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THE "SIGN AND CLOSE" – DEEMED YEAR END RULES

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The complexities of the deemed year end rules in the *Income Tax Act* (Canada)[1] were illustrated in a recent Technical Interpretation No. 2011-0424446E5 dated December 2, 2011 (the "Technical Interpretation") in which the Canada Revenue Agency ("CRA") made some thought-provoking comments relating to a "sign and close" scenario. In a sale of shares of a Canadian-controlled private corporation ("CCPC") to a non-resident or public corporation purchaser, a "sign and close" has become the prevailing wisdom (albeit subject to commercial considerations and risk) in order to avoid multiple year ends arising from the interaction of the deeming rules in subsections 249(3.1) and (4), 256(9) and 251(5)(b). It has been said that in a "sign and close," a "part-year" CCPC might exist in certain circumstances[2] which could cause problems with eligibility for the small business deduction in the fiscal period up to closing. The Technical Interpretation may be interpreted to give some comfort in this regard, although perhaps by omission only.

Background

It is well known that where control of a corporation is acquired by a person or group of persons, the taxation year of the corporation shall be deemed to have ended immediately before that time.[3] Thus tax lawyers and commercial lawyers alike are aware that the closing date of a share purchase transaction can trigger this consequence. Technically, it is the time at which control is acquired which is relevant, i.e., the particular time at which the purchaser becomes the legal and beneficial owner of shares of the target corporation carrying the right to a majority of the votes for the election of the board of directors. Subsection 256(9) ousts the particular time rule, by deeming control to have been acquired at the beginning of the day and not at the particular time, unless an election is made to not have such provision apply. Prior to amendments to subsection 256(9) in 2009[4] in response to the decision in *La Survivance* v. *The Queen*,[5] subsection 256(9) applied for purposes of the Act without exception. Subsection 256(9) was amended so that such subsection does not apply for purposes of determining whether a corporation is a small business corporation or CCPC.

It is also well known that where a corporation becomes or ceases to be a CCPC, the taxation year of the corporation is deemed to end immediately before that time.[6] Because the preamble to subsection 249(3.1) contains the words: "otherwise than because of an acquisition of control to which subsection (4) would, if this Act were read without reference to this subsection, apply", it is clear that subsection 249(4) is intended to apply in precedence.

In the context of a share purchase transaction, how does a corporation cease to be a CCPC otherwise than because of an acquisition of control by a non-resident or public corporation? Such an acquisition of control would engage subsection 249(4) in precedence to subsection 249(3.1). Paragraph 251(5)(b) is the key concern. This provision applies for purposes of the definition of CCPC, but does not apply for purposes of subsection 249(4).[7] Specifically, where at any time, a person has a right under a contract, in equity or otherwise, either immediately or in the future and either absolutely or contingently to acquire the shares of a corporation, that person is deemed to be in the same position in relation to control of the corporation as if the person owned the shares at the particular testing time. Therefore, where a non-resident or public corporation purchaser has a right to acquire shares of a CCPC, there is a change in status of such target corporation because the purchaser is deemed to have acquired such shares and thus would control the corporation. Such a right can trigger the deeming rule in subsection 249(3.1) with a resultant deemed year end immediately before that time. Absent such a right, it seems that subsection 249(4) alone (in precedence to subsection 249(3.1)) would apply on the acquisition of control. It is the specter of paragraph 251(5)(b) which has driven parties to a "sign and close" to avoid the multiple deemed year ends – one taxation year of the target CCPC ending immediately before the signing of the share purchase agreement by a non-resident or public corporation purchaser by virtue of paragraph 251(5)(b) and subsection 249(3.1) and the second taxation year ending immediately prior to the acquisition of control by such purchaser by virtue of subsection 249(4).

But even the signing of a letter of intent arguably engages paragraph 251(5)(b). A number of commentators restrict this to a "binding letter of intent"[8] although the broad wording of paragraph 251(5)(b) could encompass what might be considered a non-binding letter of intent where the parties expressly state that they are working towards the execution of a definitive agreement.[9] In the context of buy-sell arrangements in shareholders agreements, CRA previously restricted the application of paragraph 251(5)(b) to circumstances where "both (or all) parties clearly have either a right or an obligation to buy or sell, as the case may be"[10] but that language is not found in the current version of Interpretation Bulletin IT-419R2.[11] If it is not necessary that one party clearly has the right to buy and one party clearly has the obligation to sell, given CRA's views that rights may be subject to multiple contingencies[12] and that an entitlement to purchase subject to a condition constitutes a contingent right to acquire,[13] wider application of the admittedly broad wording of paragraph 251(5)(b) is clearly possible.

Technical Interpretation No. 2011-0424446E5

The Technical Interpretation involved a "sign and close" but with curious comments regarding a possible paragraph 251(5)(b) right. The facts were as follows:

1. Corporation A is a CCPC with a December 31 year end.
2. On November 30, a non-resident purchaser and Corporation A entered into a legally binding agreement of purchase and sale for all the issued and outstanding shares of Corporation A. (Presumably, the shareholders of Corporation A are also parties to such agreement.)
3. Closing date for the sale is also November 30.
4. Corporation A does not elect out of the application of subsection 256(9).

In its reply, CRA indicated that the application of subsections 256(9) and 249(4) would result in acquisition of control of Corporation A being deemed to have occurred at the beginning of the day on November 30 and therefore a corresponding taxation year end was deemed to occur immediately before that time, being the last moment of November 29. The foregoing is not unexpected.

The balance of CRA's reply made a distinction between the situation where the agreement entitles the non-resident purchaser to a paragraph 251(5)(b) right and the situation where there is no paragraph 251(5)(b) right created prior to the acquisition of control of Corporation A. No details of the facts distinguishing one situation from the other were provided.

CRA stated that "if the agreement entitles the non-resident purchaser to a right described in paragraph 251(5)(b), Corporation A would cease to be a CCPC at the time of signing of the agreement" and in accordance with subsection 249(3.1), there would be two deemed year ends. Specifically, CRA stated that in addition to the year deemed to have ended at the latest moment on November 29 pursuant to the application of subsections 256(9) and 249(4), there would be a second deemed year end immediately prior to the signing of the agreement on November 30. Such second year end would apparently be a portion of the day only, i.e., from the first moment of the day on November 30 to immediately before the time of signing. With respect to eligibility for the small business deduction, CRA's view was that Corporation A would continue to be a CCPC throughout the two taxation years in question, i.e., the taxation year ending at the latest moment on November 29 and the taxation year ended immediately before the signing of the agreement on November 30. Therefore, Corporation A would be eligible for the small business deduction in both taxation years.

If there is no paragraph 251(5)(b) right created prior to the acquisition of control of Corporation A, CRA stated that Corporation A would cease to be a CCPC as a result of the acquisition of control. Given that the preamble in subsection 249(3.1) precludes the application of such provision where a corporation ceases to be a CCPC because of an acquisition of control, CRA stated that there is one deemed year end being the year deemed to end at the latest moment on November 29. CRA also stated that as Corporation A would be a CCPC throughout the taxation year ended at the latest moment on November 29, it would be eligible for the small business deduction.

<u>Comments</u>

Given that a "sign and close" has became the prevailing wisdom to eliminate multiple year ends in a sale of shares of a CCPC, it is instructive to consider the possibility that a paragraph 251(5)(b) right may be created where the agreement of purchase and sale is signed on the same day as closing.

A "sign and close" where the disposition of shares occurs and the purchaser becomes the legal and beneficial owner of shares immediately upon the signing of an agreement, may, on reflection, be somewhat unlikely in a commercial transaction of any complexity or magnitude. While a simple minute book form of share transfer with no representations and warranties would achieve the foregoing, most share sale transactions are somewhat more involved. A typical share purchase agreement of a private corporation will contain conditions of closing including but not limited to delivery of items such as: evidence of repayment of shareholder loans; third party consents (*e.g.*, landlord or governmental);

resignation of directors and officers; signed employment contracts for continuing employees; endorsed share certificates; certified authorizing resolutions; signed non-competition agreements; and legal opinions from vendor's counsel. The share purchase agreement will likely contain closing procedures. The foregoing suggests that there can be a point in time (*i.e.*, a particular time) where the purchaser has the right to acquire shares but has not acquired such shares. Legal and beneficial ownership of shares is acquired upon the completion of closing.

The closing agenda will typically contain an escrow arrangement perhaps along the following lines:

> All documents, instruments and payments to be delivered as set out below shall be tabled at the closing in form satisfactory to all parties and their respective counsel and held in escrow until all documents, instruments and payments shown below have been tabled and all parties and their respective counsel have agreed to terminate the escrow whereupon the same shall be considered delivered and the closing deemed to have been completed, subject to any written undertakings delivered thereat.

An escrow arrangement by its very nature suggests that the purchaser has a right, conditional upon the terms of the escrow being satisfied. This right seems to commence on the commencement of the escrow and end upon release from escrow which presumably means the signing of the agreement (at which time the document is tabled) and the completion of closing, respectively.

Historically, escrow was a concept applicable to deeds; all contracts are not necessarily deeds, but would be if made under seal.[14] In an escrow arrangement, it seems to be generally accepted that the documents take effect upon satisfaction of the conditions of escrow.[15] There is a concept of "relation back" whereby once the conditions of the escrow are satisfied; the document takes effect and "relates back" to the delivery in escrow, but not for all purposes.[16] However, as the escrow is a period of suspension, it seems that the rights upon commencement of escrow are necessarily different from those once the conditions are fulfilled. It is during this period that a paragraph 251(5)(b) right may exist. Even if the share purchase agreement is not made under seal and thus is not technically a deed to which the legal concept of escrow can apply, a contract can certainly contain conditions precedent (such as the conditions of closing mentioned above) whose effect is similar to a legal escrow. In either case, it is the satisfaction of the escrow conditions or contractual conditions which triggers the binding obligations of the parties and performance of same and as a result, the transfer of the target corporation shares and the acquisition of control by the purchaser. Such fine parsing of closing procedures suggests some passage of time in the process of satisfying the conditions, unless the satisfaction of conditions can somehow occur simultaneous with the signing. And indeed, the foregoing discussion of procedures upon closing does not contemplate a pre-closing where the signed documents are available or posted by counsel for review which could also raise paragraph 251(5)(b) questions. This minute examination seems to support the argument that the purchaser may have a paragraph 251(5)(b) right upon signing the agreement on the same day as closing.

The share purchase agreement might contain language to deem the effective time of closing, notwithstanding the above process:

> The Closing shall be deemed to be effective as at the Effective Time notwithstanding the time on the closing date that the deliveries contemplated by [specified sections of share purchase agreement] are completed.

While ownership of property can pass when contracting parties intend it to pass and contracts can contain an effective time for same,[17] it is not clear that parties can effectively retroactively deem[18] as opposed to agreeing to a prospective effective time. The closing would not be effective if the deliveries were not made, so it seems that the deliveries must necessarily be made first. Until the deliveries are made, the purchaser may have a paragraph 251(5)(b) right. Once the deliveries are made, it is not clear that the retroactive deeming of the effective time of closing can retroactively cause any such paragraph 251(5)(b) right to never have come into existence.

As the Technical Interpretation contained no hint of the rationale for a paragraph 251(5)(b) right of the purchaser at the time of signing the agreement, only minute examination of closing procedures as above may provide a basis for such a finding. Based on this minute examination, the existence of a paragraph 251(5)(b) right of the purchaser on signing the agreement cannot be absolutely discounted. If so, electing that subsection 256(9) not apply will at least eliminate the multiple return obligation although leaving the challenges of a taxation year end part way through a day. It is incredible to think however that such fine parsing is needed and certainly would not be considered necessary by most commercial lawyers.

Eligibility for the small business deduction in the fiscal period to closing is a concern for the target CCPC. In both situations in the Technical Interpretation, CRA agreed that Corporation A was eligible for the small business deduction throughout the taxation years in question – the two taxation years in the situation where the purchaser has a paragraph 251(5)(b) right upon signing the agreement on November 30 and the single taxation year in the situation where the purchaser did not have such a right. CRA did not engage in any discussion of the specific exception to the deeming rule in subsection 256(9), *i.e.*, that such provision does not apply for purposes of determining whether a corporation is a CCPC or small business corporation. If the specific exception is interpreted to mean that control of Corporation A is not deemed to have been acquired at the beginning of the day but rather at the particular time on November 30 for purposes of determining CCPC status, this suggests that the "throughout the taxation year" requirement in subsection 125(1) for the small business deduction depends on maintaining CCPC status until that time. But issues could arise. For example, post-closing reorganization steps by the purchaser on November 30 such as an amalgamation could be problematic. In the discussion in the Technical Interpretation regarding eligibility for the small business deduction in the taxation year ended at the last moment of November 29, CRA expressly referred to Corporation A's CCPC status to the last moment of November 29 and not to its status up to the particular time control is acquired by the purchaser. Admittedly, the fact situation did not contemplate any steps that would have otherwise caused Corporation A to not be a CCPC immediately before the particular time control is acquired and therefore limited comfort can be taken that there would not be a "part year CCPC" problem with different facts.

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[1] RSC 1985, c.1 (5th Supp.) as amended (the "Act"). Unless otherwise stated, all statutory references in this article are to the Act.

[2] See Joel Nitikman and Michelle Moriatey, "Part-Time CCPCs Again", (2009) vol. 17, no. 5 *Canadian Tax Highlights* (Toronto: Canadian Tax Foundation) 6.

[3] Subsection 249(4).

[4] Applicable to acquisitions of control after 2005.

[5] 2006 FCA 129. The anomalies resulting from the *La Survivance* decision have been the subject of considerable commentary. See *e.g.*, "Interaction of Subsections 110.6(2.1) and 256(9)", *Tax Topics* No. 1879 (Toronto: CCH Canadian, March 13, 2008) and "Parallel Universe: La Survivance and the Capital Gains Exemption", *Tax Topics* No. 1881 (Toronto: CCH Canadian, March 27, 2008).

[6] Subsection 249(3.1).

[7] Other than the anti-avoidance circumstances set out in subsection 256(8).

[8] See *e.g.*, Philip Friedlan, "Interaction of Subsections 249(3.1) and 249(4) on sale of a CCPC", *Tax for the Owner-Manager*, Vol. 12, No. 2 April 2012 (Toronto: Canadian Tax Foundation) 5; Mark Jadd and Eoin Brady, "Structuring the Purchase and Sale of a Business: Some Tips and Traps", *2011 Ontario Tax Conference* (Toronto: Canadian Tax Foundation, 2011) 11:1-33; Shane Onufrechuk, "Purchase and Sale of a Business: Selected Topics", *2011 British Columbia Tax Conference* (Vancouver: Canadian Tax Foundation, 2011) 9C:1-20. When asked whether a letter of intent constitutes a right described in paragraph 251(5)(b), CRA has merely stated that the documents must establish that the purchaser has either an absolute or contingent right to acquire the shares without elaboration– the absolute or contingent wording comes directly from paragraph 251(5)(b) (see CRA Document No. 5-3393 (June 23, 1987) and 5-5516 (April 20, 1988)).

[9] Hartley R. Nathan Q.C., "Mastering Letters of Intent and MOU's: A Guide", *Negotiating and Drafting Key Business Agreements* (Canadian Institute, September 28, 2006). A well-drafted letter of intent typically contains both binding provisions and non-binding provisions. The binding provisions would address matters such as confidentiality; obligation to negotiate in good faith and exclusivity, whereas the non-binding provisions would address the basic transaction, proposed purchase price and conditions and may expressly state that the parties are working towards the execution of a definitive agreement reflecting their understandings in the transaction. Notwithstanding the foregoing, the enforceability of a letter of intent can and has been subject of litigation with the results typically turning on the facts. See *e.g.*, *Modderman v. Ondaatje Corp.* [1998] O.J. No. 3018 (Ont. Ct. of Justice); *Wallace v. Allen* (2009), 93 O.R. (3rd) 723 (CA).

[10] Interpretation Bulletin IT-419R, August 24, 1995, paragraph 13 (now cancelled).

[11] See discussion in a paper by the author, "Shareholders Agreements: Selected Tax Issues", *2005 Ontario Tax Conference*, (Toronto: Canadian Tax Foundation) 8B:35.

[12] See CRA Document No. 2002-0133675 (January 7, 2003).

[13] See *Income Tax Technical News* No. 38 (September 22, 2008) under the heading: "Paragraph 251(5)(b) – Conditional Agreements." The factual background related to SIFTs which enter into agreements to sell Canadian subsidiaries at a future date but subject to a condition precedent which cannot be waived being the consent of the SIFT unit holders.

> **"Question: In this circumstance, is the right under the agreement that is subject to a condition precedent a right that is described in paragraph 251(5)(*b*)?**
>
> Answer: A "right" described in paragraph 251(5)(*b*) by the phrase "a right under a contract, in equity or otherwise, either immediately or in the future and either absolutely or contingently" has been given a very broad meaning by the courts. It is our view that where the entitlement of a party to acquire the shares of a corporation owned by the vendor is subject to a condition, the party has a contingent right to acquire the shares and, therefore, one to which paragraph 251(5)(*b*) applies."

[14] The formal requirements of a deed are writing, sealing and delivery. See Youdan, T.G., "The Formal Requirements of a Deed", *Business Law Reporter* (1979) 5 B.L.R 71. *Vigoren's Real Estate & Insurance Ltd.* v. *Vigoren* [1984]6 W.W. R. 660 (Sask. Q.B.) at para. 15 cited the following explanation from Chitty on Contracts, 23rd ed. (1968), vol. 1, at p. 13, para. 18:

> All deeds are documents under seal, but not all documents under seal are deeds. A deed must either (a) effect the transference of an interest, right or property, or (b) create an obligation binding on some person or persons, or (c) confirm some act where by an interest, right or property has already passed. Many documents under seal are not deeds, for instance an arbitrator's award, a certificate of admission to a learned society, a share certificate, probate of a will or a company's memorandum of association.

Escrow suspends delivery of the deed.

[15] See Rosemary Wertschek, "The Tax Advisor and Commercial Law: Some Issues", *Report of Proceedings of the Forty-Fifth Tax Conference*, 1993 Tax Conference (Toronto: Canadian Tax Foundation, 1994)24:35; and Youdan, *supra*, at p.11.

[16] The "relation back" concept was explained in *Alan Estates Ltd.* v. *WG Stores Ltd.* [1981] 3 All E.R. 481 (CA) at p. 486:

> …what is the effect of an escrow before the conditions are fulfilled? One thing is clear. Whilst the conditions are in suspense, the maker of the escrow cannot recall it. He cannot dispose of the land or mortgage it in derogation of the grant which he has made. He is bound to adhere to the grant for a reasonable time so as to see whether the conditions are to be fulfilled or not. If the conditions are not fulfilled at all, or not fulfilled within a reasonable time, he can renounce it. On his doing so, the transaction fails altogether. … But if the conditions are fulfilled within a reasonable time, then the conveyance or other disposition is binding on

> him absolutely. It becomes effective to pass the title to the land or other interest in the land from the grantor to the grantee. The title is then said to "relate back" to the time when the document was executed and delivered as an escrow. But this only means that no further deed or act is necessary in order to perfect the title of the grantee. As between grantor and grantee, it must be regarded as a valid transaction which was effective to pass the title to the grantee as at the date of the escrow. But this doctrine of "relation back" does not operate so as to affect dealings with third parties. So far as the grantee is concerned, whilst the conditions are in suspense, he gets not title such as to validate his dealing with third persons.

See also *Thompson* v. *McCullough* [1947]1 All E.R. 265 (CA) at p. 268; and *Foundling Hospital (Governors and Guardians)* v. *Crane* [1911] 2 K.B. 367 at p.377. Wertschek, *supra*, at p. 26 notes same:

> Generally, the cases have held that it is only where necessity requires the courts to impose the fiction that the deed "relates back" (that is, to give the document retroactive effect) to the first delivery, or where the parties expressly so provide, that the deed will be treated as effective retroactively to the first delivery. Otherwise, the delivery will not be considered complete until the conditions are met. In view of the fact that it is not always possible to predict when the courts will find it equitable to treat the deed as effective at the first delivery, it is wise in implementing commercial transactions to provide for the effective date in a written escrow agreement.

[17] For example, the Tax Court of Canada in *Envision Credit Union* v. *The Queen* [2011] 2 C.T.C. 2229, para. 32 accepted that certain property was transferred at an effective time set out in documentation being the commencement of the amalgamation date of two entities.

[18] See *Nussey Estate* v. *The Queen* 99 DTC 1211 (TCC) and *Wood* v. *MNR* 88 DTC 1180 (TCC).