TSG Seminar
Inter-Corporate Dividends

A New System

Tuesday, November 22, 2016

INTER-CORPORATE DIVIDENDS

- New rules introduced in 2015 Federal Budget
- A "re-vamp" of Sec.55(2) Dividend Stripping
- Potential significant impact on Canadian Corporations
- Applies to dividends received after April 20, 2015

Sec. 55(2) Dividend Stripping [Old Rules]

- Anti-avoidance provision
- Intended to prevent inappropriate reduction of capital gain by way of deductible inter-corporate dividend; or
- Applies to deemed dividend paid on redemption, acquisition/cancellation of shares effecting a "significant reduction in …capital gain…"
- Certain exceptions

Subsection 55(2) is an anti-avoidance rule intended to prevent the inappropriate reduction of a capital gain by way of the payment of a deductible intercorporate dividend. This provision generally applies where one of the purposes of the dividend – or, in the case of a dividend deemed to be paid on the redemption, acquisition, or cancellation of shares, the result of the dividend – was to effect a significant reduction in the portion of a capital gain that, but for the dividend, would have been realized on a disposition of any share, unless an exception applies.

Sec. 55(2) Exceptions [Old Rules]

- Dividend paid out of the "safe income" attributable to the share
- Dividend paid in Related-Party-Transaction (RPT) and there are no unrelated persons
- Part IV tax applies and not refunded on payment to another corporation
- Related party transaction of qualifying butterfly under 55(3)(b)

Exceptions to the application of subsection 55(2) include the following:

- The dividend can reasonably be attributed to income earned or realized by any corporation (i.e., "safe income").
- The dividend is subject to Part IV tax that is not refunded on the payment of a dividend to another corporation.
- The dividend is received as part of certain related party transactions (the 55(3)(a) exception) or a qualifying butterfly transaction (the 55(3)(b) exception).

Under the old rules, subsection 55(2) did not apply to any portion of a dividend for which the recipient was subject to Part IV tax that was not refunded to the recipient as a consequence of the payment of a dividend to a corporation (where that payment was part of the series of transactions or events). The new rules have narrowed the Part IV tax exception by providing that subsection 55(2) does not apply to any portion of a dividend for which the recipient was subject to Part IV tax that was not refunded to the recipient as a consequence of the payment of a dividend by the corporation as part of the series. This now includes situations where the corporation receives a dividend refund by paying a dividend to any person, including an individual, as part of the series.

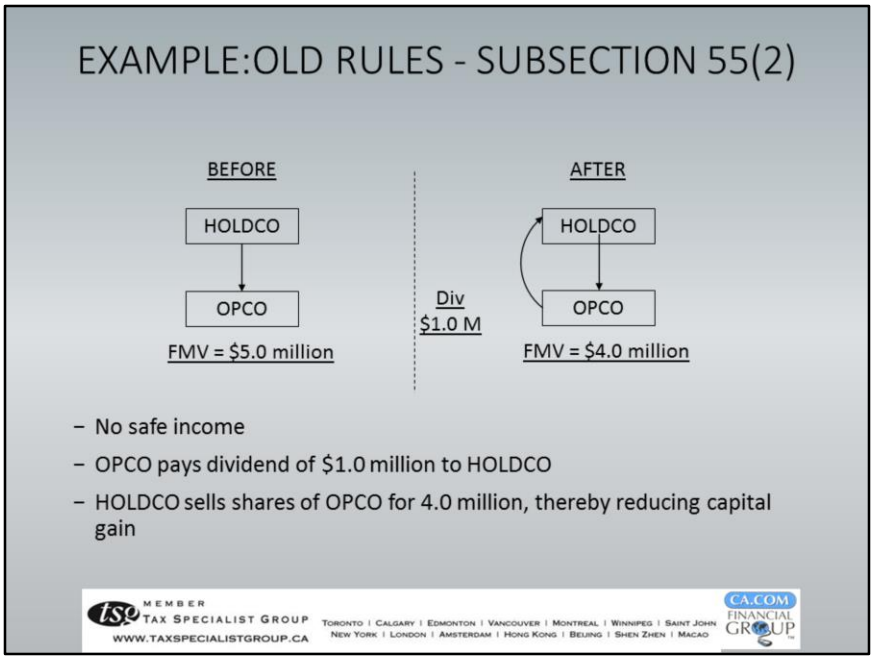
How did 55(2) Apply? [Old Rules]

- Dividend recharacterized as proceeds of disposition
- ACB of share relevant
- 55(2) did not apply to dividend that created or increased an unrealized capital loss on a share

If subsection 55(2) applies, the dividend is deemed not to be a dividend, and is treated as either proceeds of disposition of the share (where the share has been disposed of) or as a gain for the year from the disposition of capital property (where the share has not been disposed of).

Rationale for proposed changes

Subsection 55(2) does not currently apply to dividends that create or increase an unrealized capital loss on a share. In this circumstance, a shareholder may have been able to use such an unrealized loss that arose as a result of paying dividends on a share of a corporation to effectively shelter a capital gain on another property. In this type of situation, the accrued loss on the share could be utilized where a property on which there is an accrued gain is transferred to the corporation before a sale of the “loss” shares. The stop-loss rule in subsection 112(3) would not apply in these circumstances if, in fact, no loss is realized on a disposition of the loss shares. This, combined with the recent Tax Court of Canada decision in D&D Livestock Ltd. v The Queen (2013 DTC 1251 (TCC)), appears to be the Government’s main motivation in introducing significant changes to the application and scope of section 55.



The dividend has the effect of reducing the fair market value (FMV) of OPCO's shares, which reduces HOLDCO's unrealized capital gain on the shares. When HOLDCO sells the OPCO shares to Buyer, the capital gain HOLDCO realizes will be smaller than it would have been if OPCO had not paid the dividend. This technique to reduce a capital gain by the payment of a dividend is sometimes known as "capital gains stripping".

To prevent such capital gains stripping, the subsection 55(2) anti-avoidance rule generally re-characterizes the dividend that OPCO paid to HOLDCO as a capital gain. There are exceptions (under the "old" rules, where subsection 55(2) would not apply.

If there is no "safe-income" within OPCO then the inter-corporate dividend of $1.0 million would be recharacterized as "proceeds of disposition" when HOLDCO sells the shares of OPCO.

SUBSECTION 55(2)

New Rules

Two (2) new purpose tests added to existing 55(2) provisions:

- A significant reduction in the FMV of any share; or
- A significant increase in the total cost of property of the recipient of the dividend

The 2015 Federal Budget introduced two (2) new "purpose" tests for subsection 55(2), in addition to the existing "purpose" test which was always in place ("purpose to effect a significant reduction in the value of a share…)
Interestingly, the 2 tests will apply if there is

- A significant reduction in the FMV of any share; or
- A significant increase in the total cost of property by the recipient of the dividend.

A dividend to which subsection 55(2) applies will be treated as a gain from the disposition of capital property. The previous concept of re-characterizing the dividend as "proceeds of disposition" will no longer apply. This is a significant change, as any hard ACB on the share will be ignored and a full dividend subject to 55(2) would be treated as a capital gain, even if the taxpayer has hard ACB on the share. This can lead to double taxation. This new rule, which will have implications for many corporations receiving inter-corporate dividends, applies to dividends received after April 20, 2015.

SUBSECTION 55(2)

New Rules

- Purpose test exception
- Purpose test will become quite critical
- Less certainty than existing 55(3)(a)

Corporate shareholders will need to reply more heavily on the “purpose test” exception in proposed subsection 55(2). Under the proposed amendments, one of the purposes of the dividend cannot be to reduce a capital gain on a share, the fair market value of a share, or increase the total of the cost amounts of all properties held by the dividend recipient. All dividend payments would likely be considered, as a practical matter, to reduce the fair market value of a share of the capital stock of the dividend payer (unless the share has nil fair market value) or increase the total of the cost amounts of all properties held by the dividend recipient. However, based on a textual, contextual and purposive interpretation of the proposed rules, it may be reasonable to conclude that the purpose of regular periodic dividend payments is to provide a return to shareholders, and not to effect a significant reduction in the fair market value of any share or a significant increase of the total of the cost amounts of all properties held by the dividend recipient.

The purpose test exception found in the proposed amendments, which provides less certainty than the existing 55(3)(a) exception and the safe income exception, will need to be relied upon with increased regularity if the proposed amendments to section 55, as currently drafted, are enacted. Corporate taxpayers will need to consider how to demonstrate to the Canada Revenue Agency (CRA) the purpose of the payment or receipt of an intercorporate dividend so as to ensure the amended anti-avoidance provision in subsection 55(2) does not apply.

SUBSECTION 55(2)

TYPES OF TRANSACTIONS CAUGHT

- Distribution of cash from OPCO – dividend to related or unrelated corporation
- Payment of regular periodic dividends

Canadian corporations that receive dividends from other Canadian corporations may be adversely affected by the new subsection 55(2) proposals, which re-characterize certain tax-free inter-corporate dividends as capital gains subject to tax. The changes significantly broaden the circumstances in which the rule can apply. Many standard corporate transactions that give rise to dividends may now be caught.

For instance, some private companies have a practice of making periodic distributions to their shareholders by way of regular (e.g., annual) cash dividend payments. Under existing legislation, it is generally possible for a corporate dividend recipient to rely on the fact that the purpose of such a dividend is not to reduce a gain on a share, or to rely on the exception found in paragraph 55(3)(a) if, as a factual matter, the dividend was not attributable to safe income. As Budget 2015 proposes to amend the 55(3)(a) exception such that it applies only to deemed dividends arising on the redemption, acquisition or cancellation of shares by a corporation, this particular exception would not be available in respect of any other taxable dividends received by a corporation that is entitled to the intercorporate dividend deduction. Consequently, corporate shareholders may need to place an increased reliance on the safe income exception. This may necessitate dividend-paying corporations to maintain up-to-date safe income calculations so as to provide comfort to corporate shareholders that the safe income exception is available (rather than completing safe income calculations only in advance of an anticipated sale of shares).

The new rules may apply in other situations as well. All types of dividends should be considered, including cash dividends, stock dividends (including high-low stock dividends), dividends-in-kind, deemed dividends on stated capital increases, deemed dividends on share redemptions and deemed dividends on taxable wind-ups.

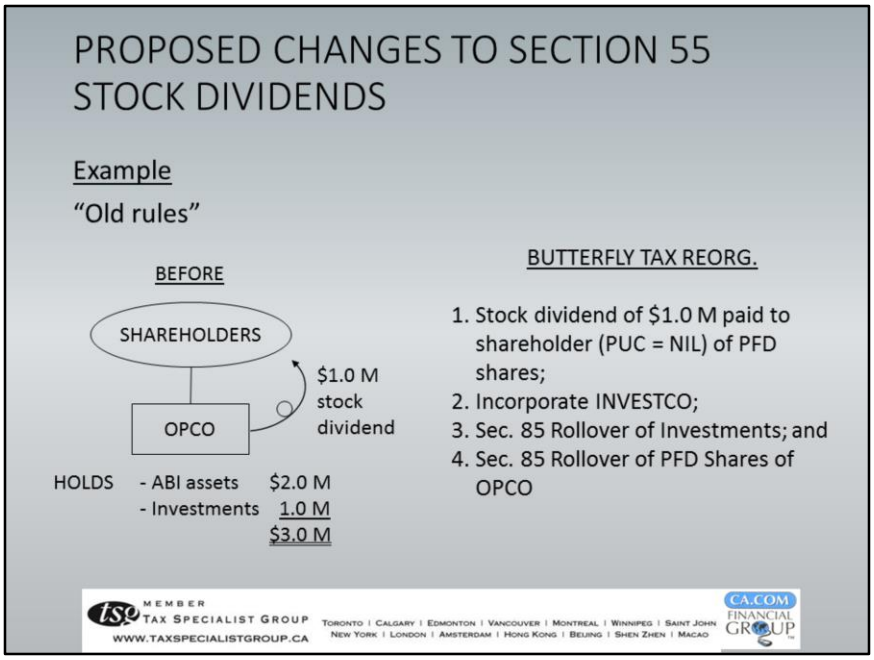
PROPOSED CHANGES TO SECTION 55

STOCK DIVIDENDS

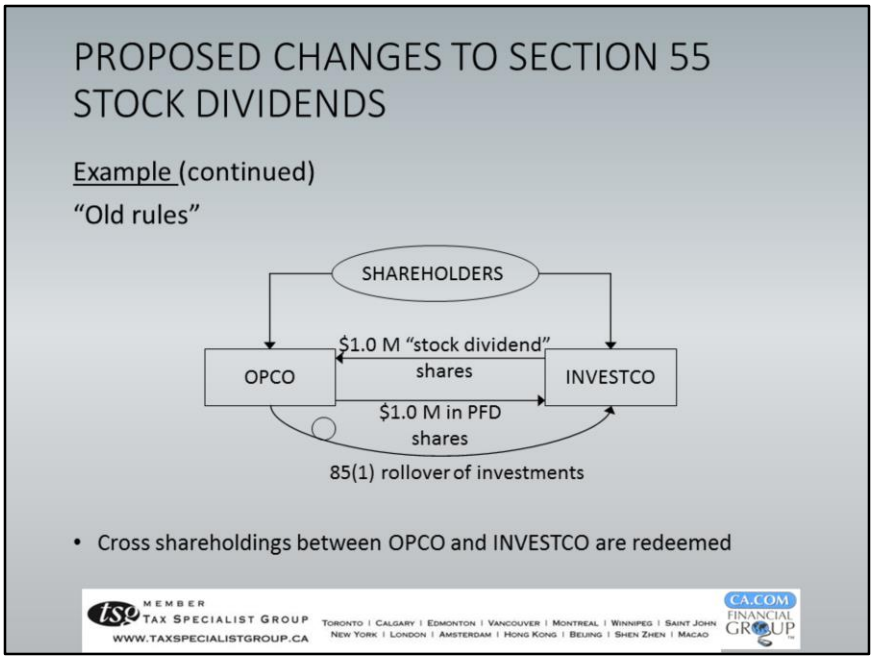
- Special rules
- Full FMV of the stock dividend shares instead of the PUC, subject to 55(2)

Special rules would apply in respect of stock dividends to ensure that the full fair market value of the stock dividend shares, rather than only the amount of their paid-up capital (PUC), is subject to the provisions of subsection 55(2).

This change is significant, as using a “stock dividend” to carve out assets as part of a RPT-butterfly transaction, was a standard means of effecting such a transaction. The butterfly transaction may still be able to be structured, but it will involve additional valuations on all of the assets and a significantly more complicated re-structuring plan.



A common way to "butterfly" out investments and separate active business assets from investments within a corporation, was to implement a "stock dividend" strategy. OPCO would pay a stock dividend to the shareholder equal to the fair market value (FMV) of the investments. The shareholder would then incorporate a new "INVESTCO" and transfer the newly acquired stock dividend shares to INVESTCO. Commensurately, OPCO would transfer its investments to INVESTCO for equivalent value of preferred shares. The cross shareholdings would then be redeemed.



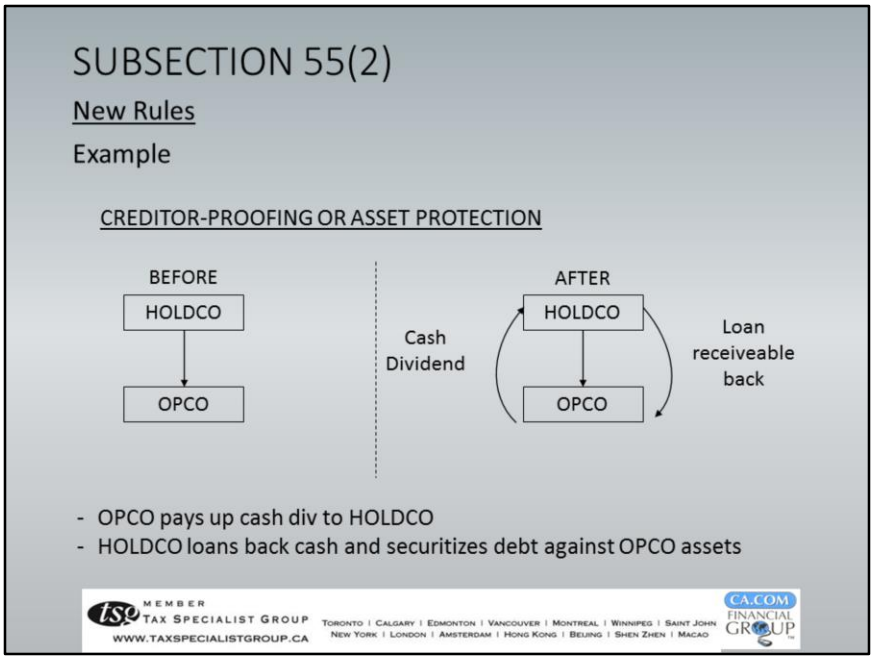
Under the new proposals, Sec. 55 will apply to a stock dividend to deem that the full fair market value of the stock dividend (rather than only the PUC), is subject to Sec. 55(2). Since there would be a significant reduction in the fair market value of the shares of OPCO, arising from the actual stock dividend paid of $1.0 million in this example, Sec. 55(2) would deem that INVESTCO has a capital gain of $1.0 M when the stock dividend shares are redeemed.

SUBSECTION 55(2)

TYPES OF TRANSACTIONS CAUGHT?

- Asset Protection?
- Pay a Dividend to HOLDCO
- Protect assets from future business risks

Corporations often pay dividends to a corporate shareholder consisting of cash in excess of that required to operate the corporation's business as a means of protecting assets from future business risks. As described above, the 55(3)(a) exception would not be available under the proposed rules, unless the distribution is completed by way of a redemption, acquisition or cancellation of shares by the corporation. Given that, in such situations, dividends would likely reduce the fair market value of the shares of the dividend payer or increase the total of the cost amounts of all properties of the dividend recipient, one will need to conclude that the purpose of the dividend payment or receipt is not to effect a significant reduction in the fair market value of the corporation's shares or a significant increase in the total of the cost amounts of all properties of the dividend recipient. Consequently, it may be advisable in such situations to rely on the safe income exception. Going forward, it may be more difficult to undertake asset protection planning involving dividend payments, unless structures as a share redemption, if there is insufficient safe income to support the amount of the dividend.



As part of an asset protection plan or a corporate reorganization involving only related parties, an operating company (OPCO) pays a cash dividend to a holding company (HOLDCO), which in turns lends the funds back to OPCO. Since the dividend is not a subsection (84(3) deemed dividend (because no shares are redeemed, acquired or cancelled), the related-party exception will not apply under the new rules. Even though no unrelated persons are involved, new subsection 55(2) could apply if one of the three purpose tests is met. [Old purpose test plus the two new purpose tests].

The current wording of the new purposes tests, combined with the narrowing of the related-party exception, creates uncertainty as to whether subsection 55(2) will apply in situations such as the example above.

Subsection 55(2) would not apply if the dividend is paid from safe income on a share that has an accrued gain.

SUBSECTION 55(2)

TYPES OF TRANSACTIONS CAUGHT?

- Internal reorganizations
- May involve payment of dividend
- RPT to another corporation

The existing 55(3)(a) exception is generally relied upon in various internal reorganizations that may involve the payment of dividends as part of certain related party transactions. As discussed above, under the proposed rules, the 55(3)(a) exception would apply only to deemed dividends arising on a redemption, acquisition or cancellation of shares. Where this exception is not available, the safe income exception or the purpose test exception would need to be relied upon. Where possible, in situations where the safe income exception is not available, it may be advisable for the parties undertaking the internal reorganization to consider structuring any contemplated dividends as deemed dividends arising on the redemption, acquisition or cancellation of a corporation's shares, to ensure that the 55(3)(a) exception is available. However, structuring the transaction in such a manner will preclude the dividend recipient from relying on the purpose test exception in the event the 55(3)(a) exception is later determined to be inapplicable.

If a corporation is contemplating a reorganization or a significant inter-corporate dividend, you should review the new rule in detail to determine whether it may apply. If so, it may be necessary to consider alternative transactions to achieve your business objectives.

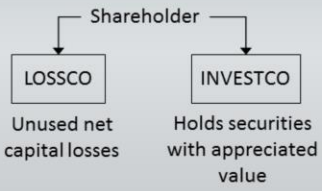
SUBSECTION 55(2)

TYPES OF TRANSACTIONS CAUGHT?

- Tax loss utilization
- Inter-co dividend to move asset within corporate group to utilize a loss

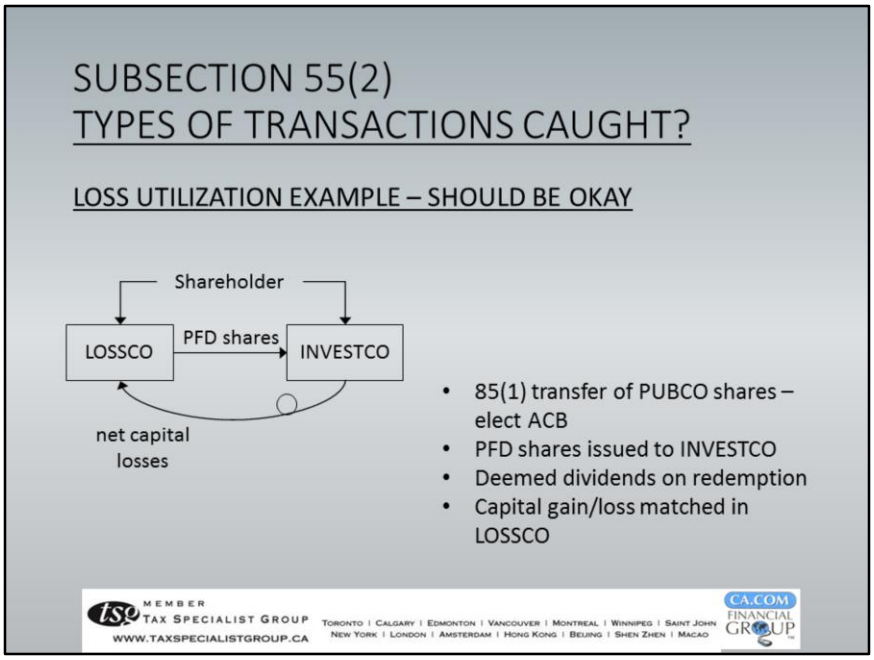
SUBSECTION 55(2)
TYPES OF TRANSACTIONS CAUGHT?

LOSS UTILIZATION EXAMPLE



PLAN:

1. Sec.85 transfer of securities by INVESTCO to LOSSCO
2. LOSSCO issues shares to INVESTCO
3. Inter-corporation holdings redeemed
4. Asset sold within LOSSCO



In certain corporate groups, there may be one or more corporations that have incurred losses for tax purposes (LOSSCOs), while other corporations in the group have been profitable or hold appreciated assets. In these situations, loss utilization structures are often implemented that allow for the losses of the LOSSCOs to be "transferred" to and utilized by the PROFITCOs.

The CRA generally extends favourable income tax rulings to taxpayers intending to implement loss utilization structures, provided certain conditions are met. With respect to the deductibility of dividends paid as part of these structures, the CRA has ruled that subsection 55(2) would not apply to the dividends because the 55(3)(a) exception would be met.

Under the proposed amendments to section 55, the 55(3)(a) exception would no longer be available unless the structure in question involves paying dividends by way of a redemption, acquisition or cancellation of the preferred shares, rather than paying cash dividends. This presents another situation where taxpayers may have to rely on the purpose test exception (i.e., that the payment or receipt of the dividend is solely to effect the loss utilization arrangement, and not to reduce the fair market value of any share or to increase the total of the cost amounts of all properties of the dividend recipient). It should be reasonable to argue that the purpose of the payment or receipt of a cash dividend on preferred shares issued in the context of a loss utilization structure is to provide a return on the preferred shares to the dividend recipient, and to fund the interest payable by the dividend recipient. We understand that it was not the Government's intention to thwart taxpayers' ability to implement loss utilization plans, especially given the CRA's practice of providing favourable rulings, and its affirmation of the acceptability of loss utilization structures in the recently issued Income Tax Folio addressing interest deductibility. In the absence of guidance from Finance, corporate taxpayers must consider whether subsection 55(2) applies to loss utilization structures under the proposed rules.

INTER-CORPORATE DIVIDENDS

TYPES OF TRANSACTIONS CAUGHT (CONT'D)

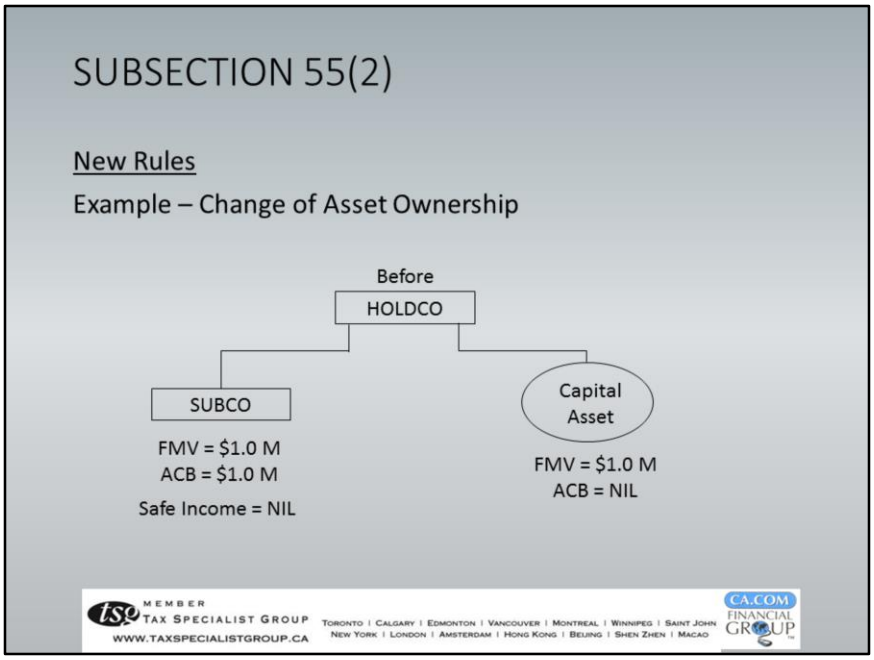
- Purification for capital gains exemption – paying inter-co dividend to remove non-active assets
- Change of asset ownership – paying inter-co dividend to move assets within related group of companies
- Share redemptions (if not related corporations)
- See examples

Possible double taxation on share redemptions

Where a corporation redeems – or acquires or cancels – shares of its capital stock, the amount by which the redemption proceeds exceed the PUC of the shares represents a deemed dividend paid by the corporation to the holder of the shares. In general terms, under the current rules, the intended effect of the application of subsection 55(2) is to ultimately ensure that the dividend recipient realizes a capital gain equal to what would normally have been such capital gain had the dividend recipient sold the shares.

Under the proposed amendments, if subsection 55(2) applies, the amount of the deemed dividend would be deemed to be a capital gain of the dividend recipient from the disposition of a capital property, without taking into account the adjusted cost base (ACB) of such shares (which would have otherwise reduced the gain has the shares been sold rather than redeemed). In addition, as a result of the disposition of the shares, another capital gain would arise on such disposition, unless consequential amendments to other provisions of the Act are made. Even if consequential amendments are introduced to address the double taxation issue, taking into account the current stop-loss rules (in subsection 40(3.6) and 112(3)), any capital loss triggered on the redemption may be suspended to a later date, or denied. This could result in a greater gain being realized by virtue of the application of 55(2) than if the dividend taxpayer had sold the shares.

These consequences may not have been intended. In the Supplementary Information accompanying the budget documents, it was noted that further consequential amendments to other provisions in the Act would be required as a result of the implementation of the proposed changes to section 55. It is unclear at this time whether these consequential amendments will fully address the aforementioned issues.



A corporation (HOLDCO) owns a property (Gain Asset) with a fair market value (FMV) of $1 million and nominal adjusted cost base (ACB) (i.e., an accrued capital gain of $1 million), which it intends to sell to an arm's length buyer.

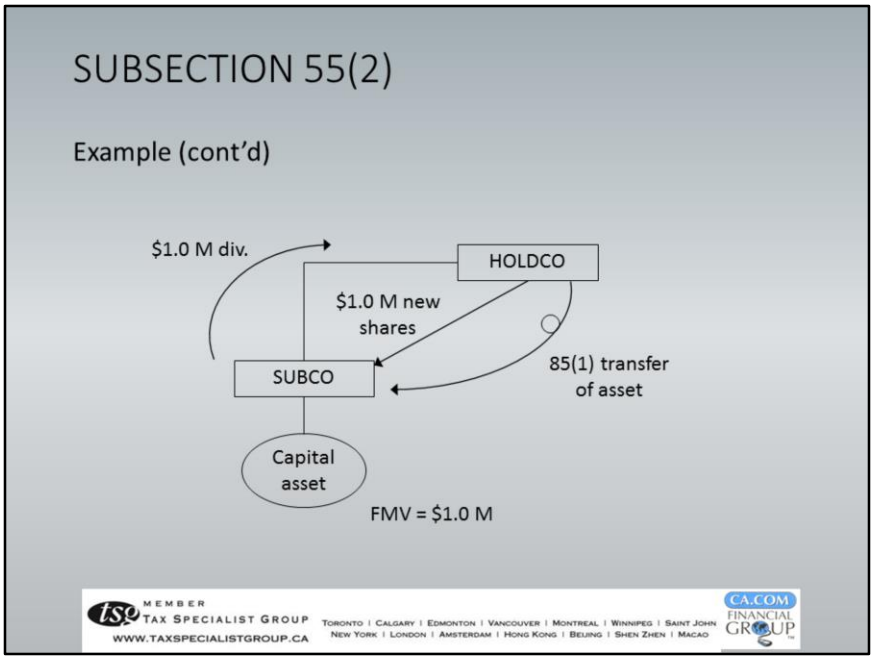
HOLDCO also owns all of the shares of a subsidiary corporation (SUBCO). The SUBCO shares have a FMV and ACB of $1 million of cash and has no safe-income-on-hand.

SUBSECTION 55(2)

New Rules

Example (cont'd)

- SUBCO pays a $1.0 million dividend to HOLDCO: reduces value of SUBCO to NIL
- HOLDCO then transfers (Sec 85) the capital asset to SUBCO in exchange for additional shares of SUBCO with FMV of $1.0 M
- HOLDCO then sells SUBCO shares to arm's length buyer, for $1.0 M, resulting in no capital gain



Under the old rule, subsection 55(2) should not have applied to the $1 million cash dividend received by HOLDCO because the purpose of the dividend was not to reduce the capital gain on the shares of SUBCO, as there was no gain on the SUBCO shares before the dividend. By following the steps in this example, HOLDCO eliminated its capital gain on the disposition of the Gain Asset without being subject to the old subsection 55(2) anti-avoidance rule.

SUBSECTION 55(2)

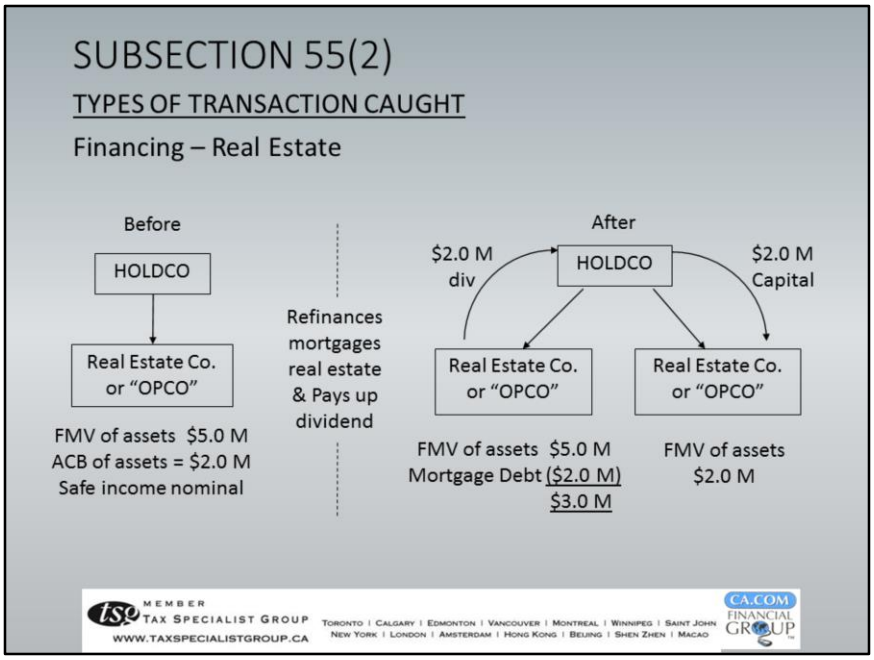
New Rules

Example (cont'd)

- Subsection 55(2) likely now applies because:
  - One of the purposes was to effect a significant reduction in FMV of SUBCO shares
  - The $1.0 M inter-co dividend from SUBCO to HOLDCO reduced SUBCO's FMV from $1.0 million to NIL (and no safe income)
- New subsection 55(2) would re-characterize $1.0 M cash dividend as a capital gain to HOLDCO

Note that 55(2) would likely apply here, even though HOLDCO has a $1.0 million ACB on the shares of SUBCO.

Proposed subsection 55(2) re-characterizes a dividend into a gain rather than into proceeds per the currently-enacted rules, a deemed dividend on a redemption of shares with ACB higher than PUC could be re-characterized in its entirety (i.e. redemption amount less PUC) into a gain under proposed subsection 55(2). Compare this result to the current rules where the deemed gain would only be the excess of the redemption amount over ACB. Also, the manner that the proposed rules are drafted appears to suggest that safe income does not protect a dividend from subsection 55(2) unless the shares of the dividend payor are in a gain position. Moreover, proposed subsection 55(2.5) is capable of being interpreted in two diametrically-opposed manners: it is either a scope-expansion provision to catch "skinny" or "dividend-sprinkling" shares, or a relieving-provision to carve out single share class corporation from one of the purpose test.



In this example, the shareholders might plan to extract the unrealized value or appreciation in the underlying assets of Real Estate Co or OPCO, by arranging for debt (a mortgage/for instance) on the assets within the company. Then, the borrowed proceeds would be paid up to HOLDCO as an inter-corporate dividend and re-deployed as new capital in another corporation.

SUBSECTION 55(2)

TYPES OF TRANSACTION CAUGHT

Example (cont'd)

- Under new 55(2) this type of re-financing caught, as
  - One of the purposes did effect a significant reduction in the FMV of any shares (Real Estate Co went from $5.0 M to $3.0 M); and
  - No safe income within payor corporation

Under the old rules, this was a common way to leverage and use financing to start other operations or another venture. In the real estate business, properties or property development is usually structured in separate corporations, so that liability can be managed. Being able to leverage against "appreciated assets", is a standard way of financing new growth and new corporate opportunities.

In example 2, with no safe income within the payor corporation, the $2.0 Million inter-corporate dividend could be re-characterized as a capital gain to HOLDCO.

SUBSECTION 55(2)

EXCEPTIONS TO THE RULE

- Related-Party Exception
- Safe Income Exception
- Part IV Tax Exception

SUBSECTION 55(2)

EXCEPTIONS

Related-party exception

- R-P exception applies only to deemed dividends arising on redemption, acquisition or cancellation of shares under 84(3)
- Far-reaching consequences

The new rules place a further restriction on related-party transactions. Under the "old" Sec 55(2), related-party inter-company dividends were basically excluded. However, under the new 55(2), the related party exception will only apply to a deemed dividend arising on the redemption, acquisition or cancellation of a share, under 84(3). Note that inter-corporate dividends paid between "related corporations" will not be caught under 55(2), where the "safe-income" test is met; however the "safe-income" test applies whether the parties are related or unrelated in any event.

Previously, a practitioner could generally rely on paragraph 55(3)(a) as an exception to subsection 55(2) if the practitioner was confident that the inter-corporate dividend was not part of a series of transactions or events that involves an unrelated party. Effective for dividends received after April 20, 2015, Finance proposes to amend paragraph 55(3)(a) so that the exception only applies in the case of a subsection 84(3) deemed dividend, which only arises on a share redemption. Therefore, even on a simple Holdco-Opco scenario where there is no unrelated party involvement on the horizon, any inter-corporate dividend is potentially subject to proposed subsection 55(2).

SUBSECTION 55(2)

EXCEPTIONS

Safe Income Exception

- Exception applies only where there is an accrued gain on the shares;
- Safe-income exception does not apply if dividend paid out of "safe-income", where
  - There is an accrued loss on the share; or
  - Where FMV of share equal to ACB

The new rules in 55(2) effectively force businesses to prove sufficient safe income on hand every time a significant inter-corporate dividend is declared in order to avoid a re-characterization of the dividend into a taxable capital gain. The concept of safe income is one of the toughest computational exercises in Canadian tax because it requires an examination of all taxation years since 1972 and because there is no complete codification of the computational rules – they are mostly derived piecemeal from CRA administrative policies and court decisions.

There is no safe-income exception where there is no gain on a share – Existing subsection 55(2) does not apply where there is no accrued gain on any share before a dividend is paid. Under the proposed amendments, subsection 55(2) can deem a capital gain to be realized even where there is no accrued gain on a share. In addition, the safe income exception would be available only where the safe income on a share could reasonably be regarded to contribute to a capital gain on the share. Where there is no accrued gain on the share, it appears that the safe income exception would not be available. However, a corporate taxpayer might be able to reduce the potential deemed capital gain on a share under these circumstances either with safe income, or by utilizing existing cost base.

SUBSECTION 55(2)

EXCEPTIONS

Safe Income Exception

- So what is "safe income"?
- Essentially… tax-paid retained earnings
- Not defined in the Act – calculation based on cumulative database of "tax knowledge"

The terms "safe income" and "safe income on hand" are not defined in the Act. These are terms referred to by tax practitioners and by Canada Revenue Agency, which describe the safeharbour within Sec. 55(2), wherein dividends can be paid to reduce share value. Essentially, safe income is the tax-paid retained earnings of a corporation.

The only guidance on the computation of "income earned or realized by any corporation" in the Act is contained in paragraphs 55(5)(b), (c) and (d), but they are merely the starting point. According to the CRA, the distinction between "safe income" and "safe income on hand" is as follows (see CRA Technical Interpretation 9408795, July 20, 1994):

""Safe income" with respect to a share of a corporation is equivalent to the "income earned or realized" by the corporation during the relevant holding period. The expression "income earned or realized" by a corporation is deemed to be the amount determined pursuant to paragraph 55(5)(b), (c) or (d), of the Act, as the case may be. Consequently, "safe income" with respect to a share of a corporation refers to the corporation's net income, as determined for purposes of the Act, as adjusted by paragraphs 55(5)(b), (c) or (d), as the case may be, that is attributable to that particular share during the relevant holding period. However, in order to contribute to a gain on a share, income earned or realized must be on hand. Consequently, "safe income on hand" with respect to a share of a corporation at a particular time refers to the portion of the income earned or realized by the corporation during the relevant holding period that could reasonably be considered to contribute to the capital gain that would be realized on a disposition at fair market value of the share at that time. It follows then that income that has been distributed as a dividend or laid out to pay taxes or non-deductible expenses is not on hand and cannot contribute to the fair market value of, or the gain inherent in, a share. A "safe dividend" can be paid only from safe income on hand. Therefore, it should be remembered that it is possible for a computation of safe income based only on income earned in the holding period to result in an amount that is greater than that which is "on hand" and that can be paid as a safe dividend."

This is the theory and back drop against which the concept of "safe income" and "safe income on hand" must be determined.

SUBSECTION 55(2)

EXCEPTIONS

Safe Income Exception

- Why is safe income and safe income-on-hand important?
- ANSWER…

Because corporate income taxed once, should not be taxed again when paid as a dividend to another corporation

Safe income on hand is meant to capture that portion of an increase in the value of a share of a corporation attributable to income earned for tax purposes (after 1971), rather than an increase in the value of a share attributable to appreciation in the assets of the corporation, internal goodwill, or some other unrealized increase in value. If income earned in a corporation, attributable to a share is taxed, then that tax paid income should be able to be distributed to another corporation without being taxed again.

To the contrary, where share value increases and is as the result of something other than earnings which have been taxed, a tax-free intercorporate distribution to another company is fundamentally inappropriate since the distribution would constitute an equity strip (tax avoidance).

This is the theory and back drop against which the concept of “safe income” and “safe income on hand” must be determined.

SUBSECTION 55(2)

EXCEPTIONS

Safe Income Exception

Safe income is generally calculated as follows:

- Net income for tax purposes

  Less:
  - Dividends paid or payable (excluding capital dividends)
  - Taxes paid, including refundable taxes
  - Charitable donations, political donations
  - Losses denied by stoploss or loss suspension rules
  - Non-deductible portion of expenses (meals and entertainment, life insurance, non-deductible auto…)
  - Cumulative dividends attributable to preferred shares not paid

CRA has modified its approach and thinking on non-deductible expenses and outlays. For many years CRA considered that non-deductible expenses would not generally reduce a corporation's safe income on hand.

However, the CRA later modified its position in its Income Tax Technical News No.37, stating that the previous approach it adopted undermined the tax policy underlying subsection 55(2) because it could result in safe income on hand that is not supported by the net FMV of assets retained by the corporation. Consequently, the CRA revised its position to require that non-deductible expenses be deducted in computing the safe income on hand attributable to the shares on which the dividend is paid since those amounts reduce the amount of disposable after-tax income, and thus could not have been attributable to (or using the wording of new subsection 55(2.1), contribute to) capital gains that could be realized on a FMV disposition of the share.

SUBSECTION 55(2)

EXCEPTIONS

Safe Income Exception

When is the "start date" for calculating safe income?

ANSWER:

- Later of:
  - January 1, 1972 and
  - Date of acquisition of the share

– Safe Income on hand for a particular share does not include safe income earned prior to taxpayer's date of acquisition of that share

The start date for calculating safe income is typically the later of January 1, 1972 and the date of acquisition, and the end is the "safe income determination time". Safe income on hand on a share does not include safe income earned by the corporation prior to the taxpayer's date of acquisition of that share because such pre-acquisition safe income was already reflected in the acquisition price (and hence ACB) of the share and therefore cannot increase capital gain inherent in the share post-acquisition. However, where shares are received by the taxpayer on a full rollover basis (proceeds elected at cost), the acquired shares generally inherit the safe income of the exchanged shares because the shares are acquired with accrued gains at the outset.

The period for which safe income is calculated ends at the "safe income determination time". This term is defined in subsection 55(1) with respect to a transaction or event or a series of transactions or events, being the earlier of (a) the time that is immediately after the earliest disposition to or increase in interest by an unrelated person that result from the series, or (b) the time that is immediately before the earliest time a dividend is paid as part of the series. The concept of a "series of transactions or events" has been defined very broadly by the courts, and this broad definition is further expanded by subsection 248(10). The broadness of a series has always been problematic in the context of applying subsection 55(2), and although new section 55 has not modified this concept or the definition of "safe income determination time", these problems are now exacerbated due to the expanded scope of new subsection 55(2).

SUBSECTION 55(2)

EXCEPTIONS

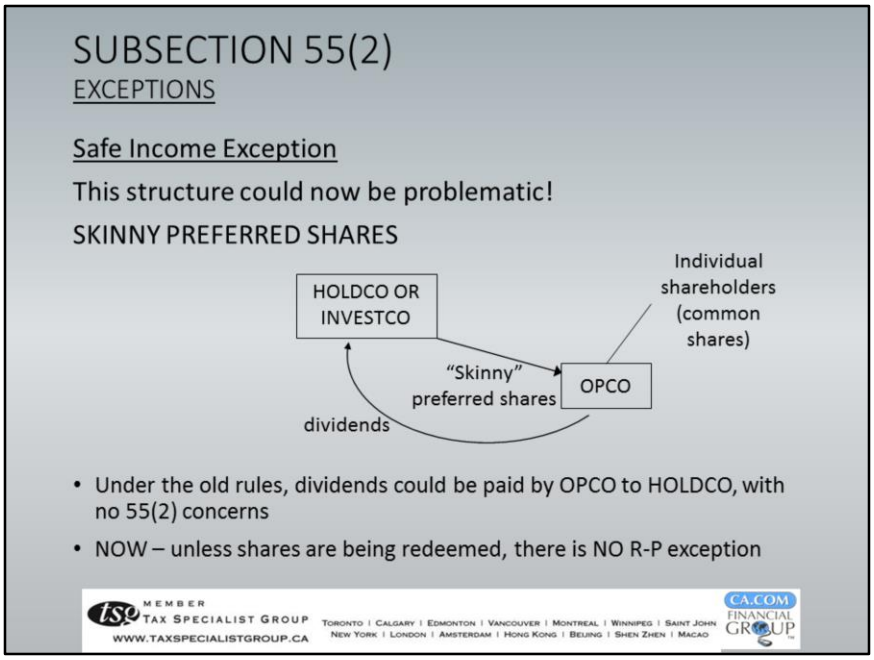
Safe Income Exception

- Allocating safe income to a share
  - Different classes of shares
  - "Skinny" preferred shares
- Are shares participating – accrued gain on the share?

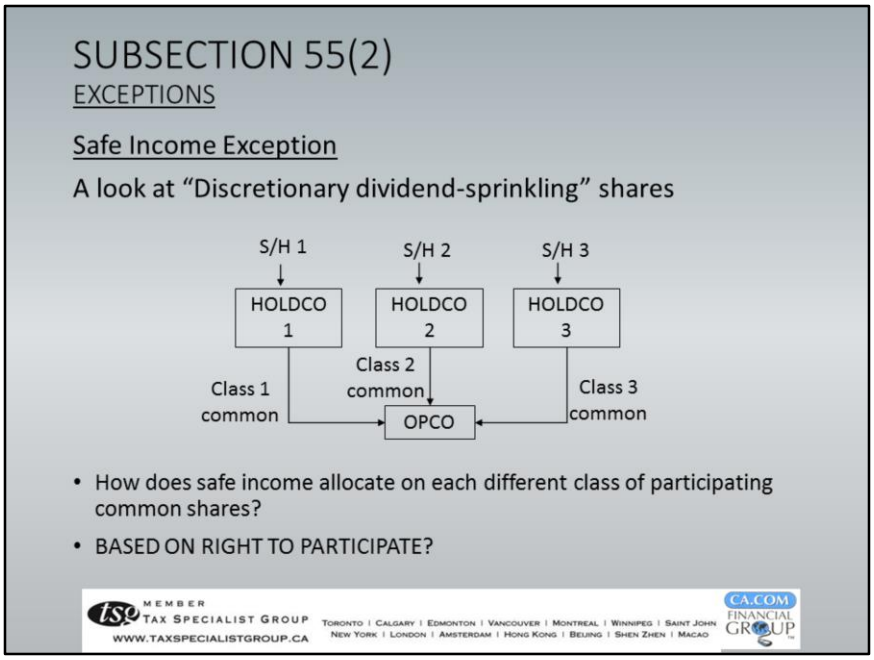
When a corporation has different classes of shares, it will now be generally necessary to determine safe income attributable to a particular class of shares, and to examine the rights attaching to each particular class.
The new provisions contained in 55(2) have changed the way in which safe income is applied to dividends. Under the old rules, safe income could theoretically attribute to preferred shares if the preferred shares were entitled to share in the income of the corporation during the holding period. It was not always clear as to how this would apply to discretionary dividend preferred shares; however, this was seldom an issue due to the related party exception.

The proposed rules state that no safe income can attribute to dividends paid on discretionary dividend or dividend streaming shares (on the assumption that such shares cannot increase in value). Also, since safe income can only be applied to shares with a gain, no safe income can be allocated to loss shares. This was never an issue under the old rules; however, the new purpose tests discussed above provide that subsection 55(2) can now apply in loss situations.

"Skinny" preferred shares, which are essentially a low or nominal value share, with a right to receive a dividend with no fixed limit, are essentially not going to share in any of the safe income of a corporation.



The above example illustrates a recent CRA determination that so-called skinny shares (i.e. shares with a right to dividends at the discretion of the directors but no other right to participate in the assets of the corporation) may, depending on the facts, never have safe income attributed to them. At the 2015 CTF Roundtable, the CRA states its view that dividends on skinny shares would be subject to the purpose tests under new subsection 55(2.1). The CRA has also states that no safe income is attributable to skinny shares if no accrued gains exist in respect of those shares, so no safe income could reasonably be considered to contribute to the capital gain that could be realized on a FMV disposition. Such a dividend still reduces safe income for the entire corporation, but if that dividend is re-characterized under subsection 55(2) into a capital gain, then the CRA will accept that the safe income on the other (participating) shares is not affected by the dividend.



In the past, when the CRA was asked about the allocation of safe income on hand amongst various classes of discretionary dividend participating shares, the guidance given by the CRA was generally that the determination was based on the right of the shares of various classes to participate in the safe income of the corporation. CRA as asked to comment on the allocation of safe income on hand where the dividend payor has multiple classes of participating discretionary dividends outstanding and has paid a disproportionate dividend on one of the classes. In such case, CRA noted that the taxpayer should compare all of the corporation's safe income on hand before the payment of the dividend with the capital gain that could be realized on a disposition of the shares on which the dividend would be paid at FMV at the time immediately prior to payment of the dividend, taking into account that such shares would be entitles to the dividend that will be paid and declared (see CRA document 2015 – 0593941E5 December 3, 2015).

This new approach taken by the CRA for discretionary dividend shares is very interesting. Firstly, it appears that the CRA is now taking a 'global' approach to calculating safe income on hand, and allocating global safe income to classes of shares solely based on the hypothetical capital gains that could be realized on each share. Secondly, it effectively allows taxpayer to use hindsight to determine FMV of the dividend paying share immediately prior to the payment of the dividend. Based on this approach, it appears that as long as the discretionary dividend share class is a common share class that participates equally with other classes in the assets of the corporation and there are no other factors that limit the accrued gain on the share, a safe income dividend can be streamed disproportionately to a single class. It will be interesting to see how this global approach to safe income on hand interfaces with CRA's previous collection of rules on the allocation of safe income for different classes and different holders of shares.

SUBSECTION 55(2) EXCEPTIONS

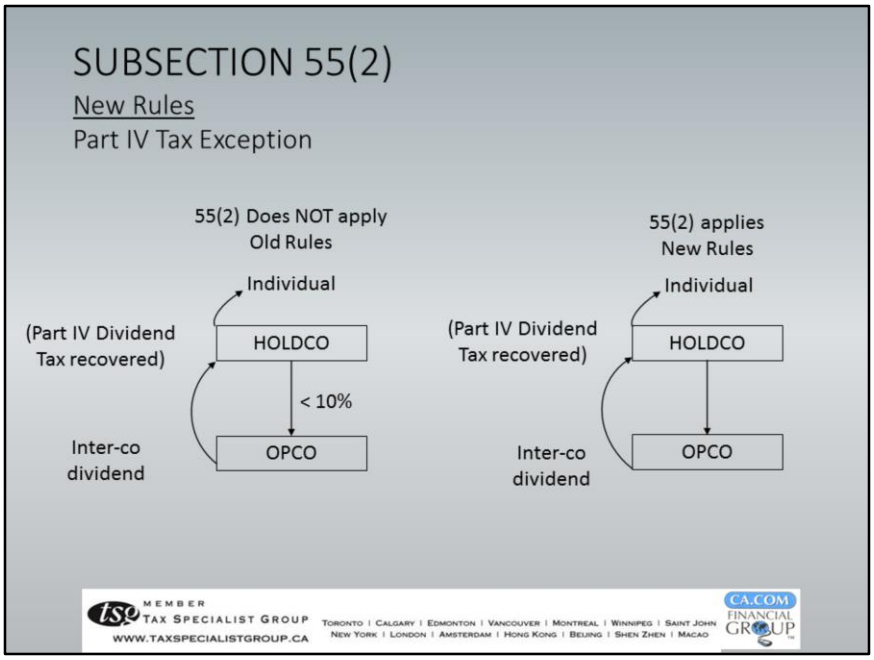
Part IV Tax Exception

- Part IV tax exception further narrowed
- If corporate recipient pays Part IV tax but receives dividend refund, exception will not apply, even if dividend paid to individual

The new rules provide further limitations on the exceptions to 55(2). Under the "old" rules, subsection 55(2) would not apply if the inter-corporate dividend was subject to Part IV tax and provided the Part IV tax was not refunded on the payment of a dividend to a corporation (i.e., the exception is available where the Part IV tax is refunded on the payment of a dividend to an individual or trust). The proposed amendments modify the wording of the subsection 55(2) such that the Part IV tax exception is not available where Part IV tax is refunded, as part of the series of transactions that includes the dividend, on the payment of a dividend by a corporation (which, presumably, includes all dividends that result in the refund of Part IV tax). It is currently unclear if it is the Government's intention to not allow the application of the Part IV tax exception where Part IV tax is refunded as part of the particular series of transactions.

There is also a timing issue re: availability of capital dividend account (CDA) balance – Under the proposed amendments, any dividend recharacterized under subsection 55(2) is deemed to be a capital gain for the year in which the dividend is received. It is not clear when the non-taxable portion of the deemed capital gain is added to the corporation's CDA (i.e., at the time of the dividend? After the taxation year end for the year in which the capital gain is realized?). From a tax policy perspective, the CDA should be available at the time of the event giving rise to the capital gain that is included in income for tax purposes.

The Joint Committee on Taxation of the Canadian Bar Association and the Chartered Professional Accountants of Canada made a joint submission to Finance on October 13, 2016 (a copy of which is attached). There are some following slides and discussion on these issues.



In this example, assume that OPCO and HOLDCO are NOT connected (less than 10% ownership) and are "unrelated corporations. If a dividend is paid out of OPCO and Part IV tax is paid by the recipient corporation – Sec 55(2) typically did not apply where the dividend was then paid through to an individual, and the Part IV tax was recovered. Under the NEW rules, the Part IV exception will not apply if the tax is recovered with a dividend paid to an individual. Conceivably, this will result in double tax because HOLDCO would be taxed on the inter-company dividend as a capital gain and the individual would still be taxable when the dividend is flowed-out and paid to the shareholder.

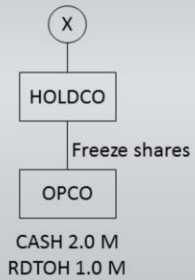
SUBSECTION 55(2)
PART IV TAX – SOME ANOMALIES

In order for 55(2) to apply:

- Must be an actual assessment of Part IV tax;
- Actual dividend refund; and
- Then 55(2) could apply to recharacterize dividend as capital gain

SUBSECTION 55(2)
PART IV TAX / SOME ANOMALIES

SCENARIO 1



ASSUMPTIONS

- HOLDCO holds freeze shares in OPCO (unrelated)
- OPCO/HOLDCO have no existing CDA
- OPCO earned SIBI of $3,750,000
  - Permanent tax (20%) (750,000)
  - RDTOH 26 2/3 % (1,000,000)
  - CASH $2,000,000
- OPCO redeems freeze shares; 84(3) deemed dividend unrelated person event

SUBSECTION 55(2)

SCENARIO 1 (cont'd)

PART IV TAX / SOME ANOMALIES

STEP 1: OPCO pays $3.0 M dividends to HOLDCO

Dividend received by HOLDCO	$3,000,000
Part IV tax paid	(1,000,000)
CASH	$2,000,000

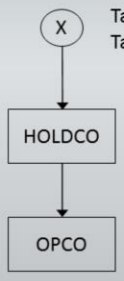
CASH	$2,000,000
Dividend refund received	1,000,000
Dividend paid	$3,000,000

SUBSECTION 55(2)

SCENARIO 1 (cont'd)

PART IV TAX / SOME ANOMALIES

STEP 2: HOLDCO pays $3.0 M dividends to Individual



Taxable dividend	$3,000,000
Tax paid by X	(1,200,000)
CASH	$1,800,000

CASH	NIL
RTDOH	NIL
	$ NIL

TAX ISSUES

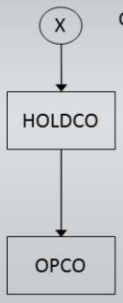
- Entire dividend subject to 55(2) due to Part IV tax refund

SUBSECTION 55(2)

SCENARIO 1 (cont'd)

PART IV TAX / SOME ANOMALIES

STEP 2: HOLDCO pays $3.0 M dividends to Individual



CASH $1,800,000

55(2) deemed gain	$3,000,000
Permanent tax on CG (10%)	(300,000)
RDTOH on capital gain	(400,000)
Dividend refund	400,000
CDA	(1,500,000)
Taxable dividend?	(1,500,000)
CASH in HOLDCO	($300,000)

TAX ISSUES

- HOLDCO liable for tax of $300 K
- NO CASH
- SH funds corp tax liability?

SUBSECTION 55(2)

SCENARIO 1 (cont'd)

PART IV TAX / SOME ANOMALIES

SUMMARY OF TAXES PAID

- Total tax if 55(2) applies:
  - OPCO $3.75 M @ 20% $750,000
  - HOLDCO $3.0 M @ 10% (deemed gain) 300,000
  - Individual $3.0 M @ 40% 1,200,000

    $2,250,000 60%
- **CDA of $1.5 M stranded in HOLDCO**
- Total tax if 55(2) does not apply:
  - OPCO $3.75 M @ 20% $750,000
  - Individual $3.0 M @ 40% 1,200,000

    $1,950,000 52%
- Earned directly by Individual:
  - Individual $3.75 M @ 50% $1,875,000 50%

SUBSECTION 55(2)

SCENARIO 1 (cont'd)

PART IV TAX / SOME ANOMALIES

ALTERNATIVE 1

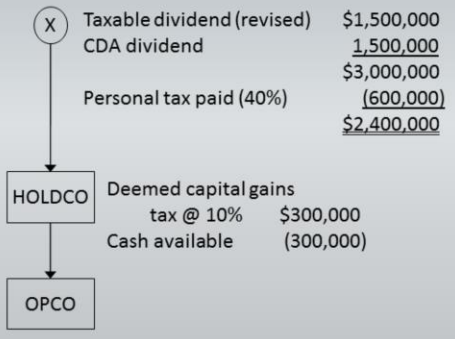
- After Part IV tax assessed…
  - Can HOLDCO late file CDA election?
    - Does CDA election retroactively undo part of Part IV tax recovery?
    - Undo part of 55(2) recharacterization?
    - Or is initial dividend/dividend refund unaffected?

SUBSECTION 55(2)

SCENARIO 1 – cont'd

PART IV TAX / SOME ANOMALIES

ALTERNATIVE 1



TAX POSITION

- Late filed T2054
- 3M dividend changed to
  1.5 M taxable
  1.5 M capital dividend
  3.0 M
- SH funds $300 K tax liability of HOLDCO

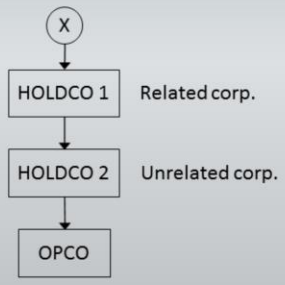
SUBSECTION 55(2)

SCENARIO 1 (cont'd)

PART IV TAX / SOME ANOMALIES

ALTERNATIVE 2

- Revise corporate structure
- Interpose another HOLDCO



TRANSACTIONS

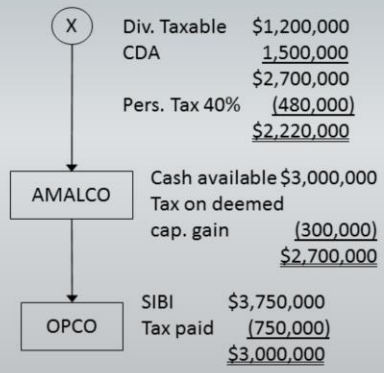
- OPCO pays dividend to HOLDCO 2
- HOLDCO 2 pays dividend to HOLDCO 1
- 55(2) applies to HOLDCO 2 because HOLDCO 2 recovers Part IV tax
- Assume dividend received by HOLDCO 1 – not subject to 55(2) – RELATED
- Then HOLDCO 1 and HOLDCO 2 amalgamate
- AMALCO has CDA of $1,500,000

SUBSECTION 55(2)

SCENARIO 1 (cont'd)

PART IV TAX / SOME ANOMALIES

ALTERNATIVE 2 cont'd



SUBSECTION 55(2)

SCENARIO 1 (cont'd)

PART IV TAX / SOME ANOMALIES

SUMMARY OF TAXES PAID

PERSONAL

• If investment income earned personally	50.0%

CORPORATE

• From HOLDCO if 55(2) applies	60.0%
• From HOLDCO if 55(2) does not apply	52.0%
• From HOLDCO if late-filed CDA; 55(2) applies	44.0%
• HOLDCO 1 / HOLDCO 2 structure	40.8%

If a late-filed T2054 (CDA election) can be filed, after the 55(2) assessment, then the individual receives net cash of $2.4 million but pays the $300 K on corporate taxes owing, leaving a net of $2.1 million. Based on the initial $3.75 million of pre-tax earnings in OPCO, the shareholder ultimately pays total taxes of $1.65 million ($3.75 million-$2.1 million retained), which is a combined rate of 44% - better than earning the investment income directly. By using the HOLDCO 1 / HOLDCO 2 structure, the "stranded" tax liability of $300 K can be eliminated, reducing combined taxes to $1.53 million, a combined corporate / personal tax rate of only 40.8%.

Inter-Corporate Dividends and Sec. 55 CRA Views and Position

Hypothetical Scenarios

Scenario 1

- DIVCO has no written dividend policy
- Dividends – amount and timing – sole discretion of directors
- Dividend would exceed comparable dividend paid by public corporation in comparable industry
- Safe income for tax purposes is less than retained earnings

See CRA document No. 2016-0627571E5 dated June 23, 2016. CRA was asked to comment a number of different hypothetical scenarios with respect to the payment of dividends by a corporation (DIVCO).

Scenario 1 would be very typical of most privately-owned CCPC's. There generally is no written dividend policy for privately-owned corporations and dividends are declared and paid at the sole discretion of the directors of the corporation. Often the dividends paid would well exceed a comparable rate of return, compared to what would be paid on the share by a publicly-traded corporation.

Inter-Corporate Dividends and Sec. 55 CRA Views and Position

Scenario 1

CRA Response

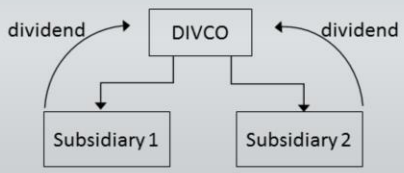
- Dividend paid from DIVCO could be subject to 55(2)
- Not determinative
- CRA commented on 55(2.1)(b)
- Section 55(2) could apply unless none of the purpose tests apply
- One of the purposes of dividend:
  - Results in significant reduction in FMV of share
  - Significant reduction in capital gain that would have been realized on disposition of the share

Scenario 1 was framed so that DIVCO pays a dividend that is in excess of its safe income for tax purposes. This could arise, for instance, where there are timing differences between the recognition of income for tax versus book purposes. Such timing differences could include CCA in excess of amortization for financial statement purposes, or reserves claimed for tax purposes. CRA's view is that "the scheme of the Act is that income that has already been taxed at the corporate level should be distributed tax-free to corporate shareholders. If corporate income has not previously been taxed, whether because the corporation was entitled to certain tax benefits… then a dividend paid by the corporation from such income should be subject to subsection 55(2) unless none of the purposes of the dividend is described in proposed paragraph 55(2.1)(b)".

Inter-Corporate Dividends and Sec. 55 CRA Views and Position

Hypothetical Scenarios

Scenario 2



- Dividends paid by subsidiaries to DIVCO
- Purpose 1: to fund dividends to shareholders of DIVCO
- Established dividend policy for DIVCO
- Purpose 2: to fund general corporate expenses of DIVCO

Inter-Corporate Dividends and Sec. 55 CRA Views and Position

Scenario 2

CRA Response

- CRA comments that dividends paid by subsidiaries:
  - Might not have a "purpose" described in 55(2.1)(b)
  - Must look at each particular dividend
  - Purpose must be analyzed at each level of payment through corporate chain

CRA commented that Scenario 2 was similar to the example described at the 2015 Canadian Tax Foundation (CTF) Round Table discussion. Their response concedes that payment of dividends by the subsidiary corporations to DIVCO may not necessarily have a purpose that would be caught under paragraph 55(2.1)(b). However, CRA went on to caution that 55(2.1)(b) requires that the purpose of the payment and receipt of each particular dividend be looked at.

It is interesting to note that, in this example, there is a well-established dividend payment policy. Presumably the existence of a dividend policy (on the surface) takes away in part, an argument by CRA that one of the purposes is to reduce share value or a subsequent capital gain, as described in paragraph 55(2.1)(b). That is to say… a written dividend policy may not be a "bad thing" to have.

Inter-Corporate Dividends and Sec. 55 CRA Views and Position

Hypothetical scenarios

Scenario 3

- DIVCO makes a year-end dividend payment to offset advances it made to another corporation of the group
- Dividend paid to offset/clear inter-company advances

Inter-Corporate Dividends and Sec. 55 CRA Views and Position

Scenario 3

CRA Response

- Similar comments as Scenario 2
- CRA comments that:
  - Year-end dividends designed to offset intercorporate advances might not be considered to have a purpose described in par. 55(2.1)(b)
  - Purpose can only be determined after review of all relevant facts and circumstances

CRA's response here is that scenario 3 has the same or similar issues as scenario 2. The payment of a divided once, at the end of the year to clear intercorporate advances does not, in and of itself, mean that one of the purpose tests is met under paragraph 55(2.1)(b). Purpose must be examined based on the facts and circumstances of the particular divided. If DIVCO does not have sufficient safe income to pay the dividend, then CRA would look at par. 55(2.1)(b) to determine if such a purpose was met, with Sec. 55(2), then becoming applicable.

Inter-Corporate Dividends and Sec. 55 CRA Views and Position

Hypothetical scenarios

Scenario 4a

- DIVCO has a class of non-cumulative preferred shares
- Dividend payable based on Redemption Amount
- Reasonable market rates for dividend
- Would any of the purpose tests be met if:
  - DIVCO pays a dividend at every entitlement period
  - DIVCO pays dividends occasionally
  - DIVCO pays dividends infrequently, depending on cash needs of preferred shareholder

Inter-Corporate Dividends and Sec. 55 CRA Views and Position

Hypothetical scenarios

Scenario 4b

- Would exception under par.55(3)(a) apply if:
  - DIVCO redeems all or some of preferred shares to meet cash needs of shareholders
- Would share redemption qualify as a "bonafide corporate reorganization"
- What if all common shares of DIVCO exchanged for preferred shares and ACB of old common shares allocated to new preferred shares

Inter-Corporate Dividends and Sec. 55 CRA Views and Position

Scenario 4a

CRA Response

- CRA comments that the share exchange at FMV terms:
  - Is an "objective manifestation" of the absence of purpose in proposed paragraph 55(2.1)(b)
- However, determination also requires subjective analysis as to "purpose"
- Frequency of payment of dividends not determinative

CRA comments and makes the assumption that the redemption value of the preferred shares of DIVCO is equal to the fair market value of the consideration received by DIVCO upon the issuance of the shares. Their comments indicated that there would be no "objective" reason why the issuance and then redemption of such preferred shares would be caught under par. 55(2.1)(b). However, CRA went on to comment that the determination of purpose or absence of purpose also requires looking at subjective manifestations of purpose and the circumstances surrounding the payment and receipt of a dividend, which would generally include, among others, the reason why the preferred shares were issued in the first place, the transactions related to their issuance, and the manner in which the preferred share structure will be unwound.

Inter-Corporate Dividends and Sec. 55 CRA Views and Position

Scenario 4b

CRA Response

- Par. 55(3)(a) applies only to R-P dividends
- A redemption of shares for cash could frustrate the object, spirit and purpose of 55(2), if exempt under 55(3)(a) and having a purpose described in par. 55(2.1)(b)
- Requires review of all relevant facts and circumstances

CRA acknowledges that the related-party exemption for a redemption of shares as contained in paragraph 55(3)(a) would generally mean that 55(2) would not apply. However, where the redemption results in one of the purposes being met under 55(2.1)(b), CRA can take a careful look at all of the relevant facts and circumstances, to determine whether the transaction would be subject to the general anti-avoidance rule.

Inter-Corporate Dividends
A New System

SO LET'S SUMMARIZE…

- 2 New Purpose Tests Added
  - Significant reduction in FMV of any share
  - Significant increase in total cost of property of recipient corporation
- LESS CERTAINTY!

Inter-Corporate Dividends
A New System

- Payment of regular dividends could be caught (related or unrelated)
- Be careful in re-structuring to
  - Creditor proof
  - Move assets around corporate group
  - Purification strategies
- Entire dividend re-characterized as deemed capital gain

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What does this mean?
A strict interpretation of the draft rules could cause the following types of common transactions involving inter-corporate dividends to be caught where a) the amount of the dividend is significant and b) one of the new "purpose" tests is satisfied:

- Asset protection transactions
- Capital gains exemption purification transactions
- The payment of dividends on dividend streaming shares

The CRA has confirmed that standard in-house loss consolidation arrangements, whereby dividends are paid on preferred shares between related companies, would likely not be subject to the new purpose test. On the contrary, a standard creditor proofing technique involving the declaration of a large cash dividend by an operating company to a holding company would probably meet the new purpose test. In this situation, the company would have to rely on the safe income exception to avoid having the dividend reclassified as a capital gain. The CRA's unfavourable position on this matter has increased the importance of knowing the safe income on hand.

The proposed changes to Section 55 have added significant uncertainty and complexity to what was already a very complex section of our tax rules. The CRA has stated that, over time, this uncertainty should be lessened as future rulings and interpretations are issued. In the interim, there are means of structuring most transactions to ensure that one of the exceptions permitted in the Act are met. Nevertheless, extreme case should always be taken when planning transactions involving inter-corporate dividends.

Inter-Corporate Dividends
A New System

- RELATED-PARTY EXCEPTION NARROWED
  - ONLY share redemption under 84(3)

Inter-Corporate Dividends
A New System

- SAFE-INCOME EXCEPTION
  - Calculations will be important
  - Only where there is an accrued gain on the share
- Allocation of safe income to a share?

Inter-Corporate Dividends
A New System

- PART IV TAX EXCEPTION
  - Many complications
  - Inconsistent tax treatment
  - Planning opportunities?

TSG Seminar
Inter-Corporate Dividends
A New System

THANK YOU!

Next session is…

Tuesday, February 7, 2017

The Annual 500K Small Business Deduction – New Rules

See you then!