LEADING TAX THOUGHT™

Tax for the **Owner-Manager**

PAID-UP CAPITAL SHIFTS: SOME PRACTICAL EXAMPLES

The definition of "paid-up capital" (PUC) in subsection 89(1) provides that the PUC of a particular share of a class of shares is determined by calculating the average PUC per share of all of the shares of that class. Accordingly, when shares of the same class are issued for different prices, individual shareholders may have PUC per share that is different from the amount paid by them as consideration for the issuance of their shares. Because the amount of PUC per share can affect the tax consequences upon a redemption or reduction in the PUC of the shares, the operation of the PUC averaging rule can raise both concerns and planning opportunities for affected shareholders. The following examples illustrate this point.

Assume that a corporation (Opco) issues one class A share to its sole shareholder, Mr. A, for $100. Over time, Opco's value grows, and Ms. B is invited to invest as a second shareholder with the same rights and participation as Mr. A. Opco issues Ms. B one new class A share for $400, its FMV. Following this investment, the PUC of all of the outstanding class A shares is increased to $500. Each of the two outstanding shares now has PUC of $250. Ms. B is concerned because the PUC of her share is less than her actual cost. Mr. A is the beneficiary of the averaging rule because the PUC of his share is now $250 rather than his cost of $100.

This result can be avoided if Opco amends its share structure to allow for its class A common shares to be issuable in series (subject to the applicable corporate-law requirements). Opco can then issue Ms. B a share of a series different from that held by Mr. A. The PUC averaging will be avoided because subsection 248(6) treats each series as a separate class. Note that the parties should still enter into a unanimous shareholders' agreement (USA) in order to avoid commercial issues in the future. Another possibility is to simply issue a different class of voting common shares (class B common) to Ms. B, and to rely on the provisions of a USA to ensure equal voting and participation rights.

Now assume instead that Ms. B invests initially in a class A share. When she realizes the effect of this investment on the PUC of her share, she wants to correct the situation. Provided that Mr. A agrees, Opco can undertake a PUC shift under section 86, in which Mr. A and Ms. B exchange their initial shares of the same class for shares of a new and different class (or series); at the same time, they reset the PUC of their new shares to the corrected amounts. In CRA document no. 9613115 (May 8, 1996), the CRA states that it does not consider a PUC shift in such circumstances to be abusive.

It is possible that despite the PUC averaging and the tax issues that arise therefrom, the parties will still want to have shares of the same class (with no separate series). The PUC averaging here does not, of itself, cause an adverse tax result. In *1245989 Alberta Ltd. v. Canada (Attorney General)* (2018 FCA 114), the court ruled that a transaction involving PUC averaging is abusive only when the offending PUC is used to extract value from the corporation. However, there may be circumstances in which the CRA will regard as abusive the subsequent reduction or redemption of the increased PUC by the benefiting shareholder: *Agence du revenu du Québec c. Custeau* (2020 QCCA 1496). (See Éric Hamelin, "Quebec Court of Appeal Considers 'Series of Transactions' in GAAR Appeal," *Tax for the Owner-Manager*, April 2021.)

In this context, a possible defence to a CRA challenge of a future PUC extraction as abusive is to assert that the PUC shift and future PUC extraction are not part of a series, as illustrated by the QCCA's decision in *Custeau*. It is in this context that one must examine a tax attribute and its tax benefit in conjunction with the notion of series, or vis-à-vis the underlying intention of the investor at the time of her investment. Specifically, the existence of a business reason to invest in the same class of shares—for example, when the sole intention is to protect the capital investment—could potentially support the position that a future extraction of PUC by a shareholder who benefited from a PUC shift is not part of the same series as the initial share subscription that caused the PUC shift. In such a situation, it is prudent for the involved parties to document (1) the commercial reason for the issuance of shares of the same class and (2) why the investment was made in shares of the same class. Of course, having a longer time between the PUC shift and the PUC extraction will also help to weaken the notion of a series and any accompanying GAAR risk.

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