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The Unintended Consequences of Subsection 256(9)

The *Income Tax Act (Canada)* (the "*Act*"), contains all manner of "shoals and traps"[1], which may result in unintended tax consequences to the unaware, and in some cases to the aware. A reminder of this fact is illustrated in a recent court decision, and subsequent Canada Revenue Agency ("CRA") technical opinion, pertaining to the application of subsection 256(9) of the *Act*.

Subsection 256(9) of the Act is a seemingly straight forward provision. It provides that where control of a corporation is acquired at any time during a given day, for purposes of the *Act*, control of the corporation will be deemed to have been acquired at the beginning of that day, unless the corporation elects this not to be the case. This corporate election is to be made with the corporation's tax return for its taxation year immediately preceding the change of control.

The rationale for this provision seems obvious. When control of a corporation has been acquired, the corporation's fiscal year is deemed to end immediately before that time. This allows the corporation's books to be closed during the time when it was owned by the previous owners and reopened in respect of the time when it was owned by the new owners. One can imagine the administrative nightmare it would be to have a corporation's fiscal year end during the middle of a business day.

Recently, this provision was considered by the Federal Court of Appeal in *La Survivance*[2]. While this case had taxpayer-friendly results for the appellant, it may result in unintended negative tax consequences in other situations.

La Survivance

In this case, the appellant, a publicly traded insurance company, sold all of its shares in a wholly owned subsidiary company ("Subco"), which also carried on an insurance business in Canada, to a private Canadian company ("the purchaser"). In respect of the sale, the appellant realized a $2,654,372 loss. Absent the operation of subsection 256 (9) of the *Act*, the appellant's loss would have been treated as a capital loss. This loss would not qualify as a business investment loss, because Subco was not a Canadian-controlled private corporation ("CCPC"), on account of the fact that it was wholly owned by the appellant, a public company.

Relying on the acquisition of control deeming provision in subsection 256(9) of the *Act*, the appellant took the position that the purchaser acquired control of Subco at the beginning of the day in which the sale took place. Consequently, when the sale occurred later that day, Subco was deemed to be controlled by the purchaser. As such, Subco was in fact a CCPC at the time of the sale and, therefore, the appellant's capital loss realized on the disposition of its Subco shares, qualified as a business investment loss.

In support of its decision to allow the appellant's allowable business investment loss claim, the court held, at paragraphs 63-66:

> With respect, I am of the opinion that subsection 256(9) applies to both the corporation acquiring control and the corporation disposing of control.
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> As persuasive evidence of this, suffice it to note that, under this subsection, the initial tax return of Les Clairvoyants under the control of Société Nationale must cover the period commencing at the very beginning of the day of July 5, 1994, just as the final return filed under the appellant's control must

> cover the period ending at that very moment (see, respectively, paragraphs 249(4)(a) and (b)). None of the corporations involved in the acquisition of control avoids being covered by the fiction.
>
> Subsection 256(9), notwithstanding its special features, must be construed in its entire context, in accordance with the grammatical and ordinary sense of its words, harmoniously with the scheme of the Act, the object of the Act, and the intention of Parliament (see, for example, *Ludmer c. Ministre du Revenu national*, **[2001] 2 S.C.R. 1082** (S.C.C.), at paras. 36-37).
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> If this approach is faithfully adhered to, it must be concluded that, for the purposes of the Act, and subject to the exceptions provided, Société Nationale is deemed to have acquired control of Les Clairvoyants and the appellant is deemed to have surrendered it at the first moment of the day of July 5, 1994. That is what flows from the ordinary sense of the words, read in their context, and from the statutory objective.

Interestingly, the court cited one of the Minister's own technical opinions in support of its decision and, in what can only be described as a gentle hand slapping, pointed out the inconsistency of the Minister's position in this case with the cited opinion. At paragraphs 75-77:

> That in fact was how the Minister read subsection 256(9) in a technical opinion issued in regard to a transaction similar to this one (Minister of National Revenue, Technical Interpretation 9525315, "Associated Corporations" (February 26, 1996), (eC: Taxnetpro)). It is not necessary to quote, in detail, the request [which led to the issuance] of the opinion. Suffice it to say for our purposes that the company that made the request (A Inc.) intended to surrender control of its subsidiary (Opco) to a third-party purchaser (B Inc.). It wanted to know whether subsection 256(9) would apply to it. It feared that, if it did not, it would continue to be associated with its subsidiary during the few hours between the commencement of the day of the transaction and the particular time when the transaction was to be consummated, with the negative consequences that this would entail. (Under the Act, a corporation is associated to another for the year if it is associated "at any time" during the year.)
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> The Minister, in an unambiguous answer, said that, in his opinion, the presumption applied in regard to each of the parties to the transaction:
>
>> [TRANSLATION] ... the Department's position is to consider that although the shares were in fact disposed of as of 5:00 p.m. on July 1, A Inc. surrendered its control of Opco immediately prior to the time when B Inc. is deemed to have acquired control of Opco....
>>
>> [Emphasis added]
>
> At the end of the day, the only reason why the Minister refuses to give effect to the fiction in the present case is that he does not like the result to which it leads.

While the result for the appellant in La Survivance was favourable, the reasoning of the court highlights the potential for unintended tax consequences under the *Act*. Specifically, this decision may put at risk the shelter of taxable capital gains, with the capital gains deduction, pursuant to subsection 110.6(2.1) of the *Act*, where a taxpayer sells his or her shares, which would otherwise qualify as qualified small business ("QSB") shares, to non-residents or public companies.

If for instance, a taxpayer sold shares, which would otherwise qualify as QSB shares, to a non-resident, subsection 256(9) of the *Act* may operate to deem the non-resident to have acquired control of the target company at the beginning day of sale day. As such, the target company would no longer be considered a CCPC when the shares were actually transferred from the taxpayer to the non-resident. In this instance, and based on the *La Survivance* decision, the taxpayer's shares in the target company would no longer qualify as QSB shares and the capital gains deduction would not be available to shelter any resulting capital gain.

Similar results may also apply if the target company were acquired by a public company as the definition of CCPC would not be met by the target company later in the day when the sale actually took place.

Minister's Policy

In a recent technical opinion, CRA Views 2006-0214781E5: Interaction 256(9) and 110.6(2.1) (February 22, 2008), the Minister confirmed that due to *La Survivance*, where a taxpayer sells shares, which would otherwise qualify as QSB shares, to a public company, resulting in an acquisition of control of the target company by public company, the taxpayer may not be entitled to the capital gains deduction unless the necessary election in 256(9) is made. The Minister stated:

> We agree with you that, in the situation you have presented, technically, Mr. A would not be entitled to the capital gains deduction, under subsection 110.6(2.1), in respect of the disposition of shares of the capital stock of Opco on the basis of the FCA's position on subsection 256(9) in La Survivance. Therefore, unless Opco elects not to apply subsection 256(9), Mr. A would not be entitled to claim the capital gains deduction in respect of the disposition of the Opco shares.
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> In view of the above, we will bring this matter to the attention of the Department of Finance for consideration as to whether a legislative change is necessary.

To date, no legislative amendments have been proposed to deal with this issue.

Recommendation

Based on the foregoing, there are both specific and general issues to be aware. Specifically, a taxpayer who intends to sell QSB shares to a public company (or non-resident), which will result in the acquisition of control of the QSB company by the public company (or non-resident), and plans on using the capital gains deduction to shelter the resulting capital gain, should elect out of the application of 256(9) of the *Act* such that the acquisition of control will occur at the time of sale, not at the beginning of the day of the sale.

Generally, taxpayers should always remember that the *Act* is amazingly complex and great care must be taken to ensure that unintended negative tax consequences are not triggered when organizing one's affairs. To do this, professional tax advisors should be consulted.

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1. Geransky v. The Queen, [2001] 2 C.T.C. 2147 (T.C.C.), at paragraph 42.
2. La Survivance c. The Queen, 2006 D.T.C. 6288 (F.C.A.) (Fr.), 2007 D.T.C. 5096 (F.C.A.) (Eng.).