To Redeem or Not To Redeem a Specified Shareholder: That Is the 55(3)(b) Question

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Authors
David Carolin , Manu Kakkar, Paola D'Agostino

The concept of a butterfly reorganization is fairly simple: it allows for a distribution of corporate property to one or more of the corporation's shareholders on a tax-deferred basis. Unfortunately, the rules that must be complied with in order to meet the butterfly requirements under paragraph 55(3)(b) are terribly complex.

In this article, we consider a situation in which a company—the distributing company ("DC")—has three shareholders, Dad and his two sons, Son 1 and Son 2 ("the sons"). The sons directly own 50 percent each of the common shares of DC, and Dad owns 100 percent of DC's frozen preferred shares. The three shareholders are no longer interested in jointly owning the company. Furthermore, Dad no longer wants to have any involvement in the DC and wants to have his shares redeemed. The sons will then butterfly the assets of the DC into two new companies—the transferee companies ("TCs")—so that each son can go his separate way.

At first glance, this transaction does not seem to offend the butterfly rules: the redemption of Dad's shares would be fully taxable, generally speaking, unless a pre-existing CDA were available. Since the purpose of CDA is to allow for integration on corporate capital gains, we do not believe that using CDA to redeem shares should offend the butterfly rules.

However, as in all cases, the butterfly-denial rules in subsection 55(3.1) need to be considered in order to determine whether a redemption would put the butterfly offside.

Paragraph 55(3.1)(a) denies the butterfly reorganization where property became property of a DC in the same series as the butterfly. Paragraph 55(3.1)(c) denies the butterfly where shares of the TC or more than 10 percent of its underlying property is sold to an unrelated party subsequent to the butterfly, but as part of the same series as the butterfly. Paragraph 55(3.1)(d) denies the butterfly where shares of the DC or more than 10 percent of its underlying property is sold to an unrelated party subsequent to the butterfly, but as part of the same series as the butterfly. But these three paragraphs do not apply to our scenario.

Paragraph 55(3.1)(b) is the problematic paragraph. The preamble to subparagraph 55(3.1)(b)(i) provides that where a person ("the vendor") disposes of property and the conditions of all three clauses 55(3.1)(b)(i)(A), (B), and (C) are met, subparagraph 55(3.1)(b)(i) will apply to deny the butterfly.

Subclause 55(3.1)(b)(i)(A)(I) applies where the vendor disposes of shares of the DC. In our case, the vendor (that is, Dad) is disposing of shares of the DC. Since only one of the conditions in subclause 55(3.1)(b)(i)(A)(I) or (II) needs to be met for clause (A) to be met, the conditions of clause (A) are met in this case.

Clause 55(3.1)(b)(i)(B) applies where the vendor is a specified shareholder of the DC or TC at any time during the series of the butterfly. A specified shareholder is defined by subsection 248(1) to be, inter alia, a shareholder that owns not less than 10 percent of any class of shares of a corporation. In our case, Dad owns 100 percent of the preferred shares of the DC. Therefore, the conditions of clause (B) are met.

Clause 55(3.1)(b)(i)(C) applies where the property or any property in substitution therefor was acquired by a person (other than the vendor) who was not related to the vendor or ceased to be related to the vendor as part of the series of the butterfly. It is debatable whether the redemption of shares by the DC constitutes an acquisition of property. For the purposes of this example, it is assumed that the redemption caused the DC to acquire its own shares, if only for a brief period. Because the DC will be wound up as part of the butterfly, the vendor will no longer be related to DC after that time. Therefore, the conditions of clause (C) are met.

Because all three of the conditions in clauses 55(3.1)(b)(i)(A), (B), and (C) are met, subparagraph 55(3.1)(b)(i) would apply to deny the butterfly.

A potential workaround would be to have Dad participate in the butterfly. This could, however, cause practical problems, such as the following:

- The property being distributed would need to be equal to the FMV of Dad's shares. Depending on the type of property, this might not be feasible. For example, the properties may be large tracts of real estate that do not correspond to the FMV of Dad's shares.
- Dad's objective of exiting the business would not be met.

Another option would be for the sons or Dad to incorporate the new TCs that will be used in the butterfly, and then for Dad to transfer his preferred shares of the DC to each of the TCs in consideration for shares of these companies. The companies would then redeem Dad.

Under this second scenario, clauses 55(3.1)(b)(i)(A) and (B) would still be met, for the same reasons as were discussed in the previous scenario. Clause (C), however, requires further examination.

As discussed above, clause (C) denies the butterfly in which the property or any property was acquired by a person (other than the vendor) who was not related to the vendor, or ceased to be related to the vendor as part of the series of the butterfly.

Dad will transfer his shares of the DC to the TCs; therefore, the TCs are acquiring property. Dad may receive voting shares of the TCs in consideration. Suppose Dad will incorporate the TCs, and, if so, Dad is considered to be related to each TC. Furthermore, since the sons will be the owners of the TCs after the completion of the butterfly, Dad will continue to be related to the TCs by virtue of subparagraph 251(2)(b)(iii) after the redemption of his shares of each TC. It is not expected that the TCs will be sold or will cease to operate in the foreseeable future, which means that Dad will not cease to be related to the TCs as part of the butterfly series.

Dad is also acquiring property—namely, shares of the TCs. Clause (C), however, allows for a specific carve-out for the vendor acquiring property; the basis for the carve-out is the phrase "the property or any other property . . . was acquired . . . by a person (*other than the vendor*)" (emphasis added). Therefore, Dad's acquisition of the TCs does not trigger the application of this clause.

Furthermore, when the TCs redeem shares of Dad, they may acquire property by virtue of the repurchasing of their own shares. As noted above, clause (C) does not apply if the person acquiring the property (the TC) is related to the vendor (Dad). Since Dad is related to the TCs, their acquisition of their own shares on the repurchase does not trigger the application of this clause. Furthermore, any property that Dad receives on redemption is not caught by clause (C), since Dad is related to the TCs.

In this second scenario, therefore, the conditions of clause (C) are not met, and because the conditions in all three of clauses 55(3.1)(b)(i)(A), (B), and (C) need to be met in order to trigger the application of subparagraph 55(3.1)(b)(i), this subparagraph would not apply to deny the butterfly.

Subparagraph 55(3.1)(b)(iii) should also be examined, because it is potentially problematic. Clause 55(3.1)(b)(iii)(A) denies a butterfly where a TC, in contemplation of a butterfly, acquired shares of the DC from a person to whom the acquiror was not related. As noted above, each TC would be controlled by a son, and Dad would be related to each TC by virtue of subparagraph 251(2)(b)(iii). Therefore, this clause should not apply to deny the butterfly in the scenario under consideration. The remaining clauses 55(3.1)(b)(iii)(B), (C), and (D) do not apply to this fact pattern.

Another potential trap occurs in paragraph 55(3.2)(c). This paragraph modifies paragraph 55(3.1)(b) and deems any particular person who acquired a share of the DC in contemplation of a distribution not to be related, for the purposes of that acquisition, to the person from whom the person acquired the share. In our case, this could deem the TCs to be not related to Dad for the purposes of paragraph 55(3.1)(b) and thus to put the butterfly offside.

However, subparagraphs 55(3.2)(c)(i) and (ii) allow two carve-outs from paragraph 55(3.2)(c), which apply where

- the particular person acquired all of the shares of the DC that were owned by the other person, or
- the particular person was related to the DC immediately after the butterfly.

In our case, the condition for the second exception under subparagraph (ii) is met because Dad would still control both TCs as well as the DC immediately after the butterfly by virtue of his voting shares of each TC. Thus, the particular persons (that is, the TCs) would be related to the DC, and this condition will have been met.

This scenario highlights that every step of a butterfly transaction, even if the step is ancillary to the butterfly itself, must be carefully considered so as to determine whether the step will be affected by the butterfly-denial rules.

As noted above, it is unclear why the redemption of shares that are owned by an individual, which would generally be a taxable transaction (subject to any capital dividend payouts, as noted earlier), is considered to be offensive to the butterfly regime. This is yet another demonstration that the butterfly regime has become very complicated and that a complete review of these rules is long overdue.

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AUTHOR INFORMATION

David Carolin - Kakkar CPA Professional Corporation, Toronto davidc@kakkar.com

Manu Kakkar - Kakkar CPA Professional Corporation, Montreal manu@kakkar.com

Paola D'Agostino - Paola D'Agostino Professional Corporation, Toronto www.dagostinocpa.ca
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