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REFDATE 130423
SUBJECT Calculation of bump limit under 88(1)(d)
SECTION 88(1)(d)

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Prenez note que ce document, bien qu'exact au moment émis, peut ne pas représenter la position actuelle de l'ARC.

PRINCIPAL ISSUES: (1) For the purposes of the 88(1)(d)(ii) bump limit, whether in a situation where the fair market value of a particular property of the subsidiary decreased between the time of the acquisition of control and the time of the winding-up, the cost to the parent of the property can still be increased up to the fair market value of the property as of the date of the acquisition of control? (2) For the purposes of the 88(1)(d)(ii) bump limit, in a situation where an identical property to the eligible property (e.g. a share of a public corporation) is acquired by the subsidiary after the acquisition of control, what is the cost amount of the eligible property, the average cost or the historic cost?

POSITION: (1) Yes. (2) Under proposed amendments to subparagraph 88(1)(d)(ii), the average cost determined under subsection 47(1) with respect to the cost amount to the subsidiary of the property immediately before the winding-up; and the historic cost with respect to the cost amount to the subsidiary of the property at the time the parent last acquired control of the subsidiary

REASONS: (1) and (2) Wording of the Act

XXXXXXXXXXXX

2012-046174
M. Séguin

April 23, 2013

Dear XXXXXXXXXXXX,

Re: Calculation of the bump limit provided under subparagraph 88(1)(d)(ii)

We are writing in response to your email received July 16, 2012 in which you have requested our comments in respect of the calculation of the bump provided under paragraph 88(1)(d) of the Income Tax Act ("Act") in the context of a hypothetical bump planning scenario.

Unless otherwise stated, every reference herein to a part, section, subsection, paragraph or a subparagraph is a reference to the relevant provision of the Act.

Written confirmation of the tax implications inherent in particular

transactions is given by this Directorate only where the transactions are proposed and are the subject matter of an advance income tax ruling request submitted in the manner set out in Information Circular 70-6R5, Advance Income Tax Rulings, dated May 17, 2002. However, we can offer the following general comments.

First question

Subparagraph 88(1)(d)(ii) provides that the bumped-up cost of the property cannot exceed the fair market value of the property when the parent last acquired control of the subsidiary. You would like us to confirm that in a situation where the fair market value of the property decreased between the time of acquisition of control and the winding-up, the cost of the property can still be increased up to the fair market value as of the date of the acquisition of control which will be greater than the fair market value of the property at time of winding up the subsidiary.

Example: a share of the capital stock of XXXXXXXXXX Inc. owned by the subsidiary at the acquisition of control was worth \$100.00. The same share on windup was only worth \$80.00. If the bump room is available, can its cost be bumped to \$100.00 even though its fair market value on windup was only \$80.00?

Our comments

We agree that the bumped-up cost of the eligible property in the present scenario can be made up to the fair market value of the property at the time the parent last acquired control of the subsidiary, even where the fair market value of the property has decreased after such acquisition of control. The wording of subparagraph 88(1)(d)(ii) is clear and unambiguous and refers specifically to the fair market value of the property at the time the parent last acquired control of the subsidiary.

Second question

In a situation where the subsidiary owns shares of the capital stock of a public corporation as of the date of the acquisition of control and acquires more shares of the same public corporation between the acquisition of control and the winding-up, subsection 88(1) provides that the only shares eligible for the bump are those which were owned at the time of the acquisition of control and owned by the subsidiary thereafter without interruption until such time as it is distributed to the parent on the winding-up. The question is the following: what is the cost that we must use to calculate the bump for those shares: is it an average cost due to the fact that other identical shares were purchased after the acquisition of control or is it the historic cost of the shares as of the acquisition of control.

Example:

The subsidiary owns 3,000 XXXXXXXXXX shares as of the acquisition of control which have a cost of \$10,000.

The subsidiary acquires 1,000 additional shares between the acquisition of

control and the winding-up of the subsidiary for \$5,000.

Only the 3,000 initial shares are eligible for the bump. The question is what is the cost that can be bumped: is it the initial cost of \$10,000 that can be bumped, or is it the average cost of the shares ($15,000 \times 3,000 / 4,000 = 11,250$).

In other words, are **two pools of shares being created**: the pre-acquisition of control shares and the post-acquisition of control shares? What then is **the cost to be used in the calculation of the capital gain upon the future sale of those shares**. If **two pools** of shares are created, it means that each pool has to be looked at separately, without taking into account the identical property rules. In your view, these rules would have to be used for the calculation of the capital gain in the future if they are used to determine the cost admissible to the bump. Moreover you suggest that if there are not two pools of shares inappropriate tax results would occur where there is a variation of value both upwards and downwards.

Our comments

When determining the cost to the parent of each property received from the subsidiary on its winding-up, subparagraph 88(1)(c)(ii) refers to the **amount that would be deemed by paragraph 88(1)(a) to be proceeds of disposition** of the property to the subsidiary as the **base amount** on which the amount determined under paragraph 88(1)(d) may be added. The deemed **proceeds of disposition** of a property under subparagraph 88(1)(a)(iii), is the **"cost amount"** to the subsidiary of the property immediately before the winding-up. For the purposes of subsection 88(1), where the property is capital property, paragraph (b) of the definition of **"cost amount"** **provided under subsection 248(1) refers to the "adjusted cost base"** to the taxpayer of the property at that time. The definition of "adjusted cost base" is provided under section 54 and in the case of identical properties, the adjusted cost base of each such identical property must be computed in accordance with the **cost-averaging rule provided under section 47**.

On that basis, in the particular situation, the cost to the parent of each XXXXXXXXXX share distributed to the parent on the winding-up would be **\$3.75 per share for a total of \$15,000 for all** the XXXXXXXXXX shares received. The cost to the parent of all the XXXXXXXXXX shares which would constitute eligible property for the purposes of paragraph 88(1)(d) would be **\$11,250 (\$3.75 x 3,000 shares)**.

Under the proposed amendments of December 21, 2012, applicable to windings-up that begin, and amalgamations that occur, on or after that date, new subparagraph 88(1)(d)(ii) provides the following:

(ii) the amount designated in respect of any such capital property may not exceed the amount determined by the formula

$$A - (B + C)$$

Where

A is the fair market value of the property at the time the parent last acquired control of the subsidiary,

B is the greater of the cost amount to the subsidiary of the property at the time the parent last acquired control of the subsidiary and the cost amount to the subsidiary of the property immediately before the winding-up, and

C is the prescribed amount, and...

The “specific” bump limit provided under new subparagraph 88(1)(d)(ii) limits the amount to be added to the cost of a property distributed to the parent to the excess of the fair market value of the property at the time the parent last acquired control of the subsidiary over the greater of the cost amount to the subsidiary of the property at the time the parent last acquired control of the subsidiary and the cost amount to the subsidiary of the property immediately before the winding-up. It means that where the cost amount to the subsidiary of a property immediately before the winding-up is lower (a variation downwards) than its cost amount at the time of the acquisition of control, the latter cost amount prevails for the purposes of computing the bump limit under 88(1)(d)(ii). Conversely, if the cost amount to the subsidiary of a property immediately before the winding-up is higher (a variation upwards) than its cost amount at the time of the acquisition of control, again, the latter cost amount prevails for the purposes of computing the bump limit under 88(1)(d)(ii).

In the particular situation, element A of the formula would be, for example, \$5 and element B would be the greater of the cost amount to the subsidiary of one XXXXXXXXXXXX share at the time of the acquisition of control, \$3.33 (the historic cost) and the cost amount to the subsidiary of the particular property immediately before the winding-up, \$3.75 (the average cost); that is \$3.75. The specific bump limit applicable in the particular situation to that XXXXXXXXXXXX share would be \$1.25 per share even though at the time of the acquisition of control the excess of the fair market value of the particular share (\$5.00) over the cost amount to the subsidiary (\$3.33) was \$1.67.

Although the purpose of the amendments to subparagraph 88(1)(d)(ii) is to counter transactions in which the amount of the bump available is increased by reducing the cost amount of the subsidiary’s property after the acquisition of control of the subsidiary and before its winding-up, the amount of the bump available is also affected in a situation where the cost amount of the subsidiary’s property after the acquisition of control of the subsidiary increased.

Even though you may consider inappropriate the tax result where there is a variation of the cost amount to the subsidiary of an eligible property upwards after the acquisition of control, we must keep in mind that in practice, the decision to buy identical properties to the eligible property is made by the parent of the subsidiary in a context where usually there is a very short time frame between the acquisition of control of the subsidiary and its winding-up. Indeed, usually what prompts parent to wind-up the subsidiary as soon as possible after the acquisition of control may be, among others, the need to match the

interest expense with the operations or to avoid that the earning of additional income in the subsidiary grinds down the bump room otherwise available. Therefore, the decision to buy identical properties to the eligible property before the winding-up of the subsidiary may be considered only as one business decision among others in the context of an acquisition of control of a target corporation by a purchaser corporation.

We trust our comments will be of assistance to you.

Yours truly,

Maurice Bisson, CPA, CGA
For Director
Reorganizations Division
Income Tax Rulings Directorate
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