The Capital Gains Exemption and the Pursuit of Purity

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Abstract

This paper examines the thorny issues related to keeping a corporation "pure" so that its shares will be qualified small business corporation shares that entitle their owner to claim the $750,000 capital gains exemption in respect of any gain realized on a disposition of the shares. The paper begins with a brief outline of the asset tests in the definition of qualified small business corporation share; it discusses the difficulties associated with meeting those tests; and it concludes with a description of some of the methods that can be used to maintain purity.

INTRODUCTION

Perhaps no tax incentive excites the interest of an owner of a small- or medium-sized business more than the $750,000 capital gains exemption. Yet no area is more fraught with potential tricks and traps for the unwary. The exemption is hedged about by more poorly-communicated exceptions and conditions than a politician's campaign promises.[1]

One of the most common problems associated with the exemption is how to meet the asset tests that are a condition precedent to claiming the exemption. The shares of a corporation will qualify for the exemption—they will be "qualified small business corporation shares" or "QSBCSs" for the purposes of the *Income Tax Act*[2]—only if the corporation meets certain rather stringent tests that relate to the assets of the corporation. This paper attempts to address the nature of these tests and outline methods for ensuring that a corporation does not fall afoul of them on an on-going basis and in the context of a purchase of the corporation's shares.

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[1] Indeed, whether an entrepreneur can obtain the benefit of the exemption seems to many of them arbitrary. It is no wonder, then, that the Technical Committee on Business Taxation Report (1998) (the "Mintz Committee") recommended replacing the exemption with enhanced RRSP contribution room and intergenerational rollovers.

[2] R.S.C. 1985, c. 1 (5th Supp.) as amended (the "Act"). All statutory references are to the Act unless otherwise noted.

THE ASSET TESTS

It is sometimes said that the Act contains three tests that a share of a corporation must meet before it will qualify as a QSBCS: the shares must meet the "24-month ownership" test, the 50% asset test and the 90% asset test. This paper does not address the ownership test. We can begin, then, with the so-called 50% asset test.

The 50% Test

The Act provides that a share will qualify as a QSBCS only if it was a share that

> (*c*) throughout that part of the 24 months immediately preceding the determination time while it was owned by the individual or a person or partnership related to the individual, was a share of the capital stock of a Canadian-controlled private corporation more than 50% of the fair market value of the assets of which was attributable to
>
> > (i) assets used principally in an active business carried on primarily in Canada by the corporation or by a corporation related to it,
> >
> > (ii) shares of the capital stock or indebtedness of one or more other corporations that were connected (within the meaning of subsection 186(4) on the assumption that each of the other corporations was a "payer corporation" within the meaning of that subsection) with the corporation where
> >
> > > (A) throughout that part of the 24 months immediately preceding the determination time that ends at the time the corporation acquired such a share or indebtedness, the share or indebtedness was not owned by anyone other than the corporation, a person or partnership related to the corporation or a person or partnership related to such a person or partnership, and
> > >
> > > (B) throughout that part of the 24 months immediately preceding the determination time while such a share or indebtedness was owned by the corporation, a person or partnership related to the corporation or a person or partnership related to such a person or partnership, it was a share or indebtedness of a Canadian-controlled private corporation more than 50% of the fair market value of the assets of which was attributable to assets described in subparagraph (iii), or

(iii) assets described in either of subparagraph (i) or (ii)[3]

Tax professionals, as a form of shorthand, will sometimes say that the 50% test must be met for the 24-month period preceding a sale, but in fact the test need only be met "throughout" that period while the share "was owned by the individual or a person or partnership related to the individual". If the individual owns a share for only six months, and no related person held the share before that time, then, assuming the 50% test is otherwise met, the test will be met even though the individual held the share for only six months.[4] On the other hand, if Mr. X owns all of the shares of Opco for 24 months but Opco has carried on an active business for only the last 22 months of that period, Mr. X's shares will not qualify as QSBCSs.[5]

Note that the 50% test must be met *throughout* the holding period. In theory, if an owner of an operating corporation ("Opco") makes the mistake of parking, say, $50,000 of cash in it for one day and that $50,000 results in Opco failing to meet the 50% asset test for that one day, then the 24-month clock must start again. That is, the individual will not be able to sell Opco's shares and claim the exemption until 24 months have passed from the date the $50,000 was removed from Opco.

A QSBCS must also be a share in the capital of a Canadian-controlled private corporation (a "CCPC"). The latter definition has its own set of difficulties, but a corporation incorporated in Ontario that is wholly-owned by "Mom and Pop" will generally have little difficulty meeting this definition provided Mom and Pop are both residents of Canada for the purposes of the Act.

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[3] Paragraph (c) of the definition of QSBCS in subsection 110.6(1).

[4] Whether the individual can meet the so-called 24-month *holding period* test is another question. The test states that, throughout the 24 months immediately preceding the time of the sale of a share, the share must have been held only by its owner and persons related to the owner. This does not mean that the person and related persons must hold the share for 24 months. A sole proprietor can incorporate her business shortly before a sale, sell shares of the corporation and claim the exemption. Ordinarily, shares issued from treasury are deemed to have been held by an unrelated person. In general, an individual who subscribes for shares from treasury for cash must hold those shares for 24 months before they will qualify for the exemption. The sole proprietor, however, can transfer her business assets to a corporation for shares in the capital of the corporation, and those shares will *not* be deemed to have been held by an unrelated person (see subparagraph 110.6(14)(f)).

[5] CRA technical interpretation 9928575 dated December 10, 1999.

For an Opco share to qualify as a QSBCS, more than 50% of the fair market value of its assets must be attributable to "assets used principally in an active business carried on primarily in Canada by the corporation or by a corporation related to it". This short (by the standards of the Act) sentence contains a number of elements that we need to unpack to make sense of them.

50% of the fair market value of the assets

50% of the fair market value of the assets refers to 50% of the *gross* fair market value of the assets of Opco. Opco's liabilities are ignored for the purposes of the asset tests, which explains why "parking" funds in a corporation can be so problematic. The entrepreneur who decides to deposit $50,000 in Opco's bank account for a day has advanced funds to Opco, and so it likely that the net value of the assets of the corporation is unaffected (the $50,000 addition to cash is offset by the entrepreneur's shareholder loan balance). For the purposes of the 50% test, however, one ignores the loan and takes into account only the cash, which can result in Opco failing to meet the asset test.[6]

To determine whether the asset test is met, one must begin by determining the fair market value of each of Opco's assets. This is often done by reviewing the balance sheet of the corporation and using the net book value of an asset as a proxy for its fair market value. Of course an asset's net book value and its fair market value are often very different. The net book value and fair market value of real estate are an obvious example. The difference between book value and fair market value must be explained carefully to the client and, if necessary, an appraiser or business valuator must be engaged to determine the true fair market value of Opco's assets.

One must also take into account assets that do not appear on the corporation's balance sheet. Goodwill is a typical example. If the gross value of the assets of Opco

[6] For a real world example of this problem, see CRA technical interpretation 2003-0030045 dated October 10, 2003 (response to question 7 at the APFF 2003 Conference). The purchaser of shares agreed to advance funds to the target company one day before the closing of the sale of the shares to allow the target to repay shareholder loans. The CRA stated that, if the advances from the purchaser caused the company to fall offside the 50% test on that day, then the shares of the company would not be QSBCSs on the closing date.

exceeds the value of the assets that appear on its balance sheet, then it is likely that the difference is attributable to goodwill, and that goodwill must be taken into account in applying the test. Again, the services of a business valuator will likely be necessary to determine this figure.

'Used'

An asset will help Opco to meet the 50% test only if it "used principally" in an active business. What does it mean to "use" an asset in a business? The CRA, in this and other similar contexts, often refers to the decision of the Supreme Court of Canada in *Ensite Limited v. The Queen*[7] for guidance. The CRA summarizes its understanding of the relevant principles in light of that case as follows:

> It is a question of fact whether a property is used principally in an active business. Factors to be considered in determining whether a property is used in an active business include the actual use to which the asset is put in the course of the business, the nature of the business involved and the practice in the particular industry. The issue of whether property was used or held by a corporation in the course of carrying on a business was considered by [*Ensite Limited*]. The court held that the holding or using of property must be linked to some definite obligation or liability of the business and that a business purpose test for the use of the property was not sufficient. The property had to be employed and risked in the business and used to fulfil a requirement which had to be met in order to do business. In this context, risk means more than a remote risk. If the withdrawal of the property would have a decidedly destabilizing effect on the corporate operations, the property would generally be considered to be used in the course of carrying on a business.[8]

The phrases "decidedly destabilizing effect" and "mandatory condition precedent to trade" have led the CRA to take a narrow view of whether cash (for example) is used in a business or for some other, non-qualifying purpose, with the result that almost any cash is bad cash (if one wishes to err on the side of caution).[9]

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[7] (1986) 2 C.T.C. 459, 86 D.T.C. 6521.

[8] CRA technical interpretation 9606355 dated March 16, 1998.

[9] For a detailed summary of the factors the CRA takes into account in determining whether cash is 'good' or 'bad', see CRA technical interpretation 9801925 dated February 16, 1998.

The Tax Court, however, appears to have endorsed *Ensite*'s statement of principle in the context of the QSBCS test. For example, in *Estate of Edward Reilly v. The Queen*[10] the Court considered whether shares of a corporation owned by an individual were QSBCSs at the time of his death. The Court concluded that the shares were not QSBCS because a subsidiary of the corporate issuer held too many redundant assets:

> There is no evidence that the cash and marketable securities held by [the subsidiary] were necessary or even important for the carrying on of its small active businesses. Or in the words of [*Ensite Limited*] there is no evidence that the cash and marketable securities were held "to fulfill a mandatory condition precedent to trade".[11]

'Principally'

The word 'principally' is meant to address circumstances where an asset has multiple uses. For example, Opco might own a building and use only part of it to carry on its business. Opco might lease the remaining portion of the building to third parties. In general, the leasing of real property in these circumstances will not constitute the pursuit of an active business—the income is derived from property and so it is "passive—with the result that the building's use for this purpose could render the building a bad asset. Nonetheless, if the building is principally used in the active business, then the entire value of the building will count as an active asset that will help Opco to meet the 50% test.

The CRA generally takes the position that "principally" means more than 50%.[12] But 50% of what? In *The Canada Trust Company v. M.N.R.*,[13] the Tax Court held that the taxpayer did not use a building "principally" in its business because more than 50% of the building's floor space was leased to third parties. On the other hand, the CRA has

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[10] 2007 TCC 404.

[11] *Edward Reilly*, supra note 10, ¶15. The Court also cites *Skidmore v. The Queen*, [2000] D.T.C. 6186, [2000] 2 C.T.C. 325 (F.C.A.), which considered whether large cash reserves held in a business were used in the business and thus constituted active business assets. The Court in the latter case held that they did not.

[12] See CRA Interpretation Bulletin IT-268R4 at ¶22, as cited in *Window on Canadian Tax,* CD-ROM (Toronto: CCH) ¶5870 ("*Window*").

[13] [1985] D.T.C. 322.

stated that a building might not be used principally in a business even where the business uses more than 50% of its space if the fair rental value of that space is less than the rent received from third parties for their use of the remainder of the building.[14] Assuming, however, that Opco leases, say, only 20% of its building (by area and value) to a third party and uses the rest of the building in its business, it is very likely that the building's entire value can be counted as part of the corporation's 'good' assets that will help it meet the 50% test.

'Active Business'

Subsection 248(1) states that "'active business', in relation to any business carried on by a taxpayer resident in Canada, means any business carried on by the taxpayer other than a specified investment business or a personal services business". The Act also provides definitions of 'specified investment business' and 'personal services business'. A detailed discussion of these definitions is beyond the scope of this paper, but in general terms a 'specified investment business' is any business the principal purpose of which is to derive income from property. A 'personal services business' carried on by a corporation means a business of providing services where the particular person providing the services or any person related the particular person is a 'specified shareholder'[15] of the corporation and, but for the existence of the corporation would be regarded as an employee or officer of the person to whom the services are provided.[16]

Under these definitions, a corporation with only two or three employees, that owns real property that it leases to third parties, will not be considered to carry on an active business. A corporation that is an investment holding company does not carry on an active business. The shares of either corporation will not qualify as QSBCSs.

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[14] *Window* ¶5437.

[15] See subsection 248(1) for a definition of this term.

[16] The definition of both of these phrases is found in subsection 125(7).

'Carried On'

In *Tara Exploration and Development Company Limited v. M.N.R.*,[17] the Court distinguished between an adventure in the nature of trade and carrying on business. The CRA, therefore, has taken the position that an asset will assist a corporation with meeting the 50% test only if it is used in an active business that is carried on. As a result, a corporation's shares will not qualify as QSBCSs where the corporation's only asset is vacant land held for re-sale as part of an adventure in the nature of trade.[18]

'Primarily in Canada'

To be a 'good' asset, an asset must be used in a business that is carried on 'primarily in Canada'. The CRA has stated that 'primarily' in this context means more than 50%. But 50% of what?

> In paragraph 8 of Interpretation Bulletin IT-147R 215 and paragraph 5 of Interpretation Bulletin IT-486R,16 the department interprets the term "primarily" to mean principally, chiefly, or greater than 50 percent; however, whether or not an active business is carried on primarily in Canada is a question of fact. Factors such as the type of business, sales, net profit, number of employees, gross assets, and net assets are taken into account in determining whether a corporation's business is being carried on primarily in Canada. The department has no set guidelines on which factors to use in particular situations since all the circumstances must be considered in deciding each case.[19]

Where is a business carried on? The CRA says that is a question of fact too:

> Under Common Law principles, a business is generally considered to be carried on in the place where the operations from which the profits arise are located. The determination of this place is largely a question of fact. As a general rule a business that involves the sale or leasing of goods is usually carried on in the country where the corporation is resident, unless the business (or a part of it) is conducted by a virtually autonomous branch operation outside of Canada or the sales contracts are concluded outside of Canada. The facts would have to be reviewed to make a determination in any particular situation. Where a corporation's business involves the rendering of services, the business is generally carried on in Canada only to the extent that services are rendered in

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[17] [1970] D.T.C. 6370 (Ex. Ct.)

[18] *Window* ¶7859.

[19] Response to question 13 at the 1991 Canadian Tax Foundation CRA Roundtable.

> Canada, necessitating an apportionment of net business income on a reasonable basis. These same principles would also apply to a partnership.[20]

The definition of a "qualifying active business" in subsection 5100(1) of the *Income Tax Regulations*—which the Act does not make applicable for the purposes of the QSBCS definition—states that a business carried on primarily in Canada includes a business where at least 50% of its full-time employees are employed in Canada or at least 50% of the salaries and wages it pays to employees are reasonably attributable to services rendered in Canada. It is suggested that an asset used in a business that meets either of these tests should be regarded as a good asset for the purposes of the 50% test.

The CRA considered a situation where Canco leased its only material asset to a wholly-owned U.S. subsidiary, which exploited the asset in a business carried on in the U.S. The CRA stated that the asset would not be considered to be used in a business carried on primarily in Canada.[21]

It is not uncommon for Opco to begin carrying on business in Canada and then expand into a foreign country by incorporating a subsidiary in that country. The status of Opco's shares as QSBCSs will not be threatened by the foreign subco when it is just beginning to carry on business. As subco grows, however, so too does the QSBCS problem. The shares of the subco count as assets for the purposes of the 50% test, as discussed below, but they will be bad assets because the issuer carries on business outside Canada. Opco's owners, to protect the QSBCS status of their Opco shares, might be wise to incorporate the foreign company as a subsidiary of a new corporation that they own directly rather than through Opco.[22]

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[20] CRA technical interpretation 2001-0090655 dated September 10, 2001.

[21] *Window* ¶5758.

[22] Where the tax adviser arrives on the scene too late, and Opco already owns Foreignco, it might be possible to retrieve the situation through a divisive reorganization or "butterfly". The task will be made very difficult or impossible, however, if the Opco shareholders are unrelated.

Assets Used by a Partnership or a Related Corporation

Assume that Mom and Pop own all of the issued shares in the capital of each of Opco and Holdco, which are, therefore, related corporations for the purposes of the Act. Opco carries on an active business through a building that it leases from Holdco. The building is Holdco's only asset. In this case, Holdco's shares might qualify as QSBCSs because its only asset is used by Opco, a related corporation, to carry on an active business. That is, a corporation need not carry on an active business itself before its shares will be QSBCSs. If it owns assets that are used by another related corporation in an active business, then the first corporation's shares could qualify for the enhanced capital gains exemption.[23]

Similarly, the CRA accepts that a corporation that is a member of a partnership that uses assets to carry on an active business itself "uses" some portion of those assets in that business for the purposes of the QSBCS definition. In this regard, the CRA makes no distinction between a limited partnership and a general partnership.[24]

Shares and Debt of Other Corporations

Can the shares of Holdco qualify as QSBCSs if its only assets are debt issued by, and shares in the capital of, Opco? Subparagraph (c)(ii) of the QSBCS definition provides that Holdco's shares can qualify if Opco is a CCPC that is "connected" with Holdco and certain ownership tests are met with respect to Opco's shares. The details of the meaning of "connected" and the ownership tests are beyond the scope of this paper. Suffice it to say that, where Holdco owns all of Opco's issued shares, Opco will be connected with Holdco. Moreover, the ownership test in subparagraph (c)(ii) should not present a problem if Holdco has held all of Opco's issued shares for more than 24 months before the determination time.

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[23] See *Window* ¶3784. A purchaser will almost always prefer to acquire real property directly rather than by acquiring the shares of a corporation that owns the property. Nevertheless, the exemption could be helpful to the estate of Holdco's owners inasmuch as the exemption could reduce the taxable capital gain that must otherwise be included in income on an owner's death.

[24] *Window* ¶3216 and ¶4832.

For Holdco's shares to qualify for the exemption, Opco must also meet an asset test, namely that "more than 50% of the fair market value of [its] assets […] was attributable to assets described in subparagraph (iii)". Subparagraph (iii) is a reference to the tests in subparagraphs (c)(i) (the test respecting assets used in an active business) and (c)(ii). That is, (c)(ii) is recursive, which means that Opco can meet the test in (c)(ii) even though *its* only asset is shares in the capital of Subco, provided Subco meets the tests set out in subparagraph (c)(ii).

Anti-Stacking

The QSBCS definition, then, permits the arbitrary stacking of corporations, which could lead to abuse. For example, assume that Holdco owns bad assets that represent 49% of the gross value of all of its assets and shares of Opco that represent the remaining 51%. Assume that Opco owns bad assets that represent 49% of the gross value of all of its assets and good assets (assets used in an active business) that represent the remaining 51%. Using the rules described above, Holdco's shares would meet the 50% test even though, on a consolidated basis, only 26% of the gross fair market value of the assets of the two corporations is attributable to assets used in an active business.

We can't have that, and so the QSBCS definition contains an anti-stacking rule, which imposes additional restrictions. If the value of Opco's shares represents more than 50% but less than 90% of the gross value of Holdco's assets, then, for the Opco shares to qualify as good assets, the reference in 50% in subparagraph (c)(ii) must be read as a reference to "all or substantially all" (ie 90% as discussed below). That is, 90% or more of the gross value of Opco's assets must be attributable to active business assets or shares of a corporation that meets the test in subparagraph (c)(ii). At the same time, if the Opco shares represent more than 90% of the value of the assets of Holdco, then Opco need only meet the 50% test.[25]

[25] This test is found in paragraph (d) of the QSBCS definition, but as stated there it is very difficult to follow. The formulation I have presented here is a paraphrase that owes much to a presentation made by Bruce Ball at BDO Dunwoody LLP at the CICA's 2006 course on Advanced Tax Issues for the Owner-Managed Business.

The anti-stacking rule is important to keep in mind because it is common for owner-managers to hold Opco shares through Holdco, which permits Opco to pay excess profits as dividends to Holdco tax-free where the profits are used to purchase investment properties such as rental real estate or portfolio securities. The latter types of properties are generally bad assets, and their value can accumulate until they represent a material portion of the value of all of Holdco's properties. But the value of the investment properties need represent only 11% or more of the total value of Holdco's properties before Opco must meet a much more stringent 90% test *throughout* the 24-month holding period in order for its shares to qualify as good assets for Holdco.

The 90% Test

It is not enough to meet the 50% for the 24-month holding period. The issuer of shares that pretend to QSBCS status must also meet a 90% test. Paragraph (a) of the QSBCS definition states that a share is a QSBCS only if, at the determination time, it is "a share of the capital stock of a small business corporation". "Small business corporation" is, of course, a defined term, which reads in part as follows (per subsection 248(1)):

> "small business corporation", at any particular time, means […] a particular corporation that is a Canadian-controlled private corporation all or substantially all of the fair market value of the assets of which at that time is attributable to assets that are
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> > (a) used principally in an active business carried on primarily in Canada by the particular corporation or by a corporation related to it,
> >
> > (b) shares of the capital stock or indebtedness of one or more small business corporations that are at that time connected with the particular corporation (within the meaning of subsection 186(4) on the assumption that the small business corporation is at that time a "payer corporation" within the meaning of that subsection), or
> >
> > (c) assets described in paragraphs (a) and (b),

The definition must look familiar, and in fact most of its elements are materially identical to the elements of the 50% test as described. The key difference, of course, is the reference to "all or substantially". The CRA takes the position that this phrase means

90% or more. The courts have not always been so categorical. In *Wood v. M.N.R.*,[26] the Court held that the phrase cannot be reduced to a bright-line test:

> I would think the Minister might be hard-pressed to refuse a claim where the percentage was 89 per cent, maybe even 85 per cent or 80 per cent or lower … Clearly the term "substantially all" does not lend itself to a simple mathematical formula. Further it would seem to me that any particular definition of "substantially" would be only valid with reference to the specific context in which it is found.[27]

Still, the cautious professional, who wishes to ensure that the client's affairs do not become the subject of a test case, will do everything possible to make sure that the assets of the client's corporation meet the 90% figure "recommended" by the CRA.

The Problem With Death

The 90% test is a stringent one, and as a result it is often necessary to purify a corporation (as described below) before its shares are sold so that the shareholders can claim the capital gains exemption. But Death often arrives unannounced, which means that the tax adviser will not have time to engage in the necessary ablutions, or the adviser might have performed them but time has passed and the corporation has gone astray again. The Act provides some relief: paragraph 110.6(14)(g) provides that, where a corporation's share fails to meet the definition of a QSBCS because the corporation is not a small business corporation at the time of the shareholder's death, the share will be considered to have met the definition if the share was a QSBCS "at any time in the 12-month period immediately preceding the death of the individual." A share in the capital of Opco might not be a QSBCS at the time of the death of one of its shareholders, perhaps because Opco does not meet the 90% asset test. The share might still qualify, however, if it met the QSBCS test at any time in the 12 months before death. Note that *all* parts of the QSBCS test must be met at the point in time chosen during the previous 12

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[26] [1987] D.T.C. 312 (T.C.C.) ("*Wood*"). Cited with approval in *Ilott et al. v. The Queen* (2002), [2003] D.T.C. 123 (T.C.C.).

[27] *Wood,* ¶5.

months. For example, the 24-month holding period test must be satisfied at the chosen time *and* at death before the shares will qualify as QSBCSs.

Seeking Purity

The foregoing review of the asset tests is not exhaustive, but it serves to highlight one of the key difficulties faced by an entrepreneur who wishes to claim the exemption. The entrepreneur who owns a successful small business is one of those lucky taxpayers who have the most to gain from claiming the exemption. A successful small business, however, makes claiming the exemption difficult because it often generates profits in excess of the needs of the business. The business generates excess profits that become bad assets for the purposes of the asset tests. If excess profits are left in Opco or paid to its parent, Holdco, eventually the shares held by the entrepreneur will cease to qualify as QSBCSs because the issuer or its subsidiaries will hold too much cash or too many passive investments.

At the same time, another key tax incentive for small business is the small business deduction. Currently, in Ontario, the first $500,000 of active business income is taxed at a combined rate of about 16%. As a result, an entrepreneur will often choose to leave profits in her corporation for investment purposes. The alternatives are to pay additional salary to herself that might be taxed at a marginal rate of 46% or to pay a dividend to herself from after-tax profits that might be taxed at a similarly high marginal rate (after taking into account taxes at the corporate and personal level). Why invest with 54-cent dollars when one has the choice of using 84-cent dollars (especially when the total tax paid on the earnings from the investments will not differ greatly irrespective of how the investments are held)? That is, given a choice—and always assuming that the entrepreneur does not need the money personally—the entrepreneur will often prefer to leave earnings in the corporation.

This is the crux of the challenge posed by the QSBCS asset tests: how does one minimize the bad assets held by Holdco and its subsidiaries so that purity is maintained while at the same time minimizing the tax payable by the entrepreneur personally?

Simple Methods for Achieving Purity

Some answers to this question are relatively straightforward. If Opco has excess cash, and it has accounts payable, bank debt or shareholders loans, then the cash can be used to pay down these liabilities. Opco's net value does not change, but the value of a bad asset (the cash) has been reduced, which will help Opco to meet the QSBCS asset tests.

Alternatively, Opco can sell passive assets and use the cash to pay down debt, or Opco can use cash to invest in new equipment that will be used in Opco's active business.[28]

Again, if Holdco owns property and related debt with a net value that is low, but the gross value of the property is high, then Holdco might consider transferring the property and the debt to a new Subco, so that the bad asset now held by Holdco is the shares of Subco, and it is only their net value that counts for the asset test.

The Butterfly

The foregoing methods have their place, but their utility is often somewhat limited. As a result, tax professionals use other tools for achieving purity. The single-wing butterfly is one such.

Imagine that X owns all of the shares of Opco, and it has accumulated $200,000 worth of portfolio investments such that its issued shares will not qualify as QSBCSs. X might undertake the following reorganization to remove these assets from Opco on a tax-deferred basis. X would incorporate a new corporation ("Investco") of which he is the sole Common Shareholder. Opco, if necessary, would file articles of amendment to create a class of non-voting Special Shares that are redeemable and retractable for a fixed amount (say $100 per share). Opco would declare a dividend of $100 that it satisfies with Special Shares with a total redemption amount of $200,000. For tax purposes, the amount

[28] It should be noted that old equipment, if it is not used any longer in an active business, will become a bad asset. In addition, the CRA has taken the position that cash that is to be used for future purchases of capital assets for the business may not be an asset used in an active business.

of this dividend—the amount that is taxable—is only $100. X then transfers the Special Shares to Investco for additional Common Shares in its capital. X and Investco would file an election under section 85 so that the transfer of the Special Shares would be deemed to occur on a tax-deferred basis. Opco would then redeem the Special Shares. If the investment assets have no accrued but unrealized gains, then Opco would simply transfer the assets to Investco in satisfaction of the liability arising on the redemption of the Special Shares. If the investments have an accrued gain, then Opco might transfer them to Investco for Investco Special Shares. Again, Opco and Investco would file an election under section 85 so that the transfer of the investments occurs without triggering capital gains. Investco would then redeem its Special Shares and the resulting liability could be set-off against the liability created on the redemption of the Special Shares in the capital of Opco.

The redemption of the Special Shares creates a deemed dividend equal to the amount by which the total redemption amount of the shares exceeds their paid-up capital for the purposes of the Act. The paid-up capital in these circumstances is usually nominal, which means that the deemed dividends are about equal to the total redemption amount of the Special Shares. Dividends generally pass between taxable Canadian corporations tax free, however, and so in this example neither Investco nor Opco should pay any tax, if all goes according to plan.[29]

This method is quite effective for removing bad assets. In the example above, Opco has gone from having $200,000 of bad assets to none without X or his corporations incurring any taxes. The method has several drawbacks, however. First and foremost, it is neither easy nor cheap to implement a butterfly. Butterflies are not for amateurs, not least because of the tax technical issues they raise (one of them is discussed below). Moreover, as a method for removing smaller amounts of bad assets on a regular basis, it does not recommend itself to the entrepreneur's wallet. Each butterfly can costs thousands, if not tens of thousands, to implement.

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[29] If Opco has accumulated refundable dividend tax on hand—and it may very well have, if it owns $200,000 of investments—then Part IV tax issues must be considered in implementing the butterfly.

Perhaps the most serious objection to the butterfly is that it engages the anti-avoidance rules in section 55. Whole books can and have been written about the fiendish complexity of this section. Very basically, section 55 will re-characterize tax-free inter-corporate dividends as taxable capital gains if a number of conditions are met. The section creates at least two problems for butterflies that are used to purify a corporation. The first is that a tax-free butterfly almost certainly cannot be implemented for a corporation that is owned by two or more unrelated individuals. The tax-free dividends will be re-characterized as taxable capital gains in such circumstances. Similarly, the dividends will be re-characterized as gains if the butterfly is completed as part of a series of transactions that includes a sale to an arm's-length party.

The CRA has sometimes stated that any purification transaction should be viewed as part of a series of transactions leading to a sale to a third party, even if the sale occurs much later. Thankfully, the courts have interpreted the phrase more narrowly, and so the method can work, even where Opco is later sold to a third party.[30] Nevertheless, caution must be exercised because the phrase does not have a definite meaning, and a tax adviser who completes a butterfly for Opco one month and then advises its shareholders on a sale to an unrelated third-party the next should prepare for close scrutiny from the CRA.

Holdco Owns Some of Opco

Instead of transferring assets to a sister company of Opco, Mr. X could transfer some but not all of his shares of Opco to Holdco. Opco could file articles of amendment to create a new class of Common Shares in addition to the existing Commons. Holdco would exchange its Common Shares for shares of the new class. Opco would be entitled to pay dividends on one class of Common Shares without paying dividends on the other.

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[30] See, for example, *Meager Creek Holdings Limited v. The Queen*, [1998] D.T.C. 2073 (T.C.C.). For a case that considered the "series of transactions" issue and arrived at a different conclusion, see *Granite Bay Charters Ltd. v. The Queen*, [2001] D.T.C. 615 (T.C.C.).

Opco could then pay excess profits to Holdco on an on-going basis so that Opco is kept pure. Again, the dividends paid by Opco should be received by Holdco tax-free.[31]

This method has the advantage of being relatively cheap and easy to work with after it has been implemented. To remove redundant assets, Opco need only pay an ordinary dividend. For technical reasons, the risks under section 55 are ameliorated as well. The only drawback is that X, by transferring shares to Holdco, potentially gives up some portion of the gain on his Opco shares that might otherwise be sheltered by the exemption. Only X, an individual, can claim the exemption, and he will likely not be able to claim it in respect of his shares in the capital of Holdco because it will hold investment assets, which will likely cause it to fail the asset tests.[32]

The question then becomes whether X can reduce the cost of this problem by transferring a small portion of his Opco shares to Holdco. If the two classes of Common Shares permit any amount of dividends to be paid on one class to the exclusion of the other, why not have X transfer 1% of his shares to Holdco? Opco could then pay excess profits to Holdco, and X would continue to own substantially all of Opco's issued shares. The provsions of the Ontario *Business Corporations Act* do not seem to prohibit this strategy. Should the CRA care? Historically, the CRA has taken a rather dim view of dividend-sprinkling shares, and it has taken at least one dividend-sprinkling share structure—albeit one used for a different purpose—to the Supreme Court of Canada.[33] In *Demers c. La Reine*,[34] the Court seemed to regard dividends paid on certain shares issued to children as artificial (or a sham) because, among other things, the shares were issued for little or no consideration although they were entitled to significant dividends (which were in fact paid).[35] Would the CRA accept that the Opco shares held by Holdco had a value equal to only 1% of all of Opco's issued shares? The CRA has begun to take a

[31] Again, this assumes that Opco does not have refundable tax on hand. This also assumes that Opco's redundant assets are not left in the corporation long enough to accumulate gains.

[32] Most purchasers do not want to buy investment holding companies anyway.

[33] *Neuman v. M.N.R.*, [1998] 1 S.C.R. 770, [1998] 3 C.T.C. 177, 98 D.T.C. 6297.

[34] 2006 CCI 504 ("*Demers*").

[35] *Demers*, ¶30.

harder line on the value of so-called “thin voting” shares (voting shares that are redeemable and retractable for a nominal amount). The CRA, at the 2007 CTF Tax Conference, when asked about such shares responded that “It is the opinion of the CRA that a hypothetical purchaser would be willing to pay some amount for the voting control of a company.”[36] What should CRA make of shares that receive all or substantially all of the excess profits of Opco in the form of dividends but that are supposedly entitled to only 1% of the net assets of the corporation on a winding-up?[37]

Corporations As Beneficiaries

Holdco could own shares of Opco “through” a trust rather than directly, which would solve a number of the problems described above. Moreover, such a structure can be integrated with an estate freeze or gel in a manner that will “mulitply” the exemption. A trust is not a true flow-through entity for tax purposes. The Act, however, contains provisions that allow a trust to make designations in respect of its distributions to beneficiaries so that the trust’s capital gains and dividends retain their character as such in the hands of the beneficiaries. A designation of a gain realized on a trust’s disposition of a QSBCS should permit the beneficiary who receives the distribution so designated to claim the capital gain exemption in respect of the gain.[38]

Accordingly, X might exchange his Common Shares of Opco for fixed-value Special Shares, and then a trust—the beneficiaries of which include X’s family and Holdco—would subscribe for Common Shares of a new class. If Opco is later sold, the resulting gain can be allocated to the individuals who are beneficiaries of the trust, and those individuals can each claim the exemption in respect of the gain if the Opco Common Shares were QSBCSs at the time of the disposition. Keeping Opco pure meanwhile, can be as simple as paying a dividend from Opco to the trust that it allocates to Holdco as a beneficiary of the trust. The trust is entitled to a deduction in respect of the

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[36] For more on this subject, see David Louis’ article in the October 16, 2008, issue of CCH’s *Tax Topics*.

[37] See also *Winram v. M.N.R.*, [1972] D.T.C. 6187 (F.C.T.D.).

[38] Subsection 104(21.2).

dividend so that the trust will not be subject to tax on the dividend provided the trust pays the dividend to Holdco. The CRA accepts that Holdco will receive the dividend as an inter-company dividend so that, in general, Holdco does not pay tax on the dividend either (assuming that Part IV tax is not payable, on which see the discussion below).

The foregoing achieves a number of goals—claiming the exemption for as many individuals as possible for as much of the value of the issued shares of Opco as possible, deferring tax at the shareholder level and removing assets from Opco to keep it "pure" for the purposes of the exemption—that often interfere with one another. As we have seen, only an individual can claim the capital gain exemption, and so it is generally desirable to ensure that, to the greatest extent possible, individuals own the Common Shares of Opco (the growth shares). On the other hand, to make sure that the Opco shares qualify for the exemption, it is often necessary to remove redundant assets from the corporation, and the easiest and most tax-effective way to do this is to pay dividends on Common Shares owned by Holdco. But every share held by Holdco is a share for which the exemption cannot be claimed. A trust that holds Common Shares of Opco where Holdco is a beneficiary of the trust reconciles these tensions.

Of course, making a corporation a beneficiary of a trust has its own set of issues, and some of the most important are not tax related. Not every entrepreneur wants to create a trust, and once a trust is created, it brings its own set of tax and non-tax issues with it. Perhaps others with more expertise in the law of trusts can address the non-tax issues. As far as the tax issues are concerned, one of the most important relates to Part IV tax. If Holdco is subject to Part IV tax on dividends it receives from Opco through the trust, then not much has been accomplished as far as deferring tax is concerned. No deferral is available because of the imposition of the refundable tax, and the individuals involved would have been better off simply paying dividends to themselves to reduce the value of redundant assets.

Assume that Opco manages its cash so that it does not accumulate refundable dividend tax on hand. In that case, to avoid Part IV tax Holdco, as a beneficiary of the

trust, must be connected with Opco, and Holdco will be connected with Opco only if Holdco satisfies either the 10% votes-and-value test or it controls Opco.[39]

To satisfy the 10% votes-and-value test, Holdco must own shares of Opco. The CRA, however, takes the position that the beneficiary of a trust does not own the trust's property. Holdco, then, if it "holds" shares of Opco only as a beneficiary of a trust, can never satisfy the 10% votes-and-value test. For example, assume that X is the owner of all of the shares of Holdco, which is the beneficiary of a trust that owns 30% of the issued Common Shares in the capital of Opco. The remaining 70% of the Common Shares in the capital of Opco are held by an individual with whom X deals at arm's length. In these circumstances, Holdco will not be connected with Opco under the 10% votes-and-value test because Holdco does not own any Opco shares (except "through" the trust).

Consequently, Holdco in the example above will be connected with Opco only if Holdco "controls" Opco. In this context, "control" has a special meaning: Holdco will be considered to control Opco only if Holdco, persons not dealing at arm's length with Holdco or Holdco and those non-arm's length persons own more than 50% of the shares of Opco having full voting rights in all circumstances.[40] Fortunately, the Act provides that Holdco is deemed not to deal at arm's length with the trust of which it is a beneficiary.[41] Holdco will be deemed to own all of the shares held by a person with whom Holdco does not deal at arm's length. That is, Holdco, for the purposes of the control test only *is* deemed to own the shares that are owned by the trust.

Of course, in the example above, Holdco will be deemed to own only 30% of the issued Common Shares in the capital of Opco, which is unhelpful from the standpoint of Part IV tax. The position would be different, however, if the trust held 70% of the issued Common Shares in the capital of Opco. In that case, Holdco would be deemed to own the shares, and so it would be deemed to control Opco. Holdco, then, would be connected with Opco, and the CRA accepts that any dividends paid by Opco to the trust that are

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[39] Subsection 186(4).

[40] Subsection 186(2).

[41] See paragraph 251(1)(b).

then allocated to Holdco would be free of Part IV tax (assuming that Opco did not receive a refund of tax in respect of the dividends declared).

What happens if two brothers, A and B, each own all of the shares of their respecting holding corporations (HoldcoA and HoldcoB respectively), which in turn are beneficiaries of trusts (TrustA and TrustB respectively) that own 50% each of Opco? Neither TrustA nor TrustB controls Opco by itself for the purposes of Part IV: neither owns more than 50% of the voting shares of Opco. The Holdcos, however, will be related to each other—and so they will be deemed not to deal at arm's length—because they are controlled by two individuals respectively who are related to each other.[42] In addition, paragraph 251(1)(b) of the Act provides in part that "a taxpayer and a personal trust [...] are deemed not to deal with each other at arm's length if the taxpayer, *or any person not dealing at arm's length with the taxpayer*, would be beneficially interested in the trust" [emphasis added]. Accordingly, because HoldcoA and HoldcoB are deemed not to deal at arm length with each other, HoldcoA is deemed not to deal at arm's length with TrustA *and* TrustB. HoldcoA, then, is deemed to own all of the issued shares of Opco and, therefore, to control Opco under 186(2), and any dividends paid from Opco through TrustA to HoldcoA should not be subject to Part IV tax.[43]

CONCLUSION

The capital gains exemption represents an important benefit for entrepreneurs and their families. It significantly reduces the tax payable on a sale of shares of a business corporation or a deemed disposition of the shares on death. The ability of an entrepreneur

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[42] See paragraph 251(6)(a), subparagraph 251(2)(c)(ii) and paragraph 251(1)(a) of the Act).

[43] What to do if A and B deal with each other at arm's length and each owns 50% of the issued shares of Opco? A might consider incorporating Holdco1 to hold his 50% of the Common Shares in the capital of Opco. A trust would hold the Common Shares of Holdco1. A would own all of the Common Shares in the capital of Holdco2, which would be a beneficiary of the trust. Dividends paid from Opco to Holdco1 would not be subject to Part IV tax because Holdco1 would meet the 10% votes-and-value test and be connected with Opco. At the same time, dividends paid from Holdco1 to the trust and then to Holdco2 would also be exempt from Part IV tax because of the analysis set out above where the trust controls Opco. Whether Mr. A will wish to deal with so many corporations will depend on the value of the exemptions that might be available to the beneficiaries of the trust and the tax that can be deferred by removing redundant assets from Opco to Holdco2.

to access the exemption is, however, conditional on meeting the many highly technical requirements found in the Act that relate to the exemption.

This paper has attempted to outline only those requirements that relate to the asset tests in the definition of a QSBCS. It has described the rules relating to good assets and bad, and it has described some of the techniques available for keeping the value of the bad assets to a minimum so that the tests can be met. None of the techniques described above is without its problems. The simple solutions tend to be less effective or they actually impair the entrepreneur's ability to take full advantage of the exemption. The more complicated solutions tend to be expensive, somewhat risky from a tax perspective and technically difficult to implement. In the final analysis, a tax professional will probably end up using some combination of these techniques at different points in Opco's lifecycle. Throughout that lifecycle, the professional must keep a watchful eye on Opco's good assets and bad with a view to using these tools to ensure that Opco's owners will be able to take full advantage of the exemption when it is needed.