

Related-Party Butterflies and Paragraph 55(5)(e)

Publication

Tax for the Owner-Manager, July, 2023

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The concept of a butterfly reorganization is fairly straightforward. It allows a corporation to transfer assets to another corporation on a tax-deferred basis. A butterfly is commonly used when an operating company desires to "purify" itself for the purposes of the capital gains exemption, by distributing its non-business assets to another corporation.

Provided that all of the parties involved in the reorganization are related, this type of butterfly can usually be executed pursuant to paragraph 55(3)(a). This provision allows all dividends paid in the course of the butterfly distribution to be exempt from the rules of subsection 55(2) . Unfortunately, the ability to rely on paragraph 55(3)(a) requires that all conditions imposed by subparagraphs 55(3)(a)(i) to (v) be met. These provisions impose quite restrictive conditions on the butterfly.

This article will focus on the conditions imposed by subparagraphs 55(3)(a)(ii), (iii), and (v). These conditions are as follows:

- Subparagraph 55(3)(a)(ii) provides that a significant increase (other than as a consequence of a disposition at FMV) in the total direct interest in any corporation of one or more persons that were unrelated persons immediately before the particular time must not be part of a transaction or event (or a series of transactions or events) as a part of which the butterfly dividend was received.
- Subparagraph 55(3)(a)(iii) provides that a disposition to an unrelated person of shares of the dividend payer (or of property whose value is derived from the dividend payer) must not be part of a transaction or event (or a series of transactions or events) as a part of which the butterfly dividend was received.
- Subparagraph 55(3)(a)(v) provides that a significant increase in the total direct interest in the dividend payer of one or more persons that were unrelated persons immediately before the particular time must not be part of a transaction or event (or a series of transactions or events) as a part of which the butterfly dividend was received.

Paragraph 55(3.01)(a) defines "unrelated persons" to mean (1) persons (other than the dividend recipient) to whom the dividend recipient is not related or (2) partnerships any member of which (other than the dividend recipient) is not related to the dividend recipient.

Generally, in a related-party butterfly, the operating company (the distributing company) and the holding company (the transferee company) are owned by related shareholders; therefore, meeting the conditions imposed by subparagraphs 55(3)(a)(i) to (v) should be unproblematic.

However, let us consider a situation with the following fact pattern:

- The operating company (Opco) carries on an active business and does not own any "non-business" assets.
- 100 percent of the shares of Opco are owned by a holding company (Holdco).
- 100 percent of the voting common shares of Holdco are owned by a family trust.
- 100 percent of the non-voting preferred shares of Holdco are owned by Dad.
- The trustees of the trust are Dad, Dad's accountant, and Dad's lawyer. Neither Dad's accountant nor Dad's lawyer is related to Dad.
- The beneficiaries of the trust are Dad, Mom, and the two children of Dad and Mom.
- In addition to the shares of Opco, Holdco owns assets that are not used in an active business; thus, the shares of Holdco would not qualify as "qualified small business corporation shares," as defined in subsection 110.6(1) .
- In order to qualify for the capital gains exemption, the shareholders desire to "butterfly" the shares of Opco from Holdco to a new company (Newco).

Because the trust owns 100 percent of the voting shares, the trust (and therefore the trustees, by virtue of subsection 104(1)) controls Holdco and Opco.

Because the trustees that control Holdco and Opco are not a related group, and Dad does not otherwise have any legal control over Holdco or Opco, Dad would not be related to Holdco or Opco.

The transferee company, Newco, is also controlled by the trust; therefore, Dad would not be related to Newco, either.

When the butterfly is executed, Dad would receive a significant increase in a direct interest in Newco. However, Dad would be an unrelated person as defined by paragraph 55(3.01)(a) , because he is not related to either Opco or Newco. Because the conditions imposed by subparagraph 55(3)(a)(ii) require that an unrelated person not receive a significant increase in any corporation (other than as a transfer at FMV, which is not the case here) as part of the butterfly, this condition will not be met.

As another part of the butterfly, Dad will dispose of shares of Holdco to Newco. As noted above, Newco is an unrelated person in respect of Dad. Because the conditions imposed by subparagraph 55(3)(a)(iii) require that a person not dispose of property to an unrelated person as part of the butterfly, this condition will not be met.

Furthermore, as part of the butterfly, Dad will acquire an increase in shares of a dividend payer (Newco). In the course of the reorganization, Newco will be deemed to pay a dividend to Holdco. As noted above, Dad is an unrelated person in respect of Holdco. Because the conditions imposed by subparagraph 55(3)(a)(v) require that an unrelated person not receive a significant increase in a butterfly dividend payer, this condition will not be met.

Because none of the conditions imposed by subparagraphs 55(3)(a)(ii), (iii), and (v) have been met, the butterfly will be offside. It should be noted that even if only one condition is violated, the butterfly will be offside.

Fortunately, there is a remedy for this situation. Subparagraph 55(5)(e)(ii) deems certain persons to be related for the purposes of section 55 . This deeming rule holds that when a person is related to each beneficiary under a trust, that person is deemed to be related to the trust. It is interesting to note that

subparagraph 55(5)(e)(ii) specifically holds that, for the purposes of applying this provision, a person is deemed to be related to himself.

In this particular case, the beneficiaries of the trust are Dad, Mom, and the two children. Dad is related to Mom and their two children under paragraph 251(2)(a) . Although Dad is not related to himself under section 251 (a topic that we addressed in the October 2021 issue of this newsletter), he is deemed to be related to himself for the purposes of applying subparagraph 55(5)(e)(ii) . Thus, Dad is related to each beneficiary of the trust. As a result, Dad is deemed by this subparagraph to be related to the trust for the purposes of section 55. Because the trust is a person (under subsection 104(2)) who controls both Opco and Holdco, the trust and Opco are related under subparagraph 251(2)(b)(i)—an interpretation confirmed by the CRA in *Income Tax Folio S1-F5-C1*, at paragraph 1.46. The trust and Holdco would also be related, on the basis of the analysis above. Furthermore, because Dad is related to the trust on the basis of subparagraph 55(5)(e)(ii), Dad is related to both Opco and Holdco under subparagraph 251(2)(b)(iii). Therefore, the conditions in subparagraphs 55(3)(a)(ii), (iv), and (v) would be met, and the butterfly could be executed successfully.

It is also worth noting that if the ownership of the common shares and preferred shares were reversed, such that Dad owned the voting common shares and the trust owned the non-voting preferred shares, a similar issue would arise: the trust would not be related to any of the companies in the group, but for the deeming rule in subparagraph 55(5)(e)(ii) .

This situation highlights how the examination of every detail, along with an analysis of subparagraphs 55(3)(a)(i) to (v), is critical to the implementation of a successful paragraph 55(3)(a) butterfly: in most cases, an estate freeze and the implementation of a family trust would not introduce non-related persons into a structure, but this time it did. Failure to examine the details would have resulted in a nasty surprise for the taxpayer.

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BIBLIOGRAPHIC INFORMATION

David Carolin and Manu Kakkar, "Related-Party Butterflies and Paragraph 55(5)(e)" (2023) 23:3 *Tax for the Owner-Manager* 11-12.