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Going Private Transactions: Consolidation Squeeze-Out

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A client ("Publico"), a Tier 2 TSX-Venture Exchange ("TSX-V") listed corporation incorporated under the *Business Corporations Act* (Ontario) ("OBCA"), approached us recently for advice in connection with a proposed going-private transaction.

Publico's common shares, the only outstanding class of shares, were trading at a historic low. The shares were unevenly distributed - the vast majority of Publico's outstanding shares were held by a small minority of its shareholders (by number). Publico's shares were also thinly traded - in the previous 12 months fewer than 5 percent of Publico's outstanding shares, in the aggregate, had traded on the TSX-V - suggesting a very limited market for the shares.

In addition, Publico's management had determined that the costs of remaining public, that is of meeting the legal obligations to Publico's public shareholders, on an ongoing basis (which amounted to approximately \$250,000 annually) could not be justified in view of Publico's present and near term projected financial performance and prospects, and Publico's limited number of public shareholders.

Accordingly, management was considering a going-private transaction to, (i) provide liquidity to Publico's shareholders, where little or no liquidity existed in the current market, and (ii) eliminate the costs of remaining public where Publico's revenues, profits, number of shareholders and future prospects were not high enough to justify these costs.

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Management had determined that, while the financial prospects of Publico were insufficient to justify Publico's remaining public, Publico nonetheless had sufficient cash on hand to finance the proposed going-private transaction, that is sufficient cash to pay the necessary fair market value consideration to the "minority" shareholders of Publico in the course of a going-private transaction.

Finally, Publico's senior management, who were also direct or indirect shareholders of Publico, wished to carry on the business of Publico as a private corporation following the completion of the going-private transaction.

No person or group of persons, including any of the existing shareholders of Publico, had expressed an interest in purchasing either the shares or the business and assets of Publico.

In the circumstances, it was suggested that Publico proceed with the consolidation squeeze-out method of carrying out the going private transaction.

The following article discusses the steps and legal requirements for the consolidation squeeze-out method of effecting a going private transaction as a stand alone (rather than second-stage) transaction, and the income tax issues arising from it. It begins with a brief discussion of the statutory definition of a going private transaction, and the various common methods of completing a going private transaction.

Definition of Going-Private Transaction

Subsection 190(1) of the OBCA defines a "going-private transaction" as follows:

"going private transaction" means an amalgamation, arrangement, consolidation or other transaction carried out under this Act by a corporation that would cause the interest of a holder of a participating security of the corporation to be terminated without the consent of the holder and without the substitution therefor of an interest of equivalent value in a participating security that,

- (a) is issued by the corporation, an affiliate of the corporation or a successor body corporate, and
 - (b) is not limited in the extent of its participation in earnings to any greater extent than the participating security for which it is substituted,
- but does not include,
- (c) an acquisition under section 188 [Take-over bid and issuer bid],
 - (d) a redemption of, or other compulsory termination of the interest of the holder in, a security if the security is redeemed or otherwise acquired in accordance with the terms and conditions attaching thereto or under a requirement of the articles relating to the class of securities or of this Act, or
 - (e) a proceeding under Part XVI [Liquidation and Dissolution].

Subsection 3(1) of the *Canada Business Corporation Regulations* contains a similar definition of a "going-private transaction".

Accordingly, a "going-private transaction" is for the purposes of the OBCA a transaction, other than the excluded transactions listed in paragraphs (c), (d) and (e) of the definition, which, if carried out by a corporation, would cause the interest of a holder of a "participating security" of the corporation to be terminated, or squeezed-out, without the consent of the holder and without the substitution thereof of an interest in a "participating security" of equivalent value.

"Participating security" is defined as a security issued by a corporation which is not limited in the extent of its participation in the earnings of the corporation.

In addition to the OBCA (or the *Canada Business Corporations Act* ("CBCA")), a public corporation considering a going-private transaction must have regard to Multilateral Instrument 61-101 - Protection of Minority Security Holders in Special Transactions ("MI 61-101"), which has been adopted in Ontario

and Quebec, and its companion policy 61-101CP (“MI 61-101CP”). MI 601-101 and MI 61-101CP contain rules which supplement and in certain cases supersede the requirements of section 190 (Going private transaction) and section 188 (Take-over bid and issuer bid) of the OBCA. Some of these rules are discussed below. MI 61-101 and MI 61-101 CP are incorporated into Policy 5.9 of the TSX-V.

Among others things, the shareholder approval, valuation and other rules set out in MI 61-101 apply to a “business combination” as that term is defined in subsection 1(1). Regard should be had to this definition, and the transactions excluded from the definition. The definition is similar to but also differs somewhat from the definition of a “going-private transaction” in subsection 190(1) of the OBCA.

Common Methods of Completing a Going Private Transaction

The most common methods of completing a going-private transaction are:

- (a) a compulsory acquisition by a 90 percent or more shareholder under section 188 of the OBCA (or section 266 of the CBCA);
- (b) an amalgamation squeeze-out;
- (c) a consolidation squeeze-out; and
- (d) a transaction carried out pursuant to a court approved plan of arrangement.

A going-private transaction may take place as a second-stage transaction following a take-over bid or issuer bid which does not achieve the 90 percent shareholdings threshold required to force a squeeze-out of the remaining shareholders under section 188 of the OBCA. Alternatively, a going-private transaction may take place as a stand alone transaction, such as in the case of Publico.

The relatively small incremental cost and time required to obtain court approval of a plan of arrangement (which may consist of a simple purchase of the “minority” shareholders’ shares

for cancellation) may be justifiable if there is a significant possibility that one or more “minority” shareholders may exercise its statutory dissent rights to receive “fair value” for its shares, and that such shareholder(s) may establish that the squeeze-out consideration to be paid to the shareholders is less than the “fair value” of the shareholders’ shares. Court approval may significantly reduce the possibility of a “minority” shareholder exercising such a dissent right or otherwise establishing that the squeeze-out consideration is less the “fair value” of its shares. On the other hand, if the possibility of a “minority” shareholder successfully exercising its dissent right is acceptably low, the additional time and cost of a court approved plan of arrangement may not be justifiable.

There are other less common methods of effecting a going private transaction, including amending the terms of the shares of the public corporation, which are beyond the scope of this article.

Both the compulsory acquisition and amalgamation squeeze-out methods of carrying out a going private transaction by their nature require that a person or group of persons other than the public corporation initiate and finance the acquisition or squeeze-out of the “minority” shareholders. A consolidation squeeze-out is, by its nature, generally initiated and financed by the public corporation itself. It is for this reason that Publico selected the consolidation squeeze-out method to carry out its going-private transaction.

Consolidation Squeeze-Out

Paragraph 168(1)(h) of the OBCA (paragraph 173(1)(h) of the CBCA) permits a corporation to effect a stock split or consolidation by amending its articles.

A consolidation of the shares of a corporation involves consolidating the existing shares of the corporation into a smaller number of shares. In the case of a consolidation squeeze-out, a consolidation ratio is selected in a manner which results in:

- (a) the holdings of each of the “minority”

shareholders being consolidated to fewer than a whole number of shares and either, (i) their selling to the corporation their right to receive fractional shares for a specified cash amount for each pre-consolidation share previously held by them, or (ii) their receiving redeemable scrip certificates which they subsequently redeem for a specified cash amount for each pre-consolidation share previously held by them; and

- (b) the remaining shareholders receiving at least one whole share and continuing as the shareholders of the corporation.

Under subsection 57(1) of the OBCA (subsection 49(15) of the CBCA), a corporation may issue to a shareholder which holds fewer than one whole share a certificate for a fractional share or a scrip certificate in bearer form. Under subsection 57(2) of the OBCA (subsection 49(16) of the CBCA), the directors of a corporation may attach conditions to any scrip certificate, including conditions that the scrip certificate becomes void if not exchanged for a certificate representing a full share before a specified date, and that the scrip certificate is redeemable for a specified cash amount.

If a share consolidation is approved by the shareholders of a public corporation, the corporation may choose not to issue to “minority” shareholders certificates for fractional shares or scrip certificates, and require that “minority” shareholders sell to the corporation their right to receive fractional shares for a specified cash amount for each pre-consolidation share held by them.¹ Under corporate law, a corporation may purchase its own shares under certain circumstances, including for the purpose of eliminating fractional shares (paragraph 31(1)(b) of the OBCA and paragraph 35(1)(b) of the CBCA). If a consolidation proceeds on this basis, the following steps normally occur:

1. The public corporation files articles of amendment consolidating its shares.
2. Each shareholder which held more than

the consolidation threshold number of pre-consolidation shares is entitled to receive one or more whole post-consolidation shares of the corporation and to continue as a shareholder of the corporation.

3. Each shareholder which held fewer than the consolidation threshold number of pre-consolidation shares is not entitled to receive any fractional shares (the corporation does not issue fractional shares) and is instead required to sell to the corporation the shareholder’s right to receive fractional shares for a specified cash amount for each pre-consolidation share held by the shareholder.
4. The specified cash amount is based upon the amount determined by the corporation’s board of directors (which in turn is generally based upon an independent appraisal) to be the fair market value of each pre-consolidation share. The public corporation agrees to pay the specified cash amount to “minority” shareholders upon presentation, within for example two years of the consolidation, of certificates for their pre-consolidation shares as well as a letter of transmittal selling to the corporation their right to receive fractional shares.

Publico proceeded on this basis, and selected a consolidation ratio of, for example, 700,000:1. Accordingly, shareholders of Publico which held 700,000 or more pre-consolidation shares were entitled upon the consolidation of Publico’s shares to receive one or more whole post-consolidation shares of Publico and to continue as shareholders of Publico. Shareholders of Publico which held fewer than 700,000 pre-consolidation shares (sometimes referred to as “minority” shareholders) were not entitled to receive any fractional shares (none were issued by Publico) but were instead entitled to receive a specified cash amount for each pre-consolidation share previously held by them upon delivery to Publico of certificates representing the pre-consolidation shares and a letter of transmittal

selling to Publico their right to receive fractional shares on the consolidation. Whether they approved the going private transaction or not, these “minority” shareholders ceased to be shareholders of Publico and instead received a cash payment for their pre-consolidation shares, and were thereby squeezed-out of Publico.

In the alternative, a consolidating corporation may choose to take the extra step of issuing scrip certificates in bearer form to all shareholders. If a consolidating corporation proceeds on this basis, the following steps normally occur:

1. The public corporation files articles of amendment consolidating its shares.
2. Each shareholder, whether the shareholder held more than or fewer than the consolidation threshold number of pre-consolidation shares, receives a scrip certificate in bearer form for each pre-consolidation share held by them. Scrip certificates have attached to them the following conditions:
 - (a) scrip certificates may be exchanged for one or more whole post-consolidation shares where the holder holds more than the consolidation threshold number of scrip certificates (in Publico’s case 700,000) and exchanges the scrip certificates prior to a specified date;
 - (b) each scrip certificate provides that the holder is entitled to redeem the certificate and receive a specified cash amount for each pre-consolidation share held by the shareholder. Again, this cash amount is based upon the amount determined by the public corporation’s board of directors (which in turn is generally based upon an independent appraisal) to be the fair market value of each pre-consolidation share. The corporation agrees to pay this amount upon presentation of any expired scrip certificates within, for example, two

years of the consolidation; and

- (c) if a holder does not prior to the specified date exchange the holder’s scrip certificates for one or more whole post-consolidation shares, the scrip certificate becomes void, and may only be redeemed for the specified cash amount.

Accordingly, shareholders which held more than the consolidation threshold number of pre-consolidation shares receive scrip certificates entitling the holder to exchange the scrip certificates prior to a specified date for one or more whole post-consolidation shares. Each “minority” shareholder which held fewer than the consolidation threshold number of pre-consolidation shares receives fewer than the consolidation threshold number of scrip certificates, which scrip certificates are not sufficient in number to be exchanged for at least one whole post-consolidation share. Such scrip certificates may only be redeemed by the holder for the specified cash amount. Again, and whether they approved the going private transaction or not, these “minority” shareholders cease to be shareholders of the consolidating corporation and instead receive a cash payment for their pre-consolidation shares, and are thereby squeezed-out of the corporation.

3. “Minority” shareholders may also be given the option of electing not to take delivery of their scrip certificates and instead to sell their entitlement to receive scrip certificates to the corporation for the specified cash amount. This avoids the need to actually issue scrip certificates to electing shareholders.

Required Approval

A proposed consolidation squeeze-out requires approval by resolution at a duly constituted meeting of shareholders.

Subsection 168(5) of the OBCA (subsection 173(1) of the CBCA) requires that a consolidation of shares effected by an amendment to the corporation's articles must be approved by a "special resolution", that is a two-thirds affirmative vote at a special meeting of shareholders called to consider the consolidation.

In addition, section 190 of the OBCA contains shareholder approval (subsection 190(4)) requirements (as well as valuation (subsection 190(2)) and information circular (subsection 190(3)) requirements) which must be met before a going private transaction, including a consolidation squeeze-out, can be completed. The shareholder approval requirements of subsection 190(4) are more onerous than the special resolution requirement in subsection 168(5) because the votes of certain security holders (identified in clause 3. of subsection 190(4)) are excluded in determining whether the required subsection 190(4) approval is obtained.

However, these rules in section 190 of the OBCA rarely apply to a consolidation squeeze-out in practice as a result of the application of MI 61-101. Section 4.7 of MI 61-101 provides that a corporation that is governed by the OBCA is exempt from the valuation (subsection 190(2)), information circular (subsection 190(3)), and shareholder approval (subsection 190(4)) requirements of the OBCA (and is not required to make an application for exemption from those provisions under subsection 190(6) of the OBCA), if the transaction is carried out in compliance with Part 4 of MI 61-101. For this purpose, compliance includes reliance on any applicable exemption from the requirements of Part 4, including a discretionary exemption granted under section 9.1 of MI 61-101.

Section 4.7 of MI 61-101 does not, however, exempt the corporation from the general special resolution approval requirement in subsection 168(5) of the OBCA.

In order for a corporation to comply with Part 4 of MI 61-101 (other than by obtaining a discretionary exemption under section 9.1), the corporation must call a meeting of the holders of the affected securities

and must deliver in advance of that meeting an information circular (subsection 4.2(2)) containing the information required by subsection 4.2(3). Unless an exemption is available under section 4.4, section 4.3 also requires that the corporation obtain and disclose an independent formal valuation.

Provided that the corporation complies with the requirements of Part 4 of MI 61-101, the shareholder approval threshold for a consolidation squeeze-out is, by virtue of section 4.5 of MI 61-101, "minority approval" under Part 8 of MI 61-101. Such "minority" approval is not required if the consolidation is carried out as a second-stage squeeze-out following a take-over bid or issuer bid in which an "interested party" achieves a 90 percent or more ownership threshold and an appraisal remedy (i.e. dissent right) is available or made available to "minority" shareholders.

Section 8.1 (in Part 8) of MI 61-101 provides that such "minority approval" requires the majority approval of each class of "affected securities" (equity securities in which the interest of a holder would be terminated as a consequence of a business combination, including a consolidation squeeze-out) voting separately as a class excluding, in the case of each affected class of shares, the votes attached to the shares of the affected class that, to the knowledge of the corporation or any "interested party" or their respective directors or senior officers, after reasonable inquiry, are beneficially owned or over which control or direction is exercised by:

- (a) the issuer (i.e. the consolidating corporation),
- (b) an "interested party",
- (c) a "related party" of an "interested party", unless the "related party" meets that description solely in its capacity as a director or senior officer of one or more persons that are neither "interested parties" nor "insiders" of the issuer, or
- (d) a "joint actor" with a person referred to in paragraph (b) or (c) in respect of the

proposed transaction.

“Related party” is defined in section 1.1 of MI 61-101 as, generally, (i) a direct or indirect “control person”, (ii) a person having beneficial ownership of, and/or control or direction, directly or indirectly, over securities carrying more than 10 percent of the voting rights attached to all of the issuer’s (i.e. consolidating corporation’s) voting securities, (iii) a director or senior officer of the issuer or a person described elsewhere in the definition of “related party”, (iv) a person which manages or directs, to any substantial degree, the affairs or operations of the issuer under an agreement, arrangement or understanding between the person and the issuer, (v) a person of which persons described elsewhere in the definition of “related party” beneficially own, in the aggregate, more than 50 percent of the securities of any class of outstanding “equity securities” of the person, or (vi) an “affiliated entity” of any person described elsewhere in the definition of “related party”.

An “interested party” is defined as, in the case of a business combination (including a consolidation squeeze-out), a “related party” of the issuer (determined at the time the consolidation is approved by the shareholders of the issuer) if the “related party” is entitled to receive, directly or indirectly, as a consequence of the proposed consolidation among other things consideration per affected security that is not identical in amount and form to the entitlement of the general body of holders in Canada of securities of the same class. Accordingly, an “interested party” is a “related party” who holds a number of shares of the issuer which is equal to or more than the consolidation threshold number of shares (again 700,000 shares in the case of Publico) and who, as a result, would be entitled to receive a whole post-consolidation share or more of the issuer as a result of the consolidation.

“Equity securities” are generally common shares, but not convertible debt or preferred shares.

In summary then, for the purposes of a consolidation squeeze-out, the shareholders of the consolidating

corporation must at a meeting approve the transaction by special resolution, that is two-thirds approval of those shares voted at the meeting. In addition, assuming that the corporation has otherwise complied with the requirements of MI 61-101, and unless the consolidation is a second-stage squeeze-out following a take-over bid or issuer bid, the consolidation must be approved by a majority of the “minority” of each class of equity securities of the corporation determined without counting the votes of those shareholders which are “related parties” and which are entitled to receive a whole post-consolidation share (or more) as a result of the consolidation. In the case of Publico, these shareholders were those “related parties” (i.e. direct or indirect “control persons”, directors and senior officers, 10 percent or more shareholders) which held 700,000 or more pre-consolidation shares of Publico.

Valuation Requirement

Subsection 190(2) of the OBCA requires a consolidating corporation to obtain a written valuation from an independent, qualified valuer indicating a per security value or range of values for each class of affected securities.

Again, however, section 4.7 of MI 61-101 exempts a corporation from the valuation requirements of subsection 190(2) of the OBCA where the consolidation is carried out in accordance with Part 4 of MI 61-101.

Section 6.1 of MI 61-101 (applicable by virtue of subsection 4.3(2)) requires that a “formal valuation” shall be prepared by a valuator that is “independent” of all “interested parties” in the transaction and that has appropriate qualifications. It is a question of fact whether a valuator is independent of an “interested party” or has appropriate qualifications. Subsections 6.1(3) and (4) set out various criteria for determining whether a valuator is independent of an “interested party” in connection with a business combination, including a consolidation. Part 6 also sets out requirements regarding, among other things, the

disclosure of the qualifications and independence of the valuator, the subject matter and preparation of the valuation, the disclosure of prior valuations, and the filing of the valuation.

It is accepted practice in the context of a proposed consolidation squeeze-out (other than a second stage consolidation following a take-over bid or issuer bid) for an independent committee of the board of directors to retain a qualified, independent valuator to prepare the required formal valuation. The valuation will usually specify a range of values for the relevant securities, and the independent committee (and the full board) must decide whether to recommend the transaction, including the cash consolidation consideration, to the corporation's shareholders.

Section 4.4 of MI 61-101 sets out certain exemptions from the formal valuation requirements of section 4.3 applicable to a business combination, including in the case of a second-stage business combination where the conditions of paragraph 4.4(1)(d) are met.

Income Tax Consequences

As discussed above, a consolidating corporation may choose either (i) not to issue fractional shares (or scrip certificates) to "minority" shareholders which held fewer than the consolidation threshold number of pre-consolidation shares and to require such shareholders to sell to the corporation their right to receive fractional shares for the specified cash amount for each pre-consolidation share held by them, or (ii) to issue redeemable scrip certificates in bearer form such that "minority" shareholders receive fewer than the consolidation threshold number of scrip certificates and may only redeem their scrip certificates for the specified cash amount for each pre-consolidation share held by them.

Taxable Disposition – "Minority" Shareholders Sell to the Corporation Their Right to Receive Fractional Shares

Paragraph (b)(i) of the definition of a "disposition" in subsection 248(1) of the *Income Tax Act* (Canada) ("ITA") provides that a disposition of a share occurs where the share is "redeemed in whole or in part or is cancelled". It was proposed in Bill C-10 (which at the date of this article requires re-introduction) that this be expanded to include the "acquisition" of a share. For tax purposes, a "share" means a share or a fraction of a share (subsection 248(1) of the ITA).

It is suggested that a "minority" shareholder which sells to the consolidating corporation the shareholder's right to receive fractional shares for a specified cash amount for each pre-consolidation share held by the shareholder has, for tax purposes, disposed of his right to receive fractional shares.

This position is consistent with the CRA's administrative position that no disposition will be considered to have occurred on a share split or consolidation if:

there is no change in the total capital represented by the issue, there is no change in the interest, rights, or privileges of the shareholders and there are no concurrent changes in the capital structure of the corporation or the rights and privileges of other shareholders.²

Applying the CRA's said administrative position, the consolidation of a share for a specified cash amount (as a result of a "minority" shareholder's having sold to the corporation its right to receive fractional shares) results in a change in the interest, rights and privileges of the holder of the share, and a change in the capital structure of the corporation, and accordingly amounts to a disposition of the holder's right to receive a fraction of a share for tax purposes.

Taxable Disposition – “Minority” Shareholders Receive Scrip Certificates Which May Only be Redeemed for Cash Proceeds

It is suggested that a scrip certificate is not a fraction of a share as a matter of corporate law. By virtue of subsection 57(3) of the OBCA (subsection 49(17) of the CBCA) a holder of a fractional share is entitled to voting and dividend rights unless the articles provide otherwise. In contrast, subsection 57(4) of the OBCA (subsection 49(18) of the CBCA) provides that a holder of a scrip certificate is not entitled to voting or dividend rights in any case.

It is suggested that the consolidation of a share which results in the holder of the share receiving a redeemable scrip certificate amounts to a disposition of the pre-consolidation share for tax purposes.

Since a scrip certificate is not a fraction of a share or a share for tax purposes, it is suggested that a share which has been consolidated for a redeemable scrip certificate has been “redeemed”, “acquired” or “cancelled” for the purposes of subparagraph (b)(i) of the definition of “disposition” in subsection 248(1), as the consolidated share ceases to exist.

Again, this position is consistent with the CRA’s administrative position above. The consolidation of a share for a scrip certificate which may only be redeemed for cash proceeds results in a change in the interest, rights and privileges of the holder of the share, and a change in the capital structure of the corporation, and accordingly amounts to a disposition of the share for tax purposes.

Where a shareholder of a corporation receives a scrip certificate and subsequently exchanges the scrip certificate for cash, the shareholder may be considered to have disposed of the scrip certificate (arguably a second disposition). No further capital gain or loss should arise, however, because the holder’s adjusted cost base of the scrip certificate should be equal to the amount of the cash proceeds to which the holder is entitled.

Taxable Disposition – Continuing Shareholders

It is also suggested that, in a consolidation squeeze-out, a shareholder which holds more than the consolidation threshold number of pre-consolidation shares, exchanges its pre-consolidation shares for one or more whole post-consolidation shares, and continues as a shareholder of the corporation following the consolidation has also disposed of its pre-consolidation shares upon the consolidation.³ Notwithstanding that it may be entitled to receive one or more whole post-consolidation shares and to continue as a shareholder, each such shareholder is still entitled to dissent to the consolidation under section 185 of the OBCA (section 190 of the CBCA) and to receive the “fair value” of its shares. Accordingly, the consolidation of a continuing shareholder’s shares is a disposition of those shares because the shareholder is *entitled* to receive “proceeds of disposition” (paragraph (a) of the definition of “disposition” in subsection 248(1) of the ITA) by virtue of the shareholder’s dissent right notwithstanding that the shareholder never exercises such dissent right. Again, this position is consistent with CRA’s administrative position above, as a consolidation which involves the squeeze-out of “minority” shareholders results in an overall change in, (i) “the total capital represented by the issue”, the (ii) “interest, rights, or privileges of the shareholders” generally, (iii) “the capital structure of the corporation”, and the (iv) “rights and privileges of other shareholders”.

Having stated that a consolidation of a continuing shareholder’s shares results in a disposition of those shares, a tax-deferred rollover is available to each such shareholder under section 86 of the ITA where such shares are otherwise capital property of the shareholder. Where the shares are capital property of the shareholder, the conditions for the application of section 86 will otherwise be satisfied because each such continuing shareholder will have disposed of all of the shareholder’s pre-consolidation shares of the consolidating corporation in exchange for “other” post-consolidation shares of the corporation in the course of a reorganization of the share capital

of the consolidating corporation. As a result, the shareholder's cost of the post-consolidation shares will be the shareholder's cost of the pre-consolidation shares, which will also be the shareholder's proceeds of disposition in respect of the pre-consolidation shares, hence the rollover.

Resident Shareholders

As the consolidation of a share for either a specified cash amount paid to a "minority" shareholder in respect of the sale of the shareholder's rights to receive fractional shares or a redeemable scrip certificate is a disposition for income tax purposes, by virtue of subsection 84(3) of the ITA the consolidating corporation is deemed to have paid a taxable dividend (subject to the potential application of subsection 55(2) of the ITA to shareholders that are corporations, discussed below) on the "redeemed", "acquired" or "cancelled" share in an amount equal to the amount by which the amount paid by the corporation for each consolidated share exceeds the paid up capital of the consolidated share immediately prior to the consolidation.

The independent valuator of Publico's shares determined that Publico's shares had a fair market value in the range of \$0.55 to \$0.66. Publico ultimately paid the "minority" shareholders \$0.61 (the specified cash amount) for each consolidated share. As each share had a paid up capital of \$0.48, the consolidation of each share resulted in a deemed dividend to each "minority" shareholder of \$0.13.

In the case of a resident shareholder who is an individual, the deemed dividend will be included in computing the shareholder's income and will be subject to the gross-up and dividend tax credit rules normally applicable to taxable dividends received from taxable Canadian corporations. The receipt of the deemed dividend may give rise to liability for alternative minimum tax. The deemed dividend will be an "eligible dividend", and each shareholder will be entitled to the enhanced gross-up under subparagraph 82(1)(b)(ii) of the ITA and the enhanced dividend tax credit under paragraph 121(b) of the

ITA, except where the consolidating corporation has at the effective time of the consolidation a low income rate pool, or LRIP.

In the case of a resident shareholder that is a corporation, the deemed dividend will be included (subject to the potential application of subsection 55(2) of the ITA, discussed below) in computing the shareholder's income and generally will be deductible in computing taxable income.

A shareholder which is a "private corporation" as defined in the ITA (or a "subject corporation", that is any other corporation resident in Canada and controlled by or for the benefit of an individual or a related group of individuals) will be liable to pay Part IV refundable tax in respect of the deemed dividend where the shareholder and the consolidating corporation are not "connected" with each other. A shareholder and a corporation are "connected" with each other under subsection 186(4) of the ITA where the shareholder controls the corporation or owns more than 10 percent of the voting shares of the corporation and the fair market value of such shares owned by the shareholder exceeds 10 percent of the fair market value of all of the issued shares of the corporation. If the consolidation does not itself trigger a year end (e.g. by virtue of a change in control of the consolidating corporation), Part IV refundable tax may also apply if a "private corporation" shareholder is "connected" to the consolidating corporation and the consolidating corporation later in the year in which the consolidation occurs becomes a "private corporation" and thereafter has a positive refundable dividend tax on hand account at the end of the year.⁴

This unexpected post-consolidation Part IV liability (again which only arises if the consolidating corporation becomes a "private corporation" in the taxation year in which the consolidation occurs and has a positive refundable dividend tax on hand account ("RDTOH") at the end of the taxation year) may be avoided if the corporation has a fiscal year-end after it becomes a "private corporation" or at least prior to realizing any RDTOH.

If the shares of the consolidating corporation include taxable preferred shares, Part IV.1 tax may also apply.

In addition to a deemed dividend, as a shareholder whose shares are consolidated will have disposed of the shareholder's right to receive fractional shares or shares (if the shareholder receives scrip certificates) for the purposes of the ITA, a capital gain or capital loss may also result. For the purpose of calculating a shareholder's capital gain or capital loss with respect to this disposition, the proceeds of disposition will be equal to the amount by which the specified cash amount paid or payable by the corporation for each consolidated share or redeemable scrip certificate exceeds the amount of the deemed dividend (paragraph (j) of the definition of "proceeds of disposition" in section 54 of the ITA) in respect of the disposition. In the case of Publico, the "minority" shareholders received proceeds of disposition equal to \$0.48 per share, that is the cash payment of \$0.61 less the \$0.13 deemed dividend. A capital gain would result to those shareholders of Publico who had an adjusted cost base per share less than \$0.48. A capital loss would result to those shareholders who had an adjusted cost base per share greater than \$0.48.

In the case of a shareholder that is a corporation, the amount of any capital loss otherwise determined resulting from the disposition of the shareholder's pre-consolidation shares may be reduced under subsection 112(3) of the ITA by the amount of dividends previously received or deemed to have been received thereon, including any dividend that is deemed to be received as a result of the consolidation. Analogous rules in subsections 112(3.1) and (3.2) may apply where a corporation is a member of a partnership or a beneficiary of a trust which owned a pre-consolidation share of the corporation. These rules also apply where a trust or partnership (of which a corporation is a beneficiary or a member) is a member of a partnership or beneficiary of a trust that owns a share of the corporation.

A shareholder will be required to include in income one half of the amount of any capital gain (a "taxable capital gain") resulting from the disposition of either a right to receive fractional shares or a share of the corporation, and will be required to deduct one-half of the amount of any capital loss (an "allowable capital loss") resulting from the disposition of either a right to receive fractional shares or a share of the corporation against taxable capital gains realized by the shareholder in the year of disposition. Allowable capital losses in excess of taxable capital gains may be carried back and deducted in any of the three preceding years or carried forward and deducted in any following year against taxable capital gains realized in such years to the extent and under the circumstances described in the ITA. Taxable capital gains realized by a shareholder which is a Canadian-controlled private corporation are subject to an additional 6 2/3 percent refundable tax under section 123.3 of the ITA. Capital gains realized by an individual, including a trust other than certain specified trusts, may give rise to alternative minimum tax under the ITA.

Under the "capital gains stripping" anti-avoidance rule in subsection 55(2) of the ITA, a shareholder that is a corporation may be required to recognize all or a portion of the dividend otherwise deemed to have been received upon the cancellation of its shares of the corporation as proceeds of disposition in the computation of the capital gain or capital loss resulting from the disposition, except to the extent the deemed dividend is subject to Part IV refundable tax (but not Part IV.1 refundable tax) and the tax is not refunded under the circumstances specified in subsection 55(2) of the ITA.

Subsection 55(2) is an anti-avoidance provision designed to preclude corporate shareholders from undertaking arrangements to realize the appreciation in corporate assets as a tax-deferred inter-corporate distribution as opposed to a capital gain. Where subsection 55(2) applies, a dividend received by a corporate taxpayer on a share is deemed not to be a dividend, and is deemed to be, (i) proceeds of disposition if the corporation

has disposed of the share, or (ii) a gain from the disposition of capital property if the corporation has not disposed of the share. In other words, where subsection 55(2) applies, a deductible dividend is transformed into proceeds of disposition so as to result in a capital gain. In general terms, subsection 55(2) applies in respect of a taxable dividend that is deductible under subsection 112(1) or 112(2) and received or deemed to be received by a corporation resident in Canada, where:

- (a) the dividend was received as part of a series of transactions, and
- (b) one of the purposes of the series of transactions (or, in the case of a deemed dividend under subsection 84(3), one of the results of the series of transactions) was to effect a significant reduction in the portion of the capital gain that, but for the dividend, would have been realized on a fair market value disposition of any share immediately before the dividend.

However, subsection 55(2) will not apply to a deductible dividend:

- (c) where the hypothetical capital gain referred to in (b), above, can reasonably be considered to be attributable to income earned or realized by any corporation after 1971 (generally referred to as “safe income”), or
- (d) to the extent that the dividend is subject to tax under Part IV of the Act which tax is not refunded as part of the same series of transactions.

Accordingly, under the exception in (c), above, subsection 55(2) would not apply to re-characterize a deemed dividend arising from the consolidation of a “minority” corporate shareholder’s shares where the deemed dividend is attributable to the consolidating corporation’s post-1971 tax paid retained earnings (safe income) in respect of the consolidated shares.

And under the exception in (d), above, subsection

55(2) would not apply to re-characterize a deemed dividend arising from the consolidation of a “minority” corporate shareholder’s shares to the extent that the dividend is subject to tax under Part IV of the Act which tax is not refunded as part of the same series of transactions. See the discussion of the application of Part IV tax above.

It is suggested that, for other “minority” shareholders which are corporations and absent sufficient safe income, subsection 55(2), which adopts a “results test” rather than a purpose test, will re-characterize the dividend otherwise deemed to have been paid to such “minority” shareholders as a capital gain. Clearly, it is not possible to actually disclose to any particular “minority” shareholder the amount of safe income attributable to the shareholder’s shares since this depends on factors peculiar to each “minority” shareholder. In such case it would be up to each “minority” shareholder to contact the corporation to determine the safe income attributable to the shareholder’s shares.

Non-Resident Shareholders

A. Deemed Dividend

A non-resident shareholder whose shares are consolidated will be also deemed to have received a taxable dividend (calculated in the manner described above under “Resident Shareholders”). Again, this results whether the non-resident shareholder sells to the corporation for a specified cash amount the shareholder’s right to receive fractional shares or receives scrip certificates which are redeemable for a specified cash amount. Such a shareholder will be subject to non-resident withholding tax under subsection 212(2) of the ITA at the rate of 25 percent (most tax treaties reduce the 25 percent rate to 15 percent) of the amount of the deemed dividend. Generally, a consolidating corporation requires that each non-resident identify to the corporation their country of residence (e.g. in the letter of transmittal) in order to determine whether the 25 percent or a lower withholding rate applies in the case of a particular non-resident.

A section 116 certificate of compliance issued by the Canada Revenue Agency (the "CRA") is not required in respect of the subsection 212(2) withholding tax on the deemed dividend, nor is it available to exempt the consolidating corporation from the subsection 212(2) withholding requirement in respect of the deemed dividend.

B. Capital Gain or Loss - "Minority" Shareholders Sell to the Corporation Their Right to Receive Fractional Shares

In addition to a deemed dividend, where a non-resident shareholder whose shares are consolidated sells to the corporation (that is disposes of) its right to receive fractional shares, a capital gain or capital loss may also result. For the purpose of calculating a non-resident's capital gain or capital loss with respect to this disposition, the proceeds of disposition will be equal to the amount by which the specified cash amount received from the corporation for each pre-consolidation share exceeds the amount of the deemed dividend in respect of each pre-consolidation share.

There is no withholding tax obligation under subsection 116(5) of the ITA in respect of any capital gain on the disposition of a share which is listed on a "recognized stock exchange", including Tier 1 and Tier 2 of the TSX-V. Such shares are "excluded property" under paragraph 116(6)(b) of the ITA and for the purposes of the excluded property exception from the withholding tax obligation in subsection 116(5) of the ITA, and the notice, security and certificate of compliance requirements in subsections 116(1), (2), (3) and (4) of the ITA. Accordingly, where a shareholder sells shares of a corporation on the open market and prior to the consolidation of the corporation's shares, there is no section 116 withholding tax where the shares are listed at the time of the sale on a "recognized stock exchange".

It is unclear though whether a fractional share or a right to receive a fractional share is also "excluded property" for the purposes of section 116 where the whole share is itself otherwise listed on a "recognized

stock exchange".

Counsel in at least two cases involving the consolidation of the shares of a publicly traded corporation have stated that a fractional interest in a share may not be an interest in a share for the purposes of subsection 116(6), and may be accordingly "taxable Canadian property".⁵ Counsel did not in either case elaborate on this position, nor did counsel in either case address whether a fraction of a share was "excluded property" or not under paragraph 116(6)(b) of the ITA. In both cases the corporation's circular stated that if non-resident shareholders did not deliver to the corporation a section 116 certificate of compliance on or prior to the shareholder's receiving the cash payment for the shareholder's consolidated shares, then the corporation would withhold 25 percent of the potential capital gain which might arise upon the disposition of the shareholder's right to receive fractional shares of the corporation.

It is not immediately apparent why counsel took this position. Paragraph 116(6)(b) of the ITA provides that "excluded property" of a non-resident person means:

a share of a class of shares of the capital of a corporation that is listed on a recognized stock exchange;

It is suggested that the words "that is listed on a recognized stock exchange" modify the words "class of shares" rather than "a share". As stated above, "share" is defined in subsection 284(1) as meaning a share or a fraction of a share. Substituting the words "fraction of the share" for "share" in paragraph 116(6)(b), the provision reads:

a *fraction of a share* of a class of shares of the capital of a corporation that is listed on a recognized stock exchange;

It would appear then that, by virtue of the definition of a "share" in subsection 248(1), a fraction of share is "excluded property" under paragraph 116(6)(b) where the share itself is listed on a recognized stock exchange. This result would be consistent with the

fact that generally fractional shares may be traded in the same manner as whole shares where the shares are listed on a “recognized stock exchange”.

Having said this, a fraction of a share may not be an “interest” in a share which is “excluded property” by virtue of paragraph 116(6)(h) of the ITA. An “interest” in share is generally considered to be a right or option to acquire a share, or an undivided interest in a share, rather than a fractional interest in a share.

If, where a share is listed on a recognized stock exchange, a fraction of such a share is not “excluded property” under either paragraph 116(6)(b) or (h) of the ITA, then the fraction of a share will be “taxable Canadian property”. However, and by virtue of new paragraph 116(6)(i) of the ITA, “taxable Canadian property” which is disposed of by a non-resident after 2008 will be “excluded property”, and not subject to the withholding tax requirements of section 116, where it is otherwise “treaty-exempt property”. Subsection 116(6.1) defines “treaty exempt property” as property that at the time of its disposition is:

- (a) “treaty-protected property” of the non-resident; and
- (b) where the purchaser and the non-resident are related at the time of disposition, the purchaser provides a notice to CRA under subsection 116(5.02) in respect of the disposition.

“Treaty protected property” is defined in subsection 248(1) of the Act as property any income or gain realized on the disposition of which by the non-resident person would be exempt from tax in Canada under the provisions of a relevant tax treaty.

It is suggested that, in order to determine whether a non-resident shareholder is a resident of a treaty country which exempts from Canadian tax the disposition by the non-resident shareholder of taxable Canadian property, the purchaser (consolidating corporation) must make a “reasonable inquiry” (paragraph 116(5.01)(a)) into the shareholder’s residence. It is currently unclear what

such a “reasonable inquiry” would entail. And it is unclear whether a purchaser must still give a notice required by paragraph 116(5.01)(c) in order to avoid the withholding requirement in subsection 116(5) where the property being disposed of is otherwise “treaty-exempt property”, and therefore “excluded property” under subsection 116(6)(i). Consequently, consolidating corporations may continue to require section 116 certificates of compliance where non-resident “minority” shareholders dispose of their right to receive fractional shares for cash proceeds.

C. Capital Gain or Loss – “Minority” Shareholders Receive Scrip Certificates Which May Only be Redeemed for Cash Proceeds

In addition to a deemed dividend, where a non-resident shareholder whose shares are consolidated receives redeemable scrip certificates, a capital gain or capital loss may also result. For the purpose of calculating a non-resident’s capital gain or capital loss with respect to this disposition, the proceeds of disposition will be equal to the amount by which the redemption value of the scrip certificate exceeds the amount of the deemed dividend in respect of each pre-consolidation share.

Such capital gain will also not be subject to withholding tax under section 116 of the ITA where the shares were listed on a “recognized stock exchange” at the time of the consolidation. Such shares will be “excluded property” for the purposes of the withholding tax obligation in subsection 116(5) of the ITA, and the notice, security and certificate of compliance requirements in subsections 116(1), (2), (3) and (4) of the ITA.

As stated above, a scrip certificate is not a “share” or a “fraction of a share”. It is not clear whether a scrip certificate is an “interest” in a share which share is otherwise listed on a “recognized stock exchange”, and therefore whether upon the exchange of a scrip certificate for cash proceeds the scrip certificate is “excluded property” by virtue of paragraph 116(6)(h) of the Act and for the purposes of section 116. If, however, a scrip certificate is exchanged for cash proceeds after the underlying shares of the

consolidating corporation are de-listed, then the scrip certificate will at the time of the exchange be “taxable Canadian property”. Again, where such property is “treaty-exempt property”, it will be “excluded property” for the purposes of section 116. And again, due the uncertainty of the nature and extent of the inquiry which a consolidating corporation may be required to undertake to determine the residence of a particular non-resident shareholder (and whether a scrip certificate is an interest in a share), consolidating corporations may continue to require section 116 certificates of compliance where non-resident “minority” shareholders exchange their scrip certificates for cash proceeds, and whether before or after the shares of the corporation are de-listed.

Dissenting Shareholders

Under section 185 of the OBCA (section 190 of the CBCA), shareholders of a corporation have a right to dissent to a consolidation squeeze-out.

A dissenting shareholder which complies with the procedures set out in section 185 of the OBCA is entitled to be paid the “fair value” of its shares (subsection 185(4)). This entitlement arises “when the action approved by the resolution from which the shareholder dissents becomes effective”. In the case of a consolidation, this is the effective time of the consolidation, which is the time which the articles of amendment effecting the consolidation are filed.

As mentioned above, a dissenting shareholder disposes of its shares when it becomes entitled to receive the “fair value” of its shares, that is “proceeds of disposition” for the purposes of the ITA.⁶ The CRA has interpreted this provision to mean that a disposition occurs when the taxpayer has an absolute but not necessarily an immediate right to be paid.⁷ A dissenting shareholder arguably has an absolute right to be paid fair value for its shares upon the filing of articles of amendment effecting the consolidation. Accordingly, the time of disposition is the effective time of the consolidation, i.e. the

time of filing of articles of amendment. Upon the dissenting shareholder complying with the notice provision in section 185, the dissenting shareholder ceases to have any rights as a shareholder other than the right to be paid “fair value”, unless the dissenting shareholder withdraws the notice, in which case the dissenting shareholder’s rights are retroactively reinstated. It follows that a dissenting shareholder may not cease to have rights as a shareholder until a time that could be after the effective time of the consolidation. Further, the shareholder may retroactively have its rights reinstated if the notice of dissent is subsequently withdrawn. Despite these provisions, it is suggested that the most appropriate position to take is that the shareholder disposes of its shares for tax purposes at the effective time of the consolidation because the shareholder thereby acquires at that time an absolute right to receive payment of “fair value” (proceeds of disposition) from the consolidating corporation.

As with other “minority” shareholders, a shareholder which exercises its dissent right will be regarded as having its shares “redeemed”, “acquired” or “cancelled”, and therefore will be considered to have received a deemed dividend under subsection 84(3) of the ITA. Again, the amount of the deemed dividend will be equal to the amount paid by the corporation for the dissenting shareholder’s pre-consolidation shares less the paid up capital of those shares. In addition to the deemed dividend and as with other “minority” shareholders, a shareholder which exercises its dissent right may also realize a capital gain or loss as a result of the disposition of its pre-consolidation shares. The discussion above on capital gains or losses of resident shareholders would also be applicable to dissenting shareholders.

Option Holders

The plan governing issued options should be reviewed to determine whether it addresses the occurrence of a consolidation. If the plan does not address the occurrence of a consolidation, normally the terms of a consolidation provide that outstanding options are exercisable for a specified cash amount

or for redeemable scrip certificates, so that the option holder will no longer have an equity interest in the corporation following the consolidation.

Ceasing to be a Public Corporation

By virtue of paragraph (c) of the definition of “public corporation” in subsection 89(1) of the ITA, notwithstanding the completion of a consolidation squeeze-out in respect of a corporation’s shares (and a consequent significant reduction in the number of its shareholders), generally the corporation will continue to be a public corporation until it elects in prescribed manner not to be a public corporation.

To make this election, the corporation must complete the prescribed form (form T2067) and file it together with a certified copy of the resolution of the directors authorizing the election to be made and a statutory declaration made by a director stating that, to the best of his or her knowledge, the corporation complies with the prescribed conditions that must be met for that election to be made (subsection 4800(4) of the *Income Tax Regulations* (“Regulations”). These prescribed conditions are set out in subsection 4800(2) of the Regulations. The prescribed conditions generally require that “insiders” hold more than 90 percent of the issued shares of each class that was formerly listed and that there be no more than a specified number of shareholders (generally fewer than 50 shareholders, or 100 in the case of non-equity shares), other than insiders of the corporation, each of whom holds not less than one block of shares of such class and shares of such class having an aggregate fair market value of not less than \$500. There must also be no class of shares of the capital stock of the corporation that is qualified for distribution to the public and that meets the conditions in paragraphs 4800(1)(b) and (c) of the Regulations.

A corporation should make the election not to be a public corporation prior to making a post-consolidation distribution as a return of capital, in order to avoid the distribution being deemed to be a dividend under subsection 84(4.1) of the ITA.

In addition to a T2067 election, in order to become a “private corporation” under subsection 89(1) of the ITA, the corporation also must not be controlled by one or more public corporations (other than prescribed venture capital corporations) or prescribed federal Crown corporations or any combination thereof.

Some of the other consequences of a corporation electing not to be a public corporation (and becoming a private corporation) include the following:

1. By virtue of subsections 4900(6) and 4900(12) of the Regulations, shares of the corporation will no longer be qualified investments for registered retirement savings plans and other deferred income plans (subject to the specific rules for shares of an “eligible corporation” and a “small business corporation”).
2. The corporation will be subject to Part IV tax and the RDTOH (refundable dividend tax on hand) mechanism.
3. The corporation will be able to take advantage of the “capital dividend” mechanism in the ITA, which permits the untaxed ½ of any capital gain realized by the corporation to be flowed out tax-free to its shareholders.
4. To the extent that the corporation constitutes a Canadian-controlled private corporation and otherwise meets the small business requirements of section 125 of the ITA, the corporation will be eligible to claim the small business deduction (a credit against tax otherwise owing) on the first \$500,000 (currently) of active business income in Canada earned by it in a year.
5. The corporation will cease to be subject to Part II.1 tax on corporate distributions.
6. Subsection 84(10) of the ITA may apply to reduce the contributed surplus of a corporation by the amount of certain dividends paid by the corporation while it was a public corporation.

Notes:

- 1 The cash payment may also be viewed as a payment *in lieu* of receiving fractional shares, rather than for the sale of a right to receive fractional shares.
- 2 See IT-65 – Stock Splits and Consolidations dated September 8, 1972.
- 3 Contrast this result with a simple share consolidation where each shareholder receives a smaller number shares and no shareholders are squeezed-out. In such case, the consolidation does not result in a disposition of the consolidated shares, and has no tax effect. See IT-65 – Stock Splits and Consolidations dated September 8, 1972, and *Brulotte v. The Queen*, 2003 DTC 4018 (TCC).
- 4 See Fred Purkey, “Unexpected Part IV Tax Liability and Deemed Dividends”, VI(4) Corporate Structures and Groups (Federated Press) 343-344 (2001).
- 5 See Spar Aerospace Limited, Management Proxy Circular dated December 19, 2001, and Hollinger Inc., Notice of Special Meeting and Management Proxy Circular dated March 4, 2005.
- 6 See again paragraph (a) of the definition of “disposition” in subsection 248(1) of the ITA.
- 7 See paragraph 5 of IT-170R Sale of Property – When included in income calculation dated August 25, 1980.

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