund does not control the acquisition corporation, it likely will not constitute a specified person. Consequently, any acquisition of attributable property (other than specified property) by the fund would preclude the bump.

## LEGISLATIVE PROPOSALS

The legislative proposals are relieving in nature and in large part propose amendments based on a number of comfort letters issued by the Department of Finance since 2002. In some cases, the proposals address the issue fairly narrowly, and technical problems remain. The proposals also do not address the uncertainty, discussed above, with respect to the application of the bump denial rules to partnerships.

In this section, we discuss the legislative proposals relevant to the concepts of substituted property and specified property (prohibited property), and the proposals affecting specified persons and specified shareholders (prohibited persons).

## SUBSTITUTED PROPERTY AND SPECIFIED PROPERTY

The following are the legislative proposals relevant to the concepts of substituted property and specified property:

- the introduction of a “safe harbour” into the definition of substituted property;<sup>54</sup>

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<sup>54</sup> Proposed subparagraph 88(1)(c.3)(i).

- expansion of the definition of specified property to include indebtedness in certain circumstances;<sup>55</sup>
- the status of stock options as substituted property;<sup>56</sup>
- the introduction of a rule that provides that distributed property is deemed not to have been acquired by a person if it was acquired prior to the acquisition of control and is not owned at any time after the acquisition of control;<sup>57</sup> and
- clarification in respect of amalgamation squeeze-out transactions.<sup>58</sup>

Below, we review these proposals and consider whether they appropriately deal with the current problems with the bump rules that they aimed to address.

### Safe Harbour

The concept of substituted property (and, in particular, attributable property) is extremely broad. Subject to exceptions for specified property, substituted property includes virtually any upstream debt or equity interest in the target. The legislative proposals narrow the concept of attributable property by introducing a safe harbour concept into subparagraph 88(1)(c.3)(i).<sup>59</sup> Under the legislative proposals, property owned at any time after the acquisition of control will be substituted property only if more than 10 percent of its fair market value is, at that time, attributable to distributed property. The Department of Finance indicates in the technical notes accompanying the legislative proposals that the 10 percent threshold has been introduced “to limit the type of property that is deemed to be substituted property”

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55 Proposed clause 88(1)(c.4)(ii)(B).

56 Proposed paragraph 88(1)(c.9).

57 Proposed subparagraph 88(1)(c.2)(ii).

58 Proposed subparagraph 88(1)(c.4)(v).

59 Consequent upon this amendment was the removal from the draft legislation of a prior proposal also of potentially broad scope. Former proposed subparagraph 88(1)(c.4)(vi) provided that if the shares of the subsidiary were acquired by the parent for consideration that consisted solely of money, a share of any corporation would be specified property (proposed in the December 2002 legislative proposals, clause 36). Under the current law, a share of the parent issued solely for cash consideration is specified property. The prior proposal would also have permitted shares of a non-resident acquiror to constitute specified property, provided that the shares of the target were acquired for cash. For example, under that proposal, a non-resident acquiror could have raised capital through an equity issuance and then used the proceeds to fund the acquisition by a Canadian corporation of the shares of the target for cash consideration. The shares of the non-resident would have been specified property under the prior proposal since the shares of the target would have been acquired by the parent for consideration that consisted solely of money. Since the amendment in the current legislative proposals is a previously announced measure, it will have application from 2001 to December 21, 2013 (with transitional relief for mergers that were evidenced in writing prior to December 21, 2013 and undertaken before July 2013).

and thus “simplify the application of the bump denial rule.”<sup>60</sup> The Department of Finance further indicates that the introduction of this threshold should reduce the need to create an exhaustive list of acceptable properties through the definition of specified property.

While the legislative proposal is fairly narrow, as a relieving measure it will be welcomed by taxpayers. Since property will not be substituted property unless 10 percent or more of its fair market value is attributable to distributed property, the legislative proposals open up, in limited circumstances, the possibility of the bump being available when shares of a non-Canadian corporation are issued to shareholders in consideration for the acquisition of a Canadian target. Under the current law, such shares constitute substituted property since their value is attributable to distributed property, and the shares cannot be specified property. Under the legislative proposals, if the value of the distributed properties was less than 10 percent of the value of the non-resident corporation, shares of that corporation should not be substituted property. This could be the case if a foreign multinational acquired a Canadian target. Provided that the Canadian target represented less than 10 percent of the value of the non-resident corporation, the bump would not be precluded simply because shares of the non-resident corporation were issued to shareholders of the target.

A criticism of this legislative proposal is that all values necessarily fluctuate over time. Under subparagraph 88(1)(c)(vi), property is ineligible for the bump if substituted property is acquired by prohibited persons as part of the series. Property will not qualify for the safe harbour if a prohibited person acquires the property as part of the series and at any time after the acquisition of control, more than 10 percent of the value of the property is attributable to distributed property. Thus, if the value of the distributed properties appreciated over time relative to the value of the other assets, the relevant property could become substituted property. Technically, the value shift may not have to occur as part of the series; only the acquisition of substituted property must be part of the series (and property will be substituted property if at any time after the acquisition of control more than 10 percent of its value is attributable to substituted property). The Joint Committee on Taxation of the Canadian Bar Association and the Canadian Institute of Chartered Accountants (“the joint committee”) has commented on this issue,<sup>61</sup> but no adjustment was made to the text of the legislative proposals from the original draft legislation (released in December 2012)<sup>62</sup> relative to the October 2013 notice of ways and means motion.

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60 Canada, Department of Finance, *Explanatory Notes Relating to the Income Tax Act, the Excise Tax Act and the Income Tax Regulations* (Ottawa: Department of Finance, October 2013), at 68.

61 Joint Committee on Taxation of the Canadian Bar Association and the Canadian Institute of Chartered Accountants, “Re: December 21, 2012 Technical Amendments,” submission to the Department of Finance, February 13, 2012. (All references herein to comments of the joint committee are to this submission.)

62 Canada, Department of Finance, *Legislative Proposals Relating to Income Tax* (Ottawa: Department of Finance, December 21, 2012).

However, as a practical matter, the provision may be construed as a point-in-time test or a throughout-the-series test.

### Indebtedness

The legislative proposals expand the circumstances in which indebtedness may constitute specified property.<sup>63</sup> Since the value of indebtedness of a parent (or other upstream entity) will be considered to be attributable to distributed properties, such indebtedness under the current law constitutes substituted property. However, under the current law, specified property includes indebtedness issued by the parent as consideration for the acquisition of the shares of the subsidiary by the parent.<sup>64</sup> This category of specified property obviously permits notes to be issued by an acquiror as consideration for the shares of a target without compromising the availability of the bump.

This category of specified property is also relevant in the structuring of dissent rights under a plan of arrangement, which is a fairly common acquisition structure for takeovers of Canadian corporations. Generally, under a plan of arrangement, minority shareholders have a statutory right of dissent. If the plan of arrangement ultimately receives shareholder approval, dissenting shareholders will be entitled to receive fair value for their shares at a later date. The dissent right represents indebtedness the value of which would be attributable to distributed property. If the plan of arrangement provides that the shares held by dissenting shareholders are to be acquired by the acquiror in exchange for payment, such indebtedness will constitute specified property since it will be issued by the parent as consideration for the acquisition of the shares of the subsidiary. In contrast, if the plan of arrangement provides that the shares held by dissenting shareholders are to be cancelled for payment, while such indebtedness will constitute substituted property, it will not be specified property. Thus, in the latter example, the acquisition of such substituted property (being the right of dissenting shareholders to receive fair value for their shares) will have to be taken into account in determining whether prohibited persons have acquired property. Consequently, it is usually preferable, from a bump perspective, to structure dissent rights in a plan of arrangement such that the shares of dissenting shareholders are to be acquired by the acquiror in return for payment.

The current law does not address circumstances in which an acquiror has borrowed third-party debt externally and has used the proceeds of the borrowing to acquire shares of the target (as, for example, in a standard leveraged buyout). In the context of a public company acquisition, an acquiror may borrow acquisition financing through a syndicate of lenders.<sup>65</sup> If it happened that a specified shareholder of

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63 Proposed clause 88(1)(c.4)(ii)(B).

64 Subparagraph 88(1)(c.4)(ii). Also, as discussed above, indebtedness of a grandparent that is a taxable Canadian corporation may be specified property pursuant to subparagraph 88(1)(c.4)(iv) (see *supra* note 25).

65 It is assumed that such borrowing is part of the series.

the target (or other prohibited person) was also a member of the lending syndicate, the bump would not be available because a prohibited person would have acquired prohibited property as part of the series. As a result, in acquisitions where reliance has been placed on the availability of the bump (for example, for valuation purposes), it has become practice for the acquiror to seek confirmation from potential members of the lending syndicate regarding their share ownership, if any, in the target.

The legislative proposals eliminate the need for these precautions. Proposed clause 88(1)(c.4)(ii)(B) provides that indebtedness that was issued for consideration that consists solely of money will be specified property. Thus, acquisition financing, assuming that it is issued solely for money, will constitute specified property. On its face, this proposal includes convertible debt or other participating debt issued solely for money as specified property. However, consideration should be given to whether such debt may constitute determinable property. In such case, it may be prohibited property.

The technical notes to the legislative proposals suggest that the amendment applies to indebtedness issued *by the parent* for consideration that consists solely of money,<sup>66</sup> but the proposed amendment is not, on its face, limited to indebtedness of the parent. For example, indebtedness issued by a non-resident acquiror solely for cash consideration, the proceeds of which are used to capitalize a Canadian acquisition corporation, would be specified property under the legislative proposals. Obviously, a more comprehensive inclusion of indebtedness in specified property provides greater flexibility for taxpayers in financing acquisitions and ongoing operations.

### Stock Options

The legislative proposals also address stock options,<sup>67</sup> which are another category of substituted property that is usually relevant in the context of public company targets. Stock options are a common form of employee compensation intended in part to align employees' interests with those of shareholders. An acquiror may seek to have new or continued equity participation by employees through the issuance of employee stock options at the level of the acquiror or other upstream entity. Typically, new options in respect of shares of the acquiror (or other upstream entity) would be issued to employees, or alternatively, existing employee stock options held by employees could be rolled into options of the parent corporation in a transaction that satisfied the requirements of subsection 7(1.4). In such a transaction, the existing employee stock options would be disposed of (that is, cancelled), and, in exchange, the optionholders would receive new options in respect of shares of the acquiror having an equivalent in-the-money amount to that of the cancelled options.

Since the value of the options (in either case) would be attributable to underlying distributed property of the target, the options would constitute substituted property. Options may be particularly problematic in determining the availability of the

<sup>66</sup> Supra note 60, at 266.

<sup>67</sup> Proposed paragraph 88(1)(c.9).

bump since optionholders may also be existing target shareholders (for example, from the past exercise of stock options). If an employee was an existing specified shareholder of the target, the issuance to that employee of an option for shares of the acquiror would preclude the bump. Thus, the impact of the receipt of substituted property (the newly issued stock options) by employees on the availability of the bump must be considered. While it is unlikely that an individual employee would be a specified shareholder of a public company, the aggregation rules discussed above must be considered in analyzing the bump denial rules.

In the past, the Department of Finance issued a number of comfort letters in response to taxpayers' requests that the definition of specified property be expanded to include options.<sup>68</sup> In those requests, taxpayers suggested that because the options were proxies for the shares to which the option related, if such shares would be specified property, the related options should be specified property. In the comfort letters, the department agreed that an option exchange should not in itself result in denial of the bump, and stated that it was prepared to recommend that the Act be amended to ensure that rights to acquire shares would not constitute substituted property.

However, the legislative proposals do not directly adopt the approach advocated by taxpayers in their requests. Rather, new proposed paragraph 88(1)(c.9) provides that for the purposes of the definition of specified property, a reference to a share of a corporation includes a right to acquire a share of the corporation (that is, an option). At first blush, this approach may seem appropriate on the basis that an option should constitute specified property only if the share to which the option relates is specified property. Presumably, in drafting this proposed amendment, the Department of Finance was concerned that only options in respect of shares that are specified property should be specified property (excluding, for example, options in respect of shares of a foreign acquiror).

Technically, however, the proposed amendment provides no relief if an option exchange is structured in a manner that is typical in the context of an acquisition of a target corporation. If the options in respect of shares of the target are cancelled by the target and, in exchange, options of the acquiror are issued to the former target optionholders, there is no category of specified property that will include such options. The relevant references to "shares" in the definition of specified property in paragraph 88(1)(c.4) specify shares of the parent that are received as consideration for the acquisition of shares of the target, or shares of the parent that are issued for consideration that consists solely of money.<sup>69</sup> Neither of these exceptions will be satisfied if a reference to a share in paragraph 88(1)(c.4) includes an option. In the

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68 See, for example, Department of Finance comfort letters dated April 22, 2002; June 24, 2003; and April 15, 2005.

69 Also included, pursuant to subparagraph 88(1)(c.4)(iv), are shares of a taxable Canadian corporation received as consideration for the acquisition.

typical arrangement described above (where new options are issued to the employees), the new options will not be issued as consideration for the acquisition of options (or shares) of the target by the parent or for consideration that consists solely of money. Similarly, if the new options are issued in an option exchange under subsection 7(1.4), the new options will not be received as consideration for the acquisition of the existing options (or shares) by the parent. Rather the existing options will be cancelled. Further, the new options clearly will not be issued for consideration that consists solely of money in an option exchange intended to comply with subsection 7(1.4).<sup>70</sup> In order to fit within the legislative proposals, the acquiror would have to acquire the existing options and issue new options in exchange therefor. Presumably the existing options held by the acquiror could then be cancelled. While this may be feasible, it is a departure from existing practice.

In its submission in respect of the December 12 draft legislation, the joint committee noted deficiencies in respect of proposed paragraph 88(1)(c.9). In particular, the joint committee noted that because stock options are compensatory in nature, such property should per se constitute specified property, including stock options in respect of shares of a non-resident corporation. These concerns are not addressed in the more recent legislative proposals. Instead, the December 2012 draft of the amendment remains unchanged.

### **Other Proposals Addressing Prohibited Property**

The legislative proposals introduce a rule that provides that distributed property is deemed not to have been acquired by a person if it was acquired prior to the acquisition of control but is not owned at any time after the acquisition of control.<sup>71</sup> The comfort letter to which this proposal responds<sup>72</sup> does not reveal much detail about the specific transactions in issue. However, it seems clear that if the distributed property is not owned by the prohibited person at any time after the acquisition of control, the acquisition of the property (prior to the acquisition of control) should not be relevant to the availability of the bump.

The legislative proposals expand the circumstances in which shares issued in an amalgamation squeeze-out will qualify as substituted property. In an amalgamation squeeze-out, assuming that a sufficient quantity of shares has been tendered to a bid, the target will amalgamate with a new corporation and issue redeemable preferred shares to minority shareholders that have not tendered to the bid. The preferred shares will be immediately redeemed to squeeze out those minority shareholders. Under the current law, for the preferred shares issued on the amalgamation squeeze-out to constitute specified property, the shares would have to be redeemed for cash. In response to taxpayers' concerns, under the legislative proposals, the preferred shares

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70 Paragraph 7(1.4)(c).

71 Proposed subparagraph 88(1)(c.2)(iv).

72 Department of Finance comfort letter dated September 1, 2006.

may instead be redeemed for consideration that includes shares of the parent.<sup>73</sup> The Department of Finance had indicated in prior comfort letters that since shares of the parent would be specified property if issued directly to shareholders, it should be possible to issue such shares to shareholders on an amalgamation squeeze-out.<sup>74</sup> As a result, there should be greater flexibility in structuring such transactions.

## **SPECIFIED PERSONS AND SPECIFIED SHAREHOLDERS**

The legislative proposals relevant to the concepts of specified persons and specified shareholders are narrowly focused. In the context of the definition of a specified person, the proposals contain a rule that is intended to be relieving in circumstances in which the bump parent is a newly incorporated corporation.<sup>75</sup> In the context of the definition of a specified shareholder, the proposals contain amendments that address technical issues that arise where a target shareholder has a controlling shareholder.<sup>76</sup> These changes are discussed in turn below.

### **Specified Person**

Specified person status is generally tested under subparagraph 88(1)(c)(vi) at the time of the acquisition of distributed or substituted property. Since the bump parent will frequently be a new Canadian acquisition corporation, and specified person status is defined by reference to the bump parent, it is prudent to incorporate the bump parent as early in the series as possible in order to impart specified person status to related persons. Proposed clause 88(1)(c.2)(i)(C) is intended to provide relief in this regard by permitting a person to be a specified person before the incorporation of the bump parent. The proposal provides that if the time is before the incorporation of the bump parent, each person that is related to the bump parent throughout the period that begins at the time that the parent is incorporated and ends at the time that is immediately before the winding up of the target is a specified person. Thus, the legislative proposals extend what would otherwise be a point-in-time test (applied at the time of acquisition of the relevant property) to a throughout-the-period test. This difference likely will not be of concern from a practical perspective. However, unless there is a compelling reason to the contrary, it may still be prudent to incorporate the bump parent as early in the series as possible, so that all related persons are clearly specified persons at the time that any substituted property is acquired.

The joint committee noted in its submission that there are deficiencies in the drafting of clause 88(1)(c.2)(i)(C) in that no person can be related to the parent corporation at the time that it is incorporated; shares of the parent must first be issued in

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73 Proposed subparagraph 88(1)(c.4)(v), which also combines existing subparagraphs 88(1)(c.4)(v) and (vi).

74 See Department of Finance comfort letters dated May 2, 2002 and January 20, 2006.

75 Proposed clause 88(1)(c.2)(i)(B).

76 Proposed clauses 88(1)(c.2)(iii)(A.1) and (A.2).

order for a person to become related. On this interpretation, the legislative proposal would never have application. However, there is a principle of statutory interpretation against such a reading of the provision.<sup>77</sup> The legislative proposals in this regard are unchanged from the December 2012 draft legislation.

### Specified Shareholder Status

The legislative proposals also contain amendments to the definition of a specified shareholder applicable for the purposes of the bump denial rules. These amendments give effect to various comfort letters issued by the Department of Finance. As noted above, they are narrowly focused to address technical issues that arise in circumstances where a target has a controlling shareholder.

Recall that, under the definition of a specified shareholder, a taxpayer is deemed to own each share of a corporation that is owned by a non-arm's-length person.<sup>78</sup> This rule is appropriate in the context of aggregating shareholders within a corporate group to determine specified shareholder status of members of the group. However, anomalous results can arise in circumstances where there is a controlling shareholder of the target or of the acquiror. If the target has a controlling shareholder, all controlled subsidiaries of the target will be specified shareholders of the target. That is, because a subsidiary of the target will be deemed to own all shares held by any non-arm's-length persons, including those held by the controlling shareholder, the subsidiary will be a specified shareholder of the target. (This issue does not arise if the target is widely held because in this situation, the subsidiaries of the target will not be dealing at non-arm's-length with the shareholders.) If the shares of the subsidiary are then sold to an unrelated purchaser that has a controlling shareholder, the subsidiary will also be a specified shareholder of the purchaser for the same reason (that is, the subsidiary and the controlling shareholder of the purchaser will not be dealing at arm's length and, as a result, the subsidiary will be deemed to own the shares of the purchaser held by the controlling shareholder and will be a specified shareholder of the purchaser). This is not an unusual or contrived fact pattern; frequently, the purpose of a bump transaction is to sell the shares of a subsidiary to a third-party purchaser. However, the bump is denied under the current law because a corporation (the purchaser) of which a specified shareholder of the target (the subsidiary) is a specified shareholder has acquired bumped property (the shares of the subsidiary).<sup>79</sup>

The legislative proposals address this unintended result by providing that a corporation (the subsidiary in this example) controlled by another corporation (the target) is deemed not to own shares of the other corporation (the target) if the corporation (the subsidiary) does not have a direct or indirect interest in any shares of

77 It is generally presumed that Parliament could not have intended an absurd result. See, for example, *Grunwald v. Canada*, 2005 FCA 421.

78 See *supra* note 37 and the accompanying text.

79 Sub-subclause 88(1)(c)(vi)(B)(III)(1).

the other corporation (the target).<sup>80</sup> Because a subsidiary does not have a direct or indirect interest in the target, the subsidiary will not be deemed to own the shares of the target owned by the controlling shareholder. Thus, the subsidiary will not be a specified shareholder of the target. While the proposal addresses this anomalous result (which was discussed in an earlier comfort letter),<sup>81</sup> it does so in a very focused manner. The relevance of the legislative proposal is largely limited to this particular fact pattern.

Another narrow amendment introduced in the legislative proposals addresses another anomalous result. Where a sale of the shares of a subsidiary of the target to a third-party purchaser is contemplated prior to the acquisition of the target, the purchaser may have entered into the agreement to acquire the shares of the subsidiary in advance and therefore may be related to the subsidiary pursuant to paragraph 251(5)(b). A corporate controlling shareholder of the target will also be related to the subsidiary. Under subsection 251(3), where two corporations (in this case the purchaser and the controlling shareholder) are related to the same corporation (in this case the subsidiary), the two corporations are deemed to be related to each other. Consequently, the third-party purchaser and the controlling shareholder will be related, causing the purchaser to be a specified shareholder of the target (since it will be deemed to own the shares of the target held by the controlling shareholder, a non-arm's-length person). In this situation, the bump will be denied because a specified shareholder of the target (the third-party purchaser) has acquired distributed property (the shares of the subsidiary).

Under the proposed amendment, a person is not deemed to own shares of the target held by non-arm's-length persons where the non-arm's-length relationship arises only because the person has a paragraph 251(5)(b) right to acquire shares of a subsidiary of the target that does not have a direct or indirect interest in the target.<sup>82</sup> Specifically, paragraph (a) of the definition of "specified shareholder" in subsection 248(1) is to be ignored in respect of shares of the target if the person would be deemed to own such shares only because of a paragraph 251(5)(b) right to acquire shares of a corporation controlled by the target (that does not have a direct or indirect interest in the target). Thus, under the legislative proposals, the purchaser would not be deemed to own the shares of the target (held by the parent) and thus would not be a specified shareholder of the target prior to the acquisition of control. While the legislative proposal addresses this specific technical issue (also discussed in an earlier comfort letter),<sup>83</sup> it does so in a very narrow fashion. As a result, the relevance of the proposal will largely be limited to the fact pattern at which it was directed.

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80 Proposed clause 88(1)(c.2)(iii)(A.1).

81 Department of Finance comfort letter dated August 13, 2007.

82 Proposed clause 88(1)(c.2)(iii)(A.2).

83 Department of Finance comfort letter dated August 13, 2004.

## CONCLUSION

The bump denial rules are among the most complex in the Act. In this regard, the aggregation rules, as well as the application of the rules in respect of partnerships, can give rise to uncertainty. However, problems with the current law can be traced largely to the broad scope of the provisions defining property that cannot be traced to specified shareholders (and other prohibited persons) as part of the series. This issue has necessitated successive changes to the bump denial rules in the form of relieving provisions and other technical amendments. As relieving measures, the most recent legislative proposals will, of course, be of benefit to taxpayers.

In particular, the changes to the definitions of substituted property and specified property will be welcomed by taxpayers. The introduction of a safe harbour into the definition of substituted property should reduce some of the complexity in analyzing the availability of the bump. While the proposal does open up the possibility that shares of a foreign acquiror may be used as consideration in an acquisition in which the bump is sought, it does so quite narrowly, since the amendment requires that the Canadian target comprise 10 percent or less of the foreign acquiror. With the introduction of comprehensive rules directed at base erosion,<sup>84</sup> it is perhaps time to revisit the restriction on the use of shares of a foreign parent as consideration in a bump transaction. The introduction of an exception for indebtedness issued solely for money is another change that should reduce uncertainty in determining the availability of the bump. The amendment should eliminate the need to seek confirmation of the ownership interests of members of a lending syndicate in the target, in support of the availability of the bump. While establishing the status of stock options as specified property in some cases has been facilitated by the legislative proposals, on the basis of comfort letters, a more comprehensive rule providing that employee stock options generally constitute specified property might have been expected. From a policy perspective, at least with respect to public company employee stock options, it would seem acceptable from a policy perspective for employees that are not specified shareholders to receive new options in connection with an acquisition.

The legislative proposals also address some longstanding technical issues that arise where a target or third-party purchaser of distributed property has a controlling shareholder. The changes address the technical issues in a narrow and specific manner, rather than scaling back some of the expansive provisions that gave rise to those issues. As a result, it is likely that other technical issues will emerge that will have to be addressed through further amendments.

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84 See *supra* note 29 and the accompanying text.

