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WAS THERE A "LIQUIDATION AND DISSOLUTION"? A (CORPORATE) EXISTENTIAL QUESTION

Michael Kandev and Olivia Khazam, Davies Ward Phillips & Vineberg LLP Montreal

"Liquidation and dissolution" is an important notion in the context of the foreign affiliate ("**FA**") rules of the *Income Tax Act* (Canada) (the "**ITA**"). The Canadian income tax consequences of the terminal stage of the existence of an FA often depend on whether it meets one of two key definitions in the ITA: a *qualifying* liquidation and dissolution (or "**QLAD**")[29] or a *designated* liquidation and dissolution (or "**DLAD**").[30] QLAD is relevant to a liquidation and dissolution of a first-tier FA into a Canadian-resident parent corporation, while a DLAD relates to inter-FA liquidations and dissolutions. Essentially, these concepts establish the threshold requirements for rollover treatment under subsection 88(3) and paragraph 95(2)(*e*), respectively.

The QLAD and DLAD definitions identify when a liquidation and dissolution is "qualifying" or "designated". However, they do not assist in identifying what transactions and/or events will qualify as a "liquidation and dissolution". The phrase "liquidation and dissolution" is not defined in the ITA, nor are the individual terms "liquidation" and "dissolution". The phrase "winding-up", which is the terminology that the ITA generally employs in the domestic context, is also undefined. A concerned Canadian-resident parent company might then ask: How and when is an FA "liquidated and dissolved"?

Where a word or expression is not defined in the ITA, but has a well-defined meaning at private law, reference must be had to its meaning at private law.[31] Transactions are generally characterized based on the law applicable to them for purposes of the ITA. The seminal decision on the characterisation of foreign-law transactions for the purposes of the ITA is the decision of the Federal Court of Appeal (the "**FCA**") in *Backman v. Canada*.[32] Foreign law is a question of fact, and Canadian courts will look to Canadian law instead where foreign law is not sufficiently proved, and the Canadian law at issue is of a general character or application.[33] Indeed, the FCA in *Backman* ultimately determined the question of whether the taxpayer was assigned an interest in a Texas partnership in light of Alberta's *Partnership Act*.

The terms "liquidation" and "dissolution" do not seem to have a well-defined or uniform meaning either in Canadian or foreign corporate law. While "liquidation", "dissolution", and "liquidation and dissolution" may have statutory meanings in Canadian corporate legislation, the uses of those terms vary between the Canadian federal and various provincial corporate law statutes and sometimes even within the same statute. These statutory meanings are narrower than the meanings of these terms as generally understood by Canadian legal practitioners. In particular, the term "dissolution" in Canadian corporate law statutes itself often encompasses the process of distributing assets and discharging liabilities that is colloquially referred to as a "liquidation".[34] The phrase "liquidation and dissolution" is often reserved in Canada's corporate law statutes for a separate, more prescriptive process that involves a *formal* liquidation in accordance with the relevant provisions.[35] As a matter of Canadian corporate law, a corporation can be (and is often) dissolved without ever being "liquidated" within the meaning of the relevant Canadian statute.

Despite this, it is reasonably clear that the terms "liquidation" and "dissolution" each have generally accepted and well-understood meaning for Canadian legal practitioners. "Liquidation" generally refers to the factual process of satisfying a corporation's creditors and distributing its remaining assets to its shareholders, and "dissolution" generally refers to the acceptance by the relevant corporate registrar of the corporation's articles of dissolution, which terminates the corporation's legal existence. It is broadly understood that a corporation is "liquidated" before it is "dissolved".

The terms "liquidation", "dissolution", and "liquidation and dissolution" have rarely, if ever, been considered by Canadian courts. Notably, the phrase "liquidation and dissolution" does not appear to have been considered by the courts in the tax context. The leading Canadian decision on the meaning of "liquidation" is the 1980 decision of the Supreme Court of Canada (the "**SCC**") in *Dauphin Plains Credit Union Ltd. v. Xyloid Industries Ltd*,,[36] which was rendered in a different legislative context from both the corporate law and tax law perspectives. A majority of the SCC accepted that "liquidation" has no fixed legal meaning and that, consistent with various dictionary definitions, it is the act or operation of winding up the affairs of a company by getting in the assets, settling with its debtors and creditors, and appropriating the amount of profit or loss to its shareholders.[37]

While the ITA generally employs the phrase "liquidation and dissolution" in relation to the end stages of the existence of an FA, likely for historical reasons, it generally refers to the end stages of the existence of a domestic corporation as a "winding-up".[38] The approach of Canadian courts to the term "winding-up" has been similar to their approach to "liquidation". Indeed, the Exchequer Court of Canada has commented that "winding-up" is a commercial and not a legal term and, even as a commercial term, it has no exact definite meaning.[39]

What appears to be important in determining whether a corporation has been "liquidated" or "wound-up" is the broad substance of what occurred: Was there a realization of the corporation's assets (if any), a discharge of its liabilities (if any), and a distribution of its surplus (if any) to its shareholders? Canadian courts have qualified transactions and events as "liquidations" or "winding-ups" where, in substance, the corporation was left with no property and no liabilities and the surplus (if any) had been distributed to its shareholders.[40]

The Canada Revenue Agency (the "**CRA**") seems to have taken a similar approach. In a 2003 technical interpretation, the CRA considered whether a "wind-up without liquidation" under the laws of the Czech Republic would qualify as a "liquidation and dissolution" for purposes of the ITA in the FA context.[41] The CRA considered the voluntary liquidation (or "liquidation and dissolution") procedure contemplated by section 211 of the *Canada Business Corporations Act*[42] and concluded that, under Canadian law, "a corporation generally has to settle its debts and allocate the property to its shareholders in order to be dissolved. Even if that stage is not referred to as a liquidation under a particular [foreign] enactment, where the property of the corporation is being distributed to the shareholder and the liabilities of the corporation are discharged, it will likely be qualified as a liquidation for the purposes of the [ITA]". Based on this technical interpretation, whether a "liquidation and dissolution" of an FA has occurred is arguably not determined by reference to the specific requirements of Canadian corporate law statutes, but rather by reference to the broader meanings of "liquidation" and "dissolution" in Canadian corporate law parlance. The CRA seems to consider that it is the substance of what occurred (as opposed to the form) that is important.

In many cases, determining whether and when an FA of a Canadian-resident parent has been "liquidated and dissolved" may be relatively straightforward. In other cases, the exercise will be more complex. Sometimes, it is possible to distribute the assets of a corporation, discharge its liabilities, close its bank accounts, cancel its registrations, and obtain a certificate of dissolution all in a short period of time and in accordance with corporate legislation that is comparable to Canadian corporate law statutes. In other cases, the legal form of an FA in its home jurisdiction can complicate the "liquidation and dissolution" analysis and, even more frequently, it may not be easy to identify the precise point in time at which the process of "liquidation and dissolution" has begun or ended. As such, Canadian-resident parent companies (and their advisers) that intend to rely on the QLAD or DLAD definitions should take steps to ensure that the end stages of the corporate existence of their FAs qualify as "liquidations and dissolutions". It is nonetheless comforting that this expression seems to have a flexible meaning that is capable of accommodating a variety of foreign-law transactions that in broad terms conform to the general commercial notions of "liquidation" and "dissolution" as understood by Canadian lawyers.

Footnotes

[29] Defined in subsection 88(3.1). All statutory references are to the ITA.

[30] Defined in subsection 95(1).

[31] *Will-Kare Paving & Contracting Ltd v. Canada*, [2000] 1 SCR 915.

[32] [2000] 1 FC 555 (FCA), aff'd [2001] 1 SCC 10 ("***Backman***").

[33] *Ibid*; see also *Marchan v. R*, 2008 TCC 158.

[34] See, for example, the voluntary dissolution process contemplated by section 210 of the *Canada Business Corporations Act* ("**CBCA**").

[35] See, for example, the voluntary liquidation process contemplated by section 211 of the CBCA.

[36] [1980] 1 SCR 1182.

[37] *Ibid* at 1202, citing *Davey v. Gibson*, [1930] 3 DLR 606 (ONCA).

[38] The CRA (as hereinafter defined) has commented on the meaning of "winding-up" in the domestic context. See CRA Interpretation Bulletin, IT-126R2, *Meaning of 'Winding-up'* (20 March 1995).

[39] *MNR v. Merritt*, [1941] Ex CR 175, 1941 CarswellNat 27 at para 7 (Ex Ct), rev'd on other grounds [1942] SCR 269.

[40] See, for example, *Dauphin Plains*, *supra* note 8 (the SCC held that the realization of the assets of a company by a receiver was a "liquidation"); *Merritt*, *supra* note 11; *Smythe v. MNR*, [1969] SCR 64.

[41] CRA Views, Interpretation — external, 2003-0034311E5, "'Liquidation and a dissolution': what does it mean" (24 March 2004).

[42] Although, interestingly, the CRA did not mention the voluntary dissolution procedure contemplated by section 210 of the same legislation.