Imperfect Timing: Subparagraph 55(5)(e)(i) Cannot Be Used in Purification Transactions

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The concept of a butterfly reorganization is fairly straightforward: it allows a corporation to distribute property to one or more of its corporate shareholders on a tax-deferred basis. However, as we have emphasized in previous articles in this newsletter, the technical requirements that a taxpayer must meet in order to comply with the butterfly regime are extraordinarily complex.

One complication often posed by the butterfly regime is that, under subparagraph 55(5)(e)(i) , siblings are deemed to be dealing at arm's length for the purposes of the butterfly rules. Historically, this subparagraph read as follows:

> For the purposes of [section 55], . . . in determining whether 2 or more persons are related to each other . . . a person shall be deemed to be dealing with another person at arm's length and not to be related to the other person if the person is the brother or sister of the other person.

Thus, if siblings are involved in a butterfly reorganization, the deeming rule described above prohibits them from undertaking a butterfly reorganization under paragraph 55(3)(a) and requires them to comply with the much more onerous rules under paragraph 55(3)(b) . The rule does so despite the fact that, for the general purposes of the Act, siblings are related under subsection 251(2) and paragraph 251(6)(a) and are therefore generally held not to be at arm's length.

On June 29, 2021, Parliament enacted an amendment to subparagraph 55(5)(e)(i). The amendment provided an exception to the deeming rule described above by adding the following language:

> [E]xcept in the case where the dividend was received or paid, as part of a transaction or event or a series of transactions or events, by a corporation of which a share of the capital stock is a qualified small business corporation [(QSBC)] share or a *share of the capital stock of a family farm or fishing corporation*. [Emphasis in original.]

It is interesting to note that this amendment was part of Bill C-208, which contained significant amendments to section 84.1. The amendments to section 84.1 were repealed effective January 1, 2024 and replaced by other rules, but this amendment was retained.

A quick reading of the amended legislation might suggest that the amendment brought some relief from the original restrictive rule, but, as we have previously discussed in this newsletter, its wording caused further complications. (See "An Unlikely Bermuda Tax Triangle: Butterflies, Amended Subparagraph 55(5)(e)(i), and QSBC Shares," in the October 2022 issue of *Tax for the Owner-Manager*.)

In this article, we address another such complication—namely, the point in time when the shares of a company acquire their status as QSBC shares. One of the QSBC tests, commonly referred to as the "90 percent test," requires that the company, in order to meet the QSBC threshold, own assets substantially all of the fair market value of which are assets used in a Canadian active business or are shares of connected companies that meet the 90 percent test. The 90 percent test is based on the definition of a "small business corporation" in subsection 248(1). The shares of a company become QSBC shares only at the particular point in time when the 90 percent test is met (assuming that all other QSBC tests are met).

The wording of the exception to subparagraph 55(5)(e)(i), cited above, is "a corporation of which a share of the capital stock *is* a [QSBC] share [emphasis added]." The use of the word "is" rather than "becomes" seems to indicate that the exception is allowed only to companies whose shares are QSBC shares in advance of the butterfly.

Excluded from this exception are companies whose shares do not meet the QSBC tests and that desire to undergo "purification" transactions by way of a butterfly in order to obtain QSBC status. They are excluded because the shares in question would not be QSBC shares at the exact moment in time when the butterfly dividend is paid or received, as the case may be; they would be QSBC shares only at the conclusion of the butterfly.

The reason for this is that, throughout the butterfly, the company that needs to be purified (that is, the "impure" company, also known as the distributing company, or DC) will *at all times* hold at least one of the following three "bad" assets:

- redundant assets,
- shares of the transferee company (TC) to which the redundant assets have been transferred, or
- a note receivable from the TC to which the redundant assets have been transferred.

It is only at the conclusion of the butterfly, when the note receivable from the TC is cancelled, that the DC will become "purified" and thus meet the 90 percent test for QSBC status. Furthermore, it should be noted that for the purposes of this provision, the shares of only one of the DC or TC need to be QSBC shares, not both. This was confirmed in CRA document no. 2021-0921261E5, March 23, 2022.

Thus, because the "bad assets" will be transferred to the TC, the shares of TC cannot be QSBC shares. Our discussion in the following example, which illustrates these matters, is therefore focused on the DC.

Mr. A1 and Mr. A2 are brothers and 50 percent shareholders of a company, Aco. Aco carries on an active business but also holds land and a building that are not used in the business. At this particular point in time, the shares of Aco do not meet the 90 percent test, but they meet all other QSBC tests. Mr. A1 and Mr. A2 desire to purify Aco by moving the land and the building, through a butterfly reorganization, into a holding company, Hco.

Before the June 29, 2021 amendment, this butterfly would have needed to be implemented under paragraph 55(3)(b), because Mr. A1 and Mr. A2 were deemed not to be related for the purposes of section 55. This implementation would have been difficult because the rules governing a paragraph 55(3)(b) butterfly are complicated.

Now that the June 29, 2021 amendment has been enacted, Mr. A1 and Mr. A2 want to use the QSBC exception to implement the butterfly, on the presumption that Aco will become a QSBC as a result of the purification.

Generally speaking, the steps involved in the Aco purification butterfly would be as follows:

1) Mr. A1 and Mr. A2 incorporate Hco.

2) Aco issues stock dividends to Mr. A1, and Mr. A2 paid in preferred shares of Aco, with an aggregate redemption amount equal to the aggregate fair market value of the land and building.

3) Mr. A1 and Mr. A2 transfer stock dividend shares of Aco (received in step 2) to Hco under section 85.

4) Under section 85, Aco transfers the land and building to Hco in return for preferred shares of Hco, with an aggregate redemption amount equal to the aggregate fair market value of the land and building. Note that, after the completion of step 4, Aco's shares do not have QSBC status even though Aco has transferred the land and building to Hco. This is because Aco now holds an investment in Hco, which is a "bad" asset.

5) Hco redeems its preferred shares, which are held by Aco, in return for a promissory note. Note also that, after the completion of step 5, Aco no longer has an investment in Hco; it has a note receivable from Hco, which is also a "bad" asset.

6) Aco redeems its preferred shares, which are held by Hco, in return for a promissory note.

7) The notes issued in steps 5 and 6 will be set off and cancelled. Only at this point will Aco be completely purified of all "bad" assets, such that its shares may become QSBC shares.

Unfortunately for Mr. A1 and Mr. A2, the wording of the exception is such that the shares of one of the companies participating in the butterfly must be QSBC shares at the point in time when the butterfly dividend is paid or received (that is, before step 5), not after the conclusion of the butterfly, subsequent to step 7. Therefore, subject to any administrative relief or further amendments to subparagraph 55(5)(e)(i) , it would seem that a company with the fact pattern shown in this example is not permitted to rely on this exception in a purification transaction: Aco's shares will not be QSBC shares at step 5, as is required; they will not be QSBC shares until after step 7.

Conclusion

As we have often maintained in the pages of this newsletter, it is difficult to rely on provisions of the ITA when they are complicated or fraught with uncertainties. In the example discussed above, the brothers tried to implement a paragraph 55(3)(a) reorganization, whereas they should have undertaken a paragraph 55(3)(b) butterfly. The steps set out above would have likely violated the more stringent paragraph 55(3)(b) requirements, including the pro rata test and the butterfly-denial rules in subsection 55(3.1) .

Clarification from the CRA or Finance regarding these points would be not only welcome but also a necessary step toward helping taxpayers not fall offside the many uncertainties of section 55.

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BIBLIOGRAPHIC INFORMATION

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