

Eyeball Networks Inc.: The Interaction Between Section 160 and a Related-Party Butterfly Transaction

Eyeball Networks Inc. v. The Queen (2019 TCC 150) considers the application of section 160 to a related-party butterfly. The appellant, Eyeball Networks Inc. (Newco), was incorporated for the purpose of receiving assets on a tax-deferred basis from an existing corporation (Oldco). Oldco had been involved in the online gaming industry and held some valuable technology assets and patents (“the Oldco property”), which the sole shareholder of Oldco, Mr. Piche, wanted to transfer to a new entity in order to fully exploit. The corporate reorganization involved several steps, summarized below.

On a rollover basis, Mr. Piche exchanged his existing shares of Oldco for class A shares and redeemable, retractable class C shares of Oldco (whose terms provided for an aggregate redemption amount equal to the FMV of the net assets of Oldco). He then sold the class C shares of Oldco on a rollover basis to Newco for shares of Newco, which purchased the Oldco property from Oldco on a rollover basis. Newco assumed certain liabilities and issued its class C shares to Oldco (the class C shares were redeemable and retractable and had an aggregate redemption amount equal to the FMV of the assets acquired less the amount of the liabilities assumed). Therefore, the aggregate redemption amounts of the class C shares of Newco held by Oldco and the class C shares of Oldco held by Newco were equal. The two sets of shares and/or the relevant agreements included price adjustment clauses that

would adjust the redemption amounts in the event of a CRA challenge. Each set of shares was then redeemed by the issuer for the aggregate redemption amount, and a demand promissory note was issued in payment by Newco (“the Newco note”) and by Oldco (“the Oldco note”). Finally, pursuant to a debt-cancellation agreement (DCA), the two notes were set off and cancelled.

On September 16, 2003, the minister reassessed Oldco for its taxation years ending July 31, 2000 and July 31, 2001 for tax and interest; on August 9, 2004, the minister reassessed Oldco’s 2002 taxation year for tax, interest, and a penalty. Oldco failed to pay the reassessments, and on March 19, 2014 Newco was assessed pursuant to section 160 in respect of Oldco’s tax debts.

The question before the TCC was whether section 160 applied so as to allow the minister to assess Newco for Oldco’s unsatisfied tax liability. Legally, that liability existed at the time of the transfers, but the sole shareholder was unaware of it at that time. The TCC reviewed the jurisprudence relating to section 160 and the four requirements for the section’s

Editor’s Note

Philip Friedlan, along with the Hon. Karen Sharlow, was named a recipient of the Canadian Tax Foundation’s Lifetime Contribution Award at the 2019 annual conference. The award celebrates and honours those individuals who, over their careers, have made substantial and outstanding contributions to the Canadian Tax Foundation and its purposes through their volunteer efforts and their body of work over a number of years.

Phil is a founding and a continuing contributor to *Tax for the Owner-Manager*. He has rendered exceptional service to the Foundation as a member of its Board of Governors (2006-2009) and as a member of the Program Committee for the Ontario Tax Conference for many years. I am very pleased to congratulate him on his receipt of this award. His articles for this newsletter, and the papers that he has delivered at Foundation conferences, are valued additions to the tax literature in Canada.

Information concerning the Lifetime Contribution Award, including the nomination process, is available [on the Foundation’s website](#).

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application set out in *Canada v. Livingston* (2008 FCA 89). The only point in dispute was the existence and FMV of the relevant consideration given for the property transferred by Oldco to Newco.

The minister accepted that the initial transaction—the issuance of the shares to Oldco—constituted sufficient consideration for the assets. However, the minister argued that the redemption of shares and the mutual debt-cancellation date nullified the consideration. The minister employed a “results-based economic reality” approach (that is, a net-result approach) and wanted to examine the transactions as a whole to determine whether Newco had given Oldco valid consideration.

The court undertook a textual, contextual, and purposive analysis of subparagraph 160(1)(e)(i). It held that the minister cannot assess under section 160 on the net results of the series of transactions and that the subparagraph is to be applied at the time at which each relevant property is transferred.

The court then turned to the question of the FMV of the relevant consideration given by Newco at each stage of the transactions. With respect to the last transaction in the series—the DCA—the minister argued that the consideration given by Newco was less than the FMV of the property transferred by Oldco. The court said that each of Newco and Oldco had received symmetrically equal consideration in the other transactions, given that the price adjustment clauses would adjust those values should the minister challenge the asset. However, the Newco note and the Oldco note were not equal in value at the time that they were set off. In fact, Bocoock J held that the value of the Oldco note was nominal. He reached this conclusion because the Oldco note was a negotiable bill, and since Oldco was no longer backed by assets (which had been transferred to Newco), its note could not be equal in value to the Newco note. Bocoock J also seems to have taken the view that the DCA was a legal mechanism to collapse a series of transfers of property for value and thus should be regarded as a transfer of property between the parties. In particular, he held that the DCA was “an abbreviation for a longer form sequence of duplicative presentment and transfer of payment under each promissory note.” He concluded that the DCA resulted in an indirect transfer of the Newco note (with significant value) by Oldco in consideration of the surrender or forgiveness of the Oldco note (with nominal value). Therefore, section 160 applied.

With respect, although we agree that section 160 is properly applied on a point-in-time basis, we question whether the FMV of the Oldco note was nominal. After the asset sale to Newco, it appears that Oldco had no business assets of any value and no liabilities (other than its tax liability, which was then unknown); but it did hold the Newco note, which was issued by a corporation with value. What would an arm’s-length third party have paid for the Oldco note? Furthermore, and again with respect, we also wonder whether the approach taken to determine that the DCA resulted in an indirect transfer of property was correct. Should the TCC have limited its analysis to the legal effect of that agreement?

The case is under appeal.

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