Section 55 May Now Apply To Every Inter-Corporate Dividend

Subsection 55(2) is an anti-avoidance rule against "capital gains stripping", a technique whereby a tax-free inter-corporate dividend is used as part of a series of transactions or events to reduce a subsequently realized capital gain. Section 55 of the Act is widely considered to be one of the most complicated provisions of the Act because of the largely subjective purpose test and its famously byzantine exceptions such as safe income dividends and butterfly transactions. For owner-managed businesses, the subsection 55(2) risks can usually be managed and mitigated because routine inter-corporate dividends are, in most cases, within the paragraph 55(3)(a) related-party exception or not done with a purpose of reducing capital gain.

However, as part of the 2015 federal Budget, the Department of Finance proposed a complete revamp of subsection 55(2) and a severe limitation of the scope of the paragraph 55(3)(a) related party exception. These proposed amendments apply to inter-corporate dividends received after April 20, 2015.

One of the most notable differences between current subsection 55(2) and the proposed rules is a new purpose test in addition to the current purpose test. The new purpose test looks to whether one of the purposes of a dividend is to effect (A) a significant reduction of the fair market value (FMV) of any share, or (B) a significant increase in the cost of property in the hands of the dividend recipient. This is a tremendously broad test. Every dividend, by its nature, reduces the FMV of the payor corporation and increases the cost of property in the hands of the dividend recipient (although CRA has previously said that cash is not property in certain contexts, the Act defines property broadly as property of any kind whatever). The interpretation of what "significant" means will also prove difficult in practice.

In the Budget, Finance explained the mischief it was trying to prevent. By using a dividend to cause the FMV of the share to fall below cost or the shareholder's cost of properties to increase, the shareholder could use the unrealized loss created to shelter an accrued capital gain in respect of other property. For example, a corporation could plan to avoid a capital gain by rolling pregnant-gain assets into a corporate subsidiary that has share capital with high cost base (ACB) but nominal FMV (which may be artificially created by injecting the subsidiary with equity and having the subsidiary pays it back as tax-free inter-corporate dividend).

While such planning could lead to tax results inconsistent with the spirit of section 55, the proposed expansion of the purpose test appear to also interfere with all manners of ordinary inter-corporate dividend plans done for legitimate tax planning or non-tax reasons. For instance, a business with a Holdco-Opco structure may fall into section 55 every time Opco pays a dividend to Holdco for credit-proofing and qualified small business corporation share purification reasons, because a purpose behind the dividend may be to significantly reduce the FMV of any share.

This effectively forces 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.

Further, proposed section 55 will deem the "amount" of a stock dividend to be the greater of paid-up capital (PUC) and the FMV of the stock dividend for purposes of applying subsection 55(2). Consequently, high-low stock dividends previously not subject to section 55 risk (because subsection 248(1) defines "amount" to be the nominal PUC), is now fully subject to proposed subsection 55(2) if used in an inter-corporate context.

As mentioned, the proposed amendment also includes a severe limitation to the paragraph 55(3)(a) exception. 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).

Aside from the highlights above, there are numerous other aspects of the proposed provisions that may cause illogical results and interpretative issues. For example, because 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.

The proposed amendments are still in consultation phase, but the government has recently shown a tendency to pass tax law substantially unchanged from the consultation stage even in the face of significant opposition from the tax community (for example, see the saga of graduated rate estate / testamentary trust rules). Therefore, a practitioner now has no choice but to turn their mind to section 55 on every inter-corporate dividend transaction.