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A Creative Way of Settling Equalization or Support Obligations

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Introduction

The following paper provides a creative solution on how to fund an equalization payment from one spouse to the other, how to creatively deal with spousal support, and / or how to pay one spouse for money owing for some other reason. A court will not impose the solutions set out below so it is one that needs to be agreed on between the spouses.

Divisive Reorganization or Butterfly Transaction

Canada Revenue Agency (CRA) allows for a Divisive Reorganization or Butterfly Transaction (hereinafter referred to collectively as a Butterfly Transaction). Unfortunately nowhere in the *Income Tax Act* is there a definitive description of how to achieve a Butterfly Transaction or the relevant rules that govern the same.

The term Butterfly was first used in reference to divisive corporate reorganizations at the 1977 annual conference of the Canadian Tax Foundation¹. Today the *Income Tax Act*² specifically deals with the elements necessary to have a valid Butterfly transaction while

¹ Robert J. Dart "Demergers," in *Report of Proceedings of the Forty-Third Tax Conference*, 1991 Conference Report (Toronto: Canadian Tax Foundation, 1992), 13:1-38, at 13:3.

² R.S.C., 1985, c. 1 (5th Supp.) <http://laws-lois.justice.gc.ca/eng/acts/I-3.3/index.html>

not specifically using the phrase. The specific provisions of the *Income Tax Act* that are relevant to the implementation of a Butterfly transaction are:

- i. Subsection 52(2);
- ii. Subsection 55(2);
- iii. Subsection 55(3)(a)
- iv. Subsection 84(3);
- v. Subsection 85(1);
- vi. Subsection 85.1
- vii. Subsection 85(2.1)
- viii. Subsection 86; and
- ix. Subsection 112(1)

The main criteria that must exist for a true Butterfly transaction is that the spouses cannot yet be divorced. In the case law set out below there are examples of the court delaying the severing of the divorce to see if a Butterfly Transaction can be completed. There appears to be no ruling from CRA if a Butterfly Transaction is available to separating common-law spouses where a joint family venture is conceded by the parties.

A Butterfly Transaction is extremely complex and cannot be undertaken by the lawyers representing the parties. To complete a Butterfly Transaction the person owing the equalization payment (or joint family venture payment) or the lump sum support payment must be the owner of a closely held corporation. An accountant (or accountants) familiar with this area of the *Income Tax Act* along with corporate lawyers

will have to be retained. It is also prudent to obtain an advance ruling³ from CRA that they will recognize the transaction as acceptable. This is imperative as even though the *Income Tax Act* has provisions dealing with Butterfly Transactions, they vary dependent on interpretations by individuals working at CRA. Failure to obtain an advance ruling may lead to CRA attacking the transaction at a later date and the lawyer (depending on the degree of involvement) having to call Law-Pro. If a Butterfly Transaction does not satisfy section 55(3)(b) of the *Income Tax Act* and if the corporations involved receives a dividend, that dividend shall be treated as a capital gain and the resulting tax consequences may likely be fairly significant. The biggest concern for CRA with Butterfly transactions are to prevent:

- i. What really is a sale or barter type transaction that would normally be subject to tax⁴;
- ii. Tax-free liquidation of a shareholder⁵; or
- iii. Obtaining some form of inappropriate tax advantage⁶.

It is a costly exercise given the professionals that are required and as such a Butterfly Transaction only makes sense to complete when dealing with a substantial equalization payment or a large lump sum support payment.

³ *Information Circular 70-6R4*, "Advance Income Tax Rulings," January 29, 2001, paragraph 6. An advance tax ruling is obtained by CRA and is a statement setting out how CRA will apply the *Income Tax Act* to the transaction in question. The ruling is binding on CRA and will provide the necessary assurances to the clients that they transaction is acceptable.

⁴ See section 55(3.1) of the *Income Tax Act*

⁵ See section 55(1) of the *Income Tax Act*

⁶ While not specifically spelled out this seems to be the overall objective of section 55 of the *Income Tax Act* if not the entire *Income Tax Act* itself.

There are essentially two types of Butterfly Transactions; a related party Butterfly and an unrelated Butterfly. Spouses are deemed to be related for the purposes of a Butterfly transaction.

The Basics of How the Butterfly Works

To determine whether or not a Butterfly Transaction will work for your clients the following is a simplified version of what can occur to complete the transaction:

1. The indebted party will transfer a percentage of their common shares in their company (Company A) into a newly incorporated company owned by the recipient (Company B) and take back shares of Company B;
2. Company A will roll over the assets⁷ of the business it wishes to place in Company B and take back preferred shares of Company B;
3. Company A will repurchase for the cancellation of its common shares held by Company B and issue a promissory note as consideration to Company B. This will trigger a deemed dividend a for Company B and a deduction on taxes
4. Company B shall then redeem the preferred shares held by Company A and issue a promissory note as consideration. This will trigger a deemed dividend for Company A and a deduction on taxes
5. The promissory notes held by Company A and Company B will be set-off against each other. The notes are of equal fair market value thereby resulting in no tax repercussions to either Company A or Company B. The original shareholders of Company A now hold shares in both companies.

⁷ The *Income Tax Act* does not define the type of property that may be transferred but CRA has generally accepted that cash, near cash, business assets and investments assets are acceptable

Example of a Related Butterfly

The most important aspect to be concerned with is to make sure that the reorganization with the transfer of assets is not deemed by CRA to be a form of dividend as this may then lead to capital gains being payable. The related Butterfly Transaction is easier to accomplish than the unrelated Butterfly as there are less restrictions with CRA. A related Butterfly Transaction does not need to comply with the *pro-rated* mandated by CRA with unrelated Butterfly Transactions.

By way of example where a Husband and Wife each own 50% of the common shares of Company A. Company A owns a business worth \$1,000 and an investment portfolio worth \$500. The wife runs the business and the husband manages the investments. The husband and wife are divorcing and want to divide the assets of Company A without realizing tax on the company assets at this time. To accomplish this, the wife would buy 16% of Company A from her husband thereby increasing her ownership to 66% and allowing the asset to be divided according to fair market value.

After the reorganization, the husband and the wife would each have their own corporations with control of the investments (\$500) and business (\$1,000).

Example of Paying for Arrears of Support Between Unrelated Parties

In this example (taken from an actual case two years ago) the spouses were divorced. It was subsequently discovered the husband had an undisclosed bank account and had used undue pressure on his wife to execute a separation agreement. It was abundantly clear on the eve of trial that the separation agreement was going to be set aside.

Based on the above, the former spouses came to an agreement which they incorporated into Minutes of Settlement for what can best be described as a quasi Butterfly Transaction. None of the terms of the transaction were incorporated into the final order.

The total amount owing to the Applicant by the Respondent for arrears of child support, section 7 expenses and spousal support, lump sum spousal support, equalization interest and costs was fixed at \$430,000.00.

It was then agreed that this sum would be paid in two instalments: the first payment in the sum of \$250,000.00 was paid concurrent with the execution of the Minutes of Settlement and upon closing of the corporate transactions described. The balance of \$180,000.00 was then paid in the next calendar year⁸.

To complete the payment by the former husband to the former wife each party agreed to fully co-operate with the following steps:

A. Step 1 – Reorganize 1234567 Ontario Inc's shares (former husband's company)

- I. A reorganization of the shares of 1234567 Ontario Inc. was undertaken, such that 100,000 Class A special shares, with a fair market value and adjusted cost

⁸ This was done to reduce some taxes as the former wife had nominal / no income as described below

base of \$100,000, was created, and 330,000 Class B special shares, with a fair market value of \$330,000 and a nominal adjusted cost base, was created.

B. Step 2 – Transfer special shares of 1234567 Ontario Inc. to the former wife

- I. The former husband transferred the 100,000 Class A special shares to the former wife at their cost and fair market value of \$100,000.
- II. The former husband transferred 29,000 Class B special shares to the former wife at fair market value, creating a capital gain to the former husband of \$29,000.
- III. The former husband transferred 301,000 Class B special shares to the former wife at a cost of nil, using the rules provided for in the *Income Tax Act*.
- IV. As a result of the transfers, the former wife held \$430,000 worth of shares of 1234567 Ontario Inc; \$100,000 worth of Class A special shares with an adjusted cost base of \$100,000, and \$330,000 worth of Class B special shares with an adjusted cost base of \$29,000. Appropriate elections were filed for tax purposes relative to the transfers.

C. Step 3 – Redemption and purchase of shares from the former wife

- I. 1234567 Ontario Inc. redeemed 50,000 of the former wife's Class A special shares in each of 2010 and 2011, paying her \$50,000 upon each redemption. The redemptions resulted in her receiving a dividend of \$50,000 in those years, as well as a capital loss of \$50,000. The 2010 redemption was done within 30 days of the Minutes of Settlement being signed and the 2011 redemption was done on a specified date in January, 2011
 - II. The former husband then purchased 200,000 of the former wife's Class B special shares in 2010 and the remaining 130,000 Class B special shares in 2011. The former wife then had a capital gain in 2010 of \$182,425, offset by a capital loss of \$50,000, for a net capital gain of \$132,425. The former wife then had a capital gain in 2011 of \$118,575, offset by a capital loss of \$50,000, for a net capital gain of \$68,575.
2. As a result of the indemnification for extra taxes the former wife warranted that had \$10,000.00 of other income in 2010 and 2011 and would claim the equivalent to married exemption for the minor child in her custody. On the basis of this warranty the former husband agreed to wholly indemnify the former wife for all additional taxes, professional fees or penalties of any kind which she incurred as a result of the corporate reorganization, share transfers and subsequent purchases and redemptions contemplated above. It was further agreed that the former wife's income taxes would be calculated by her accountant for 2010 and 2011 as if the above transactions had not occurred, based on her income from other sources only, and the total income tax payable (as well as any impact this calculation may have on

her eligibility for various government grants, benefits and credits as a low income single parent) but excluding the loss of any benefits for she is no longer entitled to as a result of the lump sum money she is receiving. This was then compared to her income tax liability and eligibility for government grants, benefits and credits after taking the transactions above into account. The former husband agreed to forthwith pay to the former wife the difference between the two sums upon receipt of the calculations prepared by the accountant.

3. The parties then agreed that the former husband would enter into an agreement acceptable to the former husband as prepared by his corporate lawyer where he is bound to acquire the Class B special shares, and to redeem the Class A special shares. The parties executed a shareholders' agreement for the period the former wife was a shareholder of 1234567 Ontario Inc. When filing her income tax returns, it was agreed that the former wife would not claim a Capital Gains Exemption in 2010 or 2011 relating to the sale of the Class B special shares as the shares did not qualify for this exemption. This term / provision was recited in the shareholders agreement the parties executed.
4. There was obviously a risk to the former wife if the former husband's company became insolvent or would not / could not pay the monies when due. To secure the balance owing by the former husband and estimated taxes owing for 2010 and 2011 to the former wife, he agreed to a mortgage being placed on his home of \$230,000.00. The mortgage was subsequently discharged upon all payments being

made and CRA issuing the Notice of Assessment to the former wife for the 2011 tax year.

The Case Law

A search of the Westlaw database in Family law using the key word of Butterfly Transaction or Divisive Reorganization reports the following cases:

In *Hughes v. Hughes*⁹ the Applicant wife and Respondent husband separated after 24 years of marriage. The husband worked during the marriage as a lawyer and had a real estate holding company. The husband owned 75% of the Holding Company and the wife owned 25%. The wife had nominal involvement in the business. Justice Deschenes notes that the husband argued strenuously that in ordering an equalization payment, certain properties contained in the real estate holding company should be transferred to a company owned by the wife by a Butterfly Transaction to minimize tax implications. The wife opposed such an arrangement as she did not want to become a landlord. Justice Deschenes agreed and indicated that the Court should not impose such a scheme upon her.

In *Hodgkinson v. Hodgkinson*¹⁰ the Applicant wife and Respondent husband separated after 9 years of marriage. The husband owned several companies that were involved in buying and selling investments. The Respondent had an expert valuation done of his companies by a Chartered Business Valuator who also testified at trial. The expert

⁹ 1997 CarswellIND 269 (Q.B.)

¹⁰ 2003 CarswellBC 2461 (S.C.)

testified about the tax that would be incurred if certain assets in the companies had to be liquidated to satisfy an equalization payment. The expert went on to state (paragraph 53) that it was appropriate to have an *in specie* division of corporate assets held by two of the husband's companies and that to minimize tax it should be done by a Butterfly Transaction. The wife argued that the court did not have jurisdiction to order the transfer of specific assets within the corporation to satisfy the equalization unless the parties agreed. Justice Dillon noted that there do not appear to be any cases wherein the specific assets of a corporation have been ordered divided *in specie*. This is because it is the shares that are the family asset and not the assets of the corporation itself. Justice Dillon did however briefly postpone the equalization and granting of the divorce to allow the parties to organize their affairs in a matter satisfactory to the wife so as to maximize any available tax planning.

On appeal¹¹ the Wife noted that the parties did not complete a Butterfly transaction which was contemplated in delaying the equalization and divorce. The wife argued on appeal that she was entitled to an *in specie* division of assets and wished to reargue this issue as it related to division of family assets. The Court of Appeal rejected this argument.

In *Kirk v. Kirk*¹² the Applicant wife and Respondent husband separated after a thirty year marriage. The matter came before Justice Arnold-Bailey eight years after separation on motion of the husband who was seeking to sever the divorce from the

¹¹ 2006 CarswellBC 767 (C.A.)

¹² 2007 CarswellBC 138 (S.C.)

corollary issues. Subsequent to separation the Husband had enjoyed considerable financial success. Justice Arnold-Bailey refused to sever the divorce and allow it to proceed prior to the resolution of the monetary issues as the husband's company shareholder agreement specifically stated that shares could only be transferred in the company to a spouse or child. The wife's lawyer argued the shareholders agreement would preclude a butterfly transaction if the parties were divorced. On this basis as well as three others the motion to sever the divorce was denied¹³.

In *Weber v. Weber*¹⁴ the issue was not whether or not a Butterfly transaction was to be used to satisfy a debt owing between a husband and wife, but whether the Respondent husband actually had a debt to his father for a Butterfly transaction that had occurred during marriage. Justice Herold notes that in 2004 as a result of John and Walter Weber being unable to work together they entered into a Butterfly Transaction. His Honour found that the debt owing under the terms of the Butterfly Transaction was legitimate.

In *Racz v. Rudolph*¹⁵ the Applicant wife (Respondent in Appeal) and Respondent husband (Appellant) reached a settlement for the husband keeping the shares of his closely held corporation. The day after the settlement the mining company in which the husband held a large block of shares announced it was closing which caused his share

¹³ The author's opinion is that if the only ground for denying the divorce was to preclude a Butterfly Transaction then the divorce would have been allowed. The primary reason to deny the divorce was likely the husband excluding the wife under his will. If the parties were no longer spouses and the husband dies, the wife would no longer have status under the *Wills Variation Act*, R.S.B.C. 1996, c. 490

¹⁴ 2008 CarswellOnt 9365 (S.C.)

¹⁵ 1998 CarswellYukon 57 (C.A.)

value to plummet. When the husband refused to complete the terms of the settlement the wife moved to enforce the terms at which time the husband was ordered to complete the settlement terms and pending the completion his assets were frozen. The husband appealed. The appeal was dismissed. It would appear the Butterfly transaction was ordered as this is what the parties consented to on the first day of trial when they executed the terms of their settlement.

*Ravoy v. Ravoy*¹⁶ is the only case found in the Carswell family law database where the trial judge ordered a Butterfly transaction be completed to deal with two vacant lots which was upheld on appeal. The Husband and Wife separated after 24 years of marriage. The wife was unable to conduct her own affairs and had a litigation guardian appointed. Professor James McLeod points out in his annotation that the husband's own expert testified there was an issue with regards to the value of the property, that a Butterfly transaction was available and that the Wife was prepared to pay the cost of completing the transaction. The Wife did not object to the Butterfly transaction so there was no basis for the Husband to object to what his expert recommended. The Husband on appeal complained the trial Judge failed to take into consideration the tax consequences of the Butterfly transaction but this was rejected as limited evidence on this point was put before a trial judge.

In *Bright v. Leslie-Bright*¹⁷ the Applicant husband and Respondent wife separated after 15 years of marriage. The parties owned two Tim Horton's franchises in the Niagara

¹⁶ 2001 CarswellAlta 1683 (C.A.)

¹⁷ 2011 CarswellOnt 3207 (S.C.), additional reasons at 2011 CarswellOnt 10403

Falls. It was agreed early in the proceedings that they would complete a Butterfly transaction whereby each party would take one store. At the time of trial the Butterfly transaction had still not been completed as the Husband and Wife could not agree on final numbers for the values. Both parties had retained experts to substantiate the values attributed to the stores. Justice Maddalena ordered that a Butterfly transaction be completed on the basis that a letter of agreement was entered into for its completion. The monetary values to be used were the average between the two expert reports. She ordered that the divorce not be completed until the Butterfly transaction was completed after which it would proceed by affidavit on an uncontested basis. The Husband wanted the Butterfly transaction and was more successful in implementing the terms after a 26 day trial where the wife was self-represented.

There is also the case of *Galbierz v. Galbierz*¹⁸ which is not so much about a Butterfly transaction but whether the Husband and Wife had a binding agreement. The Husband and Wife enter into a Consent Order which was not yet issued and entered. The wife believes the deal was not good and seeks to set aside the consent. The Trial Judge refused to set aside the consent. The Court of Appeal mentions that the parties agreed to complete a Butterfly transaction and were not prepared to set aside the consent.

Conclusion

Where substantial sums are involved and spouses are willing to cooperate and engage professionals, money can be saved and taxes minimized. CRA has been inconsistent

¹⁸ 2002 CarswellBC 3125 (C.A.)

in what transactions they will and will not allow and as such an advance ruling from them is imperative. Butterfly Transactions and the rules governing them are afflicted by great uncertainty and continue to be one of the most convoluted tax issues to complete. It is simple from the corporation's standpoint to acquire eligible assets on a tax deferred basis from other corporations. Despite this it remains arduous to remove an asset on a tax-deferred basis from one corporation to another. This appears to be primarily because of CRA's approach on an administrative level to Butterfly Transactions.