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CORPORATIONS

Tuck-Under Transactions – Accessing the Corporate Surplus of a Lower-tier Corporation

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Introduction

As time goes on, finding methods to access corporate surplus in a tax-effective manner has become a more challenging proposition, and while Parliament has attempted to curtail what it perceives as abusive "surplus stripping" through the enactment of various anti-surplus stripping provisions (for example, subsection 55(2) and section 84.1), taxpayers and tax advisors continue to develop innovative methods for accessing corporate surplus advantageously.

One such method that has been used with some degree of success is through the use of what is often referred to as "tuck-under" transactions.

What Are Tuck-Under Transactions?

In general terms, tuck-under transactions are a series of transactions that result in a shareholder of a higher-tier corporation becoming a shareholder of a lower-tier corporation. The motivation for undertaking such transactions, *inter alia*, is to create or utilize tax attributes of the higher tier corporation (such as share ACB) in the sale or reorganization of the lower tier corporation.

For example, assume the following:

1. a Canadian-resident individual ("Owner") indirectly holds all of the issued and outstanding shares of an operating corporation ("Opco") through a wholly-owned holding corporation ("Holdco");

2. the shares of Opco have nominal adjusted cost base and paid-up capital ("PUC") and both Holdco and Opco are "Canadian-controlled private corporations" ("CCPCs") as that term is defined in subsection 125(7) of the Income Tax Act;[1]

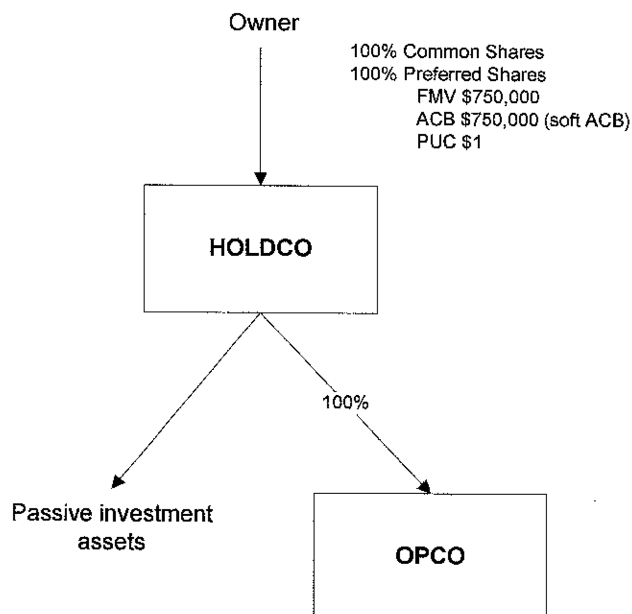
3. as a result of a previous series of transactions that crystallized his capital gains deduction, Owner owns a class of Holdco Preferred Shares with a "soft" adjusted cost base ("ACB") of $750,000 and nominal PUC; and

4. owner desires to sell the shares of Opco to an arm's length purchaser ("Purchaseco") and wants to take advantage of the $750,000 of ACB in his Holdco Preferred Shares to the best extent possible.

This situation is illustrated by the chart that appears on the following page.

* I acknowledge the invaluable insight and guidance provided by Donald N. Cherniawsky, QC, of Felesky Flynn LLP. All errors and omissions are my own.

[1] R.S.C. 1985, c. 1 (5th Supplement), as amended, hereinafter referred to as the "Act." Unless otherwise stated, statutory references in this article are to the Act.



Due to the restrictions imposed by section 84.1, any in-house attempts to access the corporate group's retained earnings would likely be ineffective. Furthermore, as it is unlikely that Purchaseco would be interested in acquiring the shares of Holdco, the ability to utilize the ACB in Owner's Holdco shares will be extremely limited. However, by undertaking the following transactions prior to the sale to Purchaseco, Owner should be able to take advantage of the crystallized ACB in his Holdco Preferred Shares as part of the sale of the Opco shares.

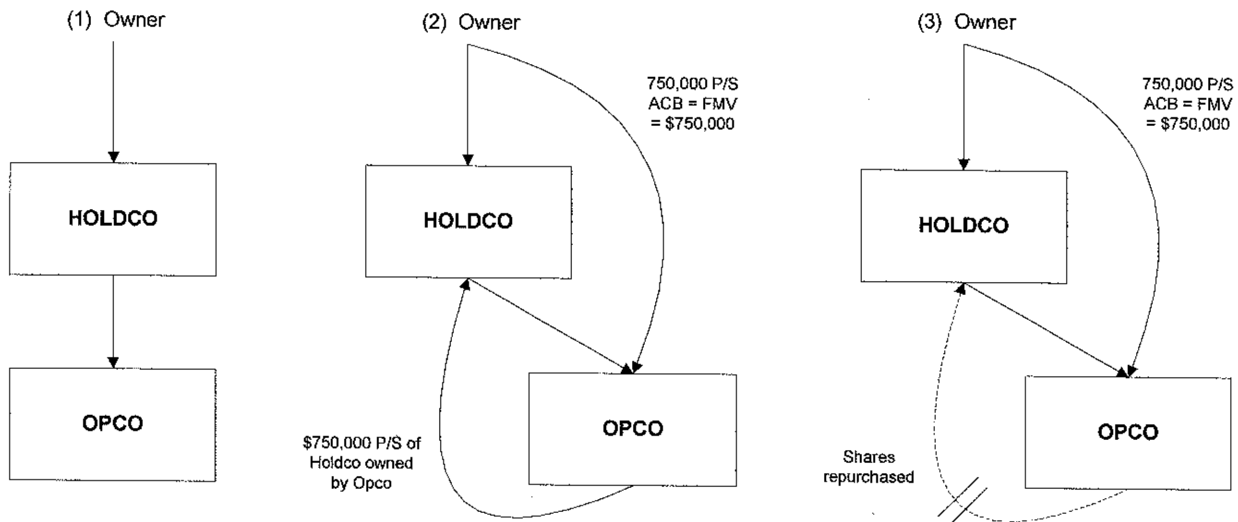
1. Owner transfers his high ACB Preferred Shares of Holdco to Opco on a tax-deferred basis pursuant to subsection 85(1)[2] and receives Preferred Shares of Opco having a nominal paid-up capital and an ACB of $750,000 in consideration for the Holdco Preferred Shares;

2. Holdco repurchases its $750,000 of Preferred Shares owned by Opco and issues a promissory note to Opco in consideration for the repurchase proceeds; and

3. Holdco and Opco offset their indebtedness (if applicable), which may involve more dividends being paid by Opco to Holdco.

The sequence of Steps can be illustrated by the chart that appears on the following page:

[2] Most corporate statutes allow for incestuous shareholdings provided that such shareholdings do not continue beyond a specified period. For example, see section 32 of the *Business Corporations Act* (Alberta), R.S.A. 2000, c. B-9, which requires the incestuous holdings to be eliminated within 30 days.



These transactions should effectively allow Owner to personally receive, without any personal income tax, $750,000 of sale proceeds that would otherwise have been received by Holdco subject to a number of technical considerations that must be considered prior to undertaking such transactions. These are discussed below in greater detail.

Tuck-Under Transactions – Technical Considerations

Subsection 55(2) and Part IV Tax

As a result of Holdco's repurchase of its shares owned by Opco, Holdco was deemed to have paid, and Opco was deemed to have received, a taxable dividend pursuant to subsection 84(3). As the shares repurchased by Holdco have ACB = FMV, subsection 55(2) should not apply to recharacterize this dividend as a capital gain or proceeds of disposition. However, to the extent that Opco must pay dividends to Holdco to eliminate inter-corporate debt arising from the share repurchase, subsection 55(2) could potentially apply on such dividends.

Given that Holdco presumably earns investment income from its passive assets,[3] it could have a refundable tax on hand ("RDTOH") balance. As the deemed dividend paid to Opco by Holdco will trigger a refund of RDTOH to Holdco pursuant to subsection 129(1),[4] Opco will incur a Part IV tax liability proportionate to the amount of Holdco's RDTOH refund that pertains to taxable dividends paid to Opco.[5]

Assuming Opco will pay taxable dividends to recover its Part IV tax liability, and that Holdco has accumulated a sufficient general rate income pool balance, consideration should be given to Opco recovering its Part IV tax by paying a taxable dividend to Holdco, and Holdco paying a taxable dividend to Owner.[6] This should result in a lower tax cost (19.29% versus 27.71% for eligible dividends compared to ineligible dividends in Alberta),

[3] Any capital gain realized by Holdco on the sale of its Opco shares would also give rise to refundable Part I tax that would be added to its RDTOH account.

[4] On the presumption that Holdco files its return of income within the three-year period following the taxation year in which the dividend was paid.

[5] As Opco and Holdco would be "connected" by virtue of subsection 186(2), paragraph 186(1)(*b*) dictates this result.

[6] As a result of the proposed amendments to subsections 89(1) and 89(14) of the Act as part of the *Jobs, Growth, and Long-Term Prosperity Act*, S.C. 2012, c. 19, a single taxable dividend can now be designated as partially eligible and partially ineligible.

without creating undue subsection 55(2) and RDTOH circularity complications.[7]

Subsection 84(2) and Surplus Strips

Tremblay v. R.

To the best of the writer's knowledge, there has only been one decision that directly dealt with tuck-under transactions – *Tremblay v. R.*[8] In *Tremblay*, through a series of transactions, the Tremblay family converted its indirect shareholdings (that is, shares owned through a holding corporation) in Le Groupe Vidéotron Ltée ("Videotron") to direct shareholdings of Videotron.

The Minister of National Revenue (the "Minister") assessed the Tremblay family on the basis that subsection 84(2) applied to the transactions.

In the decision of Favreau J., which was affirmed by the majority of the Federal Court of Appeal, it was determined that subsection 84(2) did not apply since the shares of Videotron owned indirectly through the Tremblay family's holding corporation were not "identical" to the Videotron shares received. On this basis, it could not be said that the Tremblay family appropriated any property from its holding corporation. However, Blais C.J. dissented with the majority of the Federal Court based on the belief that the *Smythe*[9] decision should govern the result. According to Blais C.J., notwithstanding that the Videotron shares received by the Tremblay family may not have been identical to the shares owned by their holding corporation, this should not preclude the application of subsection 84(2). Rather, the assets of the holding corporation had been "transformed" through a series of transactions to get them into the hands of the taxpayers in the desired form. On this basis, Blais C.J. would have applied subsection 84(2).

Nonetheless, based on the majority decision of the Federal Court of Appeal, subsection 84(2) should not apply to the tuck-under transactions in question as Owner should not be viewed as having appropriated any of Holdco's property based on the fact that the shares of Opco owned by Owner should not be viewed as being "identical" to the shares of Opco owned by Holdco.[10] However, it should be noted that the Canada Revenue Agency ("CRA") has stated that it will continue to challenge tuck-under transactions it considers offensive, including those undertaken in a manner similar to *Tremblay*.[11] Whether such challenges would be successful appears to be questionable based on recent jurisprudence, namely that of *MacDonald v. R.*[12]

MacDonald v. R.

Although currently under appeal, the decision of the Tax Court in *MacDonald* offers some interesting insights into the application of subsection 84(2). In *MacDonald*, the taxpayer was in the process of emigrating from Canada, and wanted to ensure his emigration strategy would allow not only for the use of his existing capital losses and capital losses carried forward, but also minimize the potential for any future incidence of double taxation. To achieve this result, the taxpayer sold the shares of his corporation ("PC") to his brother-in-law in exchange for a promissory note, and through a series of transactions, the cash in the PC was

[7] In general terms, RDTOH circularity refers to instances where two corporations are both payers and recipients of taxable dividends with respect to the other, and such dividends give rise to a refund of RDTOH. In Holdco's case, if the dividend received from Opco was solely attributable to Part IV tax, Holdco could make its own determination as to which dividends it paid that resulted in its Part IV tax refund. See *Canutilities Holdings Ltd. v. R.*, 2004 DTC 6475 (F.C.A.), at paragraph 76. On this basis, the dividends paid to Owner (rather than deemed to be paid to Opco as a result of the share repurchase) could be designated as dividends giving rise to Holdco's Part IV tax refund, which should minimize the effects of subsection 55(2) and the complications associated with RDTOH circularity.

[8] *Tremblay v. R.*, 2009 DTC 1204 (T.C.C.); affirmed in *Tremblay v. R.*, 2010 DTC 6833 (F.C.A.).

[9] *Smythe v. Minister of National Revenue*, 69 DTC 5361 (S.C.C.).

[10] The fact that Holdco and Opco will both presumably continue to carry on their businesses in the same manner should also support the fact that there has been no "winding up, discontinuance or reorganization," thereby providing additional reinforcement that subsection 84(2) does not apply.

[11] See Technical Interpretation 2010-0370551E5, dated August 12, 2010 and Technical Interpretation 2010-0373291C6, dated October 8, 2010.

[12] *MacDonald v. R.*, 2012 TCC 123 (under appeal).

ultimately used to repay the promissory note owing to the taxpayer. The CRA assessed the taxpayer under subsection 84(2) and section 245 (the "GAAR").

With respect to when subsection 84(2) should apply, the Tax Court provided the following comments:

> The express language of "in any manner whatever" does not redirect to whom the dividend was paid. It is the manner of effecting the distribution to the shareholder *at the time of that distribution* that the subject provision is aimed. Any manner of distribution to 601 Ltd. other than as a dividend would, pursuant to subsection 84(2), result in 601 Ltd. being deemed to have received a dividend (whether or not that invokes a tax consequence to that shareholder at that time).[13] [emphasis added]
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> [...]
>
> ... the express language of subsection 84(2) ensures that it is only a shareholder at the time of the distribution or appropriation who can be deemed to be the recipient of a dividend ...[14]

On this basis, it is only the taxpayer at the time of the distribution that could be assessed under subsection 84(2), which would appear to severely limit the circumstances in which the Minister could apply this subsection.

Although undertaken as part of his GAAR analysis, Hershfield J. called into question the Minister's notion that subsection 84(2) is an anti-surplus stripping provision, *per se*:

> The tax avoidance and tax benefit resulting from a lack of integration in this case is systemic. There is no unintended tax slippage in this sense, and in such circumstances GAAR cannot be used to prevent a tax planned approach to accessing retained earnings. Said differently, neither subsection 84(2) nor GAAR can be used to fill a gap between two approaches to taxing an individual shareholder's realization of accumulated after-tax funds in a company. There must be more. Subsection 84(2) does not employ language that attacks tax abuse issues arising from surplus strips ...[15]

It will be interesting to see how the Federal Court of Appeal decides the *MacDonald* case. Should the decision of the Tax Court be affirmed, it would appear that the scope of subsection 84(2) will be substantially narrowed and applicable in only a limited number of situations.

GAAR

Although the Minster did not use the GAAR in *Tremblay*, current jurisprudence appears to support the view that the GAAR should not apply to tuck-under transactions of the kind discussed at the beginning of this article. Even though the CRA has stated that it will continue to challenge certain tuck-under transactions, it has also stated that it would continue to apply its long-standing position that the GAAR will not be applied to tuck-under transactions where the purpose is to extract safe income on hand on the participation of a corporate taxpayer in a target corporation.[16]

Notwithstanding the CRA's administrative concession, it is unclear after a textual, contextual, and purposive analysis of the provisions relied upon[17] (in the manner outlined in *Canada Trustco*[18]) as to what provisions of the Act would be viewed as having been frustrated.

Unlike the situation in *Copthorne*,[19] which involved planning around the limitations in subsection 87(3), there are no similar specific restrictions that apply to these transactions. Generally speaking, the provisions that address the calculation of ACB in the Act are both numerous and detailed so one would argue that the legislation is operating as Parliament intended, and therefore, no abuse has occurred.

[13] Ibid. at paragraph 48.

[14] Ibid. at paragraph 50.

[15] Ibid. at paragraph 132

[16] Supra note 11.

[17] In this case, subsections 85(1) and 84(3) would be the relevant provisions.

[18] *Canada Trustco Mortgage Co. v. Canada*, [2005] 2 S.C.R. 601.

[19] *Copthorne Holdings Ltd. v. R.*, 2007 DTC 1230 (T.C.C.); aff'd, 2009 DTC 5918 (F.C.A.); aff'd, 2012 DTC 5007 (S.C.C.).

In *Geransky*,[20] through a series of transactions, the taxpayer effectively converted an asset sale into a sale of shares, and utilized his capital gains deduction on the sale of such shares. Not only was it determined that subsection 84(2) was not applicable based on the fact that no corporate property ended up in the taxpayer's hands (similar to the transactions illustrated at the beginning of this article), but it was also determined that the GAAR did not apply. As was stated by Bowman A.C.J.T.C. (as he then was):

> 42 Simply put, using the specific provisions of the Income Tax Act in the course of a commercial transaction, and applying them in accordance with their terms is not a misuse or an abuse. The Income Tax Act is a statute that is remarkable for its specificity and replete with anti-avoidance provisions designed to counteract specific perceived abuses. Where a taxpayer applies those provisions and manages to avoid the pitfalls the Minister cannot say "Because you have avoided the shoals and traps of the Act and have not carried out your commercial transaction in a manner that maximizes your tax, I will use GAAR to fill in any gaps not covered by the multitude of specific anti-avoidance provisions".
>
> 43 That is not what GAAR is all about.[21]

Similarly, in *Evans*,[22] as part of a series of transactions, the taxpayer sold Preferred Shares of a corporation ("117") to a limited partnership (in which his wife and minor children were the only partners) and then claimed his capital gains deduction in conjunction with the sale of his 117 shares. In subsequent years, 117 paid dividends on the Preferred Shares owned by the limited partnership, with such proceeds then used to repay the taxpayer. The Tax Court determined that the GAAR did not apply and that the tax planning that allowed the taxpayer to tax-effectively extract corporate surplus was not abusive. As provided by Bowman C.J.T.C. (as he then was) in his Tax Court decision:

> 29 I do not think that it can be said that there is an abuse of the provisions of the Act where each section operates exactly the way it is supposed to. The Crown's position seems to be predicated on the view that since everything worked like clockwork there must have been an abuse. The answer to this position is, of course, that if everything had not worked like clockwork we would not be here.
>
> 30 The only basis upon which I could uphold the Minister's application of section 245 would be to find that there is some overarching principle of Canadian tax law that requires that corporate distributions to shareholders must be taxed as dividends, and where they are not the Minister is permitted to ignore half a dozen specific sections of the Act. This is precisely what the Supreme Court of Canada has said we cannot do.[23]

These GAAR decisions, along with the *MacDonald* and *Tremblay* cases, appear to support the conclusion that the GAAR risk associated with undertaking tuck-under transactions in the manner contemplated should be low as each provision relied upon to achieve this result appears to be providing the intended result and should not be considered abusive. Rather, it should simply be regarded as a tax-effective method for extracting corporate surplus in a manner that does not frustrate the purpose and spirit of the provisions relied upon.

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20 *Geransky v. R.*, 2001 DTC 243 (T.C.C.).

21 Ibid. at paragraphs 42 and 43.

22 *Evans v. R.*, 2005 DTC 1762 (T.C.C.).

23 Ibid. at paragraphs 29 and 30.