Cassels

Gain on Sale of Shares May Be on Account of Income

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On a sale of shares to a third party, a vendor generally expects that any gain on such sale to be on account of capital which could mean that only one-half of the gain would be taxable to the vendor.

However, in *Atlantic Packaging Products Ltd. v. Canada*[1], the Tax Court of Canada (TCC) held that the gain on the sale of shares to a third-party purchaser to be on account of income because it did not meet the test in s. 54.2 of the *Income Tax Act* (Canada) (ITA). This has been recently confirmed by the Federal Court of Appeal (FCA).

Background

Atlantic Packaging Products Ltd. (Atlantic) is a paper products manufacturer with five divisions. As part of a sale agreement between Atlantic and Cascades Canada Inc. (Cascades), Atlantic agreed to sell the tissue division to Cascades. However, prior to the sale, certain assets (Transferred Assets) from the tissue division were transferred by Atlantic to a newly incorporated company (Newco) on a s. 85 rollover basis for consideration that included shares of Newco. Subsequently, the shares of Newco were then sold by Atlantic to Cascades. Atlantic relied on s. 54.2 when it reported the gain from the sale of the shares of Newco to Cascades as a capital gain.

Decision

The main issue to be decided by the TCC was whether the Transferred Assets represented all or substantially all of the assets used in the tissue division. Under s. 54.2, if a person has disposed of property that consisted of all or substantially all of the assets used in an active business carried on by that person to a corporation for consideration that included shares of the corporation, the shares are deemed to be capital property of that person. The Canada Revenue Agency (CRA) has generally interpreted “all or substantially all” as being at least 90 per cent of the value of the assets.

The TCC found that the Transferred Assets transferred to Newco did not represent all or substantially all of the assets used by Atlantic in the tissue division. Based on the evidence before the Court, the Transferred Assets made up only 68% of the total assets of the tissue division. While the Court acknowledged that all or substantially all does not mean 90% and that the specific percentage for the test may depend on the circumstance, the Court did not accept that 68% would meet the test. This calculation was based on the fair market value approach.

As a result, TCC held that the test for s. 54.2 had not been met, and therefore the shares of Newco were not deemed to be capital property.

The FCA upheld the judgment of the TCC and agreed that conveying 68% of the assets used in the tissue division would not satisfy the requirement that all or substantially all of the assets of the tissue division were conveyed to Newco. At the FCA, Atlantic tried to raise the alternative argument that the shares of Newco were capital property of Atlantic, irrespective of whether s. 54.2 applied, based on common law or general principles. However, Atlantic was not permitted to raise this at the FCA because it was not an issue raised at the TCC and, the FCA also stated that the absence of evidence was sufficient for the Court to not consider the issue.

Key Takeaway

Section 54.2 was meant to be a relieving provision when it was first enacted. The purpose was to ensure that the sale of a business through a sale of the shares of a corporation to which the business was recently transferred is not treated as a sale on income account. However, s. 54.2 is not intended to apply where a taxpayer sells indirectly, through the sale of the shares of a corporation, non-business assets or only some of the assets used in a business. If s. 54.2 does not apply, a taxpayer may still be able rely on general principles or common law to support capital gains treatment on such transactions.

There is case law such as the *Queen v. Continental Bank of Canada*[2], and also CRA administrative views to support the position that the ultimate sale of the shares of Newco to Cascades, which was contemplated as part of the pre-sale reorganization implemented by Atlantic, could be on account of capital, irrespective of whether s. 54.2 applies. Had Atlantic been permitted by the FCA to raise the question as to whether the shares of Newco are capital property based on common law or general principles, the outcome of the case could have been different.

Nonetheless, the reorganization implemented by Atlantic, where certain assets are transferred to a holding company prior to a sale, is contemplated quite frequently in a M&A context. When undertaking any reorganization whereby assets are transferred to a company in consideration for shares of that company, vendors should consider whether such reorganization would impact the tax treatment of the sale of such shares.

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[1] 2018 TCC 183, aff'd 2020 FCA 75.

[2] [1998] 2 SCR 358; aff ’d 96 DTC 6355 (FCA); aff ’d 94 DTC 1858 (TCC).

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