

Tax Alchemy and Paragraph 55(3.01)(g): Converting a 55(3)(b) Divisive Reorganization into a 55(3)(a) Related-Party Butterfly

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The concept of a butterfly reorganization is fairly simple: it allows for properties to be distributed within a corporate group of companies on a tax-deferred basis. However, as we noted in our previous articles in this newsletter (see the July 2023 and October 2023 issues), the rules that must be complied with in order to meet the butterfly requirements are terribly complex.

When a butterfly is being planned, it must be determined whether the transaction takes place under paragraph 55(3)(a) or 55(3)(b). Generally, paragraph 55(3)(a) is preferable because its conditions are significantly less complicated than those of paragraph 55(3)(b). That said, one of the conditions listed in paragraph 55(3)(a) is that the shareholders of the distributing company ("DC") must be related (under the special rules of section 55). Therefore, when the DC has arm's-length shareholders, paragraph 55(3)(b) is generally used. However, paragraph 55(3.01)(g) is a relieving provision. This provision allows arm's-length shareholders to transfer their shares of the DC into a new company, and the butterfly is permitted to take place under paragraph 55(3)(a), provided that the new company owns all of the shares of the DC at the start of the butterfly and owns all of the shares of the transferee companies at the end of the butterfly. The basis for this provision is that all companies involved in the butterfly will be controlled by the new company and thus be related to one another.

The rationale behind paragraph 55(3.01)(g) is that a butterfly should be able to take place pursuant to paragraph 55(3)(a) when the DC is held under a single holding company and nothing is being "split" between shareholders that are not related.

Let us consider an example in which Opco is owned by two arm's-length shareholders, Aco and Bco. Aco owns 85 percent of Opco and Bco owns 15 percent of Opco. Opco carries on an active business and also owns land and buildings ("the real property") that Opco uses in its active business.

Opco desires to "spin out" the real property to a separate company, Newco.

In order to facilitate this transaction, the following steps could be considered:

- *Step 1:* Aco and Bco incorporate Newco.
- *Step 2:* Aco and Bco transfer to Newco a certain number of shares of Opco ("the Opco shares") that are equal in value to the real property on a tax-deferred basis under subsection 85(1). Aco and Bco receive shares of Newco as consideration.

- *Step 3:* Opco transfers the real property to Newco on a tax-deferred basis under subsection 85(1). Opco receives shares of Newco ("the Newco shares") as consideration.
- *Step 4:* Newco redeems the Newco shares, creating a deemed dividend under subsection 84(3).
- *Step 5:* Opco redeems the Opco shares, creating a deemed dividend under subsection 84(3).

(In the discussion that follows, we will refer to the dividends in steps 4 and 5 as "the butterfly dividends," collectively.)

The butterfly dividends would be subject to subsection 55(2) unless one of the butterfly exceptions under paragraph 55(3)(a) or (b) is met.

In order to determine whether paragraph 55(3)(a) can be relied on, the "triggering conditions" described in subparagraphs 55(3)(a)(i) to (v) need to be considered. If even one triggering condition is violated, paragraph 55(3)(a) cannot be relied on.

In step 2, Bco would be acquiring an increase in its direct interest in Newco. Subparagraph 55(3)(a)(ii) stipulates that a person not related to the recipient of a butterfly dividend must not acquire a significant increase in its total direct interest in any corporation. Since Bco is not related to either Opco or Newco, subparagraph 55(3)(a)(ii) has been violated. Therefore, paragraph 55(3)(a) cannot be relied on.

Furthermore, subparagraph 55(3)(a)(v) stipulates that there cannot be a significant increase in the direct interest in the dividend payer of a person who is not related to the recipient of a butterfly dividend. As noted above, Bco is not related to either Opco or Newco. Therefore subparagraph 55(3)(a)(v), too, has been violated.

It should also be noted that the conditions of subparagraphs 55(3)(a)(i), (iii), and (iv) may be problematic; a detailed analysis of this matter is beyond the scope of this article.

Since paragraph 55(3)(a) cannot be relied on to implement this transaction in the manner described above, paragraph 55(3)(b) can be considered. Unfortunately, paragraph 55(3)(b) requires that the "pro rata test" be met when the butterfly is being implemented. The pro rata test, while not specifically defined, is in the definition of a "distribution" in subsection 55(1). The pro rata test requires, inter alia, that Newco receive an amount of cash from Opco that is equal to the proportion that the real property is of the total business property.

If Opco has cash on hand at the time of the butterfly, it may be very difficult in practice to distribute the correct amount of cash to Newco and remain within the rules of the pro rata test. It is conceivable that an active business could be constantly receiving and disbursing cash; therefore, it is difficult to know exactly how much cash is on hand at any given point in time.

Now, let us reconsider the sequence of steps described above, but slightly modified:

- *Step A:* Aco and Bco incorporate Middleco.
- *Step B:* Aco and Bco transfer their shares of Opco to Middleco under section 85.
- *Step C:* Middleco incorporates Newco.

- *Step D:* Middleco transfers to Newco a certain number of Opco shares, which are equal in value to the real property on a tax-deferred basis under subsection 85(1).
- *Step E:* Opco transfers the real property to Newco on a tax-deferred basis under subsection 85(1). Opco receives shares of Newco ("the Newco shares") as consideration.
- *Step F:* Newco redeems the Newco shares, creating a deemed dividend under subsection 84(3).
- *Step G:* Opco redeems the Opco shares, creating a deemed dividend under subsection 84(3).

(In the discussion that follows, we refer to the dividends in steps F and G as "the butterfly dividends.")

In step B, each of Aco and Bco would be acquiring an increase in its direct interest in Middleco. Furthermore, each will transfer its shares of Opco to Middleco for less than FMV proceeds, given the election under section 85. As noted above, subparagraph 55(3)(a)(ii) stipulates that there cannot be a significant increase in the total direct interest in any corporation of a person that is not related to a butterfly dividend recipient. Since Bco is not related to either Opco or Newco, this step violates subparagraph 55(3)(a)(ii). Subparagraph 55(3)(a)(i) stipulates that there cannot, at any particular time, be a disposition of property for proceeds less than FMV to a person not related to a butterfly dividend recipient. Middleco is not related to Opco or Newco at the time of step B, and the elected amount under section 85 is deemed to be the taxpayer's proceeds of disposition of property. Aco and Bco will elect at cost in respect of their transfer of Opco shares to Middleco. Therefore, this step violates subparagraph 55(3)(a)(i), too.

It should be noted that, in this scenario, subparagraph 55(3)(a)(v) has not been violated, since Bco did not obtain either a direct interest in Newco (as it did in the first scenario) or a direct interest in any other dividend payer.

Therefore, all else being equal, paragraph 55(3)(a) could not be relied on to implement the second scenario because subparagraphs 55(3)(a)(i) and (ii) were violated. However, the relieving rule in paragraph 55(3.01)(g) could be applied to the second scenario. This paragraph states that

- a disposition that would be described in subparagraph 55(3)(a)(i) or
- a significant increase that would be described in subparagraph 55(3)(a)(ii)

is deemed not to have been described in those subparagraphs, provided that the following conditions are met:

- *Subparagraph 55(3.01)(g)(i).* The dividend payer and dividend recipient are related immediately before the dividends were received. In our case, the dividend payer and dividend recipient are Opco and Newco. Since both companies are owned by Middleco, they are related immediately before the dividends were received. Therefore, this condition is not violated.
- *Subparagraph 55(3.01)(g)(ii).* The dividend payer did not cease to be related to the dividend recipient (as part of the series of transactions). In our case, as noted above, Opco and Newco are related. Furthermore, they did not cease to be related as part of the series. Therefore, subparagraph (ii) is not violated.

- *Subparagraph 55(3.01)(g)(iii)*. The disposition or increase (referred to in the preamble of paragraph 55(3.01)(g)) occurred before the butterfly dividends were received. In our case, Bco's significant increase in Middleco occurred before the butterfly dividends were received. Therefore, subparagraph (iii) is not violated.
- *Subparagraph 55(3.01)(g)(iv)*. The disposition or increase (referred to in the preamble) was the result of the disposition of shares to, or the acquisition of shares of, a particular corporation. In our case, Bco's significant increase in its interest in Middleco is the result of an acquisition of shares of Middleco. Therefore, subparagraph (iv) is not violated.
- *Subparagraph 55(3.01)(g)(v)*. At the time the dividends were received, all of the shares of the dividend recipient and dividend payer were owned by the particular corporation (referred to in subparagraph (iv)), a corporation controlled by the particular corporation, or any combination of such corporations. In our case, at the time the butterfly dividends were received, all shares of Opco and Newco were owned by the particular corporation (that is, Middleco). Therefore subparagraph (v) is not violated.

Paragraph 55(3.01)(g) , because all of its conditions have been satisfied, deems subparagraphs 55(3)(a)(i) and (ii) not to have been violated, and thus the butterfly can take place under paragraph 55(3)(a). A similar transaction was discussed in CRA document no. 2015-0570021E5, April 14, 2015.

Although the relieving rule in paragraph 55(3.01)(g) simplifies the butterfly, it may not present a perfect overall solution. For example, if Opco and Newco were owned directly by Aco and Bco, it would be much easier for the shareholders of Aco and Bco to access their capital gains exemptions in an eventual sale of Opco. However, given that Opco and Newco would be owned by Middleco, a sale of Opco would take place at the Middleco level, and the individual shareholders may not be able to access their capital gains exemptions unless the sale of the real property is concurrent with the sale of Opco.

Despite the practical concerns set out above, paragraph 55(3.01)(g) can be a useful tool when a butterfly transaction is being implemented; it can be a welcome relieving measure in an otherwise restrictive and complicated regime.

 2024 TOM 24(1) 7 Tax Alchemy and Paragraph 55(3.01)(g): Converting a 55(3)(b) Divisive Reorganization into a 55(3)(a) Related-Party Butterfly

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 2024 TOM 24(1) 7 Tax Alchemy and Paragraph 55(3.01)(g): Converting a 55(3)(b) Divisive Reorganization into a 55(3)(a) Related-Party Butterfly

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David Carolin , Manu Kakkar, and Boris Volfovsky, "Tax Alchemy and Paragraph 55(3.01)(g): Converting a 55(3)(b) Divisive Reorganization into a 55(3)(a) Related-Party Butterfly" (2024) 24:1 *Tax for the Owner-Manager* 7-9.