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Corporate Nonrecognition Provisions: A Comparison of the U.S. and Canadian Tax Regimes

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Articles

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Corporate Nonrecognition Provisions: A Comparison of the United States and Canadian Tax Regimes*

This article compares the rules governing the federal income taxation of corporate reorganizations in Canada with those in the United States, including transfers of property to a corporation, corporate divisions, share-for-share exchanges, amalgamations or mergers, recapitalizations, and corporate dissolutions. The paper outlines the provisions governing a particular type of corporate transaction, compares the Canadian tax results with those of the United States, comments on any differences between particular tax provisions, and examines the practical implications of these differences. The authors conclude that although there are a number of parallels between the U.S. and Canadian tax systems, fundamental differences exist that change the assumptions underlying tax planning in the two countries. The North American Free Trade Act (NAFTA)[1] makes a basic understanding of the similarities and differences between the Canadian and U.S. tax systems and their respective corporate nonrecognition provisions increasingly important to Canadian corporate tax counsel.

Cet article vise à faire la comparaison entre les lois canadiennes et les lois américaines qui gouvernent l'impôt fédéral du revenu de leurs réorganisations commerciales y compris le transfert de propriété à une entreprise, les divisions de corporation, les échanges distributives, les fusionnements, les ré-capitalisations, et les liquidations. En gros les grandes lignes de l'article soulignent les dispositions gouvernant chaque type d'opération collective, font la comparaison entre les résultats de l'impôt canadien et américain, et offrent des commentaires sur les différences entre les dispositions particulières de l'impôt en examinant les implications qu'elles comportent pour la pratique du droit. Les auteures se sont décidées qu'en dépit des nombreux parallèles entre les systèmes d'impôt américain et canadien, il y a des différences concrètes qui influencent les suppositions sur lesquelles la planification fiscale se base. Après le NAFTA, une connaissance de base des similarités et des différences entre les systèmes d'impôt canadien et américain, et de leur traitement respectif des réorganisations commerciales, s'avère de plus en plus important chez les avocats canadiens.

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1. North American Free Trade Agreement (NAFTA), Dec. 17, 1992, 32 I.L.M. 289 (1993). NAFTA entered into force on January 1, 1994.

Introduction

Unless otherwise provided, under both the Canadian and United States tax regimes, income realized upon the disposition of property is recognized.[2] Nevertheless, both regimes provide for the nonrecognition of gain in transactions where, in the opinion of the respective legislatures, the investment of the taxpayer in the transferred assets continues unliquidated. Not surprisingly, the corporate tax provisions of both countries contain many such nonrecognition provisions. With the emergence of the North American Free Trade zone, it is increasingly important for Canadian legal counsel to have knowledge of U.S. nonrecognition provisions and be sufficiently informed to act as co-counsel on cross-border projects, to work with U.S. clients living in Canada, and to confirm information provided to Canadian clients by U.S. counsel.

This article furnishes an overview of the U.S. corporate nonrecognition provisions and highlights important parallels between those provisions and the corresponding sections of the Canadian *Income Tax Act*. Although

2. I.R.C. §§ 61(a)(3), 1001(c) (1999) [hereinafter I.R.C.]; *Income Tax Act*, R.S.C. 1985 (5th supp.) c.1, s. 54(c) [hereinafter I.T.A.].

the tax regimes are similar, fundamental differences in tax principles exist between the two countries. This discussion is crafted to apprise Canadian counsel as to how U.S. corporate tax provisions will affect various corporate transactions and to examine critical tax issues in order to enable counsel to intelligently advise and plan for transactions involving U.S. corporations. These provisions may impact a taxpayer at every stage of corporate development from organization to reorganization to dissolution. This article groups the types of corporate transactions which are most similar, highlights the many similarities and distinguishes the differences between the two systems. This article is both a practical tool and a preliminary comparative study of two corporate tax systems. It will benefit any practitioner with clients who hold or intend to hold shares in a U.S. corporation.

I. *Fundamental Principles in Taxation: Some Significant Differences*

Although Canada and the United States define "income" broadly, Canada takes a "schedular" approach to defining income as opposed to the "global" approach taken by the United States. The Canadian tax system employs the source concept of income. Thus, "income" is a yield from a productive source such as employment, business or capital,[3] and the expenses incurred in producing income from a particular source are deductible.[4] Amounts that lack a source cannot be characterized as income and are not taxable unless they are expressly included in income by statute. In the United States, I.R.C. § 61 defines "gross income" to include "all income from whatever source derived" without the source of income affecting taxability. Any accretion to a taxpayer's economic power during the taxable year is included in income for that year.[5] In arriving at taxable income, the U.S. system authorizes specific deductions from gross income for both profit-related and personal expenses.[6] Profit-related deductions are allowed for expenses incurred as a cost of producing income[7] and, thereby, only net profit or gain is taxed. The deductions

3. I.T.A., s. 3.
4. I.T.A., s. 4(1)(a).
5. R.M. Haig, *The Federal Income Tax* (New York, 1921) at 54.
6. I.R.C. subchapter B, parts V to IX.
7. See, *e.g.*, I.R.C. § 162 (allowing a deduction for all ordinary and necessary business expenses); I.R.C. § 212 (allowing a deduction for expenses incurred in the production of income); I.R.C. § 165 (allowing a deduction for trade or business and investment losses); I.R.C. § 168 (providing a depreciation system for tangible assets); I.R.C. § 197 (providing a depreciation system for some intangible assets).

allowed for personal expenses are a matter of social policy.[8] Perhaps the best example of the difference in treatment of an item is the windfall which is excluded from the tax base in Canada for want of a source. In the United States, however, windfalls are included in income as accretions to wealth. Throughout the decades, the two tax systems have moved closer together as Canada has statutorily added more sources of income to its tax base[9] and the United States has tended towards a more schedular approach to taxable income in order to curb abuse.[10]

Under both the Canadian and U.S. tax systems, gains and allowable losses from the disposition of property are reflected in taxable income. Neither country taxes the mere appreciation in the value of an asset. Under both tax systems, gain or loss is not taken into account until some taxable event occurs.[11] However, what constitutes "realization" or a "deemed" disposition of an asset differs between the two countries. In Canada, both gratuitous inter vivos transfers and testamentary transfers are treated as deemed dispositions at fair market value for the transferor with the transferee taking a fair market value cost basis in the asset received.[12] Under the U.S. tax system, gratuitous lifetime and death transfers are not realization events. The donee of an inter vivos transfer acquires a transferred basis in the asset received.[13] A beneficiary, however, acquires a basis equal to the fair market value of the property at the date of the decedent's death. Thus, any appreciation or decline in the value of the asset is never reflected for income tax purposes.[14] In neither event are the items included in the gross income of the recipient. Although not a realization event for income tax purposes, in the United States, gratuitous

8. See, *e.g.*, I.R.C. § 213 (allowing a deduction for medical expenses); I.R.C. § 215 (allowing a deduction for alimony payments); I.R.C. § 23 (allowing a deduction for adoption expenses).
9. For example, in 1972, capital gains were added to the Canadian tax basis.
10. See I.R.C. § 183 (limiting the deduction of expenses incurred in an activity not engaged in for profit to the income generated by such activity); I.R.C. § 465 (limiting deductions from an income-generating activity to the income produced by the amount at risk in such activity); I.R.C. § 469 (limiting the deduction of passive losses from passive activities to the income generated by such activities).
11. R.C. § 1001; I.T.A., s. 54. Although realization is considered only a matter of administrative convenience in the United States, Congress has taken a "mark-to-market" approach only in few instances. *Helvering* v. *Horst*, 311 U.S. 112 at 115 (1940); see, *e.g.*, I.R.C. § 475 (requiring a mark-to-market accounting method for dealers in securities).
12. I.T.A., s. 69. An exception to both deemed disposition provisions is made when assets are transferred to a spouse or spousal trust, either inter vivos or on death and with respect to certain qualified farm property transferred to children of the taxpayer, either inter vivos or on death. See for example, I.T.A., ss. 70(6), 70(9) for such transfer on death.
13. I.R.C. § 1015.
14. I.R.C. § 1014.

inter vivos and testamentary transfers subject the donee or the estate to an excise tax.[15]

In Canada, considerable planning, particularly for private corporations, revolves around the deemed disposition of shares transferred by gift or death with the integrity of the deemed disposition provisions being preserved by complex anti-avoidance provisions sprinkled throughout the corporate tax provisions of the *Income Tax Act* (I.T.A.).[16] In the United States, any transfer for less than adequate consideration which is not at arm's length is treated as a gift. Despite the imposition of a gift tax, U.S. taxpayers often prefer the tax-deferred treatment of gifts to currently taxable transfers of property and the shift of income or gain from the property to another taxpayer inherent in a change of ownership.[17] In addition, the tax forgiveness provided by the fair market value date-of-death basis causes U.S. taxpayers to retain appreciated assets until death. Much of the tax planning in the United States is centred around the tax-deferred nature of gifts and the forgiveness of gain on transfers at death.

An interesting difference also exists in the relationship of the Canadian and U.S. federal governments with their provinces and states. In 1962, most Canadian provinces signed "tax collection agreements" with the federal government. Under these agreements, the province imposes its own tax at its own rate levied either as a percentage of the federal tax in the case of individuals or in addition to federal tax if the tax paying entity is a corporation. The federal government collects the provincial tax without a charge to the province.[18] In the United States, all but a few states impose some form of personal and corporate income tax. Additionally, many large municipalities levy taxes on wages and other forms of income. State income taxes are progressive with marginal rates lower than the federal tax system. Generally, the income tax provisions of both

15. I.R.C. §§ 2001(a), 2501(a)(1). A marital deduction assures that property gratuitously transferred from one spouse to another during life or at death is not a taxable transfer for gift or estate tax purposes. I.R.C. §§ 2056, 2523. The unified estate and gift tax credit allows for an exclusion from tax of the following amounts for decedents dying, and gifts made, in the following years: $625,000 in 1998; $650,000 in 1999; $675,000 in 2000 and 2001; $700,000 in 2002 and 2003; $850,000 in 2004; $950,000 in 2005; and $1,000,000 in 2006 or thereafter.

16. See, *e.g.*, the "indirect gift rule" in I.T.A., s. 85(1)(e.2). The apparent harshness of the deemed disposition rules is alleviated to some extent by a $500,000 lifetime capital gains exemption that is available to each individual taxpayer with respect to shares of a qualified small business corporation and for certain qualified farm property. I.T.A., s. 110.6(1).

17. See *infra* notes 80-81 and accompanying text (discussing the assignment of income doctrine).

18. Currently, all provinces except Quebec have agreements with respect to personal income tax and all provinces except Quebec, Alberta and Ontario have agreements with respect to corporate income taxes.

the states and cities conform closely to the federal personal and corporate income tax system. However, only three states, North Dakota, Rhode Island, and Vermont, impose the state tax as a percentage of the federal tax liability, and all of the states and cities perform their own collections.

Some of the more significant corporate tax differences are discussed below.

1. *Corporate Double Taxation* v. *Integration*

Canada purports to have at least a partially integrated tax system. Acccording to integration theory, whether income is earned by an individual directly or by a corporation and distributed to the individual as dividends, the same overall tax liability should result. The mechanism used to achieve this outcome is the dividend tax credit. Specifically, an individual who receives a taxable dividend[19] from a taxable Canadian corporation must include 125% of the amount received in income[20] and personal tax liability is calculated on this "grossed-up" amount. A dividend tax credit equal to two-thirds of the grossed-up dividend is then claimed by the shareholder.[21] The credit is intended to reflect the corporate tax that has already been paid by a Canadian controlled private

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19. A "taxable dividend" is any dividend other than a tax-exempt or tax-deferred dividend. I.T.A., s. 89(1).

20. I.T.A., s. 82(1)(b).

21. I.T.A., s. 121. Full integration for active business income under the Canadian corporate tax system is premised on several important assumptions. First, it is assumed that the federal corporate tax rate is 20%. This is rarely the case. Only CCPCs are subject to a corporate tax rate that approximates 20% and only with respect to the first $200,000 of active business income earned in Canada. Income above that level is taxed at the maximum corporate rate of approximately 45%. Second, full integration assumes a combined federal/provincial tax rate of 50% for individuals. This is also rarely the case. In 1996, provincial tax rates varied between 45% and 69%. Finally, full integration assumes no federal or provincial surtaxes, of which there are many. Canada, therefore, has at best a partially integrated system with respect to active business income earned in Canada and corporate double taxation will occur on many corporate distributions. Consequently, considerable attention is focused on reducing or avoiding the element of double taxation, particularly by private corporations. Consider the following example. A corporation earns $100 of taxable income. After paying tax of $20 (the approximate federal and provincial combined small business tax rate), $80 will be available for distribution to the shareholders. The $80 amount will be grossed up by $20 to $100. Personal tax liability is then calculated. If we assume the combined federal and provincial personal tax rate is 50%, $50 in tax is due. A combined tax credit of $20 may be claimed against this $50, resulting in $30 in personal tax liability. Total tax paid between the corporation and the shareholders on the $100 is thus $50. If this individual had earned the $100 directly, approximately $50 in tax would also be payable depending on the province in which the individual resides.

corporation (CCPC)[22] on its first $200,000 of annual active business income.

In contrast, the U.S. corporate income tax is a "classic" or double tax system. The Internal Revenue Code (I.R.C.) establishes a corporation as a separate taxpaying entity, distinct from its shareholders.[23] A corporation must pay an income tax on its profits even if the corporation distributes those profits to its shareholders as dividends.[24] Profits received by shareholders as dividends are included in the gross income of the shareholder and taxed as ordinary income.[25] This tax burden at both the corporate and shareholder level is the primary disadvantage of the corporate form in the United States.[26] The double tax can be avoided if the corporation distributes earnings to its shareholders in a form that is deductible at the corporate level. Such distributions may be recharacterized by the Internal Revenue Service as "constructive dividends." For example, a corporation can deduct only "reasonable compensation" paid to its shareholder-employees with the deduction for any excess payment disallowed.[27] The double tax also creates a bias in favour of corporate

22. See I.T.A., s. 125(7). A CCPC is generally a corporation which is resident in Canada for Canadian tax purposes and is not controlled directly or indirectly by one or more public or non-resident corporations or nonresident persons. Proposed amendments to the I.T.A. (see June 20, 1996 Notice of Ways and Means Motion) will also exclude from the definition of CCPC any corporation that is not actually controlled by nonresidents but avoids that status only because the shares are widely held, and corporations the shares of which are listed on a foreign stock exchange.

23. I.R.C. § 11(a).

24. Generally, corporate taxpayers are taxed at marginal rates of 15% on the first $50,000 of taxable income and 25% on the next $25,000 increment of taxable income. Taxable income above $75,000 is taxed at 34% with a marginal rate of 35% applying to taxable income above $10,000,000. If a corporation has taxable income in excess of $100,000, the tax liability of the corporation is increased by the lesser of 5% of the excess or $11,750. If a corporation has taxable income in excess of $15,000,000, the tax liability of the corporation is further increased by the lesser of 3% of the excess or $100,000. I.R.C. § 11(b). Qualified personal service corporations are taxed at a flat 35% marginal rate. I.R.C. § 11(b)(2). See I.R.C. § 448(d)(2) (defining qualified personal service corporation).

25. I.R.C. §§ 61(a)(7), 301. Noncorporate taxpayers are taxed at marginal rates ranging from 15% to 39.6%. I.R.C. § 1.

26. Certain domestic corporations may elect "S corporation" status which is a form of full integration. Generally, the S corporation election is available to corporations with only one class of stock and no more than 75 shareholders. The taxable income of an S corporation flows through to the shareholders whether distributed or undistributed. Each shareholder must report its proportionate share of corporate income, losses, deductions, and credits. I.R.C. §§ 1361-1378. In the United States, pass-through business entities also include partnerships, limited partnerships, and limited liability companies treated as a partnership. See Treas. Reg. § 301.7701-3 (establishing the check-the-box approach to choice of entity).

27. I.R.C. § 162.

financing through debt rather than equity. While the distribution of dividends on stock owned by a shareholder is not deductible at the corporate level, the payment of interest on securities held by shareholder-security holders is deductible.[28] Further examples of distributions by the corporation to shareholders which may result in constructive dividend treatment include excessive rents, corporate purchases of shareholder property above fair market value, bargain rents or purchases of corporate property by a shareholder, interest-free loans from the corporation,[29] loans to shareholders without shareholder intent to repay, and certain fringe benefits. In Canada, such distributions are treated as shareholder benefits and taxed as ordinary income.[30] The penalty resulting from this characterization to the individual shareholder is that no dividend tax credit is available to reflect the corporate tax that has already been paid on the income. It follows that integration in the form of the dividend gross up and tax credit will not apply and, as in the United States, double taxation results.

In order to mitigate the effect of multiple levels of taxation on intercorporate dividends, in the United States, a deduction is allowed on dividend distributions to corporate shareholders.[31] The dividend-received deduction ranges from 70% to 100% depending on the percentage of the distributing corporation's stock owned by the distributee corporation.[32] Several statutory safeguards exist to prevent the manipulation of this preference.[33] Thus, partial or full integration is achieved. In Canada, a corporate shareholder must report dividends received from a taxable Canadian corporation as income from property, but the dividends are

28. I.R.C. § 163. See I.R.C. § 385 (listing factors to be considered in distinguishing corporate equity from corporate debt).
29. See I.R.C. § 7872 (recharacterizing "foregone" interest as a constructive distribution from the corporate lender).
30. I.T.A., s. 15.
31. I.R.C. § 243.
32. Generally, the deduction is 70% of the amount of the distribution. However, the deduction increases to 80% if the corporate shareholder owns 20% or more of the distributing corporation. The deduction is 100% if the shareholder corporation and the distributing corporation are members of an affiliated group. I.R.C. § 243(a), (c).
33. I.R.C. § 246(c) denies the dividends-received deduction unless the corporate shareholder has held the stock on which the dividend is paid for more than 45 days (90 days in the case of certain preferred stock). Generally, I.R.C. § 1059 requires a corporate shareholder to reduce its basis in the stock of the distributing corporation to the extent of the deductible portion of any "extraordinary dividend").

fully deductible by the corporate shareholder.[34] As Canadian and U.S. corporate shareholders receive preferred treatment on dividend distributions, corporate shareholders in both countries generally prefer a dividend characterization of profit distributions.

2. *Corporate Distributions*

In the United States and Canada, corporate profits are distributed to the shareholders in the form of dividends. The definition of a dividend for tax purposes is typically broader than the definition for corporate law purposes. Generally, in Canada, dividends may only be paid out of profits, defined as either current or retained earnings from prior years. In computing the profits of a corporation, wages and interest are subtracted from gross revenues. Wages, interest, and other costs of producing income are also deducted from gross income in arriving at income for tax purposes, and effectively remove these items from the taxable income of the corporation. As a result, the income is only taxed once – upon receipt by the employee or debtholder. Upon distribution, dividends are not deductible as an expense at the corporate level, however, dividends are subject to the shareholder dividend tax credit, removing or partially eliminating the second level of tax. Furthermore, tax liability may arise from a corporate distribution where a payment or transfer of property is made at the direction or with the concurrence of a shareholder to another person for the benefit of the shareholder, or as a benefit the shareholder desired to have conferred on the other person.[35] The provision is intended to prevent a shareholder from avoiding tax on income by directing dividends to a third party.[36]

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34. I.T.A., s. 82(1) requires that the dividend be included in income. However, I.T.A., s. 112(1) permits a deduction for certain taxable dividends received in calculating income for the year. In order to prevent individuals from incorporating for the purpose of recovering dividend income tax free, a special Part IV tax is imposed equal to 33 1/3% of the taxable dividends received from corporations in which there is essentially a share holding of less than 10%. See I.T.A., s. 186(4). This tax is refunded to the corporation at a rate of $1 for every $3 in taxable dividends paid to shareholders. If the recipient shareholder who triggers a Part IV refund for one corporation is also a corporation, it will become responsible for payment of the Part IV tax if the payer corporation receives a Part IV refund as a result of the taxable dividend paid. See I.T.A., s. 186(1)(b).

35. I.T.A., s. 56(2).

36. Revenue Canada has taken the position that the payment of discretionary dividends represents a transfer of property with the direction or concurrence of related shareholder, generally, in their capacity as directors. *Neuman* v. *M.N.R.*, [1998] 1 S.C.R. 770.

In the United States, a distribution of property made by a corporation to its shareholders with respect to their stock is also treated as a dividend[37] and included in the shareholder's gross income as ordinary income to the extent the distribution "comes out of" the corporation's "earnings and profits."[38] Generally, corporate distributions are out of earnings and profits and, therefore, are taxed as ordinary income to the shareholder. To the extent a distribution is not out of earnings and profits, the distribution is treated as a return of capital to the shareholder and applied against the basis of the shareholder's stock.[39] If the distribution exceeds the adjusted basis of the shareholder's stock, the excess is treated as gain from the sale or exchange of the stock and usually taxed as a capital gain.[40] Because dividends are not deductible at the corporate level and are included in the shareholder's gross income as ordinary income, dividends are subject to the classic double-taxation structure.

The I.R.C. defines dividends as distributions to a shareholder with respect to their stock to the extent of the distributing corporation's current or accumulated earnings and profits.[41] "Earnings and profits" represent the dividend-paying capacity of a corporation. Although not specifically defined in the I.R.C.,[42] the term is not identical to current and retained earnings. In determining earnings and profits, the corporation's taxable income is adjusted to reflect items that represent the corporation's dividend paying capacity. For example, taxable income is increased by certain tax exempt income such as interest on municipal bonds,[43] decreased by items deducted from gross income that do not represent actual expenses such as the dividend-received deduction,[44] decreased by expenses incurred for which a deduction is not allowed such as federal taxes paid,[45] and finally timing adjustments are made including the disallowance of the installment method of reporting gain on the disposition of property.[46] The earnings and profits account is also reduced by any dividend distributions made during the taxable year.[47]

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37. I.R.C. § 301(a).
38. I.R.C. §§ 61(a)(7), 301(c)(1), 316.
39. I.R.C. § 301(c)(2).
40. I.R.C. § 301(c)(3).
41. I.R.C. §§ 301(a), (c)(1), 316(a). See Treas. Reg. § 1.316-2 (providing the order for the use of current and accumulated earnings and profits).
42. See I.R.C. § 312 (listing adjustments to the earnings and profits account for certain corporate transactions).
43. I.R.C. § 103; Treas. Reg. § 1.312-6(b) (1955).
44. I.R.C. § 243; Rev. Rul. 58-546, 1958-2 C.B. 143.
45. Rev. Rul. 63-63, 1963-1 C.B. 10.
46. I.R.C. §§ 453, 312(n)(5).
47. I.R.C. § 312(a), (b).

Generally, U.S. corporate shareholders welcome dividend treatment because of the dividend-received deduction which removes a percentage of the tax at the shareholder level,[48] and a reduction of the earnings and profits account equal to the amount of the dividend.[49] Nevertheless, characterization of the distribution as a deductible expense is typically preferred by both corporate and noncorporate shareholders in order to remove completely the burden of the double tax. Distributions that can be distributed in a deductible form remove the incidence of tax at the corporate level. If a distribution cannot be deducted at the corporate level, the preference is to structure the distribution in a nontaxable form at the shareholder level such as a tax-deferred stock dividend or as a recovery of capital such as a stock redemption. Dispositions which are characterized as a recovery of capital receive the tax advantages of a basis offset[50] and a preferred tax rate.[51] Generally, a stock dividend is tax deferred if the shareholders cannot elect to receive property other than stock in the distributing corporation and the distribution does not result in an increase in the shareholder's proportionate equity interest in the corporation.[52] Similarly, a stock redemption results in exchange treatment if the redemption results in a sufficient reduction in the shareholder's proportionate equity interest in the corporation.[53]

The attempt to distribute corporate earnings in a form which will produce capital gains as opposed to dividend income has produced much of the complexity in the U.S. corporate tax area. Anti-avoidance provisions in the I.R.C. and a vast body of case law have developed to prevent this type of "bail out" of corporate earnings. The motivation for the conversion is the greatly reduced rate of tax that applies to "net capital gains."[54] While noncorporate taxpayers are taxed on taxable income at marginal rates ranging from 15% to 39.6%,[55] generally, net capital gains on capital assets held longer than eighteen months are taxed at a maximum tax rate of 20% with a rate of 10% applying to the net capital gains of individuals in the 15% tax bracket. The net capital gains resulting from capital assets held over one year are taxed at a maximum rate of 28%. A special lower rate

48. I.R.C. § 243.
49. I.R.C. § 312(a), (b).
50. I.R.C. § 1001(a).
51. I.R.C. § 1(h).
52. I.R.C. § 305.
53. I.R.C. § 302.
54. "Net capital gain" means the excess of net long-term capital gain (long-term capital gain minus long-term capital loss) over net short-term capital loss (short-term capital loss minus short-term capital gain). I.R.C. § 1222(1), (2), (3), (4), (11).
55. I.R.C. § 1.

of 18%, and 8% for individuals in the 15% tax bracket, applies to dispositions after December 31, 2000, if the asset was held more than five years.[56] In 1986 the preference for the net capital gains of corporations was repealed and, as yet, has not been reinstated.[57] The capital losses of both corporate and noncorporate taxpayers are subject to certain statutory restrictions.[58]

In Canada, corporate shareholders generally prefer dividends since dividends are not subject to the Part I tax. Individual Canadian shareholders also generally prefer dividend treatment because of the integrated corporate tax system. However, since some capital gains may be eligible for the $500,000 capital gains exemption for qualifying small business corporations,[59] this preference may bias individual shareholders in favour of capital gains treatment. This special preference for capital gains under the I.T.A. also provides a considerable incentive for qualifying individual shareholders to receive income in this form. Therefore, this preference is the reason for many of the dividend stripping anti-avoidance provisions[60] scattered throughout the I.T.A.

Also foreign to the U.S. corporate tax system is the concept of paid-up capital. In the United States, the basis of an asset is recovered without tax. The basis of an asset is simply subtracted from the amount realized in computing gain or loss on the disposition of the property.[61] If a corporate transaction is treated as an exchange, any gain or loss on the exchange is the difference between the amount of cash plus the fair market value of other property received minus the basis of the stock relinquished. As a consequence, the paid-up capital of the shares, as computed for Canadian tax purposes, is not relevant for U.S. tax purposes.

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56. I.R.C. § 1(h).
57. I.R.C. § 11, 1201 (a).
58. Generally, capital losses are only allowable as deductions in the current taxable year to the extent of capital gains. Noncorporate taxpayers can deduct an additional $3,000 maximum amount of capital losses in excess of capital gains. Unused capital losses are carried back three years and forward five years by corporate taxpayers while noncorporate taxpayers have an unlimited carry forward of unused capital losses. I.R.C. §§ 165, 1211, 1212.
59. See I.T.A., ss. 110.6(15), 248(1). A "small business corporation" is a CCPC all, or substantially all, of the fair market value of the assets of which are used principally in an active business carried on primarily in Canada by the particular corporation or shares of the capital stock of one or more connected small business corporations. See I.T.A., s. 186(4). "Connected" means, generally, ownership by the corporation or a party related to it, of more than 10% of the voting shares and fair market value of all shares of the corporation.
60. See, *e.g.*, I.T.A., s. 84.1(implementing a dividend stripping anti-avoidance provision).
61. I.R.C. § 1001 (a).

3. *Judicial Doctrines and Principles*

In order for a transfer of property, stock, or securities to receive tax-deferred treatment, the specific requirements of a corporate nonrecognition provision must be met. In addition, a transaction must not run afoul of certain judicial doctrines that assure adherence to the intent and purpose of the provision. One of the more significant differences between Canada and the United States' tax regime is the role these anti-avoidance doctrines play in determining whether a nonrecognition provision applies to a particular transaction. While in Canada, the general anti-avoidance rule in I.T.A. section 245 must be considered, in the United States a transaction cannot be evaluated for tax purposes without a careful review of a number of critical legal doctrines, legislative requirements, and specific anti-avoidance legislation and regulations. A basic understanding of the interplay between these anti-avoidance tools and the corporate nonrecognition provisions is therefore necessary to avoid subtle traps that exist for the uninformed.

a. *Statutory Interpretation*

In the United States, the courts are responsible for a significant portion of the law particularly in the corporate tax area. Some of the case law based principles have been discarded by statute, but in many areas these judicial doctrines have remained the primary source of the law. The following doctrines must be complied with in planning a corporate transaction.

i. *Sham Transaction*

A transaction is a sham if the transaction took place solely to produce favourable tax consequences. The characterization of a transaction as a sham implies fraudulent behaviour, therefore, the courts generally reserve this doctrine for the more egregious cases.[62]

ii. *Substance Over Form*

The substance over form doctrine requires that tax consequences should turn on the substance of a transaction rather than on its form. However, the form the transaction takes often has substantive and legal consequences.

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62. The Fourth Circuit defined a sham transaction as follows: "To treat a transaction as a sham, the court must find that the taxpayer was motivated by no business purpose other than obtaining tax benefits in entering the transaction, and that the transaction has no economic substance because no reasonable possibility of a profit exists." *Rice's Toyota World, Inc.* v. *C.I.R.*, 752 F.2d 89 at 91 (4th Cir. 1985).

Generally, even though a taxpayer is legally bound by the form chosen, the transaction may be restructured for tax purposes on the ground that the form does not reflect the substance of the transaction.[63] There are two categories of what is loosely referred to as the substance over form doctrine, legal substance over form[64] and economic substance over form.[65] Legal substance over form is generally accepted in both Canadian and U.S. income tax jurisprudence, and looks to commercial factors to determine the true legal substance (i.e., the respective legal rights and obligations of the parties) of a transaction. In contrast, the economic substance over form doctrine considers economic and commercial factors and recharacterizes an otherwise legally complete and effective transaction in light of such considerations. This latter approach, although firmly established in the United States,[66] is not generally accepted in Canada. Recently, U.S. Tax Courts have been reluctant to restructure transactions if the taxpayer has shaped an otherwise legitimate transaction to comply with statutory requirements.[67]

iii. *Step-Transaction*

The step-transaction doctrine assures that an integrated transaction is not broken into independent steps. Courts apply three different tests in determining whether the step transaction doctrine applies: end result test, interdependence test and binding commitment test.

> The step-transaction doctrine is a particular manifestation of the more general tax law principle that purely formal distinctions cannot obscure the substance of the transaction. . . . [U]nder the "end result test," "purportedly

63. See *Higgins* v. *Smith*, 308 U.S. 473 (1940) (disregarding a loss sale to a wholly-owned corporation as a sham).

64. The legal substance over form doctrine states that the label put on a transaction is not determinative of what the transaction is at law. *C.I.R.* v. *Court Holding Co.*, 324 U.S. 331 at 334 (1945).

65. This approach, which is particularly important in tax cases but difficult to justify, starts from the premise that the statutory provision was intended to attach certain tax consequences to transactions creating particular legal relationships. It then regards the economic consequences of the transactions as a justification for ignoring the fact that the legal relationships were actually created under the relevant principles of private law. The transactions are recharacterized as creating different legal relationships than those actually created and the tax consequences which would otherwise have attached to the transactions are held to be inapplicable.

66. *Gregory* v. *Helvering*, 293 U.S. 465 (1935). The U.S. Supreme Court looked to the economic substance of a reorganization undertaken to effect a tax-free distribution of shares and determined that the transaction was, in substance, a dividend payment.

67. *Esmark, Inc.* v. *C.I.R.*, 90 T.C. 171 (1988), aff'd 886 F.2d 1318 (7th Cir. 1989) (respecting prearranged stock purchase and trade-in).

separate transactions will be amalgamated with a single transaction when it appears that they were really component parts of a single transaction intended from the outset to be taken for the purpose of reaching the ultimate result." . . .

A second test is the "interdependence " test, which focuses on whether "the steps are so interdependent that the legal relations created by one transaction would have been fruitless without a completion of the series." . . .

Finally, the "binding commitment" test most restricts the application of the step-transaction doctrine . . . . The "binding commitment" test forbids use of the step-transaction doctrine unless "if one transaction is to be characterized as a 'first step' there [is] a binding commitment to take the later steps."[68]

iv. *Business Purpose*

Similar to the sham and substance over form doctrines, the business purpose doctrine requires that a transaction must serve a business purpose other than mere tax avoidance.[69] This doctrine was repudiated for Canadian tax purposes by the Supreme Court of Canada in the *Stubart* decision.[70] This aspect of *Stubart* is thought to be one of the main factors that contributed to the decision of the Department of Finance to seek legislative intervention in the form of the General Anti-avoidance Rule (GAAR).[71]

v. *Continuity of Interest*

The continuity of interest doctrine requires that the transferors of property to a corporation receive a sufficient proprietary interest in the acquiring corporation to justify treating the exchange as a tax-deferred transaction.[72] Some of the difficult issues involved in the continuity of interest doctrine include the quantity and quality of the continuing proprietary interest,[73]

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68. *McDonald's Restaurants of Illinois* v. *C.I.R.*, 688 F.2d 520 at 524-5 (7th Cir. 1982) [hereinafter *McDonald's*] [citations omitted].

69. *Helvering* v. *Gregory*, 69 F.2d 809 (2d Cir. 1934), aff'd 293 U.S. 465 (1935).

70. *Stubart Investments Ltd.* v. *The Queen*, [1984] 1 S.C.R. 536 1 C.T.C. 294, 38 D.T.C. 6305. For two opposing views on whether the business purpose test was clearly and unequivocally rejected, see S.W. Bowman, "Interpretation of Tax Legislation: The Evolution of Purposive Analysis" (1995) 43 Can. Tax J. 1167 at 1176; H.J. Kellough, "Tax Avoidance: 1945 - 1995" (1995) 43 Can. Tax J. 1819 at 1835.

71. I.T.A., s. 245.

72. *Pinalles Ice & Cold Storage Co.* v. *C.I.R.*, 287 U.S. 462 (1933); Treas. Reg. §§ 1.368-1(b), (e) (1998).

73. *LeTulle* v. *Scofield*, 308 U.S. 415 (1940); *Southwest Natural Gas Co.* v. *C.I.R.*, 189 F.2d 332 (5th Cir. 1951) [hereinafter *Southwest*]; Rev. Proc. 77-37, 1977-2 C.B. 56.

the continuity of historic target corporation shareholders,[74] and post-acquisition continuity.[75] With the exception of an A reorganization,[76] some aspect of the continuity of interest doctrine is a requirement for nonrecognition within a specific provision.[77]

vi. *Continuity of Business Enterprise*

Continuity of business enterprise is necessary to meet the definition of a corporate reorganization.[78] The doctrine requires that the acquiring corporation either continue the historic business of the acquired corporation or use a significant portion of the historic business assets of the acquired corporation in a business.[79]

vii. *Assignment of Income*

Under an income tax system that imposes a tax on taxable income at progressive rates, attributing income to the proper taxpayer becomes particularly important. The assignment of income doctrine assures that income from services is taxed to the earner of the income[80] and income from property is taxed to the owner of the property.[81]

b. *Anti-Avoidance Provisions*

GAAR empowers Revenue Canada to recharacterize payments or amounts, disallow deductions, reallocate deductions, income, or losses and, generally, to ignore the tax consequences of an avoidance transaction. An avoidance transaction is a transaction, or part of a series of transactions,

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74. *Kass* v. *C.I.R.*, 60 T.C 218 (1973) [hereinafter *Kass*]; *J.E. Seagram Corporation.* v. *C.I.R.*, 104 T.C. 75 (1995) [hereinafter *J.E. Seagram*]; Treas. Reg. § 1.368-1(e)(1998).

75. *McDonald's, supra* note 67; Treas. Reg. § 1.368-1(e)(1998).

76. I.R.C. § 368(a)(1)(A). In tax practice, the seven categories of corporate reorganizations are referred to by their alphabetic designations in I.R.C. § 368(a)(1).

77. See, *e.g.*, I.R.C. §§ 351, 368(a)(1)(B), (C), (2)(E) (conditioning nonrecognition on the satisfaction of the applicable continuity requirement).

78. Treas. Reg. § 1.368-1(b) (1980).

79. *Bentsen* v. *Phinney*, 199 F. Supp. 363 (S.D. Tex. 1961); Treas. Reg. § 1.368-1(d) (1980). Certain post-reorganization transfers by the acquiring corporation of the target corporation's assets or stock to controlled corporations or the target corporation's assets to partnerships will not cause the transaction to fail the continuity of business enterprise requirement. Treas. Reg. § 1.368-2(k) (1998).

80. *Lucas* v. *Earl*, 281 U.S. 111 (1930).

81. *Helvering* v. *Horst*, 311 U.S. 112 (1940).

that would otherwise result, directly or indirectly, in a reduction, avoidance, or deferral of taxes or other amounts payable under the Act or an increase in any refund otherwise payable.[82] In addition to GAAR, Canada boasts a host of specific anti-avoidance rules.[83]

Early in the development of the U.S. tax system, common law doctrines emerged in an attempt by courts to curtail the avoidance and evasion of tax. The legislature followed by incorporating anti-avoidance safeguards as definitional requirements and enacting provisions to curb a particular type of abuse, but a general corporate anti-avoidance section like GAAR has not been enacted.

Perhaps the most general corporate anti-avoidance provision is I.R.C. § 482 which has been used extensively within the last decade in the international tax arena. I.R.C. § 482 allows the Internal Revenue Service to allocate gross income, deductions, credits, and other allowances among two or more organizations, trades, or businesses under common ownership or control whenever it determines that this action is necessary "in order to prevent the evasion of taxes or to clearly reflect the income of any such organizations, trades, or businesses." The purpose of this section is to place the controlled taxpayer on a parity with that of an uncontrolled taxpayer, by using the standard of the uncontrolled taxpayer to determine the controlled taxpayer's true taxable income.[84] The standard to be applied in determining the true taxable income of a controlled taxpayer is that of a taxpayer dealing at arm's length with an uncontrolled taxpayer.[85] This anti-avoidance section has been used extensively by the Internal Revenue Service to question transfer prices and expense allocations between domestic corporations and foreign affiliates that are not subject to U.S. income taxes on foreign income.[86]

The I.R.C. contains other provisions which provide safeguards against tax avoidance. For example, I.R.C. § 269(a) permits the Internal Revenue Service to disallow deductions, credits, or other tax allowances if the

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82. I.T.A., s. 245.
83. See, *e.g.*, I.T.A., s. 256 (2.1) in relation to associated corporations, s. 110.6(7)(a) applicable on divisive reorganizations and s. 84.1(2)(a.1)(ii) and s. 84.1 (2.1)(b) applicable in dividend stripping transactions.
84. Treas. Reg. § 1.482-1(a)(1) (1994).
85. Treas. Reg. § 1.482-1(b)(1) (1994).
86. See generally *Eli Lilly and Co.* v. *United States*, 372 F.2d 990 (Ct. Cl. 1967) (accepting comparables when they involve the same product in applying the arm's length standard); *Bausch & Lomb, Inc.* v. *C.I.R.*, 92 T.C. 525 (1989) (applying the comparable-uncontrolled-price method of determining an arm's length price); *Cadillac Textiles Inc.* v. *C.I.R.*, 34 T.C.M. 295 (1975) (rejecting purported comparables in applying the arm's length standard).

principal purpose of acquiring control of a corporation was the avoidance of federal income tax by securing a tax benefit which the acquiring corporation would not have otherwise enjoyed. I.R.C. § 446(b) allows the Internal Revenue Service to prescribe another method of tax accounting if the taxpayer's method of accounting "does not clearly reflect income." I.R.C. §§ 381, 382, 383 and 384 limit the carryover of certain corporate tax attributes during corporate acquisitions in order to prevent the trafficking in tax preferences. I.R.C. § 306 was enacted to prevent the "preferred stock bailout" used by a corporation to bail out corporate earnings at capital gains rates through a tax-free preferred stock distribution and later sale or redemption of the preferred stock. I.R.C. § 1059 prevents a corporate shareholder from abusing the dividend-received deduction[87] by orchestrating an "extraordinary dividend." This section requires the corporate shareholder to reduce its basis in the stock of the distributee corporation by the "nontaxed" portion of the dividend, if the shareholder has not held the stock for more than two years before the corporation declares, announces, or agrees to pay the dividend.

Other types of anti-avoidance tax provisions result in add-on or penalty taxes. U.S. corporations are subject to the alternative minimum tax, which is payable only to the extent that it exceeds a corporation's regular tax liability. This measure was enacted to ensure that a corporation will pay the maximum tax possible in relation to its earnings.[88] Another provision imposes the accumulated earnings tax, which is paid in addition to other taxes paid by a publicly held or closely held corporation if the corporation was formed or used for the purpose of avoiding individual income tax at the shareholder level by accumulating rather than distributing earnings and profits.[89] A personal holding company is also subject to an additional tax equal to 39.6% of undistributed personal holding company income. This section was enacted to deter taxpayers from "incorporating pocketbooks" in order to avoid the graduated income tax on individuals and to respond to the deficiencies in the accumulated earnings tax.[90] These provisions, plus the many judicial doctrines, are just some of the weapons used by the Internal Revenue Service to combat tax evasion in the United States.

87. I.R.C. § 243.
88. I.R.C. §§ 55-58.
89. I.R.C. § 531-537.
90. I.R.C. § 541-547.

II. *Corporate Nonrecognition Provisions*

Both the Canadian and U.S. tax systems allow for corporate formation, reorganizations, amalgamations and winding-ups on a tax-deferred basis. The following provides an examination and comparison of various types of corporate transactions: transfers of property to a corporation, corporate divisions, share-for-share exchanges, amalgamations, internal capital reorganizations, and liquidations.

1. *Transfers of Property to a Corporation*

I.R.C. § 351 and I.T.A. section 85 provide for nonrecognition on the transfer of property to a corporation in exchange for its stock.[91] Absent these sections, an exchange of property for stock would constitute a disposition of property at fair market value.[92] Tax deferment reflects a policy decision by the legislatures of both countries that a transfer of property to a corporation for stock represents a continuation of investment in a modified form, rather than a liquidation of the investment in the assets transferred.[93] I.R.C. § 351 is a mandatory nonrecognition provision applicable to the transfer of property to a new or existing corporation requiring that the transferors have control of the corporation immediately after the transfer.[94] By way of comparison, I.T.A. section 85 is elective and does not contain a "control" requirement. As continuity of interest is not a factor, I.T.A. section 85 applies to a wider range of circumstances.

Briefly, I.T.A. section 85[95] provides that a taxpayer who transfers eligible property to a taxable Canadian corporation in exchange for consideration that includes shares of the transferee corporation may elect an amount not less than the tax cost of the asset and not greater than its fair market value as the proceeds received on the disposition of the asset.[96] The election permits a rollover of the cost base of the transferred asset to

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91. I.R.C. §§ 61(a)(3), 351 1001; I.T.A., ss. 54(c), 69, 85.

92. *Ibid.*

93. See Treas. Reg. § 1.1002-1(c) (1960) (viewing the transaction as a continuation of the original investment).

94. For tax purposes, a voluntary contribution to capital by a shareholder is treated similar to a I.R.C. § 351 exchange. Compare I.R.C. § 118 (providing that contributions to the capital of a taxpayer are not included in the gross income of a corporation) *with* I.R.C. § 351 (extending nonrecognition of gain or loss when property is transferred to a corporation); see also Treas. Reg. § 1.118-1 (1960) (explaining this exclusion from gross income).

95. See A. Dunn & K. Nielson, "Exchanges of Property for Shares: Section 85-Part 1" (1995) 43 Can. Tax J. 203, "Part 2" (1995) 43 Can. Tax J. 496; *Information Circular* 76-19R3, "Transfer of Property to a Corporation under Section 85," June 17, 1996.

96. I.T.A., s. 85(1).

the shares received by the transferor as well as to the asset received by the transferee corporation. I.T.A. section 85 will not operate unless the transferor receives consideration from the corporation which includes shares of the transferee corporation. The section also permits the receipt of other types of consideration. The receipt, however, of nonshare consideration may result in gain recognition if such consideration exceeds the tax cost of the transferred asset. A taxpayer who transfers capital property or eligible capital property to a controlled corporation is not entitled to recognize a loss on the disposition. The taxpayer is, nevertheless, allowed to "bump up" the cost base of the shares received from the corporation by the amount of the disallowed loss.[97]

I.R.C. § 351 is similar to ITA section 85, and provides that no gain or loss will be recognized if property is transferred to a corporation by one or more persons[98] solely in exchange for stock in the transferee corporation, if the transferors are in control of the transferee corporation immediately after the exchange.[99] The corporation can be a newly organized corporation or an existing corporation. The term "property" has been broadly interpreted to include such items as cash,[100] accounts receivable, industrial know-how,[101] and nonexclusive licenses.[102] The major exception from the definition of property is services.[103] The fair market value of stock received for services performed for the corporation is included in the recipient's gross income as compensation for services.[104] Nevertheless, if a transferor receives stock in a exchange for both property and services, all of the stock received by the transferor is counted toward the control requirement.[105] The term "stock" means an equity investment in the

97. I.T.A., ss. 14(12), 40(3.4), 40(3.6). See also I.T.A., s. 13(21.2) (providing for the treatment of depreciable property).

98. The term "person" includes an individual, trust, estate, partnership, association, company or corporation. I.R.C. § 7701(a)(1).

99. I.R.C. § 351(a). Contributions to the capital of a corporation are treated similarly to I.R.C. § 351 transactions. See I.R.C. §§ 118, 1032, 362(a); Treas. Reg. § 1.118-1.

100. Rev. Rul. 69-357, 1969-1 C.B. 101.

101. Rev. Rul. 64-56, 1964-1 C.B. 133.

102. See, *e.g.*, *E.I. Du Pont de Nemours & Co.* v. *United States*, 471 F.2d 1211 (Ct. Cl. 1973).

103. I.R.C. § 351(d)(1).

104. I.R.C. §§ 61(a)(1), 83.

105. Treas. Reg. § 1.351-1(a)(2) example (3) (1996). If the primary purpose of the transfer of a relatively small amount of property is to qualify other persons transferring property, the stock will not be treated as issued for property. Treas. Reg. § 1.351-1(a)(1). The Internal Revenue Service has stated that property transferred will not be considered of relatively small value if the fair market value of the property transferred is at least 10% of the fair market value of the stock already owned, or to be received, by the transferor. Rev. Proc. 77-37, 1977-2 C.B. 568, § 3.07.

corporation, but does not include stock rights and warrants[106] or certain debt-like preferred stock.[107] "Control" is defined as the ownership of stock possessing at least 80% of the total combined voting power of all classes of voting stock and at least 80% of the total number of shares of each class of nonvoting stock.[108] This requirement is the codification of the continuity of interest doctrine as it relates to transfers of property to a corporation under I.R.C. § 351.[109] However, the transferors will not be considered in control of the corporation immediately after the exchange if the stock ownership of the transferor group drops below the required 80% pursuant to a binding agreement.[110] For the purposes of control, there is no specific limit on the number of transferors and the transfers need not be simultaneous, nevertheless, the transfers must be part of a prearranged plan, carried out with reasonable expediency.[111] It is this control requirement that greatly limits the availability of I.R.C. § 351 as compared to the more versatile I.T.A. section 85.

Under I.R.C. § 351, if the transferor receives not solely stock but also money or other property (boot), realized gain, if any, but not loss, will be recognized by the transferor on the exchange.[112] The transferors will receive nonrecognition treatment even though the transferee corporation assumes liabilities or takes property subject to liabilities.[113] However, an individual transferor will recognize gain if the aggregate amount of debt relief exceeds the basis of the property transferred.[114] Unlike I.T.A. section 85, no flexibility exists as to the amount of gain recognized; boot received will trigger recognition of gain only to the extent of gain realized. Nevertheless, as under I.T.A. section 85, the unrecognized gain or loss is preserved in the bases of the assets received by the parties to the exchange. The basis of the stock received by the transferor is the same as the basis of the transferred assets prior to the exchange, increased by any gain recognized on the transfer and decreased by the value of any boot and

106. Treas. Reg. 1.351-1(a)(1) (1996).
107. I.R.C. § 351(g), (h).
108. I.R.C. § 368(c).
109. See *supra* note 72 and accompanying text (discussing the continuity of interest doctrine).
110. *Intermountain Lumber Co.* v. *C.I.R.*, 65 T.C. 1025 at 1029-30 (1976). See *supra* note 68 and accompanying text (discussing the step-transaction doctrine).
111. Treas. Reg. § 1.351-1(a)(1) (1996).
112. I.R.C. § 351(b).
113. I.R.C. § 357(a).
114. I.R.C. § 357(c). If the principal purpose of the transferor with respect to the assumption or acquisition is to avoid income tax or is not a bona fide business purpose, the liabilities are treated as boot received by the transferor on the exchange. I.R.C. § 357(b).

debt relief received.[115] Boot received is given a fair market value basis.[116] At the corporate level, the transferee corporation does not recognize gain or loss on the receipt of money or other property in exchange for its stock.[117] With regard to the property received in the exchange, the transferee corporation receives a basis equal to the transferor's basis in the assets, increased by any gain recognized by the transferor on the transfer.[118]

The amount of consideration received by the transferor from the transferee corporation in an I.T.A. section 85 exchange is fundamental to an effective rollover. If the transferor is not the sole shareholder and related persons hold shares, the shares received by the taxpayer on the rollover must be structured to ensure the avoidance of a constructive gift. I.T.A. paragraph 85(1)(e.2) operates as a penalty provision if a benefit is conferred on a person related to the taxpayer as a result of an I.T.A. section 85 rollover. If this paragraph applies, the elected amount is deemed to be increased by the value of the benefit. The provision requires a calculation of the difference between the fair market value of the transferred property at the time of the disposition and the greater of the fair market value of all consideration received by the transferor and the elected amount. If any portion of this difference can reasonably be regarded as a benefit which the transferor is conferring on a related person, the elected amount is deemed to be increased by the benefit portion. However, this increase is not reflected for purposes of calculating the cost basis of the shares received by the transferor on the transfer.[119] Preference shares redeemable for a fixed amount will eliminate any "gifting." Thus, preference shares redeemable for the fair market value of the transferred asset are considered to be an acceptable solution to this problem. Similarly, under the U.S. tax system, when a relationship exists between parties to a transaction, the terms of the agreement are closely scrutinized; however, the method of recharacterizating the transaction has not been formalized. Under I.R.C. § 351, if the stock and boot received by the transferor is disportionate to the value of the property transferred to the transferee corporation, the entire transaction will be taxed in accordance with its true nature. For example, the additional stock

115. I.R.C. § 358(a)(1), (d)(1). For purposes of the capital gain preference, the transferor can tack holding periods if the asset transferred to the corporation is a capital asset. I.R.C. § 1223(1).
116. I.R.C. § 358(a)(2).
117. I.R.C. § 1032(a).
118. I.R.C. § 362(a). For purposes of the capital gain preference, the corporation can tax holding periods. I.R.C. § 1223(2).
119. I.T.A., s. 85(1)(e.2).

received may be recharacterized as a gift from another transferor, compensation for services paid by another transferor or the transferee corporation, or in satisfaction of an obligation owed to the transferor by either another transferor or the transferee corporation.[120]

2. *Corporate Divisions*

Tax-deferred corporate divisions are available under both the U.S. and Canadian tax systems. A divisive corporate reorganization for Canadian tax purposes is available provided there is significant continuity of interest in the property of the distributing corporation. Such divisive reorganizations in Canada are commonly referred to as "butterfly transactions." The essence of a Canadian butterfly is that property of a corporation is transferred to one or more corporate shareholders in proportion to their share interest in that corporation in a tax-deferred exchange for shares under I.T.A. section 85. Subsequently, shares of the transferee corporations owned by the transferor corporation are redeemed and the shares of the transferee corporation owned by a subsidiary of the transferor are redeemed, thereby triggering deemed intercorporate dividends pursuant to I.T.A. subsection 84(3). These dividends are deductible pursuant to I.T.A. subsection 112(1) provided the tax avoidance provisions in I.T.A. subsection 55(3) are not offended. As a result, a transaction which would otherwise give rise to a capital gain is instead executed using a combination of nonrecognition provisions and the integration mechanism which permits the tax-free flow of intercorporate dividends.

By comparison, the statutory provisions, Treasury regulations and pronouncements, and judicial doctrines that have emerged in the United States to facilitate and regulate the corporate division are numerous and complex. Generally, I.R.C. § 355 allows a tax-free division of a corporate enterprise into two separate corporations owned by the shareholders of the original corporation. A corporate division pursuant to I.R.C. § 355 need not be part of a corporate reorganization.[121] If a parent corporation distributes stock of an existing subsidiary, the transaction is governed exclusively by I.R.C. § 355. If the parent transfers part of its assets to a newly-formed subsidiary and then distributes the subsidiary stock, the transaction in its entirety will constitute a divisive D reorganization as defined in I.R.C. § 368(a)(1)(D). However, in order to satisfy the

120. Treas. Reg. § 1.351-1(b)(1) (1996).
121. I.R.C. § 355(a)(2)(C).

definition of a divisive D reorganization the stock of the transferee corporation must be distributed in a transaction which qualifies under I.R.C. § 355.

A transaction qualifying for nonrecognition under I.R.C. § 355 may take the form of a spin-off, a split-off or a split-up. A spin-off consists of a distribution by the parent corporation to its shareholders of stock in a controlled subsidiary. A spin-off is analogous to a dividend since the shareholders of the distributing corporation do not surrender stock in exchange for the distributed stock. A split-off is similar to a spin-off, except that the shareholders of the distributing corporation surrender part of their stock in the distributing corporation for stock in the controlled corporation. A split-off is analogous to a redemption. In a split-up, the distributing corporation distributes stock of two or more controlled corporations to its shareholders in complete liquidation. If the stringent requirements of I.R.C. § 355 are met, each form qualifies as a tax-free division. If the transaction fails I.R.C. § 355, the distributions will be treated as a dividend, redemption, or a liquidation, respectively.

I.R.C. § 355 is a very complex anti-avoidance provision, enacted to prevent corporations from bailing out corporate earnings at capital gain rates.[122] Currently, I.R.C. § 355 also serves as a backstop to the repeal of the General Utilities Doctrine,[123] assuring a tax at the corporate level on the distribution of appreciated assets as part of a plan of reorganization.[124] As a result, a corporate division must satisfy the many statutory requirements of I.R.C. § 355 and its accompanying judicial doctrines in order to receive tax deferment.

Briefly, I.R.C. § 355 permits a corporation with one or more businesses actively conducted for five years or more[125] to make a tax-free distribution of the stock[126] of a controlled subsidiary,[127] provided that the distribution

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122. See *Gregory* v. *Helvering*, 293 U. S. 465 (1935).

123. The General Utilities Doctrine provided that a distributing corporation did not recognize gain or loss on the distribution of property to its shareholders with respect to its stock on a liquidating or nonliquidating distribution. The doctrine resulted from the broad application of the Supreme Court decision, *General Utilities & Operating Company* v. *Helvering*, 296 U. S. 200 (1935), and was codified in I.R.C. § 311 (nonliquidating distributions), and I.R.C. § 336 (liquidating distributions). I.R.C. § 311 and § 336 were amended by the *Tax Reform Act* of 1986, and now generally provide for recognition of gain at the corporate level on the distribution of appreciated assets in liquidating and nonliquidating distributions.

124. I.R.C. §§ 355(c), (d), 361(c).

125. I.R.C. § 355(a)(1)(C), (b).

126. I.R.C. § 355(a)(1)(D). The distributing corporation must distribute all the stock of the controlled corporation or, at least, an amount of stock sufficient to constitute control within the meaning of I.R.C. § 368(c), which requires ownership of 80% of the total combined voting power and 80% of the total number of shares of all other classes of stock. *Ibid.*

127. I.R.C. § 355(a)(1)(A).

is being carried out for a legitimate business purpose,[128] is not being used principally as a device to bail out earnings and profits,[129] and the requisite continuity of interest is maintained.[130] Amplifying some of the requirements, first, both the distributing corporation and the controlled corporation must be engaged in the active conduct of a trade or business immediately after the distribution.[131] A corporation is engaged in the "active conduct" of a trade or business if it performs active and substantial management and operational functions as opposed to mere investment activities.[132] Second, the active trade or businesses must have been conducted by the distributing corporation throughout a five-year period preceding the distribution.[133] Third, the distributing corporation must be in control of at least one preexisting or newly-created corporation immediately before the transaction. "Control" is defined as ownership of at least 80% of the total voting power and at least 80% of the total number of shares of all other classes of stock. Finally, the transaction cannot be used principally as a device for the distribution of earnings and profits of the distributing or the controlled corporation, or both, at capital gains rates.[134]

If the requirements of I.R.C. § 355 are met, the shareholders of the distributing corporation will not recognize gain or loss on the distribution of stock or securities of the controlled corporation.[135] In the case of a distribution of securities, if the principal amount of the securities of the controlled corporation received by the distributee shareholder exceeds the principal amount of the distributing corporation's securities surrendered, the value of the excess is treated as boot.[136] The distribution of this and other forms of boot does not necessarily disqualify a transaction

128. See Treas. Reg. § 1.355-2(b) (1989) (defining independent business purpose).
129. I.R.C. § 355(a)(1)(B).
130. See Treas. Reg. § 1.355-2(c) (1989) (explaining that a sale or exchange not negotiated or agreed upon before the sale is substantial evidence of a device).
131. If the distributing corporation is a holding company, each of the controlled corporations must be engaged in the active conduct of a trade or business. I.R.C. § 355(b)(1)(B).
132. Treas. Reg. § 1.355-3(b)(2) (1989).
133. Treas. Reg. § 1.355-3(b)(3) (1989). The regulations permit the vertical division of a single active trade or business into two independent trades or businesses. Treas. Reg. § 1.355-3(c), examples (4)-(5).
134. The regulations use a balancing approach, weighing the relative strength and weaknesses of listed "device" and "nondevice" factors. See Treas. Reg. § 1.355-2(d).
135. I.R.C. § 355(a)(1). Stock of the controlled corporation acquired by the distributing corporation in a taxable transaction within five years of the distribution is treated as boot. I.R.C. § 355(a)(3)(B). Certain debt-like preferred stock is treated as boot. I.R.C. § 355(a)(3)(D).
136. I.R.C. §§ 355(a)(3)(A)(ii), 356(d)(2). The term "security" includes the right to acquire stock of the issuing corporation which will be treated as having no principal amount. Prop. Reg. § 1.355-1(c).

under I.R.C. § 355, but it will cause the distributee shareholder to recognize any realized gain, usually as ordinary income, to the extent of the boot received.[137] The aggregate basis of the nonrecognition property received by the distributee shareholder in an I.R.C. § 355 transaction is the aggregate basis of the shareholder's stock, increased by gain recognized and decreased by money and the value of boot received in the exchange. This aggregate basis is then allocated among the stock or securities received and retained in proportion to their relative fair market values.[138] The boot receives a fair market value basis.[139] Generally, the distributing corporation will recognize gain on the distribution only if, in addition to the stock and securities in the controlled corporation, other appreciated property is distributed.[140]

If one or more corporations are formed as a preparatory step to a qualifying corporate division, the transaction as a whole is a divisive D reorganization. I.R.C. § 368(a)(1)(D) defines a divisive D reorganization as a transfer by a corporation of all or part of its assets to another corporation if immediately after the transfer the transferor corporation, or one or more of its shareholders, or any combination thereof, is in control of the transferee corporation, but only if the stock or securities of the transferee corporation are distributed in a transaction which qualifies under I.R.C. § 355.[141] The transferor corporation does not recognize gain or loss on the transfer of its assets to the controlled corporation,[142] and takes an exchange basis in the stock and securities received.[143] The distributing corporation recognizes gain on the distribution of stock and securities of the controlled corporation only to the extent appreciated boot or other property is distributed.[144] The newly formed controlled corporation does not recognize gain on the issuance of its stock[145] and takes the assets with a transferred basis.[146]

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137. I.R.C. §§ 355(a)(4)(A), 356.

138. I.R.C. § 358(a)(1), (b).

139. I.R.C. § 358(a)(2). For the purposes of capital gain, tacking of holding periods is allowed for the property which receives an exchange basis. I.R.C. § 1223(1).

140. I.R.C. § 355(c).

141. A nondivisive D reorganization requires the transfer of substantially all of the assets of the transferor corporation to the controlled corporation and the distribution by the transferor of all of its property including the stock, securities, and other property received by the transferor. "Control" means ownership of at lease 50% of the total combined voting power of voting stock or at least 50% of the total number of shares of all other classes of stock. I.R.C. §§ 354(b), 368(a)(2)(H).

142. I.R.C. § 361(a), (b).

143. I.R.C. § 358(a).

144. I.R.C. § 361(c).

145. I.R.C. § 1032(a).

146. I.R.C. § 362(b).

3. *Share-for-Share Exchanges*

Under both the U.S. and Canadian tax systems, share-for-share exchanges are given nonrecognition treatment. A share-for-share exchange occurs when the shareholders of the target corporation exchange shares of the target corporation for the shares of the acquiring corporation. In the absence of a rollover provision, the target corporation shareholders would be considered to have disposed of the shares of the target corporation for proceeds equal to the fair market value of the shares received from the acquiring corporation.

In Canada in order to qualify for the rollover, I.T.A. section 85.1[147] requires that the shareholder of a taxable Canadian corporation[148] receive solely shares of a single class of treasury stock of a Canadian corporation. Nonshare consideration may not be received in the transaction.[149] In order to qualify for nonrecognition, the parties to the exchange must be dealing at arm's length before and after the exchange.[150] The shareholders of the target corporation and the acquiring corporation are considered not to have dealt at arm's length after the exchange if the shareholders of the target corporation, either alone or together with persons with whom the shareholders did not deal at arm's length, control the acquiring corporation, or own more than 50% of the fair market value of all outstanding shares of the stock of the acquiring corporation.[151] The rollover is not mandatory and the shareholder may recognize any gain or loss realized on the transaction. If gain or loss is not recognized, the cost base of the shareholder's old shares is rolled over into the basis of the new shares, thus, preserving any unrecognized gain or loss on the exchange.[152] The cost base in the target shares to the acquiring corporation is the lesser of

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147. I.T.A., s. 85.1 is inapplicable if the parties to the exchange have filed an election under I.T.A., ss. 85(1) or 85(2). See I.T.A., s. 85.1(2)(c). The stock on both sides of the exchange must be capital stock or non inventory stock. I.T.A., s. 85.1(1). See P. Cobb, "Share-for-Share Exchanges: Section 85.1" (1995) Can. Tax J. 2231; see also *Interpretation Bulletin* IT-450R, "Share for Share Exchange," April 8, 1993.

148. A taxable Canadian corporation is defined in I.T.A., s. 89(1) as a corporation: (1) resident in Canada, (2) incorporated in Canada, and (3) not exempt from tax.

149. I.T.A., s. 85(2)(d). Although Revenue Canada will permit the receipt of nonshare consideration for a fraction of a share. See *Interpretation Bulletin* IT-115R2, "Fractional Interest in Shares," February 20, 1995.

150. I.T.A., s. 85.1(1)(a), (b). I.T.A., s. 85.1(2)(b) precludes the application of I.T.A., s. 85.1(1) to a share transaction where immediately after the transaction the shareholder and/ or related parties either control the acquiring corporation or own shares of the acquiring corporation that have a fair market value of more than 50% of the fair market value of all the outstanding shares of the acquirer. This type of transaction is sometimes referred to as a "reverse takeout" because the shareholder(s) of the target corporation end up with control of what had been the acquiring corporation.

151. I.T.A., s. 85.1(1)(b).

152. I.T.A., s. 85.1(1)(a).

the fair market value of the shares and their paid-up capital[153] immediately before the exchange.[154] As a result, the acquiring corporation will inherit the paid-up capital of the target corporation shares as its cost base in the target shares. As a consequence, the new cost base to the acquiring corporation will generally be less than the fair market value of the exchanged shares.[155]

I.T.A. subsection 85.1(3) also provides for a tax-deferred rollover when a taxpayer disposes of shares of one foreign affiliate[156] to any other corporation that is a foreign affiliate of the taxpayer immediately following the disposition. This rollover is available provided the shares are capital property of the taxpayer and the vendor receives consideration that includes shares of the acquiring foreign affiliate. Where nonshare consideration is received there will not be a rollover if the value of the nonshare consideration exceeds the cost basis of the transferred shares.

I.R.C. § 368(a)(1)(B) defines a B reorganization as the acquisition of stock of one corporation in exchange solely for the voting stock of the acquiring corporation, or its parent,[157] provided the acquiring corporation has control of the target corporation immediately after the transaction, whether or not the acquiring corporation had control immediately before the acquisition.[158] The term "solely" has been strictly interpreted to preclude the use of any amount of consideration in a B reorganization other than voting stock of the acquiring corporation, or its parent.[159] Thus, similar to the Canadian provisions, no boot can be received. Control of the target corporation need not be acquired in one transaction. A creeping

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153. See ITA, s. 89(1) definition of paid-up-capital.
154. I.T.A., s. 85.1(1)(b).
155. ITA, s. 85.1(2.1). To prevent an artificial tax-free return of capital to the target shareholders, the increase in the paid-up capital (PUC) of the shares issued by the acquiring corporation to the target shareholders is also limited to the amount of PUC attributable to the target shares received. To the extent that the stated capital assigned to the shares issued by the acquiring corporation in exchange for the target's shares exceeds the PUC of the target's shares, a difference between the PUC and stated capital of the corporation will exist. Consequently, future reorganizations of capital, minority interest squeeze outs, or redemption of shares may be restricted since it is only the PUC amount which may be returned to the shareholders as a tax-free return of capital.
156. For purposes of I.T.A., s. 85.1(3), a foreign affiliate means a nonresident corporation in which the taxpayer's equity percentage is not less than 1% and the total of the equity percentages in the corporation of the taxpayer and of each person related to the taxpayer is not less than 10%, as defined in I.T.A., s. 95(1).
157. A combination of parent and acquiring corporation stock cannot be used. Treas. Reg. § 1.368-2(c) (1986).
158. I.R.C. § 368(a)(1)(B).
159. See *Helvering* v. *Southwest Consolidated Corp.*, 315 U.S. 194 (1942). The receipt of other consideration in lieu of fractional shares in the acquiring corporation, however, is permitted. Treas. Reg. § 1.368-2(c) (1986).

acquisition of control as well as an increase in ownership by a corporation that is already in control of the target corporation can qualify.[160] Minority shareholders unwilling to accept acquiring corporation stock cannot receive cash or other property directly from the acquiring corporation lest the solely for voting stock requirement be violated. Nevertheless, it is possible for the target corporation to redeem the stock of the dissenting shareholders with its own funds[161] or the shareholders of the acquiring corporation to purchase the stock of dissenters.[162] If a transaction qualifies as a B reorganization, no gain or loss will be recognized by the target corporation shareholders[163] or by the acquiring corporation[164] on the exchange of stock. The basis of the target corporation stock held by the target shareholders becomes the target shareholders' basis in the acquiring corporation stock and the acquiring corporation's basis in the target corporation stock.[165]

As can be seen, many significant differences exist between a B reorganization under the I.R.C. and an I.T.A. section 85.1 share-for-share exchange. Both provisions require that the consideration for the target corporation's stock consist solely of stock of the acquiring corporation. However, I.T.A. section 85.1 does not require voting stock but does require a single class of acquiring corporation stock. Control immediately after the exchange is an important part of the rationale for nonrecognition in a B reorganization while the I.T.A. section 85.1 share-for-share exchange requires that the target shareholders be at arm's length with the acquiring corporation both before and after the exchange. Finally, an I.T.A. section 85.1 share-for-share exchange is not mandatory and the shareholders may recognize gain or loss on the exchange.[166]

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160. Treas. Reg. § 1.368-2(c) (1985).
161. Rev. Rul. 68-285, 1968-1 C.B. 147.
162. Rev. Rul. 68-562, 1968-2 C.B. 157.
163. I.R.C. §§ 354, 356.
164. I.R.C. § 361.
165. I.R.C. § 362(b).
166. A share-for-share exchange can also be achieved in Canada by filing an election under I.T.A., s. 85. In that case, the I.T.A., s. 85 rollover provisions will require that the elected amount be between the cost basis of the shares and their fair market value. The cost of the new shares received on the exchange will equal the cost basis of the old shares to both the shareholder and the corporation if no nonshare consideration is received. The advantage of using I.T.A., s. 85, instead of I.T.A., s. 85.1, in a share-for-share exchange is that first nonshare consideration may be received in the transfer under I.T.A., s. 85 and second, I.T.A., s. 85 avoids a potential reduction in the cost basis of the target shares by the acquiring corporation where the PUC of the target shares is less than their adjusted cost basis. If I.T.A., s. 85.1 is used to acquire the target shares, it will be the PUC of the target shares and not the shares higher adjusted cost basis which will become the new cost basis of the shares in the hands of the acquiring corporation. The choice of using I.T.A., s. 85 rather than I.T.A., s. 85.1 can, therefore, yield significantly different tax results.

4. *Mergers or Amalgamations*

The U.S. and the Canadian tax systems both contain provisions allowing the combination of two or more corporations on a tax-free basis to the amalgamating corporations and their shareholders. I.T.A. section 87 allows for the tax-free fusion of two or more corporations into an amalgamated corporate entity.[167] The shareholders and the creditors of the transferor corporations become the shareholders and creditors of the amalgamated corporation. To qualify as an amalgamation under this provision, no new corporate entity can result from the exchange. If a new corporate entity results, the transaction constitutes an I.T.A. section 85 transfer by each transferor corporation.[168] The most common patterns are vertical and horizontal amalgamations.[169] In a vertical amalgamation, a parent corporation is merged with one or more subsidiary corporations to form the amalgamated corporation. Thus, a vertical amalgamation is similar in effect to the winding-up of a subsidiary into its parent corporation. A horizontal amalgamation is the merger of two or more corporations to form the amalgamated corporation. The corporate entity resulting from either form of amalgamation carries forward the tax attributes of the merged corporations.[170] The shareholders of the target corporations receive an exchange basis in the shares in the amalgamated corporation[171] and the amalgamated corporation receives a transferred basis in the assets received from the target corporations.[172] In addition, I.T.A. section 87 deems certain corporate transactions to be amalgamations for tax purposes.[173] A deemed amalgamation occurs, for example, where a corporation and one or more of its wholly-owned subsidiaries, or two or more corporations each of which is a wholly-owned subsidiary of the same corporate parent, are merged and no shares are issued by the amalgamated corporation.[174] Similar to an A reorganization,[175] the

167. Corporations may amalgamate only with other corporations governed by the same corporate statutes. For a discussion of the Canadian corporate law cases dealing with the effect of an amalgamation see *The Queen* v. *Black & Decker Marine Co.* [1975] 1 S.C.R. 411 and *Commercial Financial Services* v. *Mark I. Kelley Enterprises* (1995), 33 Alta. L.R. (3d) 177 (Q.B.).
168. I.T.A., s. 87(1).
169. See G. Richards, "Amalgamations" (1996) 44 Can. Tax J. 241.
170. I.T.A., s. 87(1.2) (new corporation is deemed to be a continuation of the old corporation with regards to listed provisions). See, *e.g.*, I.T.A., s. 87(2)(l) (new corporation can utilize unused research expenditures of old corporation); I.T.A., s. 87(2) (rules for the rollover of particular types of property).
171. I.T.A., s. 87(4).
172. I.T.A., s. 87(2)(e).
173. I.T.A., s. 87(1.1) (a), (b).
174. I.T.A., s. 87(1.4) (defining subsidiary wholly-owned corporation).
175. I.R.C. § 368(a)(2)(C), (D), (E).

Canadian merger provisions also allow for triangular amalgamations. If two or more taxable Canadian corporations merge to form an amalgamated corporation that immediately after the merger is controlled by a taxable Canadian corporation, the shares issued by the parent corporation are deemed to be issued by the new corporation.[176]

I.T.A. subsection 87(2) provides detailed rules for the rollover of particular types of property that may be acquired by the amalgamated corporation. For example, under I.T.A. paragraph 87(2)(e) if capital property is acquired by the amalgamated corporation by virtue of the amalgamation, the cost of that property to the amalgamated corporation is simply the adjusted cost base of that property to the predecessor corporation. There is also provision for a flow-through of the property and tax accounts to the new corporation. In addition, a number of special provisions affect the tax accounts of the predecessor corporations. For example, on the amalgamation of a parent company and one or more of its subsidiaries, I.T.A. subsection 87(2.11) deems the amalgamated corporation to be the same corporation as, and a continuation of, the parent corporation to permit a corporation formed through a vertical amalgamation, to apply its post-amalgamation losses[177] against the pre-amalgamation income of its predecessor parent corporation.[178]

For U.S. tax purposes, I.R.C. § 368(a)(1)(A) defines an A reorganization as a statutory[179] merger or consolidation. Typically effected under a state merger statute, the assets and liabilities of the target corporation are transferred to the acquiring corporation and the target corporation dissolves by operation of law. The shareholders of the target corporation receive stock or debt instruments of the acquiring corporation, cash or other

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176. I.T.A., s. 87(9).
177. I.T.A., s. 111.
178. Proposed amendments to I.T.A., s. 87 would equate the overall tax treatment of an amalgamated corporation more closely with the tax result on the winding-up of a subsidiary corporation into its parent. Specifically, the proposed provision would permit an increase in the cost of the shares of the amalgamating subsidiaries owned by the parent over the tax cost of the underlying assets. This increase will parallel the "bump" currently available on the winding-up of a wholly-owned subsidiary into its parent and incorporates the same conditions that apply on a winding-up. See Canadian Department of Finance, June 20, 1996, Notice of Ways and Means Motion. I.T.A., s. 87(2.11) was intended to put vertical amalgamations on the same footing as I.T.A., s. 88(1) wind-ups with the ability to carry back post merger losses to offset taxable income of the parent premerger. If a subsidiary has been wound up into its parent, any losses that occur after the wind-up can generally be carried back to reduce the taxable income of the parent for tax years that end before the wind-up. The reverse is not true. The losses of a wholly-owned subsidiary can not be applied to the taxable income of its parent for taxation years prior to the amalgamation. See Revenue Canada Technical Release No. 3, Jan. 30, 1995.
179. In order to qualify as an reorganization the transaction must be an merger or consolidation effected pursuant to local corporate law. Treas. Reg. § 1.368-2(b)(1) (1985).

property, or a combination of such consideration. A consolidation involves a similar transfer of assets and liabilities of two or more corporations to a newly created corporate entity and the shareholders of the transferor corporations become shareholders of the new corporation by operation of law. A great deal of overlap exists between the definition of an A reorganization, and the definition of a C reorganization,[180] a nondivisive D reorganization,[181] and an F reorganization.[182] Similarly, overlap exists between these types of reorganizations and I.R.C. § 351.[183] All of the foregoing transactions involve the acquisition of property for the stock of a corporation, and, if the specific requirements of each provision are met, tax-deferred treatment will result to the parties involved in the transaction.

Because an A reorganization is merely defined as "a statutory merger or consolidation,"[184] the doctrines of continuity of interest and business enterprise are very important considerations in characterizing a transaction[185] in order to preserve the Congressional intent for nonrecognition. The continuity of interest doctrine requires the shareholders of the target corporation[186] receive[187] sufficient proprietary interest in the acquiring corporation to justify treating the transaction as a tax-free reorganization rather than a taxable sale.[188] For advance ruling

180. In a C reorganization, the acquiring corporation acquires substantially all of the property of the target corporation solely for its voting stock or the voting stock of its parent. I.R.C. § 368(a)(1)(B). Within a reasonable time after the transfer, the target corporation must liquidate. I.R.C. § 368(a)(2)(G). A limited amount of boot may be received by the target corporation in the transaction. I.R.C. § 368(a)(2)(B).

181. See *supra* note 140 (describing a nondivisive D reorganization).

182. A F reorganization is the mere change in identity, form, and place of organization of one corporation. I.R.C. § 368(a)(1)(F).

183. See *supra* notes 98 to 120 and accompanying text (describing an I.R.C. § 351 transaction).

184. I.R.C. § 368(a)(1)(A).

185. Treas. Reg. § 1.368-1(b) (1980).

186. 187 See *Kass*, *supra* note 73; Treas. Reg. 1.368-1(e) (1998) (disregarding a disposition to an unrelated party by the target corporation prior to a potential reorganization); but see *J.E. Seagram*, *supra* note 74.

187. The step transaction doctrine has been applied to post-merger sales in determining whether the continuity of interest doctrine has been met. See *McDonald's*, *supra* note 67 (holding that a prearranged plan to sell the stock received rendered the entire transaction taxable); *Penrod* v. *C.I.R.*, 88 T.C. 1415 (1987) (holding that the step-transaction doctrine did not apply). Recently, the Treasury Department has issued final regulations allowing post-reorganization dispositions by shareholders of the target corporation to unrelated parties. Treas. Reg. § 1.368-1(e) (1998).

188. *LeTulle* v. *Scofield*, 308 U.S. 415 (1940) (holding that the transferor must receive stock in the acquiring corporation to retain a proprietary interest in the assets transferred). *Southwest*, *supra* note 73 (holding that the transferor must retain a substantial proprietary interest in the acquiring corporation and the retained interest represent a substantial part of the value of the property transferred).

purposes, the shareholders of the target corporation must receive stock in the acquiring corporation which is equal in value to at least 50% of the value of all formerly outstanding stock of the target. Sales, redemptions and other dispositions of stock occurring prior or subsequent to the exchange that are part of the plan of reorganization will be considered in determining whether the requirement of a 50% continuing interest is met.[189] The transaction must also satisfy the continuity of business enterprise doctrine. This means the acquiring corporation must either continue the target corporation's historic business or use a significant portion of the target corporation's historic business assets.[190]

If the transaction qualifies as an A reorganization, the shareholders of the target corporation, the target corporation and the acquiring corporation receive nonrecognition treatment. The target shareholders recognize gain only to the extent boot is received,[191] and the acquiring corporation does not recognize gain or loss on the exchange of its stock and securities.[192] Generally, the transferor corporation does not recognize gain or loss on an exchange of property solely for stock and securities of the acquiring corporation.[193] The transferor corporation can also receive boot without gain or loss recognition if the boot is distributed to the shareholders pursuant to the reorganization.[194] In addition, the distribution by the target corporation to its shareholders of stock and obligations of the target or the acquiring corporation does not trigger gain or loss. The distribution of other property, however, does result in gain recognition.[195] The target shareholders receive an exchange basis in the stock and securities received and a fair market value basis in any boot,[196] and the acquiring

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189. Rev. Proc. 77-37, 1977-2 C.B. 568, 569. Courts have found continuity of interest where shareholders of the acquired corporation received less than 50% in value of the acquired corporation's stock. See *John A. Nelson Co.* v. *Helvering*, 296 U.S. 374 (1935) (38% continuity sufficient).

190. Treas. Reg. § 1.368-1(d) (1986). See *supra* notes 78-79 and accompanying text (describing the continuity of business enterprise doctrine).

191. I.R.C. §§ 354, 356. If the principal amount of the securities received exceeds the principal amount of the securities surrendered, the fair market value of the excess is treated as boot. I.R.C. §§ 354(a)(2), 356(d). The term "security" includes the right to acquire stock in the issuing corporation which will be treated as having no principal amount. Prop. Reg. § 1.354-1(e); Prop. Reg. § 1.355-1(c).

192. I.R.C. § 1032(a).

193. I.R.C. § 361(a).

194. I.R.C. § 361(b). The assumption by the acquiring corporation of the liabilities of the target is not treated as boot. I.R.C. § 357(a).

195. I.R.C. § 361(c).

196. I.R.C. § 358.

corporation receives a transferred basis in the assets received.[197] The tax attributes of the target corporation are carried over to the acquiring corporation.[198]

In the United States, triangular mergers are also statutorily permitted. Generally, "triangular reorganizations" are acquisitive reorganizations in which the consideration for the stock or assets of the target corporation is the stock of the parent of the acquiring corporation. Triangular mergers are often used in order to isolate the liabilities of the target corporation from the assets of the parent corporation through the use of a subsidiary. The statute defines two types of triangular mergers. In addition to the specific statutory requirements, the transactions must otherwise qualify as valid A reorganizations. A forward triangular merger is an A reorganization in which the target corporation merges into the acquiring corporation and the former shareholders of the target corporation receive the stock of the parent of the acquiring corporation. The consideration cannot include the stock of the target corporation and substantially all of the assets of the target corporation must be transferred to the acquiring corporation.[199] A reverse triangular merger is an A reorganization in which a controlled subsidiary merges into the target corporation with the former shareholders of the target corporation receiving voting stock of the parent corporation and the parent corporation must acquire control of the target corporation in the transaction.[200]

5. *Recapitalization*

The readjustment of the financial structure of a single corporation is a tax-free transaction in both the U.S. and Canada provided the necessary statutory requirements are met. For Canadian tax purposes, a reorganization which involves the disposition of existing shares (old shares) in exchange for other shares (new shares) of the corporation may give rise to a capital

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197. I.R.C. § 362(b).

198. See I.R.C. § 381 (providing for carryover of various tax attributes, including loss carryovers). Complex rules limit the utilization of inherited losses and other items if the loss corporation undergoes a significant change of ownership. See I.R.C. §§ 382, 383 (detailing the limitations on a corporation's ability to use built-in losses and other preferences). See also I.R.C. § 384 (detailing the limitations on a corporation's ability to offset built-in gains).

199. I.R.C. § 362(a)(2)(D).

200. I.R.C. § 368(a)(2)(E). "Control" means ownership of at least 80% of the voting power of the voting stock and 80% of the total number of shares of all other classes of stock. I.R.C. § 368(c).

gain and may give rise to a deemed dividend.[201] I.T.A. sections 86 and 51 are provisions which will allow the taxpayer to defer the realization of the capital gain on the old shares exchanged for the new shares, or in the case of more flexible I.T.A. section 51, where the old shares or debt are exchanged for the new shares. Unlike the United States recapitalization provisions, the requirements of these sections are quite detailed and must be followed carefully in order to qualify for nonrecognition.

a. *Canada*

i. *I.T.A. Section 86*

I.T.A. section 86[202] is often used in an exchange of one class of shares for another class of shares for any number of commercial reasons. Provided the old shares are capital property of the taxpayer, on the disposition of the old shares for the new shares, any increase in value of the old shares is not taxed to the shareholder provided that: (1) all of the shares of that particular class owned by the taxpayer are exchanged; (2) the taxpayer receives consideration that includes shares of the same corporation; and (3) the transaction occurs in the course of a reorganization of capital of the corporation. If these requirements are met, I.T.A. section 86 applies automatically, provided I.T.A. section 85 does not apply to the transaction.[203] No gain is recognized by the shareholder unless the shareholder also receives boot in excess of the cost basis of the old shares.[204] It is not necessary that the corporation undergoing the

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201. If a deemed dividend is to be avoided, it is important to ensure that the PUC of the new shares issued on the reorganization equals the PUC of the old shares exchanged minus the fair market value of any nonshare consideration received on the exchange. In short, if the corporation's PUC is increased as a result of the reorganization or it is not decreased to reflect the value of any nonshare consideration received by the shareholder, I.T.A., s. 84(1) will apply to deem a dividend. A deemed dividend will also occur as a result of the operation of subsection 84(3) if the nonshare consideration received exceeds the PUC of the old shares.

202. For example, preference shares issued to investors with special dividend rights may be exchanged for common shares with windingup rights if dividends cannot be paid. Another common use of I.T.A., s. 86 is to freeze the taxpayer's interest in an operating company for estate planning purposes. In that case, the taxpayer may exchange common shares for preferred shares which do not participate in the future growth of the corporation. See also D. Ewens, "Reorganizations of Capital: Section 86" (1995) Can. Tax J. 783.

203. I.T.A., ss. 84(9), 86(3).

204. The results of the share exchange are as follows:

1. The cost of the boot received is its fair market value (I.T.A., s. 86(1)(a));
2. The adjusted cost base (ACB) of the new shares to the taxpayer is the ACB of the old shares minus the value of any boot (I.T.A. s. 86(1)(b)); and
3. The proceeds of disposition of the old shares is the ACB of the new shares plus the value of the boot received (I.T.A., s. 86(1)(c)).

reorganization be a resident of Canada or incorporated in Canada to obtain this rollover treatment. It is also unnecessary that the shareholder be a resident of Canada.

In an I.T.A. section 86 reorganization the indirect gift tax rules must also be considered. I.T.A. subsection 86(2) will operate to deny a tax-deferred rollover to a shareholder if, immediately after the reorganization, the total fair market value of the consideration received is less than the fair market value of the old shares immediately before the reorganization, and it is reasonable to regard any portion of the difference as a benefit that the shareholder desired to confer on a related person. Where the gift rule applies the result will be an immediate capital gain or a decrease in the cost basis of the newly issued shares.[205]

ii. *I.T.A. Section 51*

I.T.A. section 51[206] is another method of reorganizing the capital structure of a corporation, and applies to a transaction where I.T.A. subsection 85(1) and I.T.A. section 86 have no application.[207] The section allows the taxpayer to convert debt into shares or shares into shares of a different class, provided that the taxpayer receives no consideration other than the new shares on the exchange. I.T.A. section 51 has the advantage of permitting a taxpayer in a recapitalization to exchange only part, rather than all, of the taxpayer's shares. By virtue of I.T.A. paragraph 51(1)(a), the conversion will be deemed not a disposition of property. Under I.T.A. paragraph 51(1)(d), the cost basis of the new shares is the cost basis of the old shares or debt.

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205. The gift rule operates as follows: If the fair market value of the old shares before the exchange is greater than the cost of any boot received plus the value of the new shares received, and it is reasonable to regard any portion of this excess as a benefit the taxpayer desired to have conferred on a related person, I.T.A., s. 86(2) applies. If I.T.A., s. 86(2) applies, I.T.A., s. 86(1) does not. Instead, the results are as follows:

1. The proceeds of disposition of the old shares are deemed to equal the lesser of: the value of the old shares, or the cost of the boot received plus the amount of the benefit;
2. The capital loss on the disposition of the old shares is deemed to be $0; and
3. The cost of the new shares is deemed to be equal to the ACB minus the cost of boot plus the amount of the benefit.

206. See D. Ewens, "Convertible Property: Section 51-Part 1" (1994) 42 Can. Tax J. 1413; "Part 2" (1995) Can. Tax J. 42 1660; see also *Interpretation Bulletin* IT-115R2, "Fractional Interest in Shares," February 20, 1995.

207. I.T.A., s. 51(4) and *supra* note 97.

The gift rule in I.T.A. subsection 51(2) is similar to that in both I.T.A. subsection 86(2) and I.T.A. paragraph 85(1)(e.2) and imposes adverse tax consequences when the fair market value of the old shares or debt exchanged is greater than the fair market value of the new shares issued and it is reasonable to assume that the taxpayer has conferred a benefit on a related person. Again, since no new assets are being acquired by the corporation, if the paid-up capital of the new shares exceeds that of the old shares deemed dividends will arise.[208] This result is avoided by the operation of subsection 51(3) which reduces the paid-up capital of the new shares to that of the old shares for tax purposes.

b. *United States*

A recapitalization has been defined by the United States Supreme Court as a "reshuffling of a capital structure within the framework of an existing corporation."[209] It is a form of reorganization commonly called an E reorganization.[210] Although the continuity of interest[211] and the continuity of business enterprise doctrines[212] are not relevant, as only a single corporation is involved, for United States tax purposes, a recapitalization must serve a corporate business purpose[213] in order to qualify for nonrecognition.[214] There are four categories of recapitalizations depending on the type of consideration exchanged.[215]

i. *Exchanges of Stock for New Stock*

An exchange of stock-for-stock qualifies as an E reorganization.[216] In an equity-for-equity exchange, the distributing corporations is entitled to

208. I.T.A., s. 84(1).
209. *Helvering* v. *Southwest Consolidated Corp.*, 315 U.S. 194 (1942), reh'g denied 316 U.S. 710 (1942).
210. See Treas. Reg. § 1.368-2(e) (1985) (discussing a recapitalization as a reorganization).
211. See *supra* notes 185-189 and accompanying text (describing the continuity of interest doctrine).
212. See *supra* notes 78-79 and accompanying text (describing the continuity of business enterprise doctrine).
213. See *supra* note 69 and accompanying text (describing the business purpose doctrine).
214. Rev. Proc. 81-60, 1981-2 C.B. 680 (guidelines and information included in ruling requests); Rev. Rul. 82-34, 1982-1 C.B. 59 (no business-continuity requirement).
215. These exchanges may give rise to original issue discount treatment, requiring the determination of the applicability of Internal Revenue Code §§ 1272-75. See I.R.C. §§ 163(e), 1272-75 (providing the original issue discount rules).
216. An exchange of common stock-for-common stock or preferred stock-for-preferred stock in the same corporation also receives tax-free treatment under I.R.C. § 1036 even if directly between two shareholders. I.R.C. § 1036(a).

nonrecognition on the issuance of stock to the shareholders[217] and the shareholders of the corporation will not recognize gain on the exchange of stock unless boot is also received.[218] The shareholder's basis in the stock received is the same as the basis of the stock exchanged.[219] A recapitalization may constitute a deemed taxable stock dividend if the reorganization is pursuant to a plan to periodically increase a shareholder's proportionate interest in the assets or earnings of the corporation.[220] Additionally, if a corporation distributes preferred stock for its outstanding common stock, the new stock may be characterized as Section 306 stock.[221] Generally, a subsequent disposition or redemption of Section 306 stock will generate dividend income.[222]

ii. *Exchanges of Stock for New Bonds*

An exchange of stock for bonds or other securities raises a potential for tax abuse. The United States Supreme Court has held that the pro rata exchange of common stock for common stock and bonds payable on demand constituted a distribution of a dividend.[223] Even if the exchange is characterized as an E reorganization, if the principal amount of the securities received exceeds the principal amount of the securities surrendered or if securities were received and none were surrendered, the value of the excess will constitute boot.[224]

iii. *Exchanges of Bonds for New Stock*

If a corporation discharges outstanding bonds with stock, the bondholder will recognize gain only to the extent stock received is attributable to accrued interest on the bonds.[225] Generally, the corporation will not recognized gain or loss on the distribution of the stock.[226] However, if the

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217. I.R.C. § 1032(a).
218. I.R.C. §§ 354(a), 356.
219. I.R.C. § 358.
220. I.R.C. § 305(c); See Treas. Reg. § 1.305-7(c) (1995) (explaining that certain transactions will be deemed distributions of stock, taxable to the shareholder).
221. I.R.C. § 306(c)(1)(B).
222. I.R.C. § 306(a).
223. *Bazley* v. *C.I.R.*, 331 U.S. 737 (1947); See Treas. Reg. § 1.301-1(*l*) (explaining the tax consequences of transactions deemed to be dividends).
224. I.R.C. §§ 354(a), 336(d).The shareholder will receive an exchange basis increased by gain recognized and decreased by boot received. The boot will receive a fair market value basis. I.R.C. § 358(a).
225. I.R.C. § 354(a)(1), (2)(B).
226. I.R.C. § 1032(a).

value of the stock is less than the principal amount of the indebtedness, the corporation may experience cancellation of indebtedness income.[227] An insolvent or bankrupt corporation may exclude any discharge of indebtedness income by reducing certain favourable tax attributes.[228]

iv. *Exchanges of Bonds for New Bonds*

Generally, the bondholder in a bond-for-bond exchange will not recognize gain or loss unless the bonds received are attributable to accrued interest,[229] the principal amount of the bonds received exceeds the principal amount of the bonds surrendered, or bonds are received and none are surrendered.[230] In addition, the original issue discount rules may apply resulting in cancellation of indebtedness income[231] to the corporation and any debt modification may be treated as a realization event.[232]

6. *Corporate Dissolutions*

Absent an applicable nonrecognition provision, the dissolution of a corporation results in recognition of gain or loss at the shareholder and corporate levels in both the United States and Canada. The transaction is treated as an exchange of the corporation's assets for the shareholder's stock. Comparing the corporate tax systems of the two countries, it is important to note that in Canada corporate distributions in the form of dividends may, in many cases, be preferable to capital gains to the extent that the shareholder can fully benefit from Canada's integrated corporate tax system. In the United States, unless the shareholder is a corporate shareholder, capital gains treatment is generally preferred over dividend treatment.[233]

a. *Canada*

Assets distributed by a Canadian corporation to its shareholders on a winding-up are deemed to have been disposed of by the corporation at fair

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227. I.R.C. § 108(e)(8).
228. I.R.C. § 108(a), (b).
229. I.R.C. § 354(a)(2)(B).
230. I.R.C. § 354(a)(2)(A).
231. I.R.C. § 108(e)(10).
232. See *Cottage Sav. Ass'n* v. *C.I.R.*, 111 S. Ct. 1503 (1991) (swap of economically equivalent mortgage pools created deductible losses); see generally I.R.C. § 1001; Prop. Treas. Reg. § 1.1001-3 (1992).
233. Inter-corporate dividends are allowed the dividend-received deduction. I.R.C. § 243. Furthermore, corporate taxpayers do not receive a preference for net capital gains. I.R.C. §§ 11, 1201(a).

market value.[234] The shareholders are entitled to receive in cash or property an amount equal to the PUC without incurring deemed dividend treatment.[235] However, if a shareholder receives cash or property in excess of the PUC of their shares, the excess will be treated as a deemed dividend.[236] In addition the taxpayer will be deemed to have disposed of the shares. Proceeds of disposition, however, are reduced by the amount of any deemed dividend received in the transaction. The result, where the PUC and cost basis of the share are the same, is that no capital gain or loss will be realized on the winding-up.[237]

i. *I.T.A. Subsection 88(1): Winding-Up of a Subsidiary Corporation*

I.T.A. subsection 88(1)[238] provides that a taxable Canadian corporation[239] which is at least 90% owned by another taxable Canadian corporation can be wound up into its parent on a tax-deferred basis. Immediately before winding-up, the parent corporation must own not less than 90% of the shares of each class of shares of the subsidiary corporation and the remaining shares must have been owned by shareholders with whom the parent corporation was dealing at arm's length.[240] Generally, the assets and liabilities of a subsidiary are rolled over into its parent without triggering immediate gain or loss recognition. If the requirements of I.T.A. subsection 88(1) are met, the rollover is not elective, but mandatory. In the case of nondepreciable capital property, the proceeds of disposition to the subsidiary corporation on the distribution of its property to the parent corporation are deemed to be the cost amount of the property.[241]

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234. I.T.A., ss. 69(5), 88(2). Generally, full loss recognition is allowed. I.T.A., s. 69(5)(a)(ii). Although no rollover is available on a winding-up other than when a subsidiary is wound up into its parent, I.T.A., s. 88(2) does provide some tax relief in the form of special rules to facilitate the distribution of the capital dividend account and the pre-1972 capital surplus on hand. See *infra* notes 254-256 (defining and discussing pre-1972 capital surplus on hand (CSOH)).

235. I.T.A., ss. 84(2), 89(1).

236. I.T.A., s. 84(2).

237. An exception to this general rule may occur if the winding-up includes pre-1972 CSOH as defined in I.T.A., s. 88(2). This provision will be of relevance in the case of corporations incorporated prior to 1992.

238. See S. Roberts & M. Briggs, "Winding-Up: Part 1" (1996) 44 Can. Tax J. 533; "Part 2" (1996) 44 Can. Tax J. 943.

239. I.T.A., s. 89(1).

240. Related persons are deemed not to deal with each other at arm's length. I.T.A., s. 251.

241. I.T.A., s. 88(1)(a)(iii); I.T.A., s. 248(1) (defining "cost amount"). The proceeds of disposition to the subsidiary in the case of Canadian resource property is deemed to be nil. See I.T.A., s. 88(1)(a)(i).

The cost amount of depreciable property is the undepreciated capital cost. The accounts receivable of the subsidiary are transferred to the parent corporation at face amount.[242] The subsidiary's inventory is deemed to be distributed to its parent corporation at the lower of its cost and fair market value.[243] Generally, the parent corporation is deemed to acquire the assets of the subsidiary at a cost basis equal to the deemed proceeds on disposition by the subsidiary corporation.[244] The parent corporation thus steps into the shoes of the subsidiary corporation by taking over the assets at their tax values.

Although the parent corporation cannot recognize loss on the winding-up, it will recognize capital gain. The parent corporation is deemed to have disposed of the shares in the subsidiary for proceeds equal to the greater of the PUC of the shares or the tax value of the subsidiary's net assets after deducting liabilities, whichever is less, or the cost basis of the shares immediately before the winding-up.[245] If a loss occurs, the parent corporation is permitted to increase the cost of capital properties acquired on the winding-up that were previously owned by the subsidiary.[246] This is referred to as the I.T.A. section 88 "bump." The increase is limited to the amount by which the cost basis of the parent's previous shares in the subsidiary exceeds the total cost amount of the properties which were acquired from the subsidiary on winding-up. The bump for each capital property is also limited to the amount by which the fair market value of the capital property at the time the parent last acquired control of the subsidiary exceeds the cost amount to the subsidiary of the capital property. Depreciable capital property and other ineligible property do not qualify for the bump. The rollover is not available with respect to assets transferred to minority shareholders which are deemed to have been sold at fair market value. Thus, gain and loss will be recognized at both the subsidiary and shareholder levels.[247]

While offering nonrecognition on a winding-up, I.T.A. subsection 88(1) has a number of obvious limitations. First, the rollover provisions do not apply if the parent company owns less than 90% of the shares of the capital stock of the subsidiary. Second, both the parent and subsidiary corporations must be taxable Canadian corporations.[248] Finally, there is

242. I.T.A., s. 88(1)(e.2).
243. I.T.A., s. 88(1)(a).
244. I.T.A., s. 88(1)(c).
245. I.T.A., s. 88(1)(b).
246. I.T.A., s. 88(1)(d).
247. I.T.A., s. 69(5)(a). See also I.T.A., s. 88(2)(b).
248. I.T.A., s. 89(1).

no rollover in the case of the winding-up of a corporation whose shares are owned by individuals and the corporate assets are distributed to those individual shareholders. In such event there is a deemed disposition of the corporate assets distributed at the fair market value.[249] In addition, the individual shareholders will be deemed to have disposed of their shares. The corporate winding-up will thus be a taxable event both to the corporation and to its shareholders and result in the realization of any accrued gain or loss to the corporation on the property distributed, and in deemed dividends and a capital gain or loss to the individual shareholders.

ii. *Subsection 88(2): Winding-Up of Canadian Corporations*

I.T.A. subsection 88(2) may apply to the winding-up[250] of a corporation where the shareholders are individuals or where the requirements of I.T.A. subsection 88(1) have not been met.[251] Corporate assets which are distributed by the corporation to its shareholders on the winding-up are deemed to have been disposed of at their fair market value by the corporation.[252] Capital gains, recapture of capital cost allowance, or income in the case of inventory may be realized. If a capital loss is generated it is deductible.[253] The shareholders' cost basis of any property received is its fair market value. The shareholders are entitled to receive in cash or property an amount equal to the paid-up capital of the shares without incurring a deemed dividend, but may incur a capital gain if the adjusted cost base of the shares is less. However, if they receive cash or property in excess of the paid-up capital of their shares, a deemed dividend will arise under I.T.A. subsection 84(2).

249. I.T.A., s. 69(5).

250. I.T.A., ss. 69(5), 84(2); see *Interpretation Bulletin* IT 149R4, "Winding-up Dividend," June 28, 1991 (providing detailed analysis of dividends received in a winding-up).

251. Revenue Canada has indicated that the phrase "on the winding-up," for purposes of I.T.A., s. 88(2), means the period during which the winding-up takes place; that is, the period that begins on the implementation of the winding-up procedure and ends on the actual dissolution of the corporation. *Interpretation Bulletin* IT-126R2, "Meaning of Winding-Up," March 20, 1995, at para. 7. Revenue Canada has further indicated that, for purposes of I.T.A., ss. 88(2) and 84(2), the corporation is considered to have been wound up if it has followed the appropriate winding-up and dissolution procedures, or has been otherwise dissolved under the provisions of its incorporating statute. *Ibid.* at para. 3. Both federal and provincial corporate statutes require that the debts and obligations of the corporations must be paid, or creditor assent obtained, and that the corporation have distributed all assets before a dissolution will be authorized. *Ibid.* at para. 4

252. I.T.A., s. 69(5); *Interpretation Bulletin* IT-488R2, "Winding-up of 90%-Owned Taxable Canadian Corporations," June 24, 1994.

253. I.T.A., s. 40(2)(e) does not apply to deny the loss by virtue of I.T.A., s. 69(5)(a)(ii). Also, I.T.A., ss. 85(4) and (5.1) do not apply on a winding-up to prevent the immediate realization of a capital or terminal loss on the transfer of property to a controlled corporation.

Although no rollover is available on a winding-up, I.T.A. subsection 88(2) does provide some tax relief in the form of special rules to facilitate the distribution of the capital dividend account (CDA) and the pre-1972 capital surplus on hand (CSOH) where the statutory requirements are met.[254] For the purposes of computing the CDA and pre-1972 CSOH account, I.T.A. paragraph 88(2)(a) includes any unrealized capital gains in existence before the final distribution in the computation of the CDA and pre1972 CSOH accounts. [255] Each shareholder is deemed to have received a separate dividend from the CDA or pre-72 CSOH accounts or a taxable dividend in proportion to the number of shares held. If a shareholder is a nonresident, withholding tax may be payable.[256] Treaty relief should be available with respect to these dividends. If the shares are taxable Canadian property the nonresident will also be required to comply with the provisions of I.T.A. section 116. That provision requires that the nonresident shareholder provide information respecting the transaction to the Minister of Finance and pay tax equal to 33 1/3% of the estimated taxable capital gain or provide security for the tax.

b. *United States*

In the United States, a distribution in "complete liquidation" is defined as one of a series of distributions pursuant to a plan in redemption of all of the stock of the corporation.[257] The state of liquidation exists when the

254. Pre-1972 CSOH is defined and computed in I.T.A., ss. 88(2.1) and 88(2.2) Pre-1972 CSOH is the total of a corporation's 1971 capital surplus computed under specific rules, plus the portion of the capital gains realized on the disposition of capital property owned on December 31, 1971, attributable to the period before this date, minus capital losses incurred on property owned on December 31, 1971, attributable to the period before this date.

255. This is accomplished by deeming the taxation year of the corporation to have ended before the final distribution of corporate property. Also, each property distributed on the final distribution is deemed to have been disposed of at its fair market value immediately before the end of the taxation year that was deemed to have ended before the final distribution. As a result, the deemed dividends received on a winding-up will include both CDA and pre-1972 CSOH amounts. The requirement that the I.T.A., s. 84(2) deemed dividend provision include the CDA and pre-1972 CSOH accounts is set out in I.T.A., s. 88(2)(b). If the I.T.A., s. 83(2) election is made, a separate dividend from the CDA in an amount not exceeding the CDA is considered to have been paid. If the deemed winding-up dividend under I.T.A., s. 84(2) exceeds the separate CDA dividend, an amount from pre-1972 CSOH is deemed not to be a dividend, and any excess over the CDA dividend and pre-1972 CSOH deduction is a taxable dividend.

256. For the purposes of the Canadian nonresident withholding tax, only the portion of the winding-up dividend paid to a nonresident shareholder, paid out of pre-1972 CSOH (or certain capital gains dividends) will not be subject to withholding tax. The balance of the dividend paid to nonresident shareholders, including amounts elected to be paid as a capital dividend, will be subject to Canadian nonresident withholding tax.

257. I.R.C. § 346(a).

corporation ceases to be a going concern and its actions are merely for the purpose of winding up its affairs, paying its debts, and distributing remaining assets to its shareholders.[258] The treatment of a partial liquidation is determined under the redemption provisions. Generally, if the distribution results in a reduction of the size of the business at the corporate level, noncorporate shareholders receive exchange treatment. Corporate shareholders and distributions to shareholders which do not represent a corporate contraction receive dividend treatment.[259]

Prior to the repeal of the General Utilities Doctrine,[260] no gain or loss was recognized to the distributing corporation on distributions of property in complete liquidation or on the sale of assets if the complete liquidation took place within the year.[261] Since the Tax Reform Act of 1986, the distributing corporation is taxed fully on any liquidating distributions. The liquidating corporation is treated as if it sold its assets to the shareholders at fair market value.[262] However, the provision contains complex rules limiting the ability of a liquidating corporation to recognize losses on the non-pro rata distribution of certain loss assets to related parties and the distribution or sale of certain recently acquired assets with built-in losses.[263] The shareholders of the distributing corporation are considered to have exchanged their stock for an amount equal to the fair market value of the property received from the corporation.[264] The shareholders take a fair market basis in the property received.[265]

Both Canada and the United States provide exceptions to recognition upon the liquidation of a subsidiary corporation by a parent corporation. In the United States, if the requirements of I.R.C. § 332(b) are met, the distribution of property by a subsidiary to a parent in complete liquidation constitutes a nonrecognition event for the parent[266] and the subsidiary.[267] In order to qualify for nonrecognition, I.R.C. § 332(b) requires that the parent corporation own a specific amount of the subsidiary stock and that

258. Treas. Reg. § 1.332-2(c). Legal dissolution of the corporation is not required nor will the transaction be disqualified if a nominal amount of assets is retained to preserve the corporation's legal existence. *Ibid.*
259. I.R.C. § 302(b)(4), (e).
260. See *supra* note 123 (discussing the General Utilities Doctrine).
261. I.R.C. §§ 336 (amended), 337 (repealed).
262. I.R.C. § 336.
263. I.R.C. § 336(d).
264. I.R.C. §§ 331, 1001. The shareholder to whom property is distributed in a complete liquidation takes the property with a basis equal to its fair market value. See I.R.C. § 334(a).
265. I.R.C. § 334(a).
266. I.R.C. § 332.
267. I.R.C. § 337.

the liquidating distributions occur within a specified time period. The first requirement is met if the parent corporation owns stock that possesses at least 80% of the total voting power of the outstanding stock of the subsidiary corporation and has a value equal to at least 80% of the stock of the subsidiary corporation without regard to certain nonvoting stock that is limited and preferred as to dividends.[268] The 80% stock-ownership test must be met on the date of adoption of the plan of liquidation and must continue until the final liquidating distribution.[269] I.R.C. § 332(b) also requires that the liquidating distributions be completed within a single taxable year, or within a 3-year period stated in the plan of liquidation beginning at the close of the taxable year in which the first distribution occurs.[270]

If the requirements of I.R.C. § 332(b) are satisfied, the parent corporation recognizes no gain or loss on receipt of property distributed in complete liquidation of the subsidiary corporation.[271] The property distributed to the parent corporation has a transferred basis to the parent equal to the subsidiary's basis.[272] In the case of property distributed to a shareholder other than the parent corporation, the minority shareholder receives taxable exchange treatment and a fair market value basis in the assets received on the liquidation.[273] In a liquidation of a subsidiary to which I.R.C. § 332 applies, the subsidiary corporation recognizes no gain or loss on distributions to the parent corporation.[274] As to distributions to minority shareholders, the subsidiary corporation will recognize gain on the distribution of appreciated assets but generally no loss will be recognized.[275] The tax attributes of the liquidated subsidiary will generally carry over to the parent corporation.[276]

For decades the courts and the legislature struggled with the proper treatment of a stock purchase followed by the liquidation of the subsidiary corporation. Should the separate steps be respected for tax purposes, or should the step-transaction doctrine[277] apply, collapsing the steps into an

268. I.R.C. §§ 332(b)(1), 1504(a)(2). If the purchase constitutes a qualified stock purchase, the purchasing corporation may make an I.R.C. § 338 election. Without liquidating, the subsidiary is treated as a new corporation having sold and repurchased all of its assets at fair market value. *Ibid.*

269. I.R.C. § 332(b)(1).

270. I.R.C. § 332(b)(2), (3).

271. I.R.C. § 332(a).

272. I.R.C. § 334(b).

273. I.R.C. §§ 331, 334(a).

274. I.R.C. § 337(a).

275. I.R.C. § 336.

276. I.R.C. § 381.

277. See *supra* note 68 and accompanying text (describing the step-transaction doctrine).

asset purchase by the parent corporation? The issue usually was the depreciable basis[278] of the assets of the subsidiary corporation received by the parent corporation in the liquidation. If the two steps are respected, the parent corporation would receive the subsidiary's transferred basis in the assets distributed.[279] If the steps were collapsed, the transaction would be treated as an asset acquisition and the parent corporation would receive a basis in the assets equal to the cost of the target corporation stock.[280] In an attempt to resolve this controversy, in 1954 Congress enacted former I.R.C. § 334(b)(2) which treated a parent corporation's purchase and liquidation of a subsidiary corporation as a purchase of the subsidiary's assets resulting in a new cost basis for the assets equal to the amount paid for the stock of the subsidiary corporation. This provision required the parent corporation to purchase at least 80% control of the target corporation within a twelve-month period and the liquidation of the target corporation under I.R.C. § 332 within a two-year period after control was acquired.[281] Former I.R.C. § 334(b)(2) was replaced in 1982 by I.R.C. § 338 which is now the exclusive method of obtaining a cost basis in the assets of the subsidiary corporation.[282]

I.R.C. § 338 is an elective provision. If the election is made by the purchasing corporation, generally, the target corporation is treated as having sold all its assets at fair market value and is then treated as a "new" corporation that repurchased all of its assets.[283] The result to the new corporation is a clean tax history without the necessity of liquidating[284] and a basis in its assets roughly equal to the cost of the target corporation's stock.[285] In order to qualify for the election, the purchasing corporation must purchase stock possessing at least 80% of the total voting power and at least 80% of the total value of the target corporation's stock within a twelve-month period.[286] Unfortunately, after the repeal of the General

278. I.R.C. § 167(b).

279. I.R.C. § 334(b).

280. *Kimbell-Diamond Milling Co.* v. *C.I.R.*, 14 T.C. 74, aff'd *per curiam*, 187 F.2d 718 (5th Cir. 1951), cert. denied 342 U.S. 827 (1951) [hereinafter *Kimbell-Diamond*] (applying the single-transaction doctrine if the intent of the purchasing corporation was to acquire the assets of the target corporation).

281. I.R.C. § 334(b)(2) (repealed 1982) (treating a parent corporation's purchase and liquidation of a subsidiary as a purchase of the subsidiary's assets provided that the corporation has met certain requirements).

282. See *Kimbell-Diamond*, *supra* note 280.

283. I.R.C. § 338(a).

284. *Ibid.*

285. I.R.C. § 338(b).

286. I.R.C. § 338(d)(3), (h)(1).

Utilities Doctrine, this hypothetical sale of the target corporation's assets will constitute a taxable disposition[287] and, therefore, the I.R.C. § 338 has become a less desirable alternative.

Conclusion

Legal practice in the NAFTA market requires practitioners to become more involved in planning and advising around the tax consequences of transactions concerning U.S. corporations. It is thus becoming more important for Canadian counsel to have a basic understanding of U.S. corporate tax provisions. Fortunately, this task is not as daunting as it might appear at first blush. There are a considerable number of parallels between the U.S. and Canadian tax systems. This is not surprising. It is an old Canadian adage that when the U.S. coughs, Canada gets the flu. The obvious parallels between the two tax systems are often not coincidental. For better or for worse, many Canadian tax provisions are just a reflection of U.S. tax law. Nevertheless, it is the fundamental differences in the tax systems which lay the traps for the unwary.

287. I.R.C. § 1001.